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What kind of European banking union?

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WHAT KIND OF EUROPEAN BANKING UNION?

JEAN PISANI-FERRY, ANDRE SAPIR, NICOLAS VERON AND GUNTRAM B. WOLFF

Highlights

• This policy contribution discusses in detail how the transition from the current state to a future banking union could be organised.

• There are seven fundamental choices that decision makers will need to make:
  - Which EU countries should participate in the banking union?
  - To which categories of banks should it apply?
  - Which institution should be tasked with supervision?
  - Which one should deal with resolution?
  - How centralised should the deposit insurance system be?
  - What kind of fiscal backing would be required?
  - What governance framework and political institutions would be needed?

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WHAT KIND OF EUROPEAN BANKING UNION?

JEAN PISANI-FERRY, ANDRE SAPIR, NICOLAS VERON AND GUNTRAM B. WOLFF, JUNE 2012

ABSTRACT

This paper discusses the creation of a European Banking Union. First, we discuss questions of design. We highlight seven fundamental choices that decision-makers will need to make: Which EU countries should participate in the banking union? To which categories of banks should it apply? Which institution should be tasked with supervision? Which one should deal with resolution? How centralised should the deposit insurance system be? What kind of fiscal backing would be required? What governance framework and political institutions would be needed?

In terms of geographical scope, we see the coverage of the banking union of the euro area as necessary and of additional countries as desirable, even though this would entail important additional economic difficulties. The system should ideally cover all banks within the countries included, in order to prevent major competitive and distributional distortions. Supervisory authority should be granted either to both the ECB and a new agency, or to a new agency alone. National supervisors, acting under the authority of the European supervisor, would be tasked with the supervision of smaller banks in accordance with the subsidiarity principle. A European resolution authority should be established, with the possibility of drawing on ESM resources. A fully centralised deposit insurance system would eventually be desirable, but a system of partial reinsurance may also be envisaged at least in a first phase. A banking union would require at least implicit European fiscal backing, with significant political authority and legitimacy. Thus, banking union cannot be considered entirely separately from fiscal union and political union.

The most difficult challenge of creating a European banking union lies with the short-term steps towards its eventual implementation. Many banks in the euro area, and especially in the crisis countries, are currently under stress, and the move towards banking union almost certainly has significant distributional implications. Yet it is precisely because banks are under such stress that early and concrete action is needed. An overarching principle for such action is to minimise the cost to taxpayers. The first step should be to create a European supervisor that will anchor the development of the future banking union. In parallel, a capability to quickly assess the true capital position of the system’s most important banks should be created, for which we suggest establishing a temporary European Banking Sector Task Force working together with the European supervisor and other authorities. Ideally, problems identified by this process should be resolved by national authorities; in case fiscal capacities would prove insufficient, the European level would take over in the country concerned with some national financial participation, or in an even less likely adverse scenario, in all participating countries at once. This approach would require the passing of emergency legislation in the countries in question that would give the Task Force the required access to information and, if necessary, further intervention rights. Thus, the principle of fiscal responsibility of the individual member states for legacy costs would be preserved to the maximum extent possible and, at the same time, market participants and the public would be reassured that adequate tools are in place to address any eventuality.
THE CONCEPT OF EUROPEAN BANKING UNION WAS RECENTLY ENDORSED by European leaders as a component for solving the euro crisis. In order to “strengthen economic union and make it commensurate with the monetary union”, the European Council on 23 May asked President van Rompuy and other top European officials to identify “building blocks”, among which “a more integrated banking supervision and resolution, and a common deposit insurance scheme” – in short, a banking union. On 19 June the G20 leaders expressed support for “the intention to consider concrete steps towards a more integrated financial architecture, encompassing banking supervision, resolution and recapitalization, and deposit insurance”.

The rationale for a banking union complementing monetary union is straightforward. Europe’s Economic and Monetary Union (EMU) was constructed on the basis of two pillars: a monetary pillar with the independent and price-stability oriented European Central Bank (ECB), and a fiscal pillar oriented towards fiscal discipline with a modicum of coordination. It has no financial policy component apart from the ban on capital controls and the promotion of a single market for financial services, both of which apply to the whole EU, and it has no banking component, apart from those arising from the operation of monetary policy and the common banking regulation and common standards on deposit insurance. The ECB itself has few financial stability competences.

Even before the crisis there were reasons to question whether this bare-bones model was sufficient. It was known that there was an inherent contradiction between pan-European banking and exclusive national responsibility for bank crisis resolution. Recent developments have exposed further weaknesses:

• First, the previously integrated euro-area financial market has entered a process of fragmentation. Capital that was supposed to move across countries has stopped flowing from North to South, which has resulted in within-EMU surprise balance-of-payment crises. Banks that were European in quiet times have become national in crisis times as they depend on national governments for support. Furthermore, they have been encouraged by national authorities to cut cross-border lending. This is understandable from a national viewpoint, as taxpayers have little reason to pay for the consequences of imprudent lending to foreigners, but is lethal for the euro-area financial market. Integration of the interbank market is on the retreat within the euro area. This, in turn, has increased the exposure of the ECB that has become a financial intermediary replacing the interbank market.

