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THE EUROPEAN BANKING UNION HOW EFFECTIVE?

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The European Banking Union. How Effective?

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1.

The last meeting of the Council of the European Union reached an agreement on the main outlines of a package establishing a single supervisory mechanism (SSM)[1]. The SSM would include all Eurozone countries, leaving it open to other EU countries to join. The presidency of the Council is now enabled to start discussion with the European Parliament in order to reach a detailed agreement.

According to an early proposal by the Commission, the SSM should be the first step towards the creation of the European Banking Union (EBU), the other two pillars being a centralised banking resolution authority, endowed with a resolution fund, and a single insurance deposit scheme. The EBU crucially builds on the on-going re-regulation process leading to the incorporation of Basel III into the EU legislation (CRD IV/CRR), and aiming at the same time to produce a single rulebook and a single supervisory workbook across all EU Member States.

The EU authorities have explained this push towards increased centralisation and homogenisation in banking supervision with the need to break the vicious loop between sovereign and banking crises. The EBU, aided by stricter regulation, should save sovereigns from bank failures, and banks from sovereign crises. Ultimately, taxpayers and the economy should be shielded from both crises. The original plan by the Commission has encountered political difficulties and has been watered-down: only large banks will enter the SSM and the other two pillars are not seeing for now the green light.

Given that a large part of the political disagreement comes from how to treat the legacy problem, it is necessary to disentangle the way out from the current difficulties from the framework that would help the long-run viability of the EU-Euro construction. One thing is how to protect viable fiscal and banking structures from external shocks or from accumulating endogenous fragilities: transfers of resources across the Member Countries would only be eventual occurrences, much dependent upon the quality of the institutional and policy design. A different thing is to adopt a design that allows for transfers when imbalances and fragilities abound, many of which might yet not have been fully uncovered so that their effects might be of a magnitude that no sub-group of EU countries would be in the position to solve the regional problem by simply transferring resources. Added to resurgent national egoisms, this is why in the present situation the second and third pillar of the EBU,

[1] European Council, Brussels 14 December 2012 (EUCO 205/12), *Conclusions*, *http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/134353.pdf*

which imply putting mainly private national resources in common, are being postponed waiting for better days.[2] Hence, the transitional EBU will consist of the SSM and the European Stability Mechanism (ESM), whose participation, dependent upon political consensus, would be to recapitalise viable banks. Considering the limited resources and scope available to the ESM to tackle both sovereign and banking difficulties, for the time being the disconnection between sovereign and banking crises appears rather weak and time consuming.

2.

Apart from several criticisms that had been advanced to this partial solution, we should ask to what extent the full-fledged scheme initially proposed by the Commission[3] would produce the desired results.

The proposal of the Commission supposes that the following conditions are met. The translation of Basel III into EU legislation will produce bank resilience; the Commission and the EBA will be able to produce a single rulebook and a single supervisory handbook for the entire EU area; the EBA will be able to enforce the same rulebook and handbook in SSM and non-SSM countries; the ECB will make effective the single handbook inside the SSM area; the resolution authority will be able to resolve failing banks smoothly and with negligible costs for taxpayers, tapping the common privately funded resolution and deposit insurance funds. In other words, the goal of an effective level playing field for both regulation and supervision under the EU version of Basel III umbrella is reasserted, as well as the effectiveness of paraphernalia such as living wills and contingent debt for seamlessly winding down failing banks.

An appraisal of the proposal calls for an analysis of consistency and effectiveness of the entire construction.

The ability of a Basel III type framework to produce bank resilience is a highly questionable assumption. Even allowing that Basel III constitutes an improvement with respect to the previous release, this is not a guarantee given the many and serious weaknesses of Basel II. The problem does not only lie in the details. The new Accord deepens two contradictions inherent in the current regulatory approach. With the financial sector free to determine its own morphology, an effectively stronger bank regulation will strengthen the incentive for markets to shift financial activity elsewhere, making any Basel Accord less relevant for systemic resilience. More the capital and liquidity requirements are made sensitive to risks, more room we leave to the discretionary powers of supervisors, making the regulatory level

[2] Several years would be, however, necessary for these funds to accumulate significant resources.
[3] European Commission, Memo, Towards a Banking Union, Brussels, 10 September 2012 and "A Roadmap towards a Banking Union", Brussels 12.9.2012, http://ec.europa.eu/internal_market/finances/docs/committees/reform/20120912-com-2012-510_en.pdf

playing field just a joke. In addition, a bulky neo-Ptolemaic framework of regulation and supervision adds to costs and, if effective, cut gross profitability; for banking systems already suffering from structural low profitability, as we can find in many EU countries, this means increasing bank fragility and weakening banks in their support of the economy.

