

The Eurozone: banking union, bailout union or both?

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Summary

- Madrid's European bailout for the recapitalisation of some of its struggling savings banks last week has given new life to the question of 'a banking union' - pooled bank supervision and resolution and pooled depositor protection - in the EU or the Eurozone.
- European Union member states have profound political reservations about some of the implications of a banking union that are likely to slow its arrival and distort its likely form. Berlin in particular is suspicious of a banking union as an attempt to impose collective liability by the back door.
- It is also likely to drive a further wedge between the UK and the rest of the EU. London supports the idea of a banking union but sees no scope for British participation. This will have far reaching consequences for the City of London and will reinforce Britain's place on the sidelines of major changes in the EU.
- In reality, two linked kinds of a banking union are needed in the Eurozone. A long term union to supervise its banks and a short term union to save them. Europe probably needs a version of America's \$700bn Troubled Asset Relief Programme (TARP) of 2009 - a multi-billion euro recapitalisation fund that can directly recapitalise banks in place of their already impaired sovereigns. Both will strain the limits of the politically possible in Europe.

In the last Global Counsel Insight we looked at the links between the EU's new bank capital rules and the underlying problem of how Europe's banks are supervised and managed in a crisis. The last two weeks have pushed this question to the centre of the Eurozone debate, as markets have absorbed the consequences of the €100bn bailout provided to Madrid by the European Financial Stability Facility to recapitalise its banks. Spain's high profile request for help obscured the fact that in the same week Portugal also injected €6.6bn into its own banks, and the Cypriots announced that their banking sector, which is heavily capitalised with Greek sovereign debt, would need a European bailout of its own.

These capital injections are unlikely to be the end of the story. The fact that Spanish banks are collectively provisioning well over €150bn for bad loans suggests that the hole in the Spanish banking sector may prove even bigger than its EU bailout presumes. Eurozone banks are probably now sitting on more than €700bn

and rising in non-performing loans (Fig 1), more than a quarter of these in Germany. Realising even half of these potential losses would put immense strain on banks and the banking system and on the sovereigns who would feel compelled to support them.

In principle, this is a situation that a genuine 'banking union' in Europe that pooled deposit insurance schemes and created a single European supervisor with powers to restructure or resolve weak banks without requiring states to borrow to bail them out might have helped to avoid. But a banking union involves such a profound renovation of the political and technical machinery of financial regulation in Europe that it will not happen in a hurry. More importantly, the problem of untangling Europe's sovereigns and their stumbling banks is now too sweeping and already too far advanced for anything other than a bigger and more aggressive fix. Europe needs a version of America's Troubled Asset Relief Programme (TARP) of 2009. This Global Counsel

Insight note explains the politics that make this, and a wider banking union, so difficult.

Uniting to supervise banks...

We have of course been here before. Since the 2008 banking crisis the European Commission has consistently favoured a system of pan-European banking supervision and a single European bank deposit guarantee scheme. This would, in theory, prevent the kind of national competition to offer depositor guarantees that helped provoke a run on Irish banks in 2008, and remove some of the incentive for self-reinforcing capital flight from banks in the weaker EU sovereigns into those in stronger ones. The Commission has also proposed collectivising the responsibility for intervening in and resolving failed institutions, including rules that require the bailing-in of bank creditors through the conversion of their debt into equity in a revived institution.

National regulators and politicians have consistently resisted pan-European supervision. This is generally for the understandable reason that while their national taxpayers remain on the hook for bank rescues, they cannot legitimately pass supervision to the supranational level. Although their voices are invariably unheard in these debates, the new European member states have their own political concerns about centralisation. In the initial post-crisis debate in 2009 on restructuring EU financial regulation, supervisors in Poland, Hungary the Czech Republic and the Baltic states were strongly critical of the idea that they would lose their grip on the subsidiaries of larger Western European banks that dominated their banking markets. Nobody likes the idea of EU taxes to fund a central EU rescue pot either, especially London and Berlin.

But there is also a strong element of politics in this. The idea of Berlin or Paris handing responsibility for the fate of Deutsche Bank, the German Landesbanken or Société Générale to a pan-European supervisor was, and still is, a huge step. London doing the same for a Lloyds or an HSBC is genuinely inconceivable. The result is the political compromise that runs through the creation of the new EU financial regulators and the EU's new bank capital rules in

which the regulation migrates partially up towards the centre, but supervision, and the political prerogative to handle bank failure (or, more likely, rescue) remains national.



Fig 1: Non-performing loans in the Eurozone banking system, March 2012.

Source: Ernst and Young 2012, Eurozone Central Banks.

Have things got bad enough to change minds? The Commission clearly detects a fairer wind. Commission President José Manuel Barroso has started talking about a banking union as an integral part of the new economic governance of the EU (or at least the Eurozone). The Commission's bank resolution plans have now been published after having languished for more than a year as a result of a general political nervousness about talking too explicitly about writing down bank creditors.

