CEPS COMMENTARY
Thinking ahead for Europe

Banking Union in sight five years on

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Europe's response to the financial crisis has been massive and multi-pronged, but it was only last year, with the Banking Union initiative, that a quantum leap forward was taken, which may make all the difference in the long term. To better cope with financial crises in the future, the EU needs to pursue the same logic of the Single Supervisory Mechanism and apply it to bank resolution systems and deposit guarantee schemes, which constitute the main outstanding proposals. A federal safety net for financial markets would be to the benefit of all and prevent the huge declines we have seen in some markets. It may be instructive to examine the way US federal agencies have dealt with the crisis and have now managed to come out of it.

It cannot be sufficiently emphasised that the collapse of the financial system was prevented in almost all EU countries thanks to huge injections of government money, whether in the form of direct state recapitalisation of the financial sector, through government-protected 'bad-bank' schemes or in state guarantees of bank liabilities and liquidity. The total value of state aid was estimated by the European Commission to amount to about 12.5% of GDP, but it will be years before we know the full fiscal cost, once all state aid schemes have ended. In Ireland, the country in which the crisis started five years ago, the cost of state capital support to the three largest banks amounted to 29% of GDP. In several countries, including Greece, Spain and Portugal, (remunerated) state-guarantee schemes for bank liabilities are still operational and might still lead to additional losses, whereas in others, such as Denmark or Germany, they only expired two months ago and little is known about the eventual losses buried deep inside the German bad banks. Hence, it is also too early to say whether we have put to rest the 'too big to fail' dogma. State support for the banking sector continues still explicitly or implicitly in almost every country, and we still need to dare to let banks fail, also smaller ones, and reinstate market discipline. Only a few countries have managed to put in place a credible resolution system.

On the regulatory side, the driving force behind the EU's response was the G-20 agenda, even more than the single market. The EU has done well in following up on the G-20 agenda. In essence, only harmonised resolution frameworks and deposit guarantee schemes are outstanding, both of which are key issues. The European Commission has made its proposals on resolution, but it is navigating between unwillingness of some member states to create something more 'European', and the need to construct a system which is compatible with unified supervision and the single market. A federal safety net would spread state risks and losses over a larger area, reduce the risk premium and mitigate boom-bust cycles.

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Comparing the effects of the financial crisis in Ireland with those in Nevada demonstrates the stabilising effect of US federal institutions, such as the Federal Deposit Insurance Corporation (FDIC) and the home mortgage backers Freddie Mac and Fannie Mae. Both countries experienced a housing boom and bust of similar magnitudes, but thanks to a federal shock absorber in the US, Nevada's GDP declined by only 3.6%, compared to Ireland's at 17.6%.[1]

Early on, in February 2009, the EU also opted for a single rulebook, but this choice has led to a huge increase in the amount and complexity of rules at the EU level, and it remains an open question how 'single' the rulebook is. To accommodate all member states, loopholes and exemptions were agreed upon, which was clearest in the final compromise on the Capital Requirements Directive and Regulation (CRD IV or Basel III in European law), which allows member states, for example, to retain important powers in deciding on capital buffers for banks (Arts 128-134, CRD). The European Central Bank, as the supervisor waiting in the wings, will need to 'develop its own, more detailed supervision manual', as Vitor Constancio said at the Commission's conference on the review of the European Supervisory Authorities. Whether this comprises fully harmonised capital ratios under the ECB rule remains to be seen.

On the supervisory side, the creation of the SSM is a huge step towards such a more federal system, but we must wait to see the final text. The way in which decisions are made in the supervisory board of the ECB should be carefully watched: a dilution of the 'federal' nature of the ECB, with six votes for the Executive Board members in the Governing Council, should be avoided. One of the weaknesses of the European Supervisory Authorities, such as ESMA and EBA, is that the permanent chairman and managing director have no vote on their boards of EU member states' supervisors.

Hence, in hindsight, we can see that the financial crisis precipitated a huge step forward in European regulatory harmonisation and supervisory integration, but markets still need to follow. The cost of keeping the banking sector afloat during the crisis will continue to be a burden to taxpayers for years to come, but also a hindrance to efforts to restore real market discipline in the banking sector.

[1] Daniel Gros, "Banking Union: Ireland vs. Nevada, an illustration of the importance of an integrated banking system", CEPS Commentary, 18 October 2012.