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At Long Last, the EU Takes on its Banks

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The agreement on establishing a common banking authority is paving the way for a banking union. The decision was reached by the finance ministers only hours before last December's EU summit. After making headway on sovereign debt by deciding on a fiscal union one year beforehand in December 2011, the EU is by now also addressing the banking crisis and we know at least who is going to supervise who and what.

Five years have elapsed since the collapse of the banking sector in the US triggered the financial crisis. It has caused a lot of despair observing that the European heads of state and government decided to bring the banks to heel only after the looming implosion of Spain's banking sector in June 2012. Indeed, it is impossible to overlook the causative and harmful role that the banks played and continue to play in the crisis. The debts of the eurozone banks are three times higher than the sovereign debt of all of the eurozone countries taken together. In 2008 alone, Germany propped up its banks by taking over guarantees worth €480 billion.

Make no mistake, the European banking problem is just as much a home-grown affair as is sovereign debt. From the 1980s onwards and in expectation of higher growth rates policymakers significantly deregulated the financial markets. As a result, banks became involved in increasingly risky activities that were not subject to government supervision. Academic research has convincingly demonstrated the connection between deregulation and the financial crisis. The studies provide proof that in the aftermath of the Lehman crash in 2008 and 2009 poor economic performance in any given country was directly linked to poor government supervision of the banking sector.

There can be no doubt that what happened in Spain, as well as in Ireland, illustrates that the eurozone's financial stability is endangered not only by excessive indebtedness of the member states, but also – and perhaps to an even greater extent – by bad loans on the books of European banks. Government bonds and banks now form a vicious circle. The ailing banks drive up government debt, whereas financially weak states are very burdensome for the banks since their bonds are practically worthless. It is exactly this kind of interdependence that the banking union will try to break.

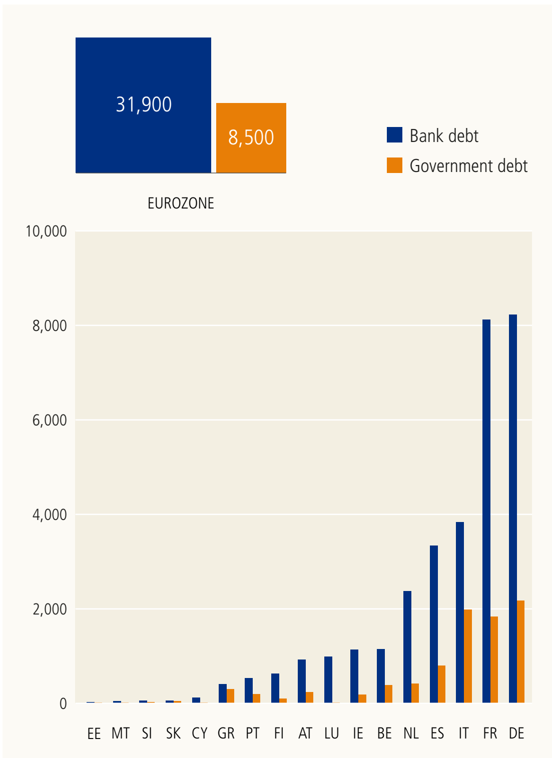
What does the banking authority actually do?

The creation of a single supervisory mechanism (SSM) with unlimited powers to discipline member states means that the EU is bringing an end to another chapter in the history of petty European polities. A distinct feature of the euro crisis has been that national supervisory authorities have played down the problems of their banks and, even if they are fully cognizant of the facts, protected their national "champions" to the detriment of others. The Spanish local banks, or cajas, are an excellent example. Without being prevented from doing so by the Spanish government, they financed a massive building boom in Spain even though they were significantly undercapitalized. That was until the property bubble burst. Their credit losses in this sector not only brought the Spanish government to its knees, but mushroomed to become a European problem.

