

Banking Union for Europe: Where do we stand?

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Banking Union for Europe

Risks and Challenges

Edited by Thorsten Beck



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Banking Union – the new kid on the block? Or a mis-behaving teenager?

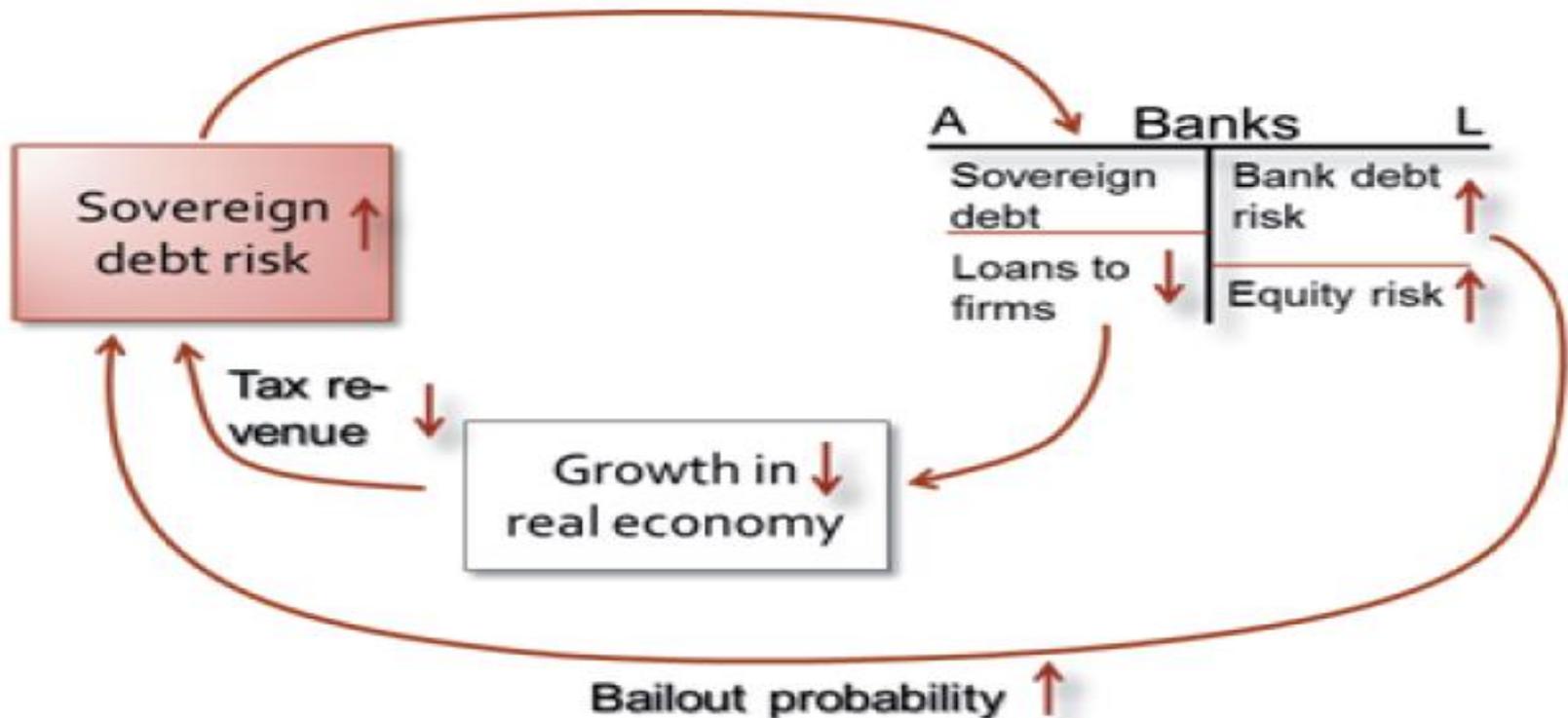
- Crisis development can be followed via buzz words
 - Remember fiscal compact, growth compact, big bazooka? LTRO, OMT...
 - Banking union seemed the latest buzz word in 2012
 - ...but this one seems to stay with us
 - But what kind of banking union? For whom? Financed how? And managed by whom?
 - What have we learned over the past few years?

