CENTRE FOR EUROPEAN REFORM

Banking union – or Potemkin village?

by Philip Whyte

Since mid-2012, the eurozone crisis has been in remission. The period of relative calm which has prevailed since then has not been the product of an upturn in economic fortunes: until the recent summer uptick, the eurozone had suffered six consecutive quarters of declining activity and rising unemployment (a result in part of synchronised fiscal austerity across the region as a whole). Instead, the period of peace has reflected two factors: the increased willingness of the European Central Bank (ECB), under Mario Draghi's presidency, to act as a lender of last resort to governments; and a belated recognition by European leaders that the eurozone suffers from design flaws that need correcting. Sadly, the success of the first factor appears to have had unfortunate consequences on the second.

A design flaw that was not spotted by critics when the eurozone was launched, and that only became apparent after the 2008 financial crisis, was the instability of a fiscally decentralised currency union backed by a limited mandate central bank. This configuration, it turned out, gave rise to stresses in the eurozone that did not arise in the US. The most destabilising of these was the emergence of 'doom loops' in which fragile banks and fiscally weak sovereigns undermined each other. Reducing member-states' vulnerability to these spirals required the eurozone to establish a banking union. The trouble, however, is that the ECB's success in lowering government bond yields in countries like Spain and Italy appears to have reduced the sense of urgency felt by European leaders to build a banking union.

Constructing a banking union was never going to be an easy task, not least because it raises the same underlying political sensitivities as Eurobonds (an idea that was abandoned by EU leaders for being too far ahead of its time). The original blueprint for a banking union outlined by Herman Van Rompuy, the president of the European Council, in June 2012 envisaged four pillars: a common authority to supervise banks across the eurozone; a single resolution authority to restructure or wind up insolvent banks; a joint fiscal backstop to recapitalise banks; and a deposit protection scheme jointly funded by eurozone members. In effect, this blueprint recognised that key functions relating to the banking sector needed to be 'Europeanised' if the eurozone was to be placed on a more stable footing.

It would be churlish to deny that some headway has been made since the Van Rompuy proposals were originally set out. Good progress, for example, has been made in establishing a joint eurozone banking supervisory authority – or 'Single Supervisory Mechanism' (SSM) in EU jargon. The debates in late 2012 about which banks should be supervised by the ECB have now been settled. The ECB will assume day-to-day responsibility for supervising the 150 largest banks in the eurozone, and "ultimate responsibility" for the remaining 6,000 or so small and medium-sized banks. Day-to-day supervision of the latter, however, will continue to be exercised by national authorities. Following a positive vote in the European Parliament on September 13th 2013, the SSM should be up and running in 2014.

Progress on the other pillars, however, has been less impressive. A common eurozone deposit protection scheme is not yet on the agenda, and will not be any time soon. A joint fiscal backstop to the banking system is also a long way off. True, European leaders have agreed that the eurozone's bail-out fund, the European Stability Mechanism (ESM), should be allowed to recapitalise banks directly. But the funds allocated to that end have been capped at €60 billion – a tiny sum given the likely scale of bank losses that have yet to be recognised. In addition, for every euro the ESM uses to recapitalise a bank, it will have to post two as collateral to preserve its credit rating. Since this will reduce the ESM's total lending capacity, it will be a disincentive to use the ESM for recapitalising banks.

Finally, the Commission's proposal to create a Single Resolution Mechanism (SRM) has run into strong opposition since it was tabled. Several countries have contested the proposal's legal base – a single market article that would avoid the need for treaty change – and argued (probably rightly) against handing responsibility for resolving banks to the European Commission. Germany, for example, has argued for a looser system located outside Brussels, focused only on the 150 or so largest banks, and based initially on co-operation between national authorities (not on the writ of a supranational body). Since EU business will be disrupted in 2014 by European elections and the end of the Commission's term, agreement on the SRM could be delayed until 2015 if it is not concluded before the end of 2013.

The banking union is still a work in progress and it is probably premature to prejudge its final shape. But what the eurozone seems to be inching towards is a structure in which banking supervision is partially Europeanised, but the various fiscal backstops to the banking system remain overwhelmingly national. To put it differently, the eurozone will continue to be a currency union shared by seventeen national banking systems, rather than a currency union with a shared banking system. Does it make sense to call such a decentralised structure a banking union? The answer is no. If the purpose of a banking union is to break the lethal interactions between fragile banks and weak sovereigns, it is doubtful whether a structure as decentralised as that which seems to be emerging will do so.

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The eurozone already starts with a handicap relative to the US, because it does not have a common debt instrument that serves as a risk-free asset for banks across the currency union. Eurozone banks therefore remain highly exposed to the sovereign debt of the state in which they are incorporated – and the price of that debt still varies widely across the currency union. The emerging banking union will do little to alleviate this weakness. Member-states that experience banking crises will still be susceptible to sovereign debt crises. The absence of a common deposit protection scheme will make individual states more vulnerable to bank runs. And if the task of resolving non-systemic banks is left in national hands, the ECB will find it hard to force (or encourage) the closure of insolvent institutions.

The eurozone, in short, is building an edifice which looks like the exact reverse image of the US's. The US combines a highly fragmented structure for banking supervision with a set of critical functions that are carried out at federal level – from deposit protection, to resolution, recapitalisation and debt issuance. The eurozone, in contrast, is building a structure that partially federalises banking supervision, but leaves the remaining functions mostly in the hands of the constituent states. The structure which is emerging may be that which best reflects political realities in the eurozone, but it does not look like a particularly stable one. Further progress will have to be made if the eurozone is to become a stable currency union with a single banking system.

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