OPINION

Europe's half a banking union

Even with all the risks in mind, we are convinced that in terms of financial stability and beyond, the half a banking union that has been undertaken will be transformative and positive for the European Union.

BY: ADAM POSEN AND NICOLAS VÉRON **DATE:** SEPTEMBER 19, 2014

This spring, the EU institutions agreed a series of legislative texts that suggest bank closure decisions will be taken at the European level, not nationally. A Single Resolution Board will be established in Brussels as a new EU agency, and backed by a Single Bank Resolution Fund to be set up by separate treaty. These measures complement last year's legislation for pooling the supervision of most of the European Union's banking sector by the European Central Bank (ECB) in Frankfurt.

The link between European countries' creditworthiness and that of banks headquartered in them still exists for a number of reasons: the limitations imposed on the Resolution Fund, the absence of common deposit insurance, and the insistence by some countries that so-called "legacy" bad debts cannot be paid for by common financial resources. In any event, it's inevitable that some European taxpayers will again be finding themselves the unwilling victims of more banking failures, perhaps as soon as this autumn.

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Skepticism about Europe's banking reforms should, however, end there.

Decisions made so far on Europe’s banking union are significant, substantial, and likely to become entrenched. As we argued in June 2009 in a paper published by the Peterson Institute and Bruegel, a system-wide process of bank triage, forced recapitalization where it was needed, and restructuring was the tried-and-tested way to resolve Europe’s systemic banking crisis, and to succeed it had to be done at the European rather than national level.

If adequately executed, the ECB’s asset quality review (AQR) of the euro area’s largest banks will provide a credible, though sadly belated, triage of the kind we proposed back then, if accompanied by the requisite resulting capital injections and restructurings. The early credibility of the AQR can be seen in banks’ widespread and substantial cutbacks in loan books, and the far fewer but still extant capital raising exercises, over the last few months to get their balance sheets ready.

The starting point of Europe’s banking union was the euro area summit statement of mid-2012, when EU leaders committed to:

- "break the vicious circle between banks and sovereigns,"
- centralize banking supervision at the ECB,
- and use the recently-created European Stability Mechanism (ESM) for direct recapitalization of individual banks, including those that were then in the process of being restructured in Spain under EU oversight.

Until that statement, EU member states had defended their local control over banking policy as an unnegotiable attribute of national sovereignty. What can be described as "banking nationalism"—a continued reliance on national policy instruments to defend and promote national banking champions in an increasingly integrated European financial market—can be identified as a key reason why the financial crisis of 2007–08 had such a severe impact on Europe, despite having started in the United States. It also explains why, unlike in the United States, European policymakers were unwilling to resolve it and were unable to rapidly reestablish trust in their banking system.

Before the crisis, national authorities had encouraged "their" banks to grow so that they could become predators rather than prey in what most anticipated would be a wave of cross-border banking consolidation across Europe. This ambition came at the expense of prudence about systemic risk; between 2003 and 2008, the aggregate assets of Europe’s banks grew by the equivalent of almost the entire European GDP. The act symbolizing this era was the takeover of the Dutch bank ABN Amro by a consortium of the UK-based Royal Bank of Scotland, the Belgium-based Fortis, and (after a follow-up transaction) Italy’s Monte dei Paschi di Siena. All three took on too much risk and debt for their own good in the process. They should have been discouraged from doing so by their respective home-country supervisors, but were not. All three acquiring banks then became costly failures, requiring fiscal bailouts and disrupting of credit flows.

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After the crisis erupted in the summer of 2007, banking nationalism again stood in the way of swift crisis management and resolution. It was a classic collective-action failure. Many national authorities knew there were weaknesses in "their" banks, but were unwilling to address them before neighboring countries did likewise, as this could put their own local champions at a competitive disadvantage and maybe lead to their takeover by outsiders. This compounded the usual harmful incentives for bank supervisors to engage in forbearance, i.e. holding off on closing or forcibly merging regulated banks in the hope that an economic recovery (or the end of the supervisor’s term) would spare them from the need to do so.

For each national authority, the incentive was thus to pretend that the extent of problem loans was not only exaggerated (while actually allowing them to increase), but also that the worst problems were outside of their own territorial remit (while going soft on supervision at home). This became all too apparent in the inadequate stress tests whose results were announced in September 2009, July 2010, and July 2011. Banks like Dexia were given a clean bill of health, only to collapse a few months later. Self-defeating supervisory behavior is hardly unique to euro area bank supervisors, but the escalation of such reality denial in the face of market panic and bank-sovereign doom loops in 2010–11 was the result of banking nationalism.