• Second, there has since 2008 been a strong correlation between banking and sovereign solvency crises. Especially but not only in Greece, Ireland, Spain and Italy, sovereign solvency concerns have affected banks and bank solvency concerns have affected sovereigns. The reasons for this correlation include a strong home bias in the composition of banks’ sovereign bond portfolios, the sovereigns’ individual responsibility for bailing out banks, and the increasingly apparent re-emergence of country risk. This two-way correlation creates vicious circles that the ECB cannot quell, because a federal central bank cannot be mandated to assist particular sovereigns and because the ECB cannot address solvency concerns and stay committed to its primary target.

• Third, the crisis has made it increasingly clear that a fragmented approach to banking policy renders it more difficult to minimise losses to taxpayers. Asset ring-fencing and risk-shifting result in coordination failures that increase the overall public cost. Furthermore, individual countries may either be prevented by neighbours from imposing losses on bondholders for fear of contagion, as was the case of Ireland in late 2010; or if they impose losses, their other domestic banks risk being at a disadvantage in the integrated European market, a fact that led Denmark to amend its policy framework to make it more creditor-friendly in 2011.

These developments undermine the foundations of monetary union and call into question its very rationale. They explain why the banking union theme has emerged as one of the key ways to respond to the incompleteness of EMU. Centralising responsibility for deposit insurance, bank supervision and crisis resolution would contribute to its resilience by cementing financial integration and reducing the potential for

4. See for example Gerlach, Schulz & Wolff (2010).
5. See Pisani-Ferry (2012).
correlation of sovereign-banking crises.

To create a banking union is, however, a step of high significance with major ramifications for financial integration within the euro area, public finances, governance and, ultimately, political integration. It requires very careful design and involves many choices, both as regards the steady state and the transition to it.

The aim of this paper is to review choices and assess alternatives. We start in section 1 with overall considerations on the principles of banking policy. We then draw an outline of what a European banking union would be in section 2, and review in section 3 the key choices and options involved. We take up transition issues in section 4. Conclusions are presented in section 5.

1 PRINCIPLES OF BANKING POLICY

The central purpose of banking policy is to ensure a proper functioning of financial intermediation exercised by the banking system. To achieve this goal, banking policy aims to prevent banking crises and, when a crisis occurs, to intervene to prevent the crisis of an individual bank giving rise to a crisis of the banking system. To ensure proper crisis prevention and management, a widely shared view of banking policy describes it as resting on four pillars: regulation, supervision, deposit insurance and bank resolution.

- **Banking regulation** aims to increase the resilience of banks to shocks and, ultimately, to reduce the externality resulting from the fact that bank failures can impose large losses on society that may lead governments to bail out bank creditors. Other aspects of banking regulation, such as on preventing money-laundering or consumer protection, are motivated by other considerations than financial stability.

- **Bank supervision** allows governments to closely monitor banks’ activities and risk-taking to ensure that they are managed in a prudent way, and to check the build-up of risk. As with regulation, its ultimate aim is to prevent financial instability and minimise risks to the taxpayers. It can involve significant reporting requirements and be intrusive with supervisors permanently embedded in supervised banks’ premises.

- **Deposit insurance** is intended to counter the threat of a bank run by protecting the value of deposits. Depending on countries, it can be either pre-funded by the financial industry through a dedicated fund, or post-funded as a consequence of crises. It always has implicit or explicit government backing, because even large pre-funded insurance may be insufficient to cover certain extreme crisis scenarios.

- **Bank resolution authority and capacity** should allow for the resolution of banks without severe systemic disruptions and ideally also without exposing the taxpayer to losses. The US Federal Deposit Insurance Corporation (FDIC)’s resolution authority that has developed since the 1930s for depositary institutions is an early example. If a resolvability assessment concludes that a financial institution is no longer viable, the resolution authority should have strong powers to stabilise the core functions of systemic importance, in particular deposits and essential intermediation functions; to preserve the value of assets by preventing fire sales; to force junior and senior unsecured creditors to share losses, with debt restructuring, debt-equity swaps and “bail-ins” among the possible instruments. While the crisis has spurred increasing international consensus on the desirability of a special resolution regime for financial institutions and the key attributes it should include (FSB, 2011), many countries, including some in the EU and euro area, still lack such a policy framework. The European Commission has recently made proposals that would partly harmonise this policy area across the EU (European Commission, 2012).

