Banking Union, Properly Structured

BY JENS WEIDMANN

The concurrence of crisis management and regulatory policy.

In the third year of the sovereign debt crisis, policymakers in Europe still face two challenges. First, they have to solve the current crisis. And second, they must make the structure of European monetary union more stable. Of course, these two challenges are interconnected, since the short-term measures taken to solve the crisis must not clash with what is important for the stability of monetary union in the long term. This means that what we need is indeed a meaningful "concurrence of crisis management and regulatory policy."

The Bundesbank has pointed to two paths towards stable monetary union. One leads via an improved Maastricht framework in which national ownership is increased—meaning countries are to decide for themselves, but must themselves also bear the consequences of their decisions. The second way leads via a fiscal union under which substantial national sovereignty would be transferred to the European level.

However, it does not look at present as if policymakers will be taking either of these paths with any great commitment. In the wake of the crisis, joint liability has expanded considerably, representing a move away from the Maastricht framework. At the same time, however, little willingness is being shown to cede national core powers. Thus, monetary union is not moving much closer to fiscal union, either. If we are to achieve a coherent structure, therefore, the main foundations still have to be laid.

Although the future architecture of monetary union remains unclear, work on a new financial market architecture is making progress—in the shape, above all, of the European banking union. This activity is well justified for, whichever of the two paths monetary union will take, a considerably more stable financial system will be needed with rules that will

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strengthen above all investors' individual responsibility. But thoughts differ on the purpose and design of the banking union project, too. In my view, at least, the banking union can play a central role in a stable monetary union. Let us examine this idea more closely, and begin by asking what the fundamental concept behind a banking union is.

For monetary union, the financial system is an open flank.

CONNECTION BETWEEN SOVEREIGN DEBT CRISIS AND PRIVATE DEBT CRISIS

For monetary union, the financial system is an open flank. The crisis has made that quite clear. The financial system played an important part in creating the economic imbalances in the crisis-stricken countries and in the massive rise in private debt and government debt that accompanied it.

Prior to the crisis, the economic prospects of several countries were drastically overestimated. When these expectations had to be revised, doubts increasingly arose as to the sustainability of their debts and their ability to repay the loans they had been granted. And although these doubts initially centered on the creditworthiness of households, enterprises, and in some cases governments, the banks, too, quickly attracted attention given their role as financial intermediaries. After all, banks' balance sheets are always a reflection of their respective economies. Another factor was that not all national banking systems were prepared for a crisis to begin with. And because of the systemic dangers involved, the risks of the banking system became the risks of the government that had to come to the rescue. Ireland, for example, had a balanced budget before the financial crisis. During the crisis, the deficit then grew to stand for a time at more than 30 percent of economic output. At the same time, however, problems in public finances also impose a strain on the banking sector. For instance, the Greek haircut for private investors tore gaping holes in the balance sheets of Greece's banks.

When this feedback effect threatens the financial stability of the entire monetary union, the result can also be to burden taxpayers in the other member states as well as the single monetary policy—just think of the rescue packages or the non-standard monetary policy measures implemented by the Eurosystem. These risks that can spread from the financial system to monetary union were certainly underestimated before the crisis.

To communitize these legacy burdens through a banking union would constitute a financial transfer.

BANKING UNION: AN APPROPRIATE RESPONSE?

The question, therefore, is how such risks can be more effectively limited in the future. Essentially, there are two approaches to solving this question. The first approach takes steps to ensure that such a dangerous situation does not arise in the first place—be it for banks or for the government.

But situations of distress cannot be entirely prevented. There can and must be no guarantee of continued operation for, say, individual banks in a market economy. That is why steps must also be taken to ensure that at least the vicious circle of weak banks dragging down weak sovereigns and *vice versa* is broken. This principle of two lines of defense is not new. It has been the basis of the reform of financial market regulation thus far.

Coming back to the specific question we are looking at, a banking union should therefore ensure that fewer crises arise within the banking system that could potentially overburden the public finances of the member states directly affected, and subsequently cause problems for the rest of the euro area and for the single monetary policy. A banking union should also guarantee that monetary union is better equipped to deal with crises that cannot be prevented.

In keeping with these two lines of defense, debate currently centers on two components of a European banking union: common banking supervision, and a common restructuring and resolution mechanism for banks. A third component under discussion is a common deposit protection scheme. However, that has slipped out of the spotlight somewhat—and, I would say, rightly so.