The main messages

- No piecemeal approach! Centralizing supervision alone is not only unhelpful but might make things worse!
- A banking union is part of a larger reform package that has to address sovereign fragility and the entanglement of banks with sovereigns.
- Immediate crisis resolution vs. long-term reforms
- Bank resolution and banking union critical part of growth compact

1. Plus ca change, plus c'est la meme chose

- Many special cases!
- One common thread: close ties between government and banks



2. A deposit insurance scheme is only as good as the sovereign backing it

- Deposit insurance is for idiosyncratic bank failures
- In case of systemic bank crisis: needs public back-stop funding
- What if fiscal situation does not allow it?
- Need for Eurozone-wide deposit insurance, with back-stop funding by ESM

3. A currency union with capital controls?

- Cypriot Euro that cannot be used outside Cyprus contradicts idea of currency union
- Transitory, or beginning of the end?
- Precedence?
- Symptomatic for disintegrating European banking and capital market
 - Need for Eurozone supervisor

4. If you kick the can down the road, you will run out of road eventually

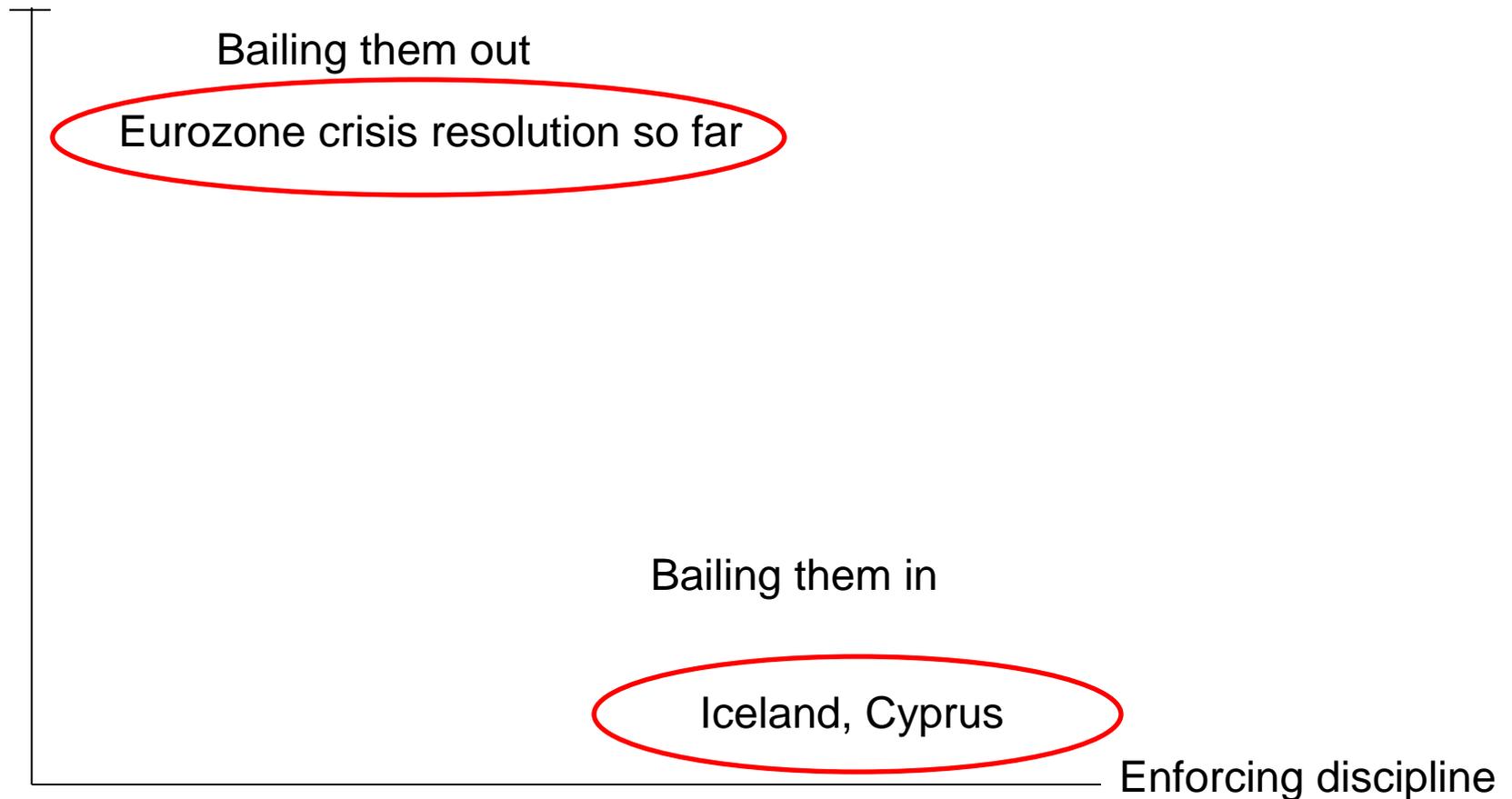
- Not recognizing losses and allocating them risks increasing losses further
- Greece, Cyprus.....
- Eurozone