The four pillars are highly connected. To be effective, strong political authority and executive capacity are needed. Decisions taken by the supervisory and resolution authority often imply significant distributional effects and may also imply significant risks to the public purse. These authorities must therefore be legitimised and held accountable, which typically involves carefully designed governance and active parliamentary oversight. The division of labour between central banks, supervisors and finance ministries differs across countries, even though the central bank always plays an important role as the ultimate provider of liquidity, not only in case of a (systemic) bank run but also in the period during which the relevant authorities make an
assessment of solvency and resolvability of a bank.

Banking policy in federations is organised at different levels depending on the degree of fiscal, political and economic integration. Box 1 summarises the cases of the US, Canada, and Switzerland.

2 A EUROPEAN BANKING UNION

The EU has a more integrated banking policy framework than any other existing regional arrangement, but even so most policy instruments remain at the national level. Regulation is increasingly harmonised following successive banking directives, the Financial Services Action Plan of 1999, and more recent moves towards the formation of a “single rulebook”, but some regulations remain set at the national level as illustrated by the Vickers Commission proposals in the UK. Supervision is mostly national, even though the creation of the European Banking Authority (EBA) in 2011 has strengthened coordination and mediation mechanisms. Deposit insurance is only partly harmonised: a minimum coverage of EUR 100,000 was introduced in 2009, but deposit insurance systems, structures, and funding patterns vary widely across member states. Crisis resolution is national: many member states have not yet introduced a special resolution regime for banks, and the coordinating role of the EBA in this area remains untested. In addition, the European Systemic Risk Board provides EU-wide macroprudential oversight. Liquidity policy for banks is exercised at the euro area level by the European Central Bank, but the Eurosystem’s national central banks retain the capacity to engage in national Emergency Liquidity Assistance (ELA) and have recently been given additional discretion for collateral assessment.

Given this current allocation of responsibilities, a long-term vision for a European banking union

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**BOX 1: BANKING POLICY IN FEDERATIONS**

In the US, the FDIC covers all deposits in banks and savings associations, whereas deposits in credit unions are insured by the National Credit Union Administration (NCUA). Both are organised at a federal level and backed by the United States government. The FDIC also acts as the resolution authority for depositary institutions, and the Dodd-Frank Act of 2010 grants similar authority over systemically important non-bank financial institutions. Federal-level supervisory functions are divided between the Federal Reserve, the Treasury’s Office of the Comptroller of the Currency (OCC), the Securities and Exchange Commission (SEC), and the NCUA. Most of the banking system is subject to federal regulation even though some banks are chartered and regulated at the state level. The OCC is the primary federal regulator of national banks. The primary federal regulator of state-chartered banks is the Federal Reserve Board if they are members of the Federal Reserve System, and the FDIC otherwise.

In Canada, the Canada Deposit Insurance Corporation (CDIC) coexists with provincial deposit insurances. Coverage of the provincial deposit insurance varies by province. Provincially chartered credit unions cannot become members of the CDIC. In terms of regulation and supervision, the federal level plays a strong role with the Office of the Superintendent of Financial Institutions (OSFI), which is separate from the Bank of Canada, and the CDIC. Securities dealing activities are regulated at a provincial level and there is no national securities regulator.

In Switzerland, the federal level exercises most banking policy competencies. The Swiss National Bank (SNB) oversees systemically important payment and securities settlement systems. The main bank supervisor is the Swiss Financial Market Supervisory Authority (FINMA), which also supervises cantonal banks and is separate from the SNB. However, some cantonal banks have their liabilities guaranteed by the canton beyond the national deposit insurance guarantee. The national deposit insurance fund is financed ex-post and limited by law to CHF 6bn. There is no explicit government backstop to the deposit insurance system.
would entail the following main building blocks:

- **European banking regulation.** As this area is already substantially harmonised, changes would be more limited than for the following three items. Even so, progress is needed to achieve the vision of a “single rulebook” (de Larosière, 2009). One important new element might be the introduction of a European banking charter, which would allow pan-European banks to compete on a truly level playing field (Cihak & Decressin, 2007).

- **European supervision.** This is made necessary both by the need to effectively supervise banking operations that are integrated on a cross-border basis, and to counter the incentives for national supervisors to overlook excessive risk-taking by banks in their jurisdiction if deposit insurance is moved to the European level. Unlike today’s EBA, the European supervisor would need direct authority over supervised entities in order to properly carry out its duties.

- **European deposit insurance.** The scheme would be financed by contributions from the participating banks. This would amount to pooling risk across banks in all participating countries and increase the potential for dealing with country-specific, region-specific or bank-specific crises. However, deposit insurance can never cover all possible risk scenarios, which is why it must be at least implicitly backed by a second, inherently fiscal line of defence. A European deposit insurance system would therefore entail some European-level fiscal capacity.

- **European resolution authority.** This is needed to prevent the combination of national crisis management decisions from resulting in excessive and avoidable cost to taxpayers in Europe, including as regards burden-sharing with creditors as discussed in the previous section.