Seen in this light, the banking union is a direct solution to the Maastricht treaty’s incompleteness in the banking area. The 1992 EU treaty combined a commitment to a single financial market and a single currency with a nationalistically-motivated refusal to integrate bank supervision and resolution at the European level. It took Europe’s leaders five years of deepening credit collapse and financial crisis and a dramatic rise in Spanish and Italian sovereign spreads, plus the brief denial of access to dollar funding experienced by French banks in the summer of 2011, to realize that this combination was proving terminal. In late June 2012, with the single currency’s survival at stake and running out of options to prevent a break-up, they took the extraordinary but necessary step of effectively bidding farewell to banking nationalism.

Perhaps inevitably, a combination of policy successes and setbacks marked initial implementation of the banking union commitment. An early disappointment came in mid-September 2012, when the finance ministers of Finland, Germany, and the Netherlands issued a joint statement opposing any direct bank recapitalization by the new European Stability Mechanism to bridge "legacy" capital gaps, i.e. losses on investments made by banks before the banking union. The statement reversed the prior agreement by those same countries’ at the European Union’s June 2012 summit that the ESM would directly recapitalize Spanish banks, if only retroactively. That reversal understandably raised doubts about the northern euro members’ commitment to the entire banking union project. However, thanks to the announcement by the ECB of its Outright Monetary Transaction (OMT) commitment, as well as the justified belief that although legacy losses were finite, banking union would be forever, investor sentiment shifted to a new equilibrium that discounted the likelihood of a euro area collapse.

The establishment of the Single Supervisory Mechanism (SSM), however, was pursued with speed and determination. By December 2012, all member states agreed on draft legislation that empowered the ECB as the bank licensing authority for the whole "banking union area", including the euro area but also including any non-euro EU country that might join the banking union voluntarily. In a concession to the uniquely powerful German local bank lobby, most smaller banks with balance sheets under €30 billion were exempted from direct supervision by the ECB. But that low threshold still leaves the vast majority of the banking union’s banking assets, including almost all German *Landesbanks* and other mid-sized institutions, under the ECB’s immediate authority. Furthermore, the ECB has room to expand its remit and retains ultimate licensing authority over all credit institutions. The ECB also gained enforceable access to information from supervised banks, and the legislation makes it practically impossible for individual national authorities to obstruct ECB supervisory processes. Despite the delays resulting from the subsequent negotiation with the European Parliament, and various procedural roadblocks by Berlin during Germany’s pre-election period, the SSM Regulation of October 2013 stands out as a swift and comprehensive pooling of sovereignty with few equivalents in the whole history of the European Union.

More recently, the European Union adopted a Bank Recovery and Resolution Directive together with the Single Resolution Mechanism, in principle paving the way towards a future in which the resolution of insolvent institutions would be conducted at European level and would minimize recourse to public funding. Unlike the SSM, the Single Resolution Board will be single in name only, as the legislation that sets it up foresees a significant degree of lingering autonomy for national resolution authorities.

Other progress has been made towards a banking union, though not all changes were equally comprehensive. The adoption of the Capital Requirements Regulation in June 2013 was a significant step towards having a "single rulebook" that the ECB could enforce uniformly across the banking union area, even though it regrettably deviated from the Basel III accord on several important points. Simultaneously, countries including France and Germany adopted idiosyncratic national laws on the separation of activities within banking groups, which conflicted with their stated commitment to the banking union. The most worrying gap remaining is that the unification of deposit insurance within the euro or banking union area has not even been broached by political leaders. This is understandable in the absence of a fiscal union that could credibly back it, but its absence underscores the dangers of incompleteness, a good example having been the huge movements of savings across borders after Ireland's unilateral extension of deposit insurance in 2008.

With supervision now meaningfully integrated within the ECB, centralized resolution on the right path even though not yet there, and common deposit insurance sadly off-limits, it is fair to label the current legislative arrangements a "half a banking union." It is much more than a small step on the journey towards eliminating the vicious circle between banks and sovereigns, but it's still incomplete. As always in European institutional development, the question is whether a half-measure of integration is helpful or is too slow and even dangerously unstable. Our view is that in the case of half a banking union, this is sufficient progress to be meaningful and of a stabilizing nature. As we argued in 2009, to end the European banking crisis required the strict testing of bank solvency by a European-level authority using a unified and transparent standard. The half a banking union meets these criteria.

