ISSUE 2012/12
JUNE 2012

WHAT KIND OF EUROPEAN BANKING UNION

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- Which EU countries should participate in the banking union?
- To which categories of banks should it apply?
- Which institution should be tasked with supervision?
- Which one should deal with resolution?
- How centralised should the deposit insurance system be?
- What kind of fiscal backing would be required?
- What governance framework and political institutions would be needed?

- The paper discusses how the transition from the current state to the future banking union could be organised and what the short term steps might be.

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This paper benefited from a workshop held at Bruegel on 11 June 2012. The authors are grateful to participants for their contributions to discussions held on that occasion. We thank Chiara Angeloni and Silvia Merler for diligent and effective research assistance in the preparation of this paper.

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WHAT KIND OF EUROPEAN BANKING UN

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ABSTRACT

This paper discusses the creation of a European Banking Union. First, we discuss questions of design. We highlight seven fundamental choices that decision-makers will need to make: Which EU countries should participate in the banking union? To which categories of banks should it apply? Which institution should be tasked with

accountable, which typically involves carefully designed governance and active parliamentary oversight. The division of labour between central towards fiscal and political union. If not backed up by fiscal support, a European deposit insurance scheme would not help deal with major banking crises. It could even blur responsibilities and make things worse. Without a centralised resolution authority, real-time decisions would be made in a area, as the way the crisis has developed since late 2009 has made it clear that a banking union is indispensable to a lasting and stable monetary union. However, there is also a rationale for creating a banking union for the EU27: a true single financial market may be undermined by incentives for national authorities to restrict cross-border operations by banks headquartered on their territory out of prudential concerns, or for differential treatment or guarantees in the event of a crisis[8]. The logic of a banking union at 27 is not to ensure the viability of monetary union, but to preserve financial integration within the European single market. This is fundamentally the rationale behind the proposals for an EU framework for bank recovery and resolution unveiled by the European Commission on 6 June 2012.

The preservation of financial integration within the single market is a valid economic reason for building an EU-wide banking union. At the same time, some of the central functions of a banking union such as the relationship between the liquidity operations of a central bank and the fiscal resolution functions, as well as the creation of a common deposit insurance scheme, are rendered more difficult by the existence of multiple currencies. Moreover, it is a matter of discussion whether the potential economic benefits of mutualising banking policy outweigh its costs in terms of shared sovereignty and mutualisation of risks for the different member states. Ultimately, this is a political judgement, on which different views are being expressed. The UK, in particular, has clearly indicated its unwillingness to be bound by a banking union that it regards as a •natural consequence• of the single currency rather than as the inevitable conclusion of the EU single market. It supports, therefore, the creation of a banking union for the euro area but is against creating one for the EU[9].

Political reservations may exist within the euro area, but here they need to be weighed against a much more powerful argument, namely that the absence of a banking union undermines the functioning, and perhaps the very existence, of the common currency. As the International Monetary Fund (IMF) puts it, •While a banking union is desirable at the EU27 level, it is critical for the euro 17Ž (IMF, 2012).

Indeed, our assessment is that creating a banking union that would include all EU member states is too high an ambition to be practical, at least for the foreseeable future. Projects for an EU-wide banking union have no chance of seeing the light of day. They can only create confusion and a tor4(h)177.8(s)-1.2 TD 0 Tc(sh, stsuni17.1(d)17 coedica t

8. See Véron (2007) and Fonteyne et al (2010).

9. In his Mansion House speech on 14 June 2012, UK Chancellor of the Exchequer George Osborne said: •A banking union … in other words, a union that stands behind the stability of Eurozone banks and their deposits in return for common financial supervision [is] a natural consequence of a single currency [...]. The same level of integration and common supervision is not considered necessary in other areas of the single market like energy. So we are clear that Britain will not take part in this banking union. British taxpayers will not stand behind eurozone banks.Ž

operations whose resolution is bound to require transnational mechanisms. At the other extreme, a •complete• banking union would entail European-level responsibility for the whole of banking policy, covering all banks no matter how small or local. In between, a range of options could be considered.

This choice involves several dimensions:

(a) Information asymmetries. European authorities would have a clear informational advantage over national authorities for the supervision of banks with significant cross-border operations. The opposite is arguably true for local banks.

(b) Sovereign/banking feedback loop. Common deposit insurance can sever the connection between domestic sovereign and banking risks only if its coverage is broad enough to mutualise a significant part of the risks. For instance, the Spanish Cajas have very little international business, yet they were collectively large enough to represent a major fiscal risk for Spain and for the financial stability of the euro area. Only a complete banking union can entirely eliminate the feedback loop.

(c) Distribution of costs and benefits. Banking concentration varies greatly across euro-area member states. For example, most of France•s banking system is composed of E-SIFIs, whereas Ireland and Portugal are home to few such institutions, if any. Other countries combine institutions whose systemic importance is at the European, national, or sub-national level, in varying proportions (See Box 3). Hence, different choices on the scope of banking union can have very different distributional consequences.

(d) Potential competitive distortions. Any partial

BOX 3: SIZE AND CONCENTRATION OF BANKING SYSTEMS IN EUROPE

Banking systems in Europe differ widely from country to country. On the liability side, deposits-to-GDP ratios vary depending on financial development, wealth and the share of non-residents in total deposits. Luxembourg and Cyprus are characterized by high deposit ratios because of the large share of non-residents. At the other extreme deposit-to-GDP ratios are low in Estonia and Slovakia.