Once again it is important to realise that in a steady state, the different pillars of a banking union cannot be separated from each other, nor are they fully separate from parallel advances towards fiscal and political union. If not backed up by fiscal support, a European deposit insurance scheme would not help deal with major banking crises. It could even blur responsibilities and make things worse. Without a centralised resolution authority, real-time decisions would be made in a disorderly manner at the national level, as committees based on consensus could not act at the required speed. Equally, without European supervision, moral hazard would undermine the common insurance scheme and make it prone to distributive biases. It is only by pooling competences in all areas that the banking union would be able to strengthen the system. By the same token, such a transfer amounts to a significant devolution of responsibility to the European level, which makes it imperative to strengthen the accountability and legitimacy of European-level decision-making from a democratic standpoint.

### 3 KEY CHOICES FOR THE DESIGN OF A EUROPEAN BANKING UNION

The creation of a banking union is an ambitious and complex endeavour, in some respects no less ambitious and complex than the creation of monetary union itself. It will take time to achieve and is likely to require multiple successive steps. The essential choices that will shape its steady-state form can be summarised along seven axes:

1. Which countries should participate in the banking union?
2. To which banks should it apply?
3. Which institution(s) should be tasked with supervision?
4. How should bank resolution authority be assigned?
5. How centralised should the deposit insurance system be?
6. How should fiscal backing be organised?
7. What governance framework should be put in place?

In what follows we successively review and discuss these seven choices.

**1. Which member states?**

As indicated in the introduction, there is a strong rationale for creating a banking union for the euro area, as the way the crisis has developed since late 2009 has made it clear that a banking union is indispensable to a lasting and stable monetary union. However, there is also a rationale for creating a banking union for the EU27: a true single financial market may be undermined by incentives for national authorities to restrict cross-border operations by banks headquartered on their territory out of prudential concerns, or for differential treatment or guarantees in the event...
of a crisis. The logic of a banking union at 27 is not to ensure the viability of monetary union, but to preserve financial integration within the European single market. This is fundamentally the rationale behind the proposals for an EU framework for bank recovery and resolution unveiled by the European Commission on 6 June 2012.

The preservation of financial integration within the single market is a valid economic reason for building an EU-wide banking union. At the same time, some of the central functions of a banking union such as the relationship between the liquidity operations of a central bank and the fiscal resolution functions, as well as the creation of a common deposit insurance scheme, are rendered more difficult by the existence of multiple currencies. Moreover, it is a matter of discussion whether the potential economic benefits of mutualising banking policy outweigh its costs in terms of shared sovereignty and mutualisation of risks for the different member states. Ultimately, this is a political judgement, on which different views are being expressed. The UK, in particular, has clearly indicated its unwillingness to be bound by a banking union that it regards as a “natural consequence” of the single currency rather than as the inevitable conclusion of the EU single market. It supports, therefore, the creation of a banking union for the euro area but is against creating one for the EU.

Political reservations may exist within the euro area, but here they need to be weighed against a much more powerful argument, namely that the absence of a banking union undermines the functioning, and perhaps the very existence, of the common currency. As the International Monetary Fund (IMF) puts it, “While a banking union is desirable at the EU27 level, it is critical for the euro area.”

Indeed, our assessment is that creating a banking union that would include all EU member states is too high an ambition to be practical, at least for the foreseeable future. Projects for an EU-wide banking union have no chance of seeing the light of day. They can only create confusion and distract from the essential priority of addressing the euro crisis. A banking union for the euro area is urgently needed, and the simplest option is one that encompasses only the euro area.

One might also consider intermediate options that would include some countries which are not members of the euro area, but (unlike the UK) would be willing to embrace the banking union while staying outside of monetary union. But this would create additional risks and uncertainties, for example the coordination of liquidity policies by different central banks in different currency areas during a funding crisis. It would also be incompatible with some policy choices, such as if the ECB is chosen as the single supervisor of the banking union. We view such options as more difficult and less desirable from a technical standpoint than an identity of perimeter between monetary and banking unions. That said, they are not impossible, and ultimately subject to political judgment.

Appropriate transitional arrangements should in any case be considered for non-euro-area members that have expressed the intention to join the currency area and signalled willingness to consider membership of a banking union from the outset, given the high degree of integration of their domestic banking systems with the euro area.

In any event, European banking union should be designed taking into account the interests of all EU countries. The goal should be to have a banking union that can live in harmony with the single market.

In order to ensure a smooth relationship between the different groups of countries – those in the euro area and the banking union, those outside the euro area but in the banking union, if any, and the others – the following guiding principles (based on Pisani-Ferry, Sapir and Wolff, 2012) should apply:

- Euro-area countries should be allowed to create a banking union that goes over and above the limited remit envisaged in the Lisbon treaty for the monetary union.
- The integrity of the EU single market should be ensured with equal treatment in the application of common rules. This principle would be enforced by the European Commission.
- The mandate of the EBA and the ESRB should be upheld, with due adaptation of their structures to the creation of the banking union.