This also demonstrates that in an economic and monetary union the impact of misdemeanours or mistakes made in the banking sector of one member state can no longer be restricted to that particular country. They impact on other member states, and may even endanger the very existence of the European Economic and Monetary Union (EMU). This is why there is a need for a single set of criteria for the supervision of banks, and for a better and above all independent kind of supervisory body which can insist on closing down ailing banks – even when this defies the wishes of policymakers. Only if such a regime is put in place we can expect that developments as we witnessed in the Spanish and Irish banking sector will not recur in the future. Nevertheless, in the current crisis taxpayers will have to foot the bill. The restructuring and closing down of banks cannot be done for nothing – and the losses could

Bank Debt and Government Debt

In billions of euros, June 2012



Source: German Federal Bank, Eurostat
Compiled by ifo institut

run into the billions. This reveals the political dynamite inherent in a European banking union based on the notion of joint and several liability. And the costs attached are the reason why there were such tough negotiations before eventually an agreement could be reached on who will be in charge of a new European banking supervision authority.

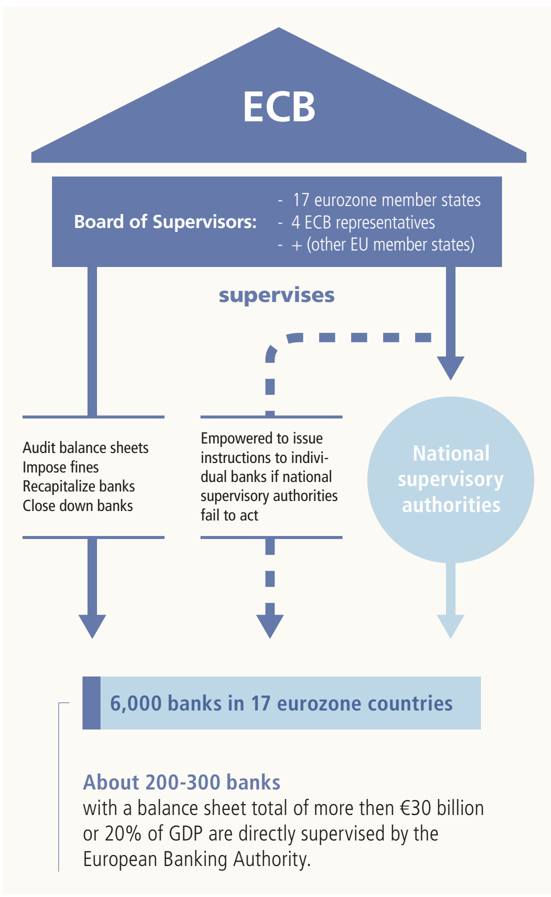
Who supervises?

The ECB has been entrusted with supervising the banks in the eurozone as well as non-eurozone banks that want to join the SSM. This was contentious until the very end. There had already been heated debates in autumn 2012, shortly after the Commission published its first proposal. It was the European Council's highest legal advisor who rejected the idea that the Commission's legislation could be implemented without amending the treaties. There are two reasons why what at first sight seems to be no more than legal quibbling should actually be taken seriously. First, the ECB has been given a mandate that is based solely on an article in the treaty that was not originally designed for this purpose. Thus the federalization of the bank supervisory system, though an undeniable necessity, is once again something being pushed through without consulting the EU citizenry. This is of course a practical way of doing things when there is a crisis since the process of amending a treaty, as the Lisbon Treaty debacle demonstrated, is time-consuming and its outcome unpredictable. But a trick of this kind merely adds to the legitimacy deficit of the EU, which is moving ahead with integration without the participation of its citizens.

Second, as soon as the ECB has been granted the powers to close down banks in member states, the ECB will encroach on property rights and take decisions that impinge on national budgets. As a result and in order to uphold the fundamental tenets of democracy and of the rule of law, the ECB will have to be supervised by governments, parliaments, and the courts. For this reason there are fears that if the ECB is accountable to the member states in the area of banking supervision, its independence might be undermined when it comes to monetary policy.