But none of the basic political problems have actually gone away. These can be divided into four categories, in ascending order of political intractability. The easiest, at least for the rest of the EU, is what to do about the UK, for which moving financial market governance or the taxation of the City of London to the EU level is anathema. The simple answer is that the UK will remain outside a pan-European system of supervision. The core of a new system would be the Eurozone, probably expanding to take in most of the other members of the EU.

The British government acknowledges both the inevitability and the necessity of a banking union in the Eurozone as a backstop to the single currency. But the weight of a Eurozone banking union in debates on rules for Europe's single market in financial services would present a permanent frustration for the UK's attempts to assert its prerogative in the governance of the City of London.

Commission officials privately expect the protracted debate on a banking union to deepen further the UK's peripheral position in the evolving structure of the EU. This is not particularly good news for financial institutions based in London.

Then there is the question of who actually does the supervising and who they supervise. The new European Banking Authority, which along with the European Commission is responsible for managing banking regulation in the EU, is based in the UK, which rules it out. This leaves the ECB as the obvious candidate. Berlin has already suggested that it is willing to contemplate ECB pooled supervision and resolution only for 'systemically important institutions', a formula designed to rule out Germany's politically hypersensitive Landesbanken and Sparkassen savings banks. It would also presumably rule out the savings banks whose five year lending binge is at the heart of Spain's current problems. Which seriously misses the point.

Thornier still is the question of how to pay for it. A single European deposit scheme and resolution fund could be funded either by governments, or directly by taxes on financial institutions (including in principle a Financial Transactions Tax). The Commission favours a single deposit scheme and fund, but has also floated a weaker version of coordination in which deposit guarantee schemes and bank resolution funds would be pre-subscribed and their scale pre-determined, but they would remain national. States would, however, have an obligation to lend to each other in extremis, and to have pre-designed plans for resolving large cross border institutions. To this point, European states have strongly disagreed on the merits of pre-funding such schemes, and on the desirability of having financial sector taxation dictated from Brussels.

None of these problems are likely to be resolvable quickly or easily. Bank resolution proposals could take two years or more to negotiate and implement. A pan-European banking supervisor would have to be created and resourced, stress tests devised and rescue and restructuring protocols agreed. But the biggest problem of all will remain the basic political question of Berlin's dislike of any collective liability

that does not come with the ability to impose policy change on other EU states.

This comes down to the question of whether a banking union in the Eurozone can advance faster than political and fiscal union. The Germans seem to think not. Bundesbank Vice President Sabine Lautenschlaeger criticised a banking union last week as a potential source of moral hazard and an attempt to impose collective liability 'by the back door'. This is a pretty good summation of the instinctive German position, and probably the single most important reason why any explicit widening of collective liability will advance only in lockstep with fiscal union and a tight grip on the behaviour of members.

... and uniting to save

The more immediate issue for the June 28 Summit will be the fact that none of this will do much to alleviate the immediate problem of a teetering banking system in states that are, in many cases, already too weak - or simply unable - to borrow to keep it afloat. Europe's immediate need is for something akin to the US \$700bn Troubled Asset Relief Programme (TARP), which was big enough to put a backstop behind the US banking system and backed by a genuinely Federal political structure. US politicians may have (briefly) debated the ideology, size and role of the TARP. They did not have to reconcile New York's sovereign and political interests with California's in doing it. Europe's politicians and technocrats have to do exactly this.

The closest the EU has to the TARP is the European Stability Mechanism (ESM) bailout fund. This fund has the theoretical capability to lend directly to banks, bypassing government balance sheets. But Berlin was careful to ensure that it could only do this with unanimous approval of all EU states, providing it with an effective veto. Berlin is unlikely to explicitly waive this right. Angela Merkel's defining tactic to this point has always been to refuse to write cheques in advance, especially on questions where it perceives moral hazard to be at stake. It basically got its way with Spain, ensuring that the bailout was channelled through the national balance sheet, with explicit conditions on scrutiny of Madrid's approach attached.

Even assuming that Berlin was in principle willing to loosen its grip on the ESM for the purposes of bank recapitalisation, which it probably won't, practical problems remain. Designed as a 'firewall', the ESM is a show of political intent as much as an actual pot of money. Much of its resources are made up not of paid-up capital but of guarantees. Bank recapitalisations would eat heavily into that capital. Paris under Sarkozy argued that the ESM should be given a banking license and authorised to leverage its capital, and François Hollande has now argued that it should be able to refinance itself through the ECB. But Berlin remains sceptical. Even assuming states could agree on how to pay for it, it is not at all clear how decisions would be made as to who got what support and on what terms. Given the scale of the current problems in the Eurozone banking system, the questions of precedence and precedent would loom large.

Will the urgency of the June 28 European Summit force these short term questions? All the signals from Berlin at least suggest not. The June 28 Summit will probably produce a general commitment to some form of supervisory union sometime towards the middle of this decade with more refined proposals towards the end of the year. But in reality there are two types of a banking union being debated here. One, driven chiefly by the European Commission's agenda, is a long term vision for banking supervision in the EU. The other is a much more urgent problem of if, and how, European states can unite now to save their banking system without crippling themselves.

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