Banking Union: Inevitable, But Profoundly Challenging?

Iain Begg*

In some eyes, banking union is the latest in a long line of 'magic bullets' capable of ending the rolling crisis that has engulfed the euro area. It is, though, better seen as a further piece of the jigsaw of reinvention of the governance of the euro area aimed at the flaws in the euro exposed by the crisis. Among these flaws, the diagnosis that the toxic interactions between sovereign and bank debt would imperil the single currency is at the heart of calls for banking union in Europe.

The new 'impossible trinity' articulated by Pisani-Ferry (2012) points to the following facets of monetary union that cannot all simultaneously hold:

- The prohibition on direct monetary financing of the debts of Member States which appears to preclude the ECB from direct purchases of sovereign debt.
- The fact that there is no collective responsibility for public debt, such that Member States in difficulty are susceptible to market pressures much more rapidly than if there were a common borrowing capability. Some form of Eurobonds, jointly and severally guaranteed by all Member States (at least of the euro area) is the eventual answer.
- The interdependence between sovereigns and banks in each Member State which results in banks becoming fragile if they hold their country's public debt, while the fragility of the banks undermines the borrowing status of the sovereign that has to stand behind them. Sovereign bonds tend to be thought of as safe assets, but the problems in Ireland and Spain have shown that market sentiment can turn quickly, leading to a vicious circle, especially in smaller countries.

* London School of Economics and Political Science.

Among the directions for reform mapped out by the 'four presidents' (see European Council 2012), it has become clear that banking, fiscal and political union are firmly on the agenda with the aim of establishing what they call a 'genuine economic and monetary union'. At the same time, all of these putative 'unions' are beset by ambiguity. Nevertheless, in the same way as monetary union offered a way out of the original Mundell impossible trinity, an underlying rationale for banking union is to provide part of the solution to the Pisani-Ferry one.

While the rationale for banking union is broadly accepted, it is far from clear what it will encompass, nor how the many institutional, sequencing and distributive difficulties it engenders will be resolved. This paper looks in particular at the political economy dimensions of banking union, including burden-sharing and institutional issues, and proposes possible solutions.

What banking union entails

Conceptually, banking union is about the case for integration of four distinct, though overlapping functions:

- prudential supervision,
- resolution of failing banks,
- protection of depositors, and
- broader regulatory oversight of the financial sector.

At present, these functions are undertaken mainly at national level, though within the framework of single market rules that are based on the mutual recognition principle. The Turner Review (see FSA 2009) into the causes of the 2007/8 financial crisis argued that this approach of home country control of banking was no longer suited to the post crisis financial setting, so that the EU faces a stark choice between closer integration and re-creating barriers. Given that the implicit answer to Turner's dilemma is to further integration, banking union necessarily involves a recasting of not only 'who does what?' in overseeing financial Europe, but also of 'who is liable for what?'.

Distributive challenges are therefore fundamental to the form of banking union. Each of the four elements of a putative union has implications for different interests and will require differing degrees of institutional change.

As a result, political economy is bound to pervade the debates. Likely conflicts will pit Member States against each other; taxpayers against bank shareholders and bondholders; and borrowers against savers at the level of the household, the economic sector and the Member State. In addition, there will be institutional complications about the roles of the various agencies of governance, accentuated by the disjunction between EU membership, euro area membership and the willingness of some euro 'outs' nevertheless to take part in banking union. The elephant in the room is the dominant position of the City of London as Europe's financial centre. In all this, the key issue is how the costs of assuring a functioning European banking system are both shared and contained.

Several underlying aims of banking union can be identified, some of which are primarily about exit from crisis, while others are about the long term functioning of monetary union. Among the former, restoring the functionality of the inter-bank system at EU level is critical, since the freezing-up of wholesale financial markets has imperilled recovery. Stemming the outflow of money from the banking systems of Member States in difficulty is also vital. An imperative is reducing the exposure of sovereigns and, through them, of taxpayers to bank failures. Given that many financial intermediaries have become so large relative to their national economies, a pooling of capacity at EU level is needed to cope with financial risk.