9. In his Mansion House speech on 14 June 2012, UK Chancellor of the Exchequer George Osborne said: ‘A banking union – in other words, a union that stands behind the stability of Eurozone banks and their deposits in return for common financial supervision [- is] a natural consequence of a single currency.’ The same level of integration and common supervision is not considered necessary in other areas of the single market like energy. So we are clear that Britain will not take part in this banking union. British taxpayers will not stand behind eurozone banks.”
10. If a “partial” banking union is adopted, covering only the largest banks, the countries belonging to the banking union would be represented in the EBA and ESRB by both their national supervisory authorities and the common supervisory authority. If it is a “complete” banking union, only the European supervisor would represent those countries that form part of it (see item 3 of this section).
In the FSB’s terminology on SIFIs, systemic importance is recognised either at the global level (G-SIFIs) or at the domestic country level (D-SIFIs). A European banking union would need to consider the intermediate European level, thus E-SIFIs. By implication, all G-SIFIs based in Europe are E-SIFIs, but there might be additional E-SIFIs that are not G-SIFIs; and all E-SIFIs are D-SIFIs for their individual home countries with the EU.

There should be adequate consultation of those EU member states outside of the European banking union in designing the functions of the banking union. Under such conditions, all EU countries should in principle welcome the creation of a European banking union, even if it is limited to the euro area, since this would help deliver more stability to the entire EU.

It might be the case, however, that even these four conditions would not be sufficient to ensure unanimity of EU member states on the creation of the banking union, which is required in order to establish it under the EU treaty. Specifically, the UK has particular concerns and may ask for additional guarantees (Box 2).

If the demands of the UK and other countries outside the banking union fail to elicit consensus, it is also imaginable that the banking union would be created and organised outside the EU treaty. As with the European Stability Mechanism (ESM) and fiscal compact, however, a compromise should be found to ensure a proper relationship between the institutions of the banking union and those of the EU.

The bottom line is that all EU countries need to find a way to attain two common objectives: to preserve the integrity of the single market, which many see as the EU’s most important common asset; and to ensure the stability of the euro area, for which a banking union has become necessary.

In general, EU financial integration and euro-area financial stability should go hand in hand, even though there may be some instances where the two objectives may be at odds with one another. The current situation, where the inability of the euro area to ensure its financial stability has led to financial disintegration that threatens the entire EU single market, is clear proof of this complementarity. Thus, all EU member states should recognise that they share a fundamental incentive to find cooperative solutions to create the European banking union.

2. Which banks?

How comprehensive should the banking union be? At one extreme, a “partial” banking union could cover only those banks that should be considered systemically important financial institutions (SIFIs) on a European scale, which might be termed “E-SIFIs” to extend the now commonly used classification of the Financial Stability Board. Those banks have significant cross-border operations whose resolution is bound to require transnational mechanisms. At the other extreme, a “complete” banking union would entail European-level responsibility for the whole of banking policy, covering all banks no matter how small or local. In between, a range of options could be considered.

This choice involves several dimensions:

[a] Information asymmetries. European authorities would have a clear informational advantage over national authorities for the supervision of banks with significant cross-border activities.

Although the British government supports the creation of a banking union amongst euro-area members, there is concern in the UK that its creation might jeopardise the standing of the City of London as both the main financial centre of the EU, and as a global financial centre. Regarding its role vis-à-vis the euro area, many in the City are worried about potential regulatory decisions of euro-area authorities which could require certain financial activities to be located within the euro area so as to be able to supervise them for financial stability reasons. An example of such a decision may be the 2011 announcement by the ECB that the Eurosystem has major concerns with regard to the development of major euro financial market infrastructures that are located outside of the euro area. As far as the City’s global role is concerned, there are also fears that, by creating a banking union, the euro-area countries would act as a caucus on EU single market issues and impose changes to the single banking and financial rulebook that might reduce the attractiveness of London compared to other global financial centres like New York, Hong Kong, Singapore or Shanghai. Those things matter particularly for the UK because the City, and more generally the financial services industry, contribute significantly to its GDP.

BOX 2: THE UK AND BANKING UNION

Although the British government supports the creation of a banking union amongst euro-area members, there is concern in the UK that its creation might jeopardise the standing of the City of London as both the main financial centre of the EU, and as a global financial centre. Regarding its role vis-à-vis the euro area, many in the City are worried about potential regulatory decisions of euro-area authorities which could require certain financial activities to be located within the euro area so as to be able to supervise them for financial stability reasons. An example of such a decision may be the 2011 announcement by the ECB that the Eurosystem has major concerns with regard to the development of major euro financial market infrastructures that are located outside of the euro area. As far as the City’s global role is concerned, there are also fears that, by creating a banking union, the euro-area countries would act as a caucus on EU single market issues and impose changes to the single banking and financial rulebook that might reduce the attractiveness of London compared to other global financial centres like New York, Hong Kong, Singapore or Shanghai. Those things matter particularly for the UK because the City, and more generally the financial services industry, contribute significantly to its GDP.
operations. The opposite is arguably true for local banks.

