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European Banking Union one year on: a guide for non-bankers

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Summary

July 2013 marks one year since European governments committed to the creation of a 'banking union' in the EU. In their own way each of the three steps taken by European leaders since June 2012 has suggested that there is little real distinction between banking union and political union in Europe. Confronted with the political reality of pooling exposure to each other's banks, and the concomitant pooling of the power to govern banks in the collective rather than the 'national' interest, Berlin in particular has pulled back from full 'Europeanisation' at each stage. In this respect, Europe's idea of progress on banking union over the last year tells us a lot about the current limits of a unified political economy in Europe.

July 2013 marks one year since European governments committed to the creation of a 'banking union' in the EU. European political leaders ended that year with two further sets of agreements on how this might work. The first covered the terms on which money might be injected directly from the EU level into failing national banks. The second, EU-wide protocols for how losses should be imposed on bank creditors before taxpayers can bear any costs of a bank rescue. These two agreements follow an earlier agreement in December 2012 to move the supervision of the largest banks in the banking union – banks with balance sheets over €30bn like Deutsche Bank, BNP Paribas or Santander - to the ECB in Frankfurt.

Although 'banking union' is often treated as distinct from 'political union' in Europe, in their own way each of these three difficult steps since June 2012 has suggested that there is little real distinction. What links all three is the essentially political question of the terms on which taxpayers in one European state will take on exposure to the failure of banks in another. This, in turn, raises equally political questions about the extent to which states will retain national sovereignty over policies for which the costs of failure have been significantly 'Europeanised'. For business as well as banks the slow road to banking union over the last year tells us a lot about the limits of a unified political economy in Europe.

Making your bank my problem

The essential nature of banking union lies in breaking the link between a failing bank and the European government required to bear the upfront costs of resolving or rescuing it by pooling that risk at the European level. Many European states are host to banking sectors whose balance sheets are larger than that of their national product, or simply too fiscally impaired to bear credibly the costs of local bank failure without fatally undermining their own solvency. By June 2012 this dilemma had bankrupted Ireland, and was rapidly eroding market confidence in the solvency of Spain, where the massive costs of resolving the losses of the *caja* savings banks on property lending looked like an unsustainable burden for the national balance sheet given rising debt costs.

The way banking union proposed to fix this is by escalating those potential exposures to the European level, where even the costs of saving large banks could in principle be borne easily enough by the collective balance sheet of the EU. Whether this would be done prospectively or retrospectively was

unclear in June 2012. However Berlin and The Hague subsequently made it clear that 'legacy' debts incurred before 2012 would remain a national problem. Although Spain received European money to recapitalise it weakest banks in July 2012 the funds remained on the Spanish balance sheet.

The basic political problem with the banking union idea is also the basic political problem for Europe. Even assuming you can convince taxpayers in one European state that they should be liable for the costs of fixing a potential bank failure in another, serious prior political guarantees will be required with respect to the management of that bank. The political cost of the elimination of full sovereign exposure to national banks would be the elimination of national discretion over how they were supervised. So the first element of banking union was to be the pooling of bank supervision in a Single Supervisory Mechanism (SSM), on the basis of a single European rulebook, in the ECB. This elimination of discretion is the basic reason that the UK opted out of any banking union from the start.

The second element was to create a pool of funds at the EU level large enough credibly to stand behind the pledge to directly bear the costs of bank resolution or recapitalisation and a Single Resolution Mechanism (SRM), to oversee and deploy it. The vehicle for this is to be the European Stability Mechanism (ESM) – the institutional manager of the credit lines created initially in 2010 to fund the sovereign bailouts of Ireland, Portugal and Greece. A final element of banking union would harmonise and pool at the level of the banking union the deposit protection systems of national states, which represent a most cases a significant exposure to their banking systems.

This theory quickly collided with political reality. In defining the scope of the single supervisory mechanism in December 2012, Germany insisted on a minimum balance sheet size for banks that would be initially subject to ECB supervision. This ensured the inclusion of big German banks like Deutsche Bank but the exclusion of its politically well-connected Regional and Savings banks, despite the fact that it is these kinds of regionally undiversified and politically patronised lenders that were at the heart of problems in Spain. Berlin has also resisted creating a new autonomous bank resolution authority at the level of the banking union, pushing back this week against European Commission proposals that it should be given new centralised powers over bank resolution. Berlin wants instead a council of national resolution authorities.

The agreement on the capability of the ESM to directly recapitalise European banks reflects the same reluctance to take the final step to pooled governance. While Member States have agreed that the ESM should be able to recapitalise banks directly, national governments will have to contribute 20% of the funds for the first two years and 10% thereafter. Creditors and national governments will also have to foot the bill for returning a failing bank to a minimum risk- weighted capital ratio of 4.5% before ESM funds can be injected. This leaves member states still exposed to some degree the costs of bank rescues.

The funds available within the ESM for bank recapitalisations have also been capped at €60bn. This money is something of a political illusion – it exists for now only in the form of pledges from EU states. Even as hard cash it would still represent only a fraction of the €36trn balance sheet of the EU's banks. The ECB reckons that around 4% of these assets are non-performing. That leaves well over a trillion euros in likely losses waiting to be crystallised on European bank balance sheets. Further deteriorations in growth or an aggressive hand from the ECB when it takes over supervisory duties next year could force this issue. Even if these numbers are off by an order of magnitude, the resources committed at the EU level will still look puny to a sceptical market.

Make me European… but not yet.

Why does all of this matter? A credible plan for the bearing of the losses still implicit in Europe's weakened banking system is central to any credible exit from the Eurozone crisis. Some of this plan is addressed through higher and stronger capital cushions for banks, but the scale of the potential problem is such that it requires a credible public

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safety net for the banking system as well. The June 2012 agreement on banking union was recognition in principle that only the pooled faith and credit of an EU banking union was sufficient to ensure market confidence that bank failure no longer posed an existential threat to individual EU states.

What they recognised in principle, European capitals have sidestepped delivering in political practice. Instead, one year on what we have is a limited pooling of that credit, on a limited scale, with significant risk exposures left at the national level and important elements of the overall oversight of the system remaining in national hands. Optimists or pragmatists – and the Brussels technocracy has plenty of both - might argue that for all the limitations of this outcome, the principle of Europeanising both bank supervision and resolution has been agreed, as have the rudiments of the tool box for making it work. As so often with European integration, the incremental process of widening and expanding this European remit will trump political concern and caution.

Perhaps, but this presumes long term market calm and lenience. Since June 2012 ECB promises to preserve the euro have stabilised markets and bought some time for European politicians to fix the foundations of the Eurozone. But they have also removed the irresistible pressure to do so. This explains some of the compromises of the last year on banking union, but they also relate to a more fundamental political block on pooling liabilities and sovereignties in the Eurozone. In this respect there is little distinction between passing powers to Brussels over a national bank or a national budget deficit or debt. This is Europe's basic political dilemma. Further deterioration in growth prospects and market sentiment, or greater pressure on Europe's banks to realise losses – and late 2013 and 2014 may bring the former and will certainly bring the latter – will surely expose the limitations of a partial solution.

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