5. The Eurozone crisis – a tragedy of commons

- Interest to share the burden, through ECB's liquidity support or Target 2
- Eurozone decisions are sum (or smallest common denominator?) of national interests
- Nobody internalizes externalities
- No Eurozone authority

6. Learning from the Vikings

Minimizing external costs



7. Learning from the U.S.

- US history suggests large gains from buffering currency unions with a union-wide deposit insurance, and partial debt mutualisation...
- ... but it is a long process: 12 systemic banking crises over 200 years, lots of failed deposit insurance schemes and lots of institutional experimentation, even after introduction of FDIC
- Eurozone crisis is a governance crisis! Lots of representatives of national interests (typically cut along creditor/debtor lines)
- Who represents the Eurozone?

8. Banking union with just supervision does not work

- Centralizing supervision alone, while leaving bank resolution and recapitalization at the national level, is not only unhelpful but might make things worse
 - Supervision without consequences
 - Walking zombies that cannot be resolved
 - Cannot solve vicious cycle between bank and sovereign fragility
- Banking union for all financial institutions, not just large institutions
 - Monetary and financial stability linked through systemic channels, not just large institutions

9. A banking union is needed for the Eurozone, but won't help for the current crisis!

- Status quo: short-term fixes with enormous pressure and burden on ECB and piece-meal approach to long-term reform
- BUT: Urgent need to address banking and sovereign fragility – transitional solutions
 - Suggestion: European Recapitalization Agency?
 - Banking union takes longer time to build necessary institutional framework
- Don't mix crisis resolution with long-term reforms
 - Introducing insurance after the accident
 - Distributional fights
 - Political sensitivity

10. Finally, there is no free lunch

- Dutch savers attracted by high interests in Icesave
- Cypriot banks piling up on Greek government bonds promising high returns even in 2010
- Zero risk weights for government bonds and no concentration limits might be good in the short-term for government funding (“Sarkozy-trade”), but the risk is still there!

In summary

- No sustainable Euro-zone without an effective and complete banking union
- Banking union will NOT help us for the current crisis

Implications for SSM and AQR?

- Who will set criteria for asset quality review?
- What if.....
 - The zombies are being outed?
 - Capital levels are lower than expected?
- Who will resolve the weak banks?
 - National level, with ESM funds? Incentives?
 - European level – temporary structure?

Thank you

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