(b) Sovereign/banking feedback loop. Common deposit insurance can sever the connection between domestic sovereign and banking risks only if its coverage is broad enough to mutualise a significant part of the risks. For instance, the Spanish Cajas have very little international business, yet they were collectively large enough to represent a major fiscal risk for Spain and for the financial stability of the euro area. Only a complete banking union can entirely eliminate the feedback loop.

(c) Distribution of costs and benefits. Banking concentration varies greatly across euro-area member states. For example, most of France’s banking system is composed of E-SIFIs, whereas Ireland and Portugal are home to few such institutions, if any. Other countries combine institutions whose systemic importance is at the European, national, or sub-national level, in varying proportions (See Box 3). Hence, different choices on the scope of banking union can have very different distributional consequences.

d) Potential competitive distortions. Any partial banking union involves the risk of competitive distortions and regulatory arbitrage between federally and nationally supervised banks. As partial union would not eliminate the sovereign-banking feedback loop, it may also risk undermining local banks in countries with weaker fundamentals.

The choice of a scope for banking union should be made in a way that takes into account informational constraints, ensures an adequate coverage of risks, limits asymmetry across countries, and minimises distortions. A partial union covering solely E-SIFIs would mean that the European supervisor would only deal with a limited number of pan-European entities, but it would address the banking-fiscal feedback loop only partially and would result in a high degree of asymmetry across countries. Conversely, a partial union might run into less political resistance at the national (and in some cases, sub-national) level than a complete one. Including only E-SIFIs or E-SIFIs plus large banks would also create

**BOX 3: SIZE AND CONCENTRATION OF BANKING SYSTEMS IN EUROPE**

Banking systems in Europe differ widely from country to country. On the liability side, deposits-to-GDP ratios vary depending on financial development, wealth and the share of non-residents in total deposits. Luxembourg and Cyprus are characterized by high deposit ratios because of the large share of non-residents. At the other extreme deposit-to-GDP ratios are low in Estonia and Slovakia.

**Figure 1:** Deposit-to-GDP ratios, 2010

Source: Source: ECB and Swiss National Bank, Bruegel calculations
Table 1 gives a measure of cross-country dispersion for bank deposits and for banking sector assets, using the same decomposition as in Figure 2. It is apparent that the dispersion is maximal for G-SIFIs and gets lower as coverage of the banking system increases, although it remains larger than for the size of deposits. Consequently coverage should be as broad as possible if the aim is to minimize distributional effects arising from banking sector size differences across countries.

Table 1: Size and concentration of banking systems, 2010

<table>
<thead>
<tr>
<th>Coefficients of Variation</th>
<th>EEA COUNTRIES</th>
<th>ALL COUNTRIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposits (MFI deposits excluded)/GDP</td>
<td>All Banks</td>
<td>0.34</td>
</tr>
<tr>
<td>Total assets/GDP</td>
<td>All Banks</td>
<td>0.66</td>
</tr>
<tr>
<td>G-SIFIs + Banks with assets higher than 5% of domestic GDP</td>
<td></td>
<td>0.69</td>
</tr>
<tr>
<td>G-SIFIs</td>
<td></td>
<td>1.54</td>
</tr>
</tbody>
</table>

Note: Cyprus and Luxembourg are excluded.
significant distortions between smaller and larger banks.

In this debate, centralisation of authority should not be confused with operational centralisation. Even in a complete banking union, the subsidiarity principle would apply and there would be a delegation of many supervisory operations to national or sub-national entities under the authority of the European supervisor. In no scenario should and would the thousands of banks that exist in the EU be all supervised centrally.

These considerations lead us to advocate broad coverage extending significantly beyond E-SIFIs, and ideally a “complete” banking union covering the entire sector if a political consensus can be achieved for it. The choice of scope of the banking union has significant implications for the way deposit insurance should be organised. This is discussed below under item 5.

3. Which supervisor?

At the level of individual countries, there is a longstanding debate on whether bank supervision should be conducted by the central bank or by a separate public authority that may have stronger links with the finance ministry. A number of dimensions are relevant for this:

• First, the central bank is the last-resort provider of liquidity to banks. In times of crisis, it needs to strongly increase its liquidity provisioning and by doing so it increases risk on its balance sheets. Therefore, the central bank naturally has to make assessments about its counterparts, and has better expertise on liquidity conditions affecting banks than an agency that is more remote from markets. All other things equal, this gives the central bank a natural advantage in supervision.

• A second dimension concerns the potential conflict of interest between monetary policy and supervisory action: the central bank may be led to be more dovish on monetary policy than the inflation objective warrants in order to safeguard certain banks it supervises, or even in order to conceal supervisory failures; conversely, it might be tempted by supervisory forbearance to prevent a crisis happening that could result in price instability. All other things equal, this argument speaks against supervision by central banks.