More than any other country, Germany has always championed the idea of a central bank beyond the reach of politicians. In the negotiations, it sought to strictly separate the ECB's monetary policy mandate from the envisioned new banking supervision mandate. German Finance Minister Wolfgang Schäuble called for nothing less than the construction of a "Chinese Wall" to separate the two. It remains to be seen whether the newly created ECB supervisory committee will be a bulwark of this kind. In addition to representatives of the participating member states, four ECB members will have a seat and the right to vote. The barrier between monetary policy and supervision might thus be high, but permeable. Furthermore, doubts were raised about the quality of the decisions of the supervisory committee in lieu of the fact that the ECB cannot be given instructions by member states.

European Banking Supervision



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As far as Germany is concerned, the rejection of its proposals to weight the votes in the supervisory committee in accordance with the liability size may turn out to be an even greater problem. As is the case in the ECB, every country no matter how large or how small has one vote. Decisions are taken on the basis of simple majority voting.

But the ECB is also faced with conflicts of interest in other areas. In the euro crisis it has interpreted its monetary mandate rather generously by loosening the rules governing the collateral that banks have to pledge when they borrow. In addition, the ECB has made it possible for illiquid banks to gain access to long-term refinancing operations – so-called LTROs. Many "zombie banks" were thus enabled to stay afloat in the markets. To liquidate these banks, which is what needs to be done, will probably not be easy for the ECB given this record. Losses for the ECB seem to be unavoidable.

Who is being supervised?

The question of which and how many banks the ECB will supervise was a contentious issue up to the very end of the negotiations. The Commission's original proposals, which received the support of France, referred to all of the 6,000 or so banks in the eurozone. In view of time and staff requirements, this did not really seem to be a feasible idea. Moreover, it immediately conjured up fears of a new and monstrous bureaucracy. There was also criticism of the fact that the ECB has no experience supervising banks or terminating their activities.

Opposition to all-embracing supervisory powers emerged in various areas. It was especially fierce in the case of the savings, cooperative and mutual savings banks that constitute the largest part of Germany's banking sector. The stumbling block was the proposed European deposit insurance system to which all the eurozone banks were going to have to contribute. An unusual feature of the savings and cooperative banks is that they already have a deposit insurance organization that will, if necessary, cover payment defaults by one of its members. Those at the head of the German saving banks have made it clear that they reject the idea of sharing their emergency reserves with other banks. They obviously believe that once under ECB supervision the next thing that will happen is the mutualisation of their reserve funds.

The German government did not have much of a choice in the matter. In Germany it is impossible to pursue policies that go against the wishes of the savings banks. Thus, it took a long time to reach a compromise. A middle ground was found in that only system-relevant banks will be directly under the single supervision of the ECB. Banks are deemed system-relevant if they have a balance sheet total amounting to more than €30 billion or if it amounts to more than 20 percent of the economic power of their homeland. This means that all of the German savings banks are excluded, whereas almost all French banks will be under direct ECB supervision. Initial estimates suggest that the regulations will apply to about 200 to 300 banks, and at least three banks in every eurozone country come under ECB supervision.

However, part of the compromise is an exception clause, which could lead to total ECB supervision via the back door. It specifies that at the first sign of trouble the ECB may also intervene in the case of small financial institutions. This would certainly make sense. After all, in Spain the problems were caused by many small banks. And when it comes down to it, the German savings banks and the regional "Landesbanken," which made serious errors of judgement with regard to the securitization of mortgages, are not as virtuous as they would like people to believe.

The fact that the ECB is empowered to intervene in the case of banks below the €30 billion threshold means that there are bound to be questions about how it will interact with the existing national banking authorities. Can the ECB act like a superior authority and issue specific instructions? Or is it merely permitted to issue "general instructions"? (This is what Schäuble maintained when meeting the press after the agreement was reached on December 13, 2012.) Obviously, the final word on this has not been spoken. The fact that the finance ministers have taken the precaution of setting up a mediation panel for potential conflicts between the ECB and the national banking authorities can be seen as an indication of this.

What about the eurozone "outs"?