In the context of the Basel approach, the SSM derives its main operational attribute from the enforcement of single rulebook and supervisory handbook, produced by the Commission and the EBA. It should be quite easy to make some steps towards higher homogenisation starting from a situation in which the 27 EU countries adopted 27 different definitions of capital for a regulation based on capitalisation, and from marked differences in their approach to supervision. However, looking at what is in the process of being delivered, we are far away from what we should consider as single rulebook and handbook and from what officials define maximum harmonisation. Important national discretions remain, as for the definition of capital, and the same founding act of the EBA states that the technical standards it will produce must leave room for national specificities. Moreover, some countries, like the UK, are fighting hard to retain the previous method of minimum harmonisation. To a certain extent it was naïve to think of maximum harmonisation for a matter as complex as the Basel approach to prudential regulation, standing relevant differences in national legislations.

More in general, national heterogeneities in the EU are not an historical accident. One thing is working for making them weaker and physiological in a healthy heterogeneous environment; a very different and dangerous thing is behaving as if they did not exist. If national specificities exist, and are recognised to be of such relevance that they require abandoning *de facto* an effective regulatory level playing field, we must doubt why we have to stick to a framework based on that philosophy.[4] Montanaro and Tonveronachi (2012) show how relevant are national heterogeneities in the banking sectors across the EU and EMU countries and how ill served their economies would be by homogenous practices. From a social point of view, we need resilient non-systemic banks that finance the economy, not an approach that oblige to apply homogeneous rules to heterogeneous contexts. To be clear, it is quite acceptable for the EU countries to adopt a common regulatory framework. However, the nature of such a framework should allow specific standards to be adapted to the physiological specificities of national banks and economies.[5]

In the present regulatory context, where it is left to banks to decide if and how to serve the economy, the national discretions that will be allowed may not be always those that are physiological to the health of banking and the economy. The SSM will not change this outcome. Moreover, more the Commission, the EBA and the SSM

[4] Perhaps the question on national heterogeneities is even more relevant outside the boundaries of the EU.

[5] Montanaro and Tonveronachi (2012) present the outlines of such a framework. Resilient non-systemic banks, not necessarily homogeneous supervisory practices, are also what is strictly required to make effective the common monetary policy for the EMU countries subset.

will be allowed to enforce 'average' homogeneous rules and practices, current fragilities may not be dealt with, while distancing even more the banking activity from the necessities of the economy.

Actually, we may consider the intended strengthening of regulation and the single supervision (for large banks) under the aegis of the single rulebook and handbook as the political constraints necessary for accepting the single resolution authority and fund and the common insurance deposit scheme, i.e. just the other two pillars for which no agreement was reached up to now. Without entering into unavailable details, these two pillars, based on funding from the financial industry, should disconnect national sovereign debt from bank failures. This problem is particularly pressing in the EU given the huge size of many national large banks and banking systems in relation to national GDP. It is thought that, adding to the scheme rules that make unsecured debt liable for bank resolution, the pooling of private resources at the EU (or EZ) level would leave the common sovereign fund (the ESM) to easily manage the recapitalisations of reborn viable banks.

In other terms, the problems posed by the extra size are tackled by enlarging the cohort of payers, not by addressing the basic issue. However, as the tables below show, systemic risk would remain at dangerous levels.

Even discounting differences in accounting rules and the absence of investment banks from the US data, the weight of potential bank losses on GDP in the EU 12 is a large multiple with respect to the USA (Table 1). The recapitalisation of the EU banks for 1% of assets means a toll of 4% of GDP.

Table 1 – Bank assets / GDP, %

	2007	2008	2009	2010	2011
Austria		416	413	395	388
Belgium	470	410	349	323	310
Denmark		406	405	386	383
Finland		208	222	259	335
France	331	370	335	330	334
Germany		405	363	316	308
Ireland		906	830	754	750
Italy	173	175	178	178	177
Netherlands		504	462	461	481
Portugal	262	277	303	308	300
Spain		334	356	363	368
UK		473	613	596	637
EU 12		378	380	365	372
USA	77	86	83	81	82

Source: own calculations on data from ECB and Federal Reserve.

Not less worrisome are the results if we look at the largest banks. Table 2 shows that for many EU countries the present situation is not sustainable and how much they would eventually benefit from pooling resources at the EZ or EU level. However, the light would go from red to orange, not to green. It is then difficult to explain why the issue of bank size is so hotly debated in the USA, including conservative official circles, while is rarely mentioned in Europe.

Table 2 - Too big to fail and resolve, year 2011

Bank assets/Domestic GDP at current prices, %			
USA			
5 largest	56		
J. P. Morgan	15		
UK			
5 largest	413		
HSBC	109		
		Eurozone (17)	European Union (27)
Bank assets/Domestic GDP at current prices, %		Bank Assets/EZ GDP at current prices, %	Bank Assets/EU GDP at current prices, %
5 largest		91	78
Deutsche Bank (DE)	84	23	17
BNP Paribas (FR)	98	21	16
ING Group (NL)	212	14	10
Santander (ES)	117	13	10
Unicredit (IT)	59	10	7
Dexia (BE)	110	4	3

Source: Montanaro and Tonveronachi (2012).

