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The European Banking Union

Background, Function and Problems

A currency without a country

The Euro is a currency without a country. It is a currency of fifteen countries. This is why it lacks the institutional, legal, economic, political, etc. framework in which a national currency is normally embedded.

Although the fifteen countries have a single currency, their economies are very heterogeneous. For this reason, from the beginning many economists were sceptical that the Euro would function without a common framework usually in place in a nation state. The theory of optimal currency space deals with these problems.

Crutches for the common currency

As the integration of the Euro-zone into a fully-fledged nation state ("United States of Europe") is unrealistic for the foreseeable future, there are two basic options: either one gives the Euro up and returns to national currencies (or different currency areas, for instance South-Euro and North-Euro), or measures are taken which provide the functions a common currency needs. Among them is a Fiscal Union (in place since January 2013), which tries to harmonise the fiscal policy of the Euro-zone members. A second crutch is now the Banking Union project, which is currently under preparation. Its special purpose is to break the vicious cycle between public debt and private finance: if systemically relevant banks run into problems, they are bailed out by the state, which then increases public debt. If public debt increases, interests for public debt go up and make public debt unsustainable. The entire economy is put at risks through this mechanism.

The Banking Union proposal in the Euro-zone has three pillars: common supervision, restructuring and resolution mechanisms, and a common deposit guarantee scheme.

Supervision

Lack of proper supervision was one of the reasons of the financial crisis. Therefore, the EU already implemented a new EU-wide supervisory structure in 2012 with the European Banking Authority (EBA) and similar bodies for insurance and security regulation. The EBA suffers from the general problems of supervision in the past: not enough resources, not enough legal power and always lagging behind the "innovations" of the finance industry. Hence, it was not surprising that the EBA did not realise the LIBOR scandal, nor the dramatic crisis of Spanish banks.

A new body created only for the Euro-zone, the Single Supervisory Mechanism (SSM) has now been designed to fix the problems. It will be established under the umbrella of the ECB and supervise all banks in the Euro-zone with a balance sheet over 30 bn. Euros, or 20% of the GDP of a rsp. country. This means approximately 150 to 200 banks out of 6,000 will be supervised by the SSM. The rest will continue to be supervised by national authorities. The SSM will have the right to directly intervene into the banks under its control without the consent of the rsp. country. This represents a substantial transfer of sovereignty from the nation state to the supranational level.

EU countries that don't use the Euro can join the body but won't have voting rights. The SSM is scheduled to start in March 2014.

Criticism has been raised, particularly with regard to the connection between the SSM to the ECB. Detailed regulations are not yet on the table, but the decisive questions will be whether there is a clear separation between the ECB and the SSM, which should also include a separate leadership. If there is no strict separation, conflicts of interest will arise.

Furthermore, the SSM cannot fall under the independence rule of the ECB. Therefore, it has to be made accountable to democratically legitimate institutions, i.e. the European Parliament and the national parliaments of the Euro-zone.

Finally the SSM must be provided with the necessary resources to be able to fulfil its mission.

Restructuring and resolution

During the financial crisis, banks were bailed out or "bad banks" were established at the cost of the taxpayers. Most governments have understood that this type of "restructuring" is economically counterproductive and unsustainable, as it perpetuates the moral hazard problem and leads to public debt. Politically and ethically, it is unacceptable that the losses of banks are socialised while the profits remain private.

Therefore, restructuring and resolution should be made possible in a way which allows for restructuring or bankruptcy without using public money.

The EU has prepared a draft directive (for the EU 27), though it has not yet been adopted. Its core elements are the following:

- If a bank fails, the normal procedure should be that it goes bankrupt.
- The hierarchy for a bailout is as follows: first shareholders, then creditors.
- If compensations are paid, they would have to come from a resolution fund, which is funded by the financial industry (for instance, through a bank levy).
- Deposits up to a certain threshold should be protected.

Basically, the approach is a step in the right direction. However, many open questions remain. For instance, it should not be taken for granted that the proposal will be accepted by all Member States. In particular, the UK might want to keep its national regulations. The value of the proposal would be very limited if the UK, as Europe's biggest banking location, were not to participate. Problems of cross-border resolution would occur and opportunities for regulatory arbitrage would be opened.

Also, without the resolution fund, the whole proposal lacks credibility. Even if there would be an agreement on such a fund, it would take several years to collect the necessary funds. However, the Spanish banks – and perhaps also Slovenian and other banks – might run into trouble. In this case, the European Stability Mechanism (ESM), which initially was meant to prevent state insolvency, would once again be used to rescue the private sector with taxpayers' money. The Spanish government is speculating to draw on this option for its de facto failed banks as soon as this is possible.

Finally, even if a resolution fund were in place, it is doubtful whether there would be enough money to absorb the insolvency of a big global player such as Deutsche Bank or BNP Parisbas.

Deposit guarantee scheme

As the Cyprus crisis has shown, the issue of a deposit guarantee scheme is very important. It is not only a question of social fairness to protect small deposits and savings, but also an issue of financial stability. Without a credible deposit guarantee, the risk of a bank run is very high. And as the 1930 crisis demonstrates, bank runs can trigger a systemic collapse.

These days, only national guarantee systems exist, most of them protecting deposits of up to 100,000 Euros. As a EU or a Euro-zone scheme would imply that in case of crisis transnational support could be required, there will be reluctance to agree. It would mean officially entering into what the Germans call "Transfer Union." The German government has already declared that it would not accept a transnational scheme.

But the common supervision, the deposit guarantee scheme and the resolution mechanism are like a tripod. If one leg is missing, the whole structure will tumble.

Conclusion

The basic idea of a Banking Union goes in the right direction. However, it will fall short of what is required as long as there is no fundamental reform of the structure of the banking sector. Core elements of such a reform would be:

- Strict separation between conventional business banking and the speculative activities of investment banking.
- Banks that are still too big to fail must become small enough to fail.
- Speculation has to drastically shrink to a level justified to hedge real economy activities.

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Links:

- EU: Roadmap towards a Banking Union
- EU directive establishing a framework for the recovery and resolution

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