Crucially, the key transition step was put into motion by Article 33(4) of the SSM Regulation, which mandates the ECB "to carry out a comprehensive assessment, including a balance-sheet assessment, of the credit institutions" that it would start directly supervising in November 2014. The importance of this process, now widely referred to as the asset quality review (AQR), has become ever more obvious during the course of 2013. It amounts to a massive front-loading of the ECB's supervisory effort by a near-term deadline that is now approaching. This requirement creates large operational as well as political challenges, but to its credit the ECB is taking them on. One can hardly imagine the ECB granting or confirming a banking license to a bank that it wouldn't consider insolvent—and the many past failures of national supervisors imply that the ECB could not base its initial supervisory assessment only on their respective opinions. Most importantly of all, the AQR holds the promise of putting an end to the systemic banking fragility that has affected Europe since mid-2007.

It is now possible to be confident that the AQR will be more robust and credible than the previous European stress tests. The ECB will have direct access to bank information that was unavailable to the Committee of European Banking Supervisors (CEBS) in 2009 and 2010, and to its successor the European Banking Authority (EBA) in 2011. As the future supervisor, it will be able to demand much more cooperation from both banks and national authorities, and it has the legal means to enforce its information requests. It has a much larger staff than the CEBS or EBA had, and in addition can rely on armies of consultants and auditors. But given that the previous European stress tests ended in policy failure, just this comparative statement of capabilities may not be enough to guarantee that the AQR will be certain of success.

Nor can the success or failure of the AQR be demonstrated simply by either zero forced recapitalizations, which is likely to mean too soft an approach, or by some pre-set target number of banks being compelled to fail, which would be likely to indicate arbitrary political decisions rather than by supervisory assessment. In essence, the AQR should be deemed successful if three criteria are met:

- On the micro-prudential level, it will succeed if there is no equivalent case to Dexia in 2011—meaning that insolvent cross-border banks get identified and resolved rather than having their problems put aside and allowed to accumulate;
- On the systemic stability level, it will succeed if credit growth to normal nonfinancial borrowers turns positive again after the AQR results and any recapitalizations;
- On the market level, it will succeed if there is greater differentiation of prices among bank equity and debt within any given national economy, and banks deemed sound are not excessively punished for their country of headquarters—i.e., a narrowing of spreads.

Not all of this will be revealed immediately at the time of announcement of the AQR results, expected in October, but we expect there will be many indications within a short period of time thereafter.

The ECB's approach appears, reasonably, to be to incentivize banks to act ahead of this deadline, to write down any dubious assets, and to recapitalize proactively to the extent needed, as Italy's UniCredit and Intesa Sanpaolo and Germany's Deutsche Bank have announced. But pre-emptive capital-raising is unlikely to be feasible for the weaker banks, which may fail to convince investors to buy newly issued capital instruments, and may also be unable to sell distressed assets at prices high enough to bridge their capital gap. Problem banks of this sort will need restructuring or resolution by national public authorities, as ESM direct recapitalization is unavailable for "legacy" situations, and the Single Resolution Board won't yet exist when the AQR results are announced.

For the AQR to succeed, the ECB must not flinch at naming problem banks, and the relevant member states must address them in a manner consistent with their policy commitments, including the new state aid rules issued last year by the European Commission that restrict the potential for overt or covert bank bailouts. The fact that lending has been falling even as the euro's growth prospects have been improving and government interest rates have declined is evidence that the banks subject to the AQR have been taking this threat as credible and are raising their ratio of capital to loans. And the self-separation of those banks that can raise sufficient capital from those that cannot is further evidence, as well as progress on our third criterion.

Against this yardstick, our expectation is that the AQR will be broadly, if perhaps not entirely, successful. There could still be a failure of nerve by the ECB to see this through, or an unwillingness of a national resolution authority to do its job, but we believe this is unlikely to be on a large enough scale to compromise the whole exercise. Such a failure would have major negative consequences for the ECB, the euro area and the European Union as a whole, which would become apparent in markets almost immediately. The point of public pre-commitment is to make the costs of reneging so high that carrying out an obviously unpleasant duty nevertheless becomes a matter of self-interest. Government talk is often cheap (witness the previous failed European bank stress tests), but our assessment is that European policymakers, including the ECB, have now made a credible commitment. They have burnt their bridges and cannot retreat.