The euro area faces the further challenge of countering incentives for Member States to seek to resolve national problems by shifting the burden to partner countries through various forms of buck-passing. It is also about complementing the lender of last resort function which the ECB has, somewhat reluctantly, agreed it must fulfil – and continues to cloak in ambiguity. However, a delicate balance will have to be struck between cross-border provision of insurance mechanisms and aggravation of moral hazard risks.

Political time to banking union

Throughout the euro crisis, there has been a disconnection between the time it has taken to enact change and market expectations of action. Decision-makers have often appeared to procrastinate, despite the paradox that the extent of governance reforms has been – by EU standards – almost frenetic (see Begg 2013). Markets bemoan the dilatory approach of political leaders, but overlook the fact that these same leaders have, first, to persuade their different constituencies of the necessity of reform, then to follow due constitutional process in enacting it. Both steps take time and mean that the immediacy that markets look for can almost never be satisfied, except in the rare instances of crisis weekends where the authorities simply have no choice but to cobble together an emergency package (examples are the near meltdown of the banking system in October 2008 and the initial culmination of the Greek crisis in May 2010). Moreover the first step can take considerably longer where the reform under consideration has significant distributive consequences.

Through this lens, the timing of adoption of elements of banking union can be seen as a process rather than a menu of choices, and more time will be needed to agree some of the politically more sensitive elements. Thus, common supervision is likely to be easier to sell to sceptical citizens and other stakeholders because it is viewed (largely, if not entirely accurately) as a technical matter. The test of its legitimacy would be whether a sound banking system can be assured more effectively than if supervision is fragmented among Member States.

A slow route to banking union (recalling the debates prior to monetary union about the pace of convergence) is advocated by the German Council of Economic Experts (2012) who suggest three phases (again echoing the Maastricht formula), the third of which could take up to a decade:

- a legal and institutional preparation phase,
- a period during which banks qualify, and
- full banking union.

The German Experts have also championed the idea of dealing with legacy problems first, then revisiting how common policies can be introduced for the indefinite future. Their proposed European Redemption Pact (ERP) would deal with what might be called the excessive debt of sovereigns as a one-off exercise, subject to the Member States accepting a range of conditions designed to prevent moral hazard. Similar proposals have been put forward (e.g. Beck *et al.* 2012) for a temporary bank resolution agency that would manage the process of recapitalising failing banks.

Delay is, though likely to be costly. Today, difficult questions surround timing, not least because there is an urgency to the crisis-exit side of banking union. Rapid progress would have an immediate crisis resolution benefit, in addition to the longer term gains from an improved approach to containing systemic risk. The crisis resolution effect will be enhanced if, as is expected, the ESM is allowed to inject money directly into fragile banks, rather than (as in Ireland) support being channelled through the Member State's public finances.

Institutional framework

Banking union is beset by institutional difficulties, none of them wholly intractable, but all politically awkward. The most glaring is the disjunction between an ECB seen as an agency of the euro area, and therefore lacking legitimacy for the euro 'outs' (some of which wish to be part of banking union, while others demur), and a single credit market that encompasses all Member States of the EU. There will also be institutional problems to solve concerning the existing supervisory and regulatory structures, notably the role of the European Banking Authority (EBA) and the European Systemic Risk Board (ESRB), again both EU27 entities.

What is sometimes forgotten is that the ECB is an institution of the EU as a whole and a possible solution is that, in the General Council, it has a structure that includes all EU Member States. As explained on the ECB website,[1] this Council is a transitional body that will be dissolved once all EU members have adopted the euro. Since there is no realistic prospect of that contingency occurring soon, a possible solution to the current 17/27 incompatibility is to confer responsibility for oversight of banking union on the General Council. The treaty states (Art 141.1, TFEU) that "the General Council of the European Central Bank referred to in Article 44 of the Statute of the ESCB and of the ECB shall be constituted as a third decision-making body of the European Central Bank".

Although the specific tasks assigned to the General Council are limited, they are also defined somewhat vaguely. Thus, the fourth indent of Art. 141.2, TFEU, refers to the ECB holding consultations on issues falling within the competence of national central banks affecting financial stability. The responsibilities of the General Council listed in Art. 46 of the Statute of the ESCB and of the ECB (a Protocol to the Treaty) include an advisory function on prudential supervision. Moreover the enabling clause which states that the ECB may have additional tasks conferred on it in relation to financial supervision (Art 127.6, TFEU), makes no reference to Member States not participating in the euro.

