The financial implications of a banking union

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With calls for a banking union to resolve the issue of banking interdependence within the Eurozone, this paper explores the reasons behind such a policy, how it should be implemented and the possible ramifications.

The European Commission's recent proposals for a Eurozone banking union note that many banks have outgrown the ability of their home governments to rescue them, and emphasise the need to break the link between troubled banks and sovereign indebtedness.[1] A single supervisory mechanism (SSM) is proposed as a necessary precursor to the use of "European backstops" (i.e. the European Stability Mechanism) to recapitalise banks directly. One way of interpreting these statements is that exposure to problem banks needs to be pooled at the European level, and that the only way to make this politically palatable is for bank supervision to be organised at the European level as well. Taxpayers in one country will naturally be reluctant to pay for failed banks in another if they believe that national supervisors are to blame.

However, the ultimate goal of the proposed banking union is said to be to ensure that taxpayer funds will never again be needed to support distressed banks.[2] Whatever

1 "Global financial integration and the EU single market have enabled the banking sector in some Member States to outgrow national GDP many times over, resulting in institutions which are "too-big-to-fail" and "too-big-to-save" under existing national arrangements." See here.
"Many banks have developed cross-border activities and have outgrown their national markets." See here.

2 "To make sure that supervisory authorities have all the tools they need to deal with bank failures without taxpayers' money." See here.
Michel Barnier: "It will be the role of the ECB to make sure that banks in the euro area stick to sound financial practices. Our ultimate aim is to stop using taxpayers' money to bail out banks" See here.

the merits of a banking union for Europe, it would be truly miraculous if it were to completely eliminate the need to use taxpayer funds (even temporarily) to deal with failing banks. For this reason, it is important that European leaders take the fiscal implications of the proposed banking union seriously.

Current Commission proposals for an SSM imply that transferring "ultimate responsibility for supervision of banks in the euro area" from national supervisors to the ECB will improve the effectiveness of such supervision.[3] Underlying this assumption is the accusation that national supervisors have engaged in regulatory forbearance of their perceived national champions: in order to avoid embarrassment, they are supposed to have delayed acknowledging problems and thus allowed them to worsen.[4] It is implied that the ECB will take a more hard-headed view of troubled banks and hence resolve them swiftly without fear or favour.

There is good reason to believe, however, that the ECB might in fact be inclined to treat failing banks (and particularly their creditors) more leniently than national supervisors in cases where contagion is a threat. Indeed, this risk of contagion is at the heart of the Commission's justifications for moving towards a banking union in Europe.[5] If the ECB perceives that imposing haircuts on creditors (or forcibly converting their debt claims into equity) might lead to contagion across banks in the Eurozone (an externality

3 See here.

4 "[S]upervision of banks remains to a large extent within national boundaries and thereby fails to keep up with integrated banking markets. Supervisory failings have, since the onset of the banking crisis, significantly eroded confidence in the EU banking sector and contributed to an aggravation of tensions in euro area sovereign debt markets." See here.

"The effective impact and implications of the single supervisory mechanism on the operational functioning of the EBA will be further examined in the forthcoming review on the functioning of the European Supervisory Authorities to be presented by the Commission by 2 January 2014. In that context, the Commission will in particular examine whether the role of the EBA with regard to stress testing exercises needs to be strengthened, to avoid making the authority too dependent on information and contributions by those authorities competent for assessing the effective resilience of the banking sector across the Union." See here.

5 "Given pooled monetary responsibilities in the euro area and closer financial integration, there are specific risks in the euro area in terms of cross-border spill-over effects in the event of bank crises." See here.

"[P]ooled monetary responsibilities have spurred close economic and financial integration and increased the possibility of cross-border spill-over effects in the event of bank crises, and to break the link between sovereign debt and bank debt and the vicious circle which has led to over €4,5 trillion of taxpayers money being used to rescue banks in the EU." See here.

that may not be taken into account by national supervisors), it may be more prone to bailouts than national supervisors. There is in fact a precedent for the view that the ECB might be more favourable to bank creditors than national supervisors; whereas the Irish government was keen to impose haircuts on bondholders in Anglo Irish Bank, the ECB insisted that they be repaid in full.[6]

The likelihood of the ECB being a more lenient supervisor than national authorities is compounded by the greater resources it has at its disposal. One implication of our recent work (Allen et al. 2012; Gimber 2012) is that authorities with deeper pockets face a more severe commitment problem, since there is no more credible anti-bailout commitment device than being simply unable to pay. Since the marginal cost of bank bailouts would be lower if the necessary tax increases or spending cuts were spread across a larger population, the ECB would likely have fewer qualms about raising additional bailout funds than national governments.

We do not wish to downplay the threat of contagion, with which the Commission is rightly concerned. The history of the Great Depression and the literature on the financial accelerator tell us that banking panics can have devastating consequences for the real economy. However, the Commission should acknowledge that its objective of preventing contagion may be in conflict with its stated desire to make creditors (rather than taxpayers) bear the costs of bank failures under a single resolution mechanism.[7] An important lesson of the recent financial crisis is that bank runs by depositors are not the only source of banking crises. When banks and other financial institutions are dependent on short-term funding, rollover runs by nervous creditors can cause their liquidity to dry up very rapidly. Perhaps for this reason, the authorities have so far been generally reluctant to impose losses on creditors. As such, it is imperative that future proposals for a single resolution authority explain how losses could be imposed on

6 See here.

7 Under the proposed single resolution mechanism, "In particular shareholders and creditors should bear the costs of resolution before any external funding is granted, and private sector solutions should be found instead of using taxpayers' money." See here.

creditors while avoiding systemic risk, or acknowledge that taxpayer funds may indeed be required to prevent contagion.

The proposals appear to suggest that funds for deposit insurance and resolution could be raised by levies on the banks themselves. The principle of trying to link the size of such charges to the riskiness of banks is a laudable one from the point of view of trying to limit moral hazard. However, given the size of Europe's banking sector, it is unlikely that adequate resources for deposit insurance and resolution could be raised without recourse to taxpayer funds. In order to ensure the credibility of deposit insurance and resolution arrangements, it is important that European leaders make clear where such additional funds would come from. Moreover, explicit provisions should be made to deal with the debts of Eurozone banks which are already in trouble.

Although a banking union with shared funding of deposit insurance and resolution could weaken the link between a country's banks and its sovereign debt, it is impossible (in the absence of an ironclad commitment against bailouts) to break this link at the European level. Furthermore, the collapse of a country's banking sector would still have a deleterious effect on its fiscal position even if taxpayer-funded recapitalisations could be completely eliminated. Reinhart and Rogoff (2009) find that rescuing the banking system often does not cost very much compared to the drop in tax revenues and increase in government expenditures resulting from recessions following banking crises. The broader effects of a recession due to a collapse in credit could potentially be ameliorated by a banking union if it encouraged cross-border lending.

In conclusion, we think it is unrealistic to expect governments to totally avoid providing funds for bailouts. The devastating effect of contagion and other types of systemic risk on the real economy mean that relying on creditors alone is not a desirable policy. Putting the ECB in charge allows the externalities across borders within the Eurozone to be taken into account and that is desirable. Hopefully externalities with other EU countries not in the Eurozone will also be taken fully into account. However, this has to

be accompanied by clear and credible resolution procedures as well as burden sharing rules.

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