Let me start with common supervision and the advantages it offers. I consider four of them to be especially important:

■ First, common supervision increases the transparency of national banking systems. And in particular, more transparency means less uncertainty about the possibility of hidden risks.

■ Second, common supervision is likely to make national banking systems less likely to become swept up in the fiscal problems of their respective domestic governments. This is because it is easier for a supranational supervisory authority than national supervisors to intervene when domestic banks are co-opted to provide overly cheap loans to the government or to households.

■ Third, common supervision ensures that the same high standards are applied everywhere and, therefore, that competitive conditions, too, are the same. The concentration of excessive risks in banks' balance sheets, the emergence of hypertrophic banking systems, and the financial crisis as a whole were aided and abetted, amongst other things, by differences between individual countries regarding the strictness of their prudential supervisory regimes.

■ And fourth, common banking supervision also facilitates measures to deal with cross-border systemic effects. This, too, would have gone a considerable way towards preventing the current crisis, and would have helped to deal with it more effectively.

In sum, common supervision could make the banking system more resilient and crises less likely. This would take considerable strain off both the public finances of all member states and the single monetary policy.

Yet common supervision cannot of course prevent every case of distress in the banking system. This is where the second component of a banking union enters the picture: the common restructuring and resolution mechanism, which facilitates the orderly resolution of distressed banks. This spares the government the considerable expense of a bank rescue operation, and shields monetary policymakers from demands that they make a contribution to stabilization that could come into conflict with their main mission, namely price stability.

It almost goes without saying that, in the event of the resolution of a distressed bank, first the owners and creditors of that bank must be made liable. The costs that arise when a bank becomes distressed must not be passed on primarily to the taxpayers of the country in question—far less to those of other member states. For this reason, there is a lot to be said for setting up a dedicated fund to which the supervised banks have to make payments. The costs of restructuring or resolving a bank could then be reimbursed mainly from the fund's coffers, making only subsidiary recourse to taxpayers necessary, that is, if it looks as though the fund will be overstretched.

Steps must be taken to ensure that at least the vicious circle of weak banks dragging down weak sovereigns and vice versa *is broken.*

Getting the design of the banking union right is a precondition for success.

The key components of a banking union, then, are common supervision and a common restructuring and resolution mechanism. They would help to loosen the close interconnectedness between the banking system and public finances. However, the actual design of a banking union is crucial. A number of points have to be borne in mind in this respect.

■ First, the banking union should not overshoot the mark with regard to the Europeanization of competences. National responsibility can remain in place whenever risks can be borne at the national level and no risks exist for the taxpayers in other member states.

■ Second, the guiding principle of stability-oriented monetary union must also apply to the banking union. A balance must be maintained between liability and control. If the European level is collectively liable for risks, it must also have shared powers of intervention and control.

■ Third, common supervision and a common restructuring and resolution mechanism also call for decision-making guidelines. This is particularly true in times of crisis, when pressure grows to redefine discretionary leeway on an *ad hoc* basis. For this reason, clearly defined objectives and appropriate and verifiable procedural rules are necessary.

■ Fourth, the banking union has to be neatly dovetailed into a coherent overall framework for monetary union.

To explain that last point in more detail, a change of perspective is necessary. The banking union focuses on problems emanating from the banking system. But what about the dangers to the stability of the banking system that emanate from public finances or the economy as a whole? This is an issue where microprudential policy overlaps with macroprudential policy and with the fiscal and economic policy framework of European monetary union, and two lines of defense can be drawn here, too. It is possible to lower the likelihood of such undesirable developments, particularly in fiscal policy, and to limit the effects they have on the banking system.

To lower the likelihood of difficulties in public finances, the banking union needs to be accompanied by

The banking union can play a central role in a stable monetary union.

European-level powers of fiscal policy intervention to be used if a member state persistently violates the European rules or the conditions tied to the financial assistance programs. At the same time, this would reduce the danger that problems in public finances could be passed on to the taxpayers of the euro area through the mechanisms of the banking union. If the main purpose of the banking union were, ultimately, to introduce extensive joint liability through the back door, thereby giving the government more leeway to incur debt, this would be a disservice to monetary union. Such a danger does exist, and I believe we should not take it lightly.

Along the second line of defense, the banking system needs to be better protected from the fallout of public finance problems. The regulatory reforms implemented so far, which likewise serve to make the financial system more resilient, already play an important part in this respect. But over and above that, banks need to be more strongly reined back from the tendency to expose themselves to excessive government solvency risks. To this end, the banking union must be accompanied by further regulatory measures. I consider two to be of particular importance, and the aim of both, ultimately, is to end the practice of giving claims on the government preferential treatment over other balance sheet assets. First, an upper limit or a kind of large exposure cap needs to be imposed on individual banks' exposure to sovereign debt. Second, banks need to back government bonds or loans to the government with equity capital.

Backing government bonds with capital would result in a further advantage, namely that price signals would be sent out earlier if indications arose of an unsound development in public finances—giving rise to pressure to consolidate. This requirement, paired with common supervision, would prevent a situation in which governments continue to receive cheap credit despite budget difficulties, thereby plunging not just themselves but also the banks into even greater budgetary problems.

The importance of setting the barriers higher in this respect is illustrated by current developments. It's the done thing nowadays to criticize the close interrelationship between public finances and national banking systems. Yet individual countries, being financially strapped, are still encouraging domestic banks to buy more and more of their own government's bonds. This is a good, but also worrying, example in that it clearly illustrates how short-term attempts to combat the crisis are not compatible with what is needed in the long term.

CONCLUSION

If properly structured, a banking union can be an important building block, or even a pillar, of stable monetary union. But is it also the key to solving the crisis? No, it is not, and to expect that would be to demand too much of it. The banking union is a future-oriented concept whose purpose should be to help prevent future risks or at least to help deal with them better.

However, the present problems affecting the banking system are the result, above all, of past undesirable developments at the national level. The risks in the balance sheets arose on the watch of national authorities, and the respective member states have to deal with them. This is the only way to maintain a balance of liability and control. To communitize these legacy burdens through a banking union would run counter to the purpose for which the banking union was established: it would then constitute a financial transfer. If policymakers believe that transfers of this kind are necessary, then they should also refer to them as such. In some countries, national fiscal policy could certainly bear the balance sheet legacy burdens; in other cases, the rescue mechanisms would be at the ready to grant conditional financial assistance. What is more, the expectation that legacy problems can be passed on to the future banking union and, therefore, to the other member states threatens to protract the reform process in the banking system. This is because it could then be worthwhile for those affected to put off cleaning up banks' balance sheets until the banking union is in place.

But since the banking union is a concept for the future and because it cannot, moreover, solve the current crisis, it should be introduced in a timely fashion but not over-hastily. From a conceptual perspective, the banking union is a much-needed addition to monetary union, but its implementation faces many hurdles and raises a number of questions:

- What banks should be subjected to common supervision? Only the systemically important banks, or all of them?
- How will the banking union include countries that are not part of monetary union but are members of the European Union and, therefore, of the single market?
- How will the common resolution and restructuring mechanism draw on taxpayers' money?
- What form will the EU legal framework for the banking union take?

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■ How can we make sure that the sovereign tasks of banking supervision are adequately legitimized and are subject to parliamentary control?

■ What is the banking union's position *vis-à-vis* other policy areas, in particular macro-prudential policy and monetary policy?

Many of these questions will be even more pressing if the European Central Bank is made responsible for banking supervision. The banking union has to ease the pressure on the single monetary policy—but in terms of practical implementation, conflicts of interest between banking supervision and monetary policy persist. In fact, the risk of such conflicts already played a major role in Germany when there were plans for a banking supervision under the umbrella of the Bundesbank.

That is why both functions have to be strictly segregated. Though feasible, such segregation would be difficult to realize—difficult from an organizational perspective as well as legally. Another challenge is that, on the one hand, supervisory decisions must at least be subject to indirect parliamentary control; but on the other hand, the central banks' independence must not be undermined. And in connection with the legitimization of supervisory decisions, there is the question of voting modalities. Since decisions of this kind can also entail fiscal costs, the only logical answer would be to weight votes, for instance in accordance with capital shares.

I am convinced that we must answer these questions if the banking union is to prove a success—and it will be possible to answer them. The banking union is not a remedy for acute problems, but constitutes regulatory policy in the best sense. It offers the opportunity to add an important pillar to the monetary union structure, thereby safeguarding monetary union as a community of stability. And that should be our prime objective. ◆