There are also calls for some form of common bank resolution authority (see Carmassi *et al.* 2012; Schoenmaker and Gros 2012). The case for an EU level resolution capability is, primarily, that national systems faced with an asymmetric shock are at too great a risk of being unable to cope, with the corollary that there is a contagion risk across borders. Here lessons can be learned from how the United States and Britain went about rescuing fragile banks, but also how the Nordic countries dealt with their banking crises in the early 1990s. A crucial question is whether what is now needed is, in effect, a European TARP, encompassing a means of separating good bank and bad bank assets.

Obstacles and concerns

Numerous objections to banking union have been articulated, some self-serving, some more principled. Underlying many of these concerns is how to move to a new framework from a present in which the crisis is still unresolved and its aftermath will continue to cast a dark shadow. One of the main challenges is how to restore precarious banks to health. Recapitalisation has been occurring, albeit slowly in too many countries, but there is also a latent problem of non-performing assets.

Although there are arguments for retaining a supervisory capability close to the supervised at national level, there is also a strong 'economies of scope' argument for centralised supervision of banks with significant cross-border business – in effect rooted in the Olsonian notion of equivalence. There are also open questions about whether, first, a supranational supervisor can put (desirable) distance between itself and the banks, or, second, whether diversity in approaches to supervision is an obstacle or leads to an excessive degree of conformity that accentuates risk (see Wagner 2012).

Also difficult, and the core of the disputes between France and Germany about the adoption of banking union, is whether to limit European level involvement

[1] See http://www.ecb.int/ecb/orga/decisions/genc/html/index.en.html.

to the largest banks and/or those with extensive cross-border activity. Although systemic risk is normally associated with the expression 'too big to fail', leading to the German preference for a banking union that focuses on the largest European banks, financial crises are often triggered by smaller or medium-sized entities. Examples are Lehman Brothers, Anglo-Irish Bank or Bankia.

Many commentators argue that partial banking union would be a serious mistake (e.g. Wyplosz 2012; Schoenemaker 2012) because it would result in information gaps and ambiguities about responsibilities which, in a worst case, could aggravate systemic problems. Moreover, Pisani-Ferry and Wolff (2012) argue, however, that mutualisation of liabilities is of second-order importance. While these analyses may be logically correct, the element of timing is critical and the key challenge is sequencing. Even if manifestly sub-optimal, a banking union that starts with supervision can then move on to the more contested elements, provided that there is a clear destination.

The argument that banking supervision and monetary policy should be separated has some force and has, if anything, become the preferred approach in the EU in the last two decades (see Begg 2009). The reasoning is straightforward: if the same institution (in practice, the ECB) is responsible for both tasks, it may have incentives to be lax in supervision to prevent financial instability. Conferring supervisory responsibility on the ECB risks compromising the independence of monetary policy and needs a clear separation which for which it is debateable whether 'Chinese walls' would suffice. Those who argue for the ECB (e.g. Eijffinger and Niskens 2012) recognise that there can be incentive compatibility problems, but maintain that the benefits outweigh the risks. Particularly in more difficult times, rapid access to relevant information and speed of action are of the essence.

Burden-sharing has been at the heart of much of the debate on reform of EU economic governance and is an issue that will unavoidably be prominent in banking union for the simple reason that bank resolution and deposit insurance require 'back-stopping' by the taxpayer. Consequently, a common approach will often impose some potential burden on taxpayers in other Member States when problems arise in just one. In an integrated market, the difficulties of home country control become evident. Citing the difficulties encountered in the resolution of Dexia and Fortis, both with significant activity in more than one country, Goodhart (2012) argues forcibly for establishing a firm *ex-ante* rule for how the costs of resolution will be distributed, although he concedes that even then there will be disputes over how to attribute blame.

He also points out that there are differing ramifications of calling on different stakeholders to contribute funds to a resolution process. Thus, in Ireland, allegedly under pressure from the ECB – worried about possible contagion effects that would imperil the stability of the EU banking system – the tax-payer was prevailed upon to shoulder the burden, while senior bondholders were protected. The reverse was true in Iceland, triggering a case still before the European Court of Justice. In the end, it is undeniable that whether it is the bondholder or the general tax-payer who comes to the rescue, the public is always hit – what is at issue is how the costs are distributed among the population.

In today's context, it is German (and other Northern European) taxpayers who balk at taking on commitments for the consequences of bank failures that might occur in Spain, Cyprus or Italy. Over time, these potential costs might even out and there are credible arguments about the scope for lowering the long-term costs by pooling, but the political time needed to make the case inhibits a quick decision. As in any insurance mechanism, ways of limiting adverse selection and moral hazard will have to be found.

Paying for banking union

Because emergency liquidity provision, bank resolution and deposit insurance require injections of funding, inevitable questions are who pays and carries which risks? Liquidity, in principle, is a monetary policy issue and the obvious actor to provide that liquidity is the ESCB, with the ECB taking the lead in assuring liquidity as an explicit lender of last resort.

Dealing with insolvency implies a formula for distributing the costs, for which there are three main options. The first is to impose a levy on banks that builds up to a contingency fund, something that will take time to become sufficiently well-endowed and will be especially difficult in a period when European banks are already struggling to bolster their capital base. Second, there could be a specific fund – the European Stability Mechanism is a model – hypothecated to bank resolution.

The third possibility is an open-ended commitment by tax-payers to step in where necessary. As the crisis has dragged on such a commitment has grown, with retail depositors in most countries effectively having all their money guaranteed, even though there are notional ceilings on how much is protected.[2] Although these guarantees, along with the cash for shoring up banks have elicited howls of outrage, governments have consistently been able to draw on these resources. However, with the exception of the Icelandic banks for which British and Dutch taxpayers had to bear the cost – and even then they were largely bailing out their own citizens – and the resolution of Fortis, which required an awkward tripartite approach involving all three Benelux countries, the bank rescues have been national.

There are viable solutions that, while certain to encounter stiff resistance, deserve to be explored. The revenue to establish a supranational fiscal capacity could come either from tapping into a new source of revenue – a financial transactions tax (FTT) is the obvious contender and would have the added attraction of having a direct link to banking – or from reassignment of an existing revenue stream. However, if Britain and others continue to object to an EU-wide FTT, the ability of other Member States to raise significant amounts through it will be limited. Among existing revenue streams, two options are the monetary income of the ECB and the ESCB, or a harmonised corporate income tax.

The monetary income of the ECB in recent years has been sizeable, reaching 2 billion euros in 2011, 40 percent of which comes from the ECB's 8 percent share of currency issue, implying a much larger figure for national central banks. Moreover, when the Bank increases its lending, as it does in periods of turmoil, the scope for generating revenue is typically enhanced: half the ECB profit in 2011 came from net interest from the Securities Market Programme, showing an ability to boost revenue at precisely the time it is needed. Conservatively, annual monetary income can be estimated at around 0.2 percent of EU GDP. Monetary income has the further political attraction of being largely invisible to citizens, even though finance ministers would resent losing their share of it.

Taxes on profits are both intrinsically difficult to apportion fairly among Member States in a closely integrated single market, and anti-cyclical because of the well-known sensitivity of profits (the tax base) to the economic cycle. CIT would therefore, be a strong candidate for financing a supranational fiscal capacity with a primary role in stabilisation, although strong resistance can be anticipated from Member States which have structured their tax systems around low CIT rates to attract inward investors. It could also, however, provide resources for banking union. Although the yield of CIT can fluctuate sharply, especially in times as difficult as the present, it is typically 2 percent or more of GDP.

[2] Thus, in Britain and Ireland, no depositor lost money.

Conclusions

Any trajectory towards banking union will have to combine immediate crisis resolution with the putting in place of a new long-term framework. For the former, rapid action is vital, whereas making the right choices, rather than undue haste, will be critical for the latter. It follows that the sequencing of steps towards banking union needs great care but that there has to be an unambiguous goal. A key conclusion of this paper is that Europe's leaders should focus on the end goal rather than trying to do it all at once.