Assuming a successful AQR, the European half a banking union will become a reality, offering a reasonably clean and well-capitalized starting point for the vast majority of the banking union area's bank assets and all of its large credit institutions. Barring large external shocks to European financial stability, we expect this to have a more transformative impact on Europe's financial and economic structures than many observers seem to realize. This impact should become evident along a number of dimensions:

- ***Credit crunch resolution:*** A successful and complete AQR would trigger the return of trust in Europe's banks and an end to balance sheet contraction in those banks. This will improve retail credit conditions, particularly in the European periphery, thus reducing a major drag on economic growth and employment. A reliable signal of a return to normality would be growth in bank lending to small and medium-sized enterprises, with reduced spreads between lenders from different member states. On the policy side, this would allow an exit from the Eurosystem's extraordinary liquidity provision program to banks, known as fixed-rate full allotment, which has been in place since October 2008.
- ***Stricter supervision:*** Unhampered by banking nationalism, the ECB is likely to be a more demanding and less forbearing supervisor than the national authorities it will supersede. This will apply to supervisory practice, but we expect it will also improve regulation. Compared with national authorities from the euro area in the recent past, the ECB will not resist as much the strengthening of regulatory standards at the Basel Committee and in EU rulemaking processes, even though it may still champion advantages for European banks in international discussions.
- ***Fewer taxpayer-funded bailouts:*** As banking nationalism was a major driver of the EU preference for public bailouts during the first five years of financial crisis, the shift of supervisory authority to the ECB lends credibility to the proclaimed objective of relying more on "bail-in" and financial burden-sharing by creditors in future bank

restructurings—even though systemic stability considerations would still justify a recourse to public financing in severe crisis scenarios. This in turn would further weaken the vicious circle between banks and sovereigns, a significant part of which is the anticipation of nationally-funded bank rescues.

- ***More cross-border financial integration within the banking union area:*** The ECB will have no incentive to discourage cross-border entry and acquisitions, as national authorities have done time and again in spite of formal commitments to the EU single market. In turn, the gradual emergence of truly pan-European banking groups will create a powerful interest in favour of the gradual elimination of countless cross-border competitive distortions and onerous national "gold-plating" of the EU single rulebook. In this new political economy, Europe's banking market may become more open to entry by non-European-headquartered banks, including into retail market segments, or at least more open to pressure on this front.
- ***The reduced dominance of banking in European finance:*** So far, banks have remained uniquely dominant in Europe's financial system when compared to other developed economies. One reason is the protection they have enjoyed from public authorities against potential competition from alternative credit channels, again motivated consciously or not by banking nationalism. The ECB has indicated it would take a much more sanguine view of the growth of market-based finance and nonbank financial intermediaries. Together with the previous point, this might contribute to a more diverse European financial ecosystem that could prove both more supportive of growth and employment, and more resilient in the face of systemic risk.
- ***A lower home bias in sovereign debt portfolios:*** The large holdings of home-country sovereign debt by a number of banks, particularly in periphery countries, have powerfully contributed to the euro area's bank-sovereign vicious circle. A large part of these holdings result from so-called moral suasion, or nonpublic arm-twisting, by national authorities on the banks they supervise to help finance "their" national government. The ECB is unlikely to have any interest in exerting this.
- ***A new balance in external representation:*** The ECB and other European-level agencies such as European Securities and Markets Authority and the Single Resolution Board can be expected to gradually gain prominence, in comparison to national authorities in banking union area countries, in international bodies such as the Financial Stability Board, the Basel Committee and the International Organization of Securities Commissions.

Many things could still go wrong for European financial stability. The ECB could become too prescriptive on the corporate governance and business models of supervised banks, leading to a damaging erosion of diversity in banking structures within the banking union area. Political confrontation between European and national authorities over resolution of a given bank could prove damaging to the sustainability of the whole framework, at least in the early stages. Conflicts of jurisdiction may appear. The divide between the banking union area and the rest of the European Union could prove damaging to the single market, and if (as is likely) some noneuro countries join the banking union, competitive distortions between these and the euro area could arise. The exclusion of smaller banks and nonbanks from direct supervision at European level could lead to harmful regulatory arbitrage. The reduced ability of member states to exert moral suasion over local banks will create political resistance to what reduces credit availability in dependent regions and sectors. But even with all these risks in mind, we are convinced that in terms of financial stability and beyond, the half a banking union that has been undertaken will be transformative and positive for the European Union.

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