For a long time the non-eurozone states were also opposed to task the ECB with the supervision of the banking sector. After all, they are not represented on its committees. Above all, they feared that with the establishment of a banking union eurozone members could dominate decisions relating to the free movement of capital in the internal market. These fears were further amplified by Christian Noyer, Governor of the Banque de France and a member of the ECB executive board, when he suggested that for liquidity reasons the majority of euro-based transactions should no longer take place in London, but within the eurozone. This was certainly not calculated to dispel British reservations about the banking union.

The new supervisory board is designed to address such fears. EU member states are entitled to be represented on this committee; every EU member state that joins the banking union will receive a seat and have the right to vote. This though was not enough for Sweden and the Czech Republic that declared that they will not be joining the banking union for the foreseeable future.

In the end, the resistance put up by the "outs" was rather muted. Britain knows that it cannot prevent the move to more integration, which is the way the eurozone states are correcting the design faults in the EMU and are hoping to overcome the euro crisis. For this reason, proposals to upgrade the European Banking Authority (EBA), which is located in London, were quickly dropped.

In point of fact, this authority was set up in 2010 together with three other supervisory authorities in order to improve the quality of financial supervision in the EU. However the EBA has not been an unqualified success. All but eight of the 91 financial institutions that were subjected to the bank stress test in 2011 received a clean bill of health. This clearly did not reflect the realities of the market and was not a significant contribution to confidence-building. As part of the new approach, the EBA is taking over the task of developing a "single rulebook" by the middle of 2013. Thereafter it will supervise implementation of the new regulations in the member states.

In order to dispel anxieties about a two-speed Europe, the British government has insisted on changes in EBA voting regulations. The idea is to make it impossible for the eurozone countries to vote as a bloc and to prevent them from dominating the authority's decision-making. For this reason, all decisions will in the future be taken on the basis of a double majority of the eurozone and non-eurozone states. However, it seems that the ECB Council will continue to be able to overrule such decisions.

What still needs to be done?

The eurozone must not stop short at banking supervision, and should soon introduce a single bank closure mechanism and a European deposit insurance system. Supervision is a good idea, but is not much good when it comes to resolving the crisis, especially if the liquidation of banks continues to be the responsibility of the national authorities. Crises will continue to crop up, even if all of the eurozone members suddenly behave like paragons of virtue.

There are those who may be irritated by the fact that the US is actually a shining example of how things ought to be done. Indeed, in its approach to resolving the banking crisis the US has shown the Europeans that a truly integrated banking market is of paramount importance for the stability of a common monetary area. Daniel Gros of CEPS, the Brussels-based think tank, has demonstrated this quite clearly in a comparison between Nevada and Ireland. The two entities, which are roughly the same size, were severely impacted by the wave of bankruptcies that hit the property market in 2008. In Nevada, despite numerous bank insolvencies and a 30% decline in gross national product, the local banking market did not grind to a standstill. Ireland, on the other hand, first had to bail out its banks and then had to be bailed out by the EU.

