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Banking Union: Are the EMU design mistakes being repeated?

Stijn Verhelst

This Policy Brief pleads for an unambiguous commitment by eurozone leaders to establishing a Banking Union that is based on all three of its pillars: common supervision, a single bank resolution authority and a joint deposit insurance. There is a clear risk that the EU will agree on common supervision, but subsequently fails to put in place the remaining elements of its Banking Union. By doing so, the EU would make the same mistake as when it designed EMU, namely, creating a system with built-in flaws that risks leading to huge costs and a questioning of the European project as such.

Since the bankruptcy of the US investment bank Lehman Brothers, Europe has tumbled from one crisis into another. The initial financial crisis led to an economic crisis and a sovereign debt crisis, hitting the eurozone in particular. To bring these crises to an end, the vicious circle between them needs to be broken.

Policymakers have increasingly come to this understanding, as was made clear at the June 2012 Eurozone Summit. The Summit provided the impetus to move towards a Banking Union, which implies transferring control of the banking sector to the European level. This bold step in European integration needs to be carefully executed, as a flawed design could spark future crises.

This Policy Brief tries to draw the lessons from a previous major step in European integration: the creation of the Economic and Monetary Union (EMU). In its attempt to create a Banking Union, the EU risks repeating the same mistakes as when it designed EMU – even though these mistakes are a major cause of current difficulties.

The mistakes when designing EMU

In 1992, the EU took one of the most important decisions in its integration process. By signing the Treaty of Maastricht, Member States committed to a markedly closer Union. One of the Treaty's crucial decisions is the move towards a common European currency, which was to be supported by both an economic and a monetary pillar (Delors Report, 1989). However, when negotiating the Maastricht Treaty, Member States made the mistake of pushing through one pillar of EMU (monetary union), while not putting in place a sufficiently strong second pillar (economic union).

Firm decisions were made on monetary union. Member States went beyond fixing their exchange rates, as they agreed on an ambitious roadmap towards a shared currency. The consequence was a single European monetary policy for the entire monetary union.

Member States were more reluctant to allow for European control of their economic policies, as this was considered the heart of national sovereignty. Only with regard to fiscal policies, some binding rules were decided. For macro-economic policymaking, European coordination was governed entirely by non-binding instruments. Furthermore, the EU did not provide for substantive solidarity across Member States. Whilst the EU's cohesion policy budget was increased[1], it could not counterbalance national economic shocks.

Many details of economic union were to be decided after the Treaty of Maastricht. Yet, after signing the Treaty, there was little willingness to set up a strong economic union (Dyson and Featherstone, 1999). Macro-economic coordination instruments were put in place, but they remained non-binding. On fiscal matters, more detailed rules were worked out in the Stability and Growth Pact.

[1] The Cohesion Policy budget approximately doubled from 0.2% of EU GDP in 1988 to 0.4% of EU GDP in 1993 (House of Lords, 2008). However, this is still too small to play a significant anti-cyclical role.

Nonetheless, when the Pact was tested by Germany and France in the early 2000s, the weak nature of the economic union was exposed (Flouzat-Osmont d'Amilly, 2010). The consequence of all of this was that the EMU was a project with built-in flaws. As former Commission President Jacques Delors puts it in his memoirs: "*Economic and Monetary Union walks only on its monetary leg*" (Delors, 2004: p. 463).

The weaknesses in the design of the EMU have led to huge social costs, and to the questioning of the European project as such. If European leaders could have predicted such events, they would most likely have designed another type of EMU. They would have opted either for an *EMU light*, one in which Member States retain national control over both exchange rates and economic policy. Alternatively, they could have opted for a genuine EMU, with European control over both economic and monetary policies.

Towards a Banking Union

Twenty years after signing the Treaty of Maastricht, Member States again take a major step in European integration by agreeing to work towards a closer integrated financial framework. Yet, there appears to be a substantial gap between the initial rhetoric and the actual commitments.