The likely outcome will be a quasi-federal model in which significant tasks remain with national supervisory agencies (a possible model is put forward by Carmassi *et al.* 2012), drawing on the experience of EU competition policy after 2003 (see Begg 2009). However, it will not be easy to establish an effective institutional structure in which the advantages of a federal arrangement can be achieved without blurring responsibilities and accountability. In a context in which so many actors are likely to be involved (ECB, national central banks, ESRB, EBA, national supervisors and regulators, the Commission, finance ministries and, possibly, separate deposit insurance providers), clarity will be vital. Perhaps most critical will be where the buck stops. For this reason, assigning the responsibility for banking union to the General Council of the ECB could help to make progress.

Public money will be needed to deal with bank problems at the supranational level (EU27 or euro area), but as things stand, there is no direct revenue source that the supranational level can use for this purpose. The quandary is that if supranational supervision fails – and it will on occasion – it leads to costs for the public finances, but there is no EU taxpayer, only national ones. As Goodhart (2012, 111) sharply observes: "it is

always the public who bear the burden of taxation one way or another". While it is easy to devise simple and tolerably equitable keys for distributing any costs, such as basing shares on the relative nominal GDP of each Member State,[3] the political economy of paying for failing banks is likely to be highly contested. To put it bluntly, how will German taxpayers react to an obligation to pay for a failing French or Belgian bank, let alone a Greek one?

Consequently, banking union is going to struggle until there is a credible power to tax at European level, something that will entail a step-change towards federalism in European integration. An answer could come from assigning the proceeds of a financial transaction tax and the monetary income of the ECB and, possibly, the rest of the ESCB to a common pool, while examining the scope for an integrated corporate income tax.

None of this will be easy, but the *status quo* is manifestly untenable.

[3] As a parallel, the monetary income accruing to the ECB is distributed in this way.

References

Beck, T. (ed., 2012), *Banking Union for Europe: Risks and Challenges*, London: CEPR.

Begg, I. (2013), "Are Better Defined Rules Enough? An Assessment of the Post Crisis Reforms of the Governance of EMU", *Transfer*, forthcoming.

Begg, I. (2009), "Regulation and Supervision of Financial Intermediaries in the EU: The Aftermath of the Financial Crisis", *Journal of Common Market Studies* 47, 1107–1128.

Carmassi, J., C. Di Noia and S. Micossi (2012), *Banking Union: A Federal Model for the European Union with Prompt Corrective Action*, CEPS Policy Brief 282, Brussels.

Eijffinger, S.C.W. and R. Niskens (2012), "Banking Union and Ambiguity: Dare to Go Further", *VoxEU.org*, 23 November.

European Council (2012), *Towards a Genuine Economic and Monetary Union*, Interim Report, Brussels, 12 October.

FSA (2009), *The Turner Review: A Regulatory Response to the Global Banking Crisis*, London: Financial Services Authority.

German Council of Economic Experts (2012), *After the Euro Area Summit: Time to Implement Long-term Solutions, Special Report*, http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/download/publikationen/special_report_2012.pdf.

Goodhart, C.A.E. (2012), "Funding Arrangements and Burden Sharing in Bank Resolution", *Butterworths Journal of International Banking and Financial Law* 27, 535–557.

Gros, D. and D. Schoenmaker (2012), A European Deposit Insurance and Resolution Fund: An Update, *DFS Policy Paper* 26, Amsterdam, Duisenberg School of Finance.

Pisani-Ferry, J. (2012), "The Euro Crisis and the New Impossible Trinity", *Bruegel Policy Contribution* 2012/01, Brussels.

Pisani-Ferry, J. and G. Wolff (2012), *The Fiscal Implications of a Banking Union*, Bruegel Policy Brief, Brussels.

Schoenmaker, D. (2012), "Banking Union: Where We're Going Wrong", in: Beck, T. (ed.), *Banking Union for Europe: Risks and Challenges*, London: CEPR, 97–103.

Wagner, W. (2012), "How to Design a Banking Union That Limits Systemic Risk in the EU", in: Beck, T. (ed.), *Banking Union for Europe: Risks and Challenges*, London: CEPR, 121–126.

Wyplosz, C. (2012), "Banking Union as a Crisis Management Tool", in: Beck, T. (ed.), *Banking Union for Europe: Risks and Challenges*, London: CEPR, 19–23.