

The Banking Union in the context of the EU crisis

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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

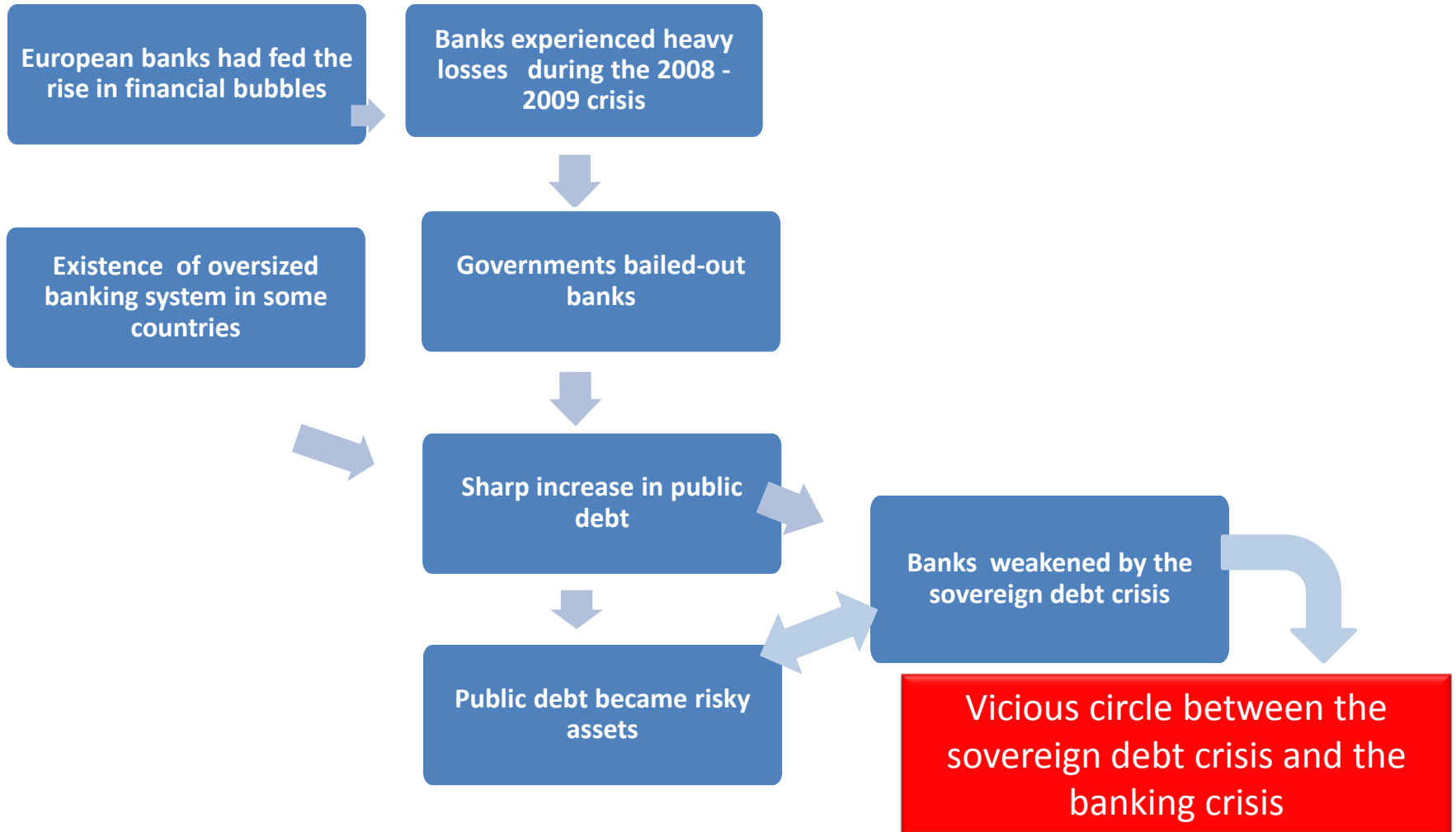
IV/ Unresolved Issues

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 :
 - strengthening the regulation of European banks
 - eliminating the perverse links between sovereign debt crisis and banking crisis

The twin crisis in the eurozone



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

C/ A European deposit guarantee system (DGS)

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**