The three pillars of Banking Union

While the concept of a European Banking Union is rather new, reflection on what would be needed to lift supervisory control to the European level is not (Goodhart, 2004; Verhelst, 2011). In recent discussions, a general consensus has emerged about the desired scope of a Banking Union (e.g. Constâncio, 2012; IMF, 2012 and Pisani-Ferry et al., 2012).

In line with the aim of ensuring a stable financial system, a European Banking Union should consist of the following three pillars:

1) European banking supervision

As of present, each Member State carries out its own, national supervision of the banking sector. Some mechanisms for cross-border coordination have been put in place (i.e. colleges of supervisors and the European Banking Authority), but supervisory authority still resides with the national supervisor. A Banking Union would change this set-up by transferring supervisory authority to a single European supervisor. The hope is that such supervision would reduce the temptation to favour champions of national banking and hide problems from other supervisors.

2) A common bank resolution authority

The management of banking crises is currently a national competence. As many banks operate on a cross-border basis, crisis management hence requires coordination between Member States. Yet, in the past, national capitals have not been able to cooperate effectively. An additional problem is the fact that Member States, especially the smaller ones, cannot credibly bear the huge potential costs that are attached to large-scale banking crises. In Ireland for instance, the banking crisis resulted in the country itself losing access to the financial markets. In Spain, the same risks manifest themselves. A common resolution authority can address these problems, as the authority would be able to design and apply a cross-border strategy for dealing with banking crises. This should reduce the need for public money to finance bailouts, although the possibility of burdening tax payers cannot be fully excluded. To be credible, a fiscal backstop is therefore needed. This backstop should consist of both ex-ante funding and potential ex-post financing, the latter through a European tax, the European Stability Mechanism and/or last resort lending by the European Central Bank.

3) Common deposit insurance

Deposit insurance protects depositors against the failure of a bank. If a bank fails, the insurance scheme is to redeem depositors up to a predetermined amount. Some European harmonisation of deposit insurance schemes has taken place, but the schemes are still Member State specific. In a Banking Union, deposit insurance would instead be lifted to the European level. A single scheme would then cover the entire Banking Union. As for bank resolution, a sufficiently strong fiscal backstop is required.

Each of these three pillars is needed to support the Banking Union[2]. In line with the expression "*you break it, you own it*", the responsibility for banking supervision during normal times should be aligned with the responsibility for dealing with banking crises (i.e. bank resolution and deposit insurance). Put otherwise: if supervision fails, the same level of government should have to deal with the consequences. Transferring only some elements to the European level would result in a most uneven system, one that would not be able to safeguard financial stability[3].

A Banking Union that would transfer crisis management and its financing to the European level without common supervision would lead to so-called moral hazard.

[2] It is argued that common deposit insurance is less urgent than a common bank resolution authority. Nonetheless, the three pillars are deemed of importance in the long-term.

[3] This has been referred to as the "*Financial Trilemma*", in which the combination of financial integration and national financial policies is incompatible with financial stability (Schoenmaker, 2011).

National supervisors would be tempted to underestimate risks in their banking sector, as the costs for supervisory failure would after all be borne by the wider Banking Union. In such a scenario, the European level would – rightly so – object to its lack of powers to detect burgeoning bank crises.

Conversely, if crisis management remains national and the European level only becomes responsible for banking supervision, other problems would occur. The European supervisor might be tempted to pass the bill too quickly to the national level. The national level in turn might refuse to bear the costs, as it would blame the EU-level for a bank failure. Furthermore, investors and depositors would still distinguish between banks situated in "*safe*" Member States and banks situated in "*risky*" Member States. Such a partial Banking Union would not undo the link between banking and sovereign debt crises, as Member States would still have to pay the bill if a banking crisis occurred.