BOX 3: SIZE AND CONCENTRATION OF BANKING SYSTEMS IN EUROPE (CONTI

Figure 2:Size and concentration of banking systems, 2010

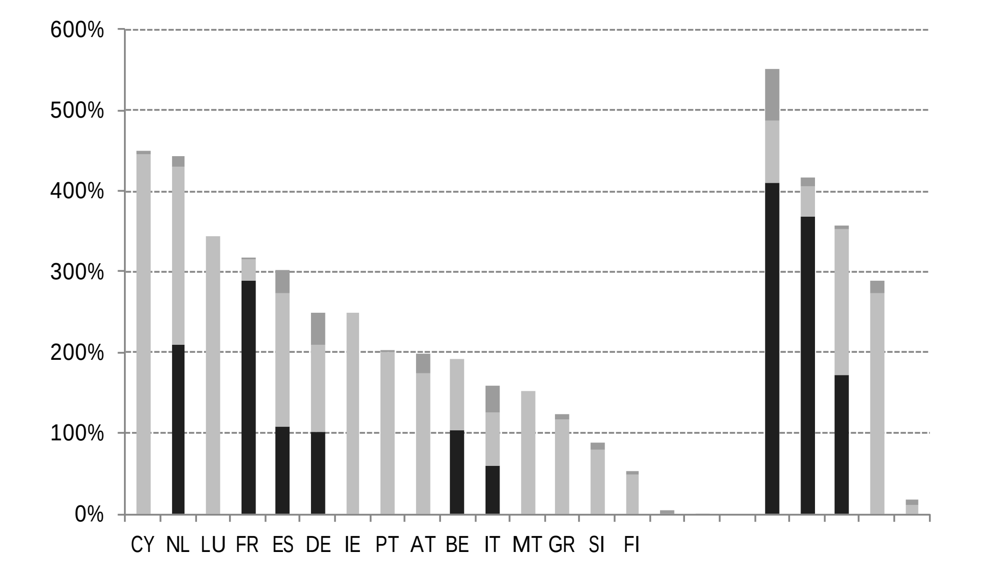

Table 1 gives a measure of cross-country dispersion for bank deposits and for banking sector as using the same decomposition as in Figure 2. It is apparent that the dispersion is maximal fo SIFIs and gets lower as coverage of the banking system increases, although it remains larger for the size of deposits. Consequently coverage should be as broad as possible if the aim minimize distributional effects arising from banking sector size differences across countries.

of risks, limits asymmetry across countries, and minimises distortions. A partial union covering solely E-SIFIs would mean that the European supervisor would only deal with a limited number of pan-European entities, but it would address the banking-fiscal feedback loop only partially and would result in a high degree of asymmetry across countries. Conversely, a partial union might run into less political resistance at the national (and in some cases, sub-national) level than a complete one. Including only E-SIFIs or E-SIFIs plus large banks would also create significant distortions between smaller and larger banks.

In this debate, centralisation of authority should not be confused with operational centralisation. Even in a complete banking union, the subsidiarity principle would apply and there would be a delegation of many supervisory operations to national or sub-national entities under the authority of the European supervisor. In no scenario should and would the thousands of banks that exist in the EU be all supervised centrally.

These considerations lead us to advocate broad coverage extending significantly beyond E-SIFIs, and ideally a •complete• banking union covering the entire sector if a political consensus can be achieved for it. The choice of scope of the banking union has significant implications for the way deposit insurance should be organised. This is discussed below under item 5.

3. Which supervisor?

At the level of individual countries, there is a longstanding debate on whether bank supervision should be conducted by the central bank or by a separate public authority that may have stronger links with the finance ministry. A number of dimensions are relevant for this:

€ First, the central bank is the last-resort provider of liquidity to banks. In times of crisis, it needs to strongly increase its liquidity provisioning and by doing so it increases risk on its balance sheets. Therefore, the central bank naturally has to make assessments about its counterparts, and has better expertise on liquidity conditions affecting banks than an agency that is more remote from markets. All other things equal, this gives the central bank a natural advantage in supervision.

€ A second dimension concerns the potential conflict of interest between monetary policy and supervisory action: the central bank may be led to be more dovish on monetary policy than the inflation objective warrants in order to safeguard certain banks it supervises, or even in order to conceal supervisory failures; conversely, it might be tempted by supervisory forbearance to prevent a crisis happening that could result in price instability. All other things equal, this argument speaks against supervision by central banks. However, the crisis has also shown that the central banks• functions extend beyond price stability. In fact,

12. See on this issue Alesina and Tabellini (2007) or Maskin and Tirole (2004).

insurance fund would be prefunded by contributions from the member states• governments. In case the national DIS was to be

euro- area countries. The problem is that putting in place the necessary mechanism would involve transforming the euro area into a full-fledged monetary union with a fiscal and banking union. In turn, this would require agreement on sharing sovereignty, mutualising risk and creating European-level accountability channels that would amount to creating a political union.

Although nothing short of a political union might ultimately be sufficient to ensure the long-term viability of the monetary union, it is equally clear that it will take significant time to achieve even under the most optimistic assumptions. What appears possible, however, at this juncture is to take a decisive step forward by creating a banking union. This step would not only help to address directly the negative feedback loop between sov-

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