However, the crisis has also shown that the central banks’ functions extend beyond price stability. In fact, a vivid discussion has emerged about the best way central banks can reconcile financial stability and price stability.

• The central bank’s role in supervision also is a matter of a delicate balance with regard to the link with the resolution authority. Bank resolution has potential fiscal implications and therefore resolution needs to be exercised by an authority endowed with appropriate political legitimacy.

One way to take into account these divergent arguments is to have the supervisory function exercised both by the central bank and by a separate supervisor. As illustrated by Box 1, the US provides such an example with the complementary and overlapping remits of the Fed, OCC, FDIC, SEC and NCUA. Japan similarly has complementarities between the respective roles of the Bank of Japan and the Financial Services Agency, each of which supervises banks through parallel frameworks. However, a longstanding body of comparative literature generally concludes that no single pattern of division of supervisory responsibilities between central banks and other authorities is unquestionably superior to the alternatives.

At the European level, a number of additional factors need to be considered when deciding on the appropriate supranational supervisory authority. The EBA already exists at the European level, and one possibility would be to grant it supervisory authority. As indicated, however, we find it unlikely that a banking union could cover the whole EU, which makes it unlikely that the European supervisor could be the EBA. By the same token, the ECB could be chosen as supervisor if the scope of the banking union is limited to the euro area.

In legal terms, Article 127.5 provides the treaty base to increase the supervisory power of the European System of Central Banks (ESCB), and thus give prominent supervisory authority to the European Central Bank (ECB). However, a new institution could also be created by relevant member states without prior definition in the treaty, and could possibly be endorsed in a future treaty revision.
A further practical argument speaking in favour of giving supervisory powers to the ECB is the fact that the ECB is a strong institution with resources and significant credibility earned before and during the crisis. From the central bank standpoint, risk management would also benefit from better access to information derived from supervisory authority. Conversely, the democratic and executive deficit of EU institutions creates two risks if the ECB is made into European supervisor. First, the accumulation of policy instruments under its authority may make it appear too powerful given the absence of a strong countervailing elected executive as exists in national environments. Second, in the [in the long term, inevitable] event of future supervisory failures, the political pressure on the ECB could result in erosion of its monetary policy authority and independence.

In both options, governance will be an important concern. If the European supervisor is the ECB, it will be important that safeguards are introduced to reduce the conflict of interest between monetary policy and supervisory action. This could perhaps be achieved by giving supervisory authority to a separate body from the Governing Council (which comprises the executive board and the national central bank governors), which would retain the decision-making role on monetary policy. If a “partial” banking union is retained [cf item 2 above], national supervisors will retain a role and may need to be empowered in the governance as part of the European supervisor, as is the case of national central banks in the ECB. If a “complete” banking union is retained, national supervisors will have to derive their authority from the European supervisor, and their relationship with national governments will need to be comprehensively redefined. Another aspect is that if supervisory authority is given to the ECB, it will arguably need to be cleanly separated from any resolution tasks in order to avoid ECB interference with fiscal policy. In such a scenario, additional supervisory powers should also be granted to the European resolution authority.

Given this last point, and assuming the geographical perimeter of the banking union is limited to the euro area, we see two options as possible: either a single supervisor endowed with resolution authority, which would be a new institution; or a combination of ECB supervision with parallel [and coordinated] supervision by the resolution authority. These two options’ respective strengths and shortcomings are markedly different and should be carefully considered by policymakers before making a final choice.

4. What resolution authority?

Bank resolution authority potentially involves significant choices about the distribution of costs between shareholders, creditors, uninsured depositors, taxpayers, and/or surviving banks, as well as about ownership and competition in the sector as a whole. The nature of such decisions excludes giving this task to an independent central bank whose legitimacy derives from the limited scope of its mandate. Distributional choices in principle belong to elected officials and can only be delegated to an independent agency to the extent that it operates under clear rules and with a robust framework of accountability. In the case of the euro area, the ECB is even less suitable to perform resolution tasks as it would be drawn into inevitable controversies as regards the distribution of losses and banking activities across euro-area member states. In other terms, the ECB should not be the resolution authority for the European banking union, even assuming a geographical scope limited to the euro area.