The Commission proposal

In contrast to the widely accepted idea of a three pillar Banking Union, the Commission proposal of September 2012 focuses on only one pillar: common supervision. It suggests a gradual move towards a single supervisory mechanism for the eurozone (possibly also including other Member States). Under the proposal, the ECB can decide to take over supervision of specific banks from January 2013 onwards, focusing on banks that have received public financial assistance. In July 2013, the ECB would then become the responsible supervisor for the largest, systemic banks. In 2014, the process would be completed by making the ECB responsible for the supervision of all banks in the eurozone. The Commission proposal would hence result in firmly putting in place the supervisory pillar of the Banking Union (Commission, 2012a).

However, the Commission is much less detailed about the two other pillars of the Banking Union. In the short-term, the institution calls on Member States to agree on earlier proposals on crisis resolution and deposit insurance. Yet, these proposals remain stuck in a national logic, as no responsibilities would be transferred to the European level. In the longer term, the Commission promises to make a proposal on a "*single resolution mechanism*" for bank crises, falling short of proposing a single resolution authority. It furthermore made no commitments on working towards a common deposit insurance (Commission, 2012b). This would be insufficient to attain a sustainable Banking Union[4].

It seems as though the Commission's proposal remains deliberately vague on the final scope of the European Banking Union, due to political reasons. By working first towards common supervision, the Commission hopes to create the momentum to move ahead on a common bank resolution authority and common deposit insurance at a later stage. This way, it would create a Banking Union by stealth.

Repeating the mistakes of the EMU design?

By postponing essential decisions on two out of the three pillars of a Banking Union, the EU risks making the same mistake as when it

[4] In previous statements on a Banking Union, the Commission was clearer on the need for a comprehensive approach. This underlines the institution's backtracking in its September 2012 proposal and the accompanying roadmap. See the Memos by the Commission on Banking Union of 6 and 22 June 2012.

decided to create an EMU. If the flaws in the design of the EMU teach us one thing, it is that ambitious integration projects should be put in place in a coordinated manner.

Europe can, in the words of Robert Schuman, "*be built through concrete achievements*" (Schuman, 1950). However, the success of these achievements should not fully depend on hypothetical future actions. The monetary union was not sustainable because it was not backed by a sufficiently strong economic union. In the same vein, common supervision risks failure if it is not backed by common responsibility for bank crises. As discussed above, a Banking Union needs all three pillars in order to be viable. There is a clear risk that the EU will agree on common supervision, but subsequently fails to put in place the remaining elements of its Banking Union.

The only way to avoid the risk of having an unstable Banking Union is to provide sufficient clarity on the road ahead. Therefore, the EU needs to be clear on the final objectives of a Banking Union, instead of trying to move by stealth. The objective could be either to move towards a genuine Banking Union, with common responsibility both in normal times and during crises, or, alternatively, the EU could choose to leave banking supervision and crisis management at the national level. As for the EMU, these two options are to be preferred over any half-way solution.

Conclusion: In need of clear, high-level commitment

The EU and its institutions deserve credit for taking the bold decision to move towards a Banking Union. Nonetheless, while Member States embraced the concept of a Banking Union, they still have difficulties with the transfer of sovereignty and the potential fiscal consequences it entails. There is a tendency to postpone discussions on these sensitive issues. However, as the EMU has shown, executing such a crucial step in European integration requires foreseeing all necessary elements from the start.

It is, of course, not possible to agree on all characteristics at the same time. A gradual move towards a Banking Union can be envisaged, leaving certain non-essential options open for now. Nevertheless, a clear joint political commitment with regard to the general outline of the future Banking Union should precede any legal decisions. Therefore, eurozone leaders should adopt a resolution in which they confirm the desire to establish common supervision, a single bank resolution authority and common deposit insurance, as well as a strong fiscal backstop that makes the project credible.

Only by being clear about what it aims to achieve, will the EU be able to convince citizens and financial markets that it is serious about creating a Banking Union. By doing so, European leaders would take a crucial step towards tackling the ongoing sovereign debt crisis, and undoing the EMU's birth defects.

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Stijn Verhelst is Senior Research Fellow at Egmont - Royal Institute for International Relations.

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EGMONT
Royal Institute for International Relations
Naamsestraat 69
1000 Brussels
BELGIUM

> www.egmontinstitute.be