Summing up, although marking an improvement with respect to the calamitous experience of the last decade, the design of the single rulebook, handbook and supervision has already encountered the limits posed by national heterogeneities. As far as the Financial Stability Board and the IMF will make their peer reviews effective, it is not to be expected a significant higher homogeneity of supervisory practices across the EU than at the international level. The new EU regulatory and supervisory frameworks are not much more than window-dressing in the effort to obtain the green light for pooling resources at the EZ-EU level. If it will be ever approved, this solution would be, again, an improvement with respect to the existent unviable situation in many EU countries, but not the solution for one of the main fragilities of the EU financial systems. On the contrary, adding further costs to the higher costs of re-regulation the effect could be to increase the overall fragility.

Higher capital and liquidity requirements, higher costs of compliance and the contribution to the resolution fund will make a significant dent into bank profitability. Formally extending to uninsured creditors the cost of bank resolutions will not help to decrease funding costs. Differently from the focus of the Basel approach, the long-term resilience of a bank comes from its perspective to earn enough income in the future to maintain adequate defences against adverse conditions, not from capital inherited from the past.

Table 3 shows the low profitability structurally characterising the generality of EU banking systems. From a social point of view, bank profitability should dynamically serve to finance the growth of the economy. Utilising the methodology presented in Montanaro and Tonveronachi (2012), I have performed a rough exercise computing the potential nominal asset growth rate coming from internal resources (PNAG), assuming a common 0.5 retention ratio and taking the average values of ROA after tax and leverage for the 1992-2007 period.[6] The result is then compared with the average rate of growth of nominal GDP for the same period (NGDP).

Table 3- Averages 1992-2007

	ROA, % Before tax	ROA, % After tax	Leverage	PNAG, %	NGDP, %
Austria	0.49	0.43	20.3	4.4	4.0
Belgium	0.46	0.35	31.8	5.6	4.1
Denmark	0.87	0.79	16.2	6.5	4.2
Finland	0.57	0.46	14.0	6.9	4.8
France	0.42	0.32	22.9	3.7	3.6
Germany	0.40	0.22	24.2	2.6	2.9
Ireland	1.09	0.84	18.5	7.8	10.6
Italy	0.80	0.47	14.6	3.4	4.5
Netherlands	0.67	0.50	25.9	6.5	6.1
Portugal	0.79	0.66	9.6	3.2	6.4
Spain	0.88	0.71	12.5	4.4	7.1
UK*	1.00	0.69	23.8	8.2	5.5
USA	1.67	1.13	11.4	6.4	5.5

* Large commercial banks.
Data source: OECD, Bank Profitability and National Accounts.

Given marked differences in ROA and leverage, and since the retention ratio is not a policy variable that banks direct at serving the demand for credit, the exercise shows how the disconnection between the growth of banks assets and of nominal GDP, fostered by the Basel approach, may produce in the long run either bank disintermediation or increased bankarisation. Despite the limits of the exercise, we may expect that a regulation affecting negatively both profitability and leverage would put the difference PNAG-NGDP in the negative for the majority of countries. The unwanted effect could be to make more countries dependent on foreign funding and give a further substantial push to shadow banking.

[6] PNAG = ROA after tax*Retention Ratio*Leverage.

3.

The assessment of the benefits of the Banking Union cannot be made solely referring to its formal institutional setup.

The convergence towards the single rulebook and handbook, both products of the Commission and EBA, was decided before the green light was given to the SSM and independently from it. It is an open question how much the SSM will make more effective the supervisory handbook within its affiliates. The exclusion from its surveillance of medium and small sized banks, the backbone of banking in many countries, does not augur well.

The future inclusion of EBU's second pillar, the central resolution authority and fund, would be a substantial addition for severing the link between bank and sovereign crises, but should be evaluated in terms of its negative effect on bank profitability, being additional to the already significant ones imposed by the re-regulation process. In addition, the fierce opposition against the third pillar, on the common deposit insurance, leaves taxpayers heavily exposed to local bank crises.

More specifically, the nature of the EBU much depends on that of the regulatory framework. Banks that are free to maintain and increase their already excessive and senseless size, that are free to take the type and quantity of risks they like, that are subject to the variable and uncertain use of discretionary powers by supervisors and react by lobbying and using innovations to elude regulation, cannot be said to be directed by regulation to best serve the economy. At the same time, banks must pay for this freedom with charges that are becoming oppressive, especially for 'physiological' banking. The SSM and the EBU would be different animals if based on a radically different approach to regulation. In the present regulatory context, hardly the EBU will make a significant difference for the goals for which has been thought. On the contrary, if used to enforce a stronger/costlier regulation based on a largely *laissez faire* system, it cannot but lead to a regulatory gruyere, possibly weakening banks with much satisfaction of the so-called shadow banking.

References

Montanaro E., Tonveronachi M. (2012), "Financial re-regulation at a crossroads: How the European experience strengthens the case for a radical reform built on Minsky's approach", forthcoming in *PSL Quarterly Review*, December.