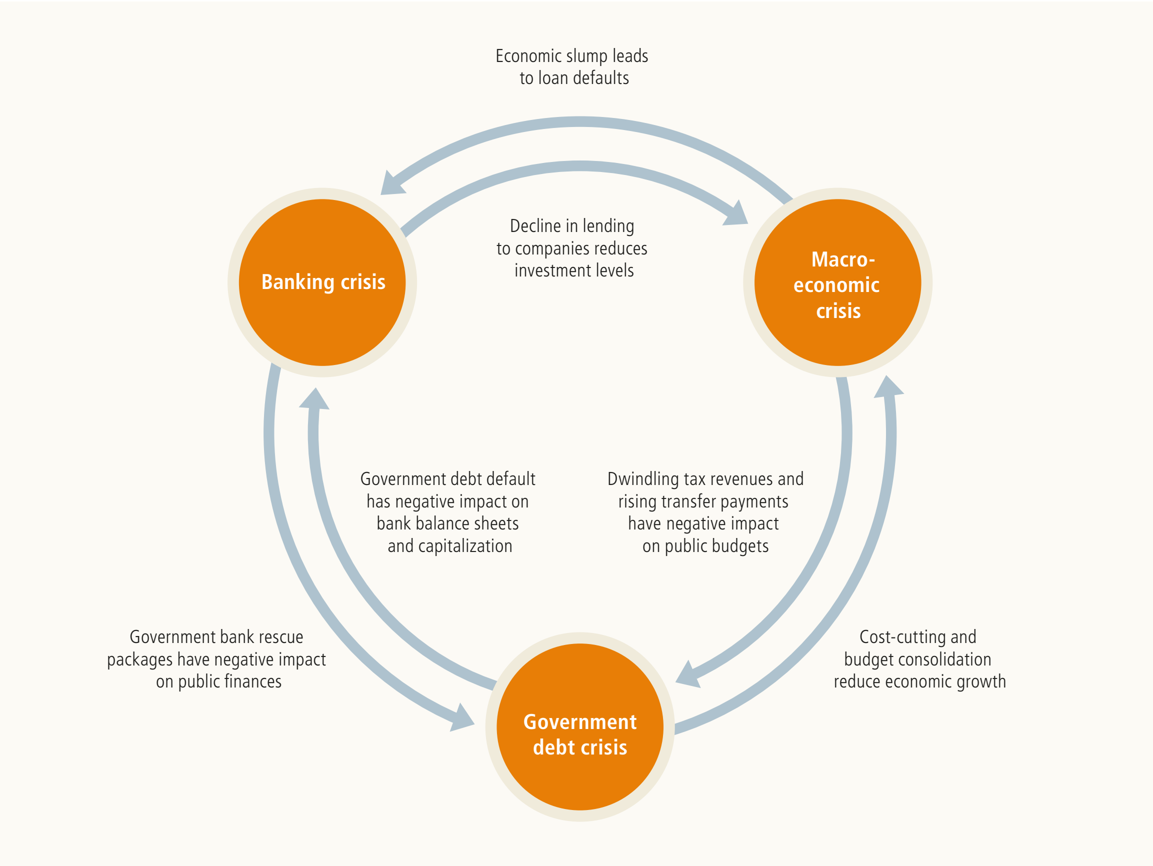
Why is it that the State of Nevada did not go down with its banks? Clearly what made the difference in the US is the federal banking system, which means that risks are widely distributed. Furthermore, the large deposit insurance systems such as the Federal Deposit Insurance Corporation (FDIC), which redistributes losses and provides compensation, provide an additional safeguard. At the same time there is a kind of private banking union in the United States. Thus financial institutions that operate in a state of the union other than the one in which they are incorporated can deduct losses incurred in this state from profits made in other states. It has never been possible to do this in the EU, and as a result it is difficult for business entities to absorb asymmetric shocks.

Some member states still may feel inclined to hold their heads in their hands and mutter when thinking about the costs of bailing-out banks. They are unwilling to impose additional burdens on their citizens, especially in election years. And, indeed, it is unfair to be asked to pay for the faults of others. This is something that should be avoided if at all possible. But what is the point? If one has come to the conclusion that there are vital reasons why the euro should be saved under any circumstances, then the bill has to be paid one day.

Cyprus's finance minister called the banking authority "a Christmas present for the whole of Europe." Yet, it would be even better if we were going to be given the whole of the banking union by Easter. It is not out of the question: the proposals are on the table for a single European deposit insurance system that protects savers, and single rules for the restructuring and closure of banks including a new European bank closure agency with its own bank closure fund. Systemic banking crises would then, hopefully, be a thing of the past, and the vicious circle between banks and government bonds would be broken. Savers would no longer have to be afraid of losing their savings, and taxpayers would no longer be alone when it comes to bearing liability for the risky deals of the banks. ■

A Vicious Circle

A vicious circle of bank debt, government debt, and the macroeconomic crisis



Source: German Council of Economic Experts

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