CEPS COMMENTARY

Thinking ahead for Europe

An incomplete step towards a banking union

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At the beginning of the financial crisis, it was said that banks were "international in life, but national in death". At the time (2008-09), large international banks had to be rescued by the government of their home country when they ran into trouble. However, in Europe today, the problem is the opposite: banks are "national in life, but European in death".

In Spain, for example, the problem arises at the national level, where local savings banks (called '*cajas*') financed an outsized real estate boom. As the boom turned to bust, the losses threaten to overwhelm the capacity of the Spanish state, and the problem becomes European, as it threatens the very survival of the euro.

The Spanish case is symptomatic of a larger problem: national supervisors have always a tendency to minimize problems on their own turf. In the case of large international banking groups, the instinct (and the bureaucratic self-interest) of the home country supervisors is to defend their 'national champion' abroad. But the resistance of national supervisors to recognize any general problem at home is even stronger. This has become apparent again in Spain where the authorities have until very recently maintained that the problems in the real estate sector were temporary. If they were to admit reality, they would have to disqualify themselves because they would then have to confess that they had overlooked for years the build-up of a huge construction boom whose bust now threatens to bankrupt the entire nation. In the case of Ireland, the situation was initially not much different: when the problems first started to surface, the finance minister glibly exclaimed that this would be "the cheapest bank rescue ever".

Given this predictable tendency of national supervisors not to recognize problems at home, it seemed natural that the cost of cleaning up insolvent banks should also be borne at the national level. At first sight it thus made sense that even in the euro area banking supervision remained largely national, with only some loose coordination at the EU level. A European Banking Authority (EBA) was recently created, but it has only very limited powers over national supervisors whose daily work remains guided by national considerations.

But recent developments have shown that this approach, i.e. 'national problem and hence national responsibility for cleaning up', is not tenable. The problems might arise at the national level, but they quickly threaten the stability of the entire system.

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The need to rectify this situation has now finally been recognized by Europe's leaders who decided at their last summit that the responsibility for banking supervision in the euro area should be transferred to the European Central Bank. They naturally put the ECB in charge given that the integration of the financial system is particularly strong within the euro area. Moreover, the ECB is already de facto responsible for the stability of the euro area's banking system. But at present it has to lend massive amounts to banks without being able to judge their solidity because all the detailed information about the health of the banks is still in the hands of national authorities who guard this information jealously and have every tendency to pretend that there is no problem until it is too late. The ECB already de facto started to assume some supervisory power in a little-noticed step when it announced that government-guaranteed bank bonds would be accepted as collateral for new lending only if the bank draws up a funding plan indicating how it will be able to finance its operations without excessive recourse to the ECB.

Putting the ECB in charge would also help to stop the creeping disintegration process which is not publicly visible, but nevertheless very real. There are several cases of large international banking groups headquartered in countries that today are under financial stress. These groups are being torn apart by the conflicting pressures from national supervisors. Consider the case of a bank headquartered in Italy, but with an important subsidiary in Germany. The German operations naturally generate a surplus of funds (given that savings in Germany on average far exceed investment). The parent bank would of course like to use these funds to reinforce the liquidity of the group. But the German supervisory authorities consider Italy at risk and thus oppose any transfer of funds from the German subsidiary to the Italian headquarters. The supervisor of the home country (Italy) has of course the opposite interest. It would like to see the 'internal capital' market operate as fully as possible. Here again it makes sense to have an institution in charge that is neutral with respect to these competing interests, like the ECB.

Putting the ECB in charge of banking supervision thus solves one problem. But it creates another: Can one still hold national authorities responsible for saving banks that they no longer supervise? The report of the de Larosière group,[1] which in 2009 became the basis for the creation of the EBA and the European Systemic Risk Board (ESRB), argued that the ECB should not be involved in 'micro' supervision mainly because banking rescue and resolution involves taxpayers' money, which they assumed had to be national.

Economic (and political) logic thus requires that the euro area will soon need also a common bank rescue fund. Officially this is not yet fully acknowledged, except for a hint in the Euro Area summit statement of June 28-29th, which says that once a system of supervision involving the ECB has been created, it would become possible for the permanent rescue fund, the ESM, to inject capital into banks. European integration has often proceeded in this incremental fashion: an incomplete step in one area later requires further integration in related areas. This method has worked well in the past: indeed, the European Union of today is the result of such a process. But a financial crisis does not give national leaders the time they used to have to explain to their electorates why one step required another. They will have to walk much more quickly if they have any hope of saving the euro.

[1] Report of the High-Level Group on Financial Supervision in the EU, 25 February 2009 http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf)