The Banking Union
in the context of the EU crisis

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ASSA Conference, Philadelphia, January 5, 2014
Overview of the presentation

I/ A new piece in the European architecture

II/ The three pillars of the Banking Union

III/ The strategic purpose of the Banking Union

IV/ Unresolved Issues

V/ Perspectives for the future of Europe
I/ A new piece in the European architecture to solve the eurozone crisis

- The eurozone crisis can be viewed as a « twin crisis », i.e. banking crisis & sovereign debt crisis
- => two new European pieces created in 2012 :
  - The Fiscal Stability treaty (Fiscal Compact) which aims at reducing fiscal deficits
  - The Banking Union which aims at :
    • strenghtening the regulation of European banks
    • eliminating the perverse links between sovereign debt crisis and banking crisis
The twin crisis in the eurozone

- European banks had fed the rise in financial bubbles
- Existence of oversized banking system in some countries
- Banks experienced heavy losses during the 2008 - 2009 crisis
- Governments bailed-out banks
- Sharp increase in public debt
- Public debt became risky assets
- Banks weakened by the sovereign debt crisis

Vicious circle between the sovereign debt crisis and the banking crisis
II/ The three pillars of the Banking Union

A/ ECB as a single supervisory authority of the eurozone

B/ Common resolution fund & mechanisms for failing banks

C/ Common deposit-insurance scheme to prevent bank runs
A/ ECB as a single supervisory authority

ECB: direct responsibility for the 28 largest banks, but will have power to deal with small banks if necessary.

The goals of the Single Supervisory Mechanism (SSM) are:

- to have an independent, powerful and credible supervisory authority without political interferences.
- To put banks in trouble under strict supervision before they become a threat to financial stability.
- To avoid the bias of protection of national banks by national authorities.
B/ A single resolution mechanism (SRM)

- A common crisis resolution mode
- An early detection and correction of banking difficulties
- Organize possible bankruptcies and liquidation of banks
- “Bail-in” to limit the use of public funding if recapitalizations are needed
- Allow the European Stability Fund (ESM) to directly recapitalize banks
The goals of a unique deposit guarantee system are:

- A same protection for all euro zone depositors
- Reducing the risks of bank run => avoiding solvency crises
- A European dimension: a full and credible guarantee

Modalities

- 100 000 euros guaranteed per depositors
- Including all European banks
- Financed by contributions from banks and public funding
III/ The strategic purpose of the Banking Union

- Copes with the **deficit of bank regulation** in the euro area, a major cause of the financial crisis (Larosière Report)
- Brings **new mechanisms for financial stability** besides existing ECB’s instruments (LTRO, OMT) and the European Stability Mechanism
- Creates **common instruments for crisis management** => micro and macroprudential supervision
- **Increases the homogeneity** necessary for a Monetary Union (Mundell conditions for Optimal Currency Area) : failure of the « Lamfalussy process » for convergence of supervisory practices
IV/ Unresolved issues

Three major issues:

• Monetary policy and the new role of ECB
• Governance of the Banking Union
• Banking model for the eurozone
A/ Monetary policy and the new role of ECB

• ECB now in charge of both monetary stability and financial stability
  – The separation principle (Goodfriend, 2009) is abandoned
  – The inflation targeting model needs to be revisited

• The ECB will be faced with a « optimal policy mix » problem:
  – More targets => more instruments
  – Conflicting targets (monetary stability may lead to financial instability : « tranquillity paradox », zero lower bound)
  – Hierarchy for targets ? Who will decide ?
B/ Governance of the Banking Union (BU)

• Two questions:

  – What will be the geographical scope of the BU?

  – What transfer of sovereignty from country members to the BU authorities?
Geographical scope of the Banking Union?

- A BU limited to the eurozone or including the EU?
  - Relationships between the ECB (eurozone) and the EBA (EU)? Competition or cooperation?
    - The ECB does not control decision-making of EBA
    - EBA is weakened by the new role of ECB as supervisor
  - The efficiency of the BU weakened if the City is outside the BU
  - Remaining outside the eurozone but inside the EU is it sustainable?
What transfer of sovereignty from country members to the BU authorities?

• One of the major goals of the BU is to cut the links between banks and national authorities
  – Will governments accept to lose their ability to influence the distribution of credit and the banking sector organization? e.g. the Banque Publique d’Investissement in France
  – High heterogeneity of national banking systems: is this consistent with a single bank regulation system? (Case of tax havens)
C/ Banking model for the eurozone

• The banking crisis has shown that the universal banking model needs to be adapted SIFIs « too big to fail », « too interconnected »
• Proposed reforms (Vickers, Liikanen) => (mild) separation of retail banking from investment banking
• The BU reform will consolidate the universal banking model which is dominant in Europe
Impact of the Banking Union on the banking system

The Banking Union:

- **will increase competition among banks** in the euro area on a unified basis => oligopolistic structure of banking market will be reinforced

- **will cut the links** between domestic borrowers (Government, local authorities, firms and households) and domestic banks.

- **Will increase the dependency of banks on financial markets**

  2 risks:

  1. Increasing role of market-based intermediation at the expense of traditional intermediation => a threat for stability and growth

  2. Local & regional banking will be weakened => negative effect on local business

In the end, the BU will favor **large universal banks** and stimulate the **financialization process** in the eurozone
V/ Perspectives for the future of the European construction (1)

- The Banking Union => sizeable improvement in the regulation & supervision of banks

- However, the Banking union will not end the eurozone crisis
  - the making of the BU will take time
  - important issues need to be settled down
V/ Perspectives for the European construction (2)

- **The Banking Union creates political problems:**
  - Risk of splitting of the EU: exit of Britain?
    Some countries may not accept to lose their sovereignty
  - Risk for democracy: increased power given to the ECB without significant increase in accountability

  => Need for a renewed ECB mandate enlarged to financial stability

  ⇒ Need for a renewed definition of ECB independence - Accountability of ECB to democratic institutions
     - Cooperation with other entities responsible of economic policy

- **The Banking Union cannot be considered separately from:**
  - Financial reforms => disarm financial markets
  - Fiscal union => Common EU budget and taxation
  - Political union => Democratic control on banking authorities and ECB

The Banking Union = **technocratic federalism with limited legitimacy**