The European Commission with its Directorate General for Competition currently plays an important role in bank resolution under its authority over state aid, as discussed by Dewatripont, Nguyen, Praet and Sapir (2010). Granting resolution authority to the European Commission based on its competition policy competencies would have the advantage of relying on an existing institution with experienced staff. However, the competition mandate is about different policy objectives than those inherent in resolution authority. Furthermore, bank resolution is arguably a less judicial and more political process than decisions on state aid cases. Finally, the Commission is an institution of the EU as a whole while bank resolution would have to be exercised within a more limited geographical scope. Thus, we do not see it as practical to opt for the European Commission as the resolution authority.
Another option, again assuming that the perimeter of banking union is identical to the euro area, would be to give the ESM direct authority to perform bank resolution. It could do so under the political authority of the Eurogroup, extending its current mandate to provide financial assistance to euro-area member states. Decisions on assistance to member states and decisions on bank resolution are both political decisions potentially involving the same taxpayers’ money. However, in most countries that do have a special resolution regime for banks, it is kept at arm’s length from the fiscal authority to avoid excessive politicisation of decisions. Giving this responsibility to the ESM under the guidance of the Eurogroup would entail similar risks. Furthermore, for such a structure to be effective, different decision-making rules would need to be defined from the current 85 percent majority threshold, which would risk blocking resolution decisions.

Ultimately, we think the European resolution authority should be vested in a new institution still to be created, even though it might have strong links with the ESM – as is typically the case in national contexts between bank resolution authorities and treasuries. As discussed under item 3, this new institution should also have some degree of direct supervisory authority over those banks that are covered by the banking union. It could also be the same institution in charge of the future European deposit insurance system, as discussed below.

4. What deposit insurance?

As previously argued, there is little question that the European banking union must include a component of deposit insurance. An important further choice to be made concerns the degree of centralisation of that deposit insurance function. In national contexts, including those of EU member states in the current framework, deposit insurance is at least implicitly backed by national treasuries, in other words by fiscal resources. However, national fiscal resources may be too limited to credibly back national deposit insurance, and this relationship also contributes to the feedback loop between banking and sovereign risks. Keeping insurance and fiscal backing purely national would therefore undermine both the effectiveness of deposit insurance as a mechanism to maintain trust in the banking system, and the very purpose of the banking union.

A first option would be to construct a system in which the national deposit insurance schemes (DIS) would subsist but would be partially re-insured by a European deposit reinsurance fund. Such a scheme would need to be only partial so as to avoid free-riding by individual countries. In other terms, the national taxpayer would continue to back the national DIS with fiscal resources. If the national DIS were to be depleted, its commitments would be met with a combination of resources from the supranational fund and of national fiscal resources in a proportion to be set ex ante and equal for all participating countries, for example half and half or a different proportion. By doing so, national governments would keep a strong interest in preventing imprudent banking behaviour, while the feedback loop between banking and sovereign risk would be attenuated.

For the system to be fully credible, the European reinsurance fund itself would need to have its own federal fiscal backing and the implications of this for fiscal union are discussed below.

In a second option, the supra-national re-insurance fund would be prefunded by contributions from the member states’ governments. In case the national DIS was to be depleted, the supra-national fund would step in. To avoid moral hazard and free-riding, the annual contributions to the supra-national re-insurance fund could be made dependent on past drawings on the re-insurance scheme. Such an “experience rating”, where subscriptions depend on the record, are well established moral hazard-mitigating mechanisms that exist for example for car insurance.

A third option would be to centralise the entire deposit insurance scheme into one single federal system, akin to what exists in the US. This however requires both that member states be entirely deprived of all instruments of banking policy, to avoid perverse incentives that would lead to the accumulation of risk in some countries’ banking
systems, and that a fiscal union be built in parallel to the banking union.

Deposit insurance should also be appropriately connected with the supervision and resolution authority. In one possible design, the European deposit insurance fund could be managed by a European supervisory and resolution authority, as is the case in the US with the FDIC (in relation with other federal supervisory authorities).

6. What fiscal backstop?

Moving deposit insurance to the European level would amount to transferring a significant contingent liability. Laeven and Valencia (2012) reckon that the median direct gross cost of a national banking crisis has been 4 per cent of national GDP in advanced economies and 10 in emerging economies, but tails of the risk distribution are fat, as illustrated by the cases of Iceland (44 per cent), Ireland (41 per cent) and Korea (31 per cent), to mention advanced economies only. The pooling of resources at European level would arguably diminish this cost as more of it could be absorbed by deposit insurance (but it might also increase the frequency of crises) and the adoption of a resolution framework that puts more emphasis on the involvement of private shareholders and creditors would also reduce fiscal costs significantly. Nevertheless the potential liability remains significant.

For this reason a banking union requires some degree of fiscal union, though it does not necessarily entail a federal budget. The EU budget could remain of the same size as it is at the moment and there would be no need to increases tax revenues as long as a crisis does not materialise. But by mutualising insurance, it creates a common contingent liability and for this reason requires access to potential budgetary resources. To be credible, the ability to draw on potential resources needs to be assured. Without exhausting all dimensions of the fiscal union debate that go well beyond the scope of this paper, one possible way would be for a European fiscal entity (or quasi-treasury) to be given a limited and contingent taxation capacity for the purpose of resolving banking crises, up to a certain proportion of GDP and to be triggered only in the event of depletion of the European deposit insurance. This would make it possible to convert the potential income stream into an intervention chest, either through accumulation within a fund, or through borrowing, or through a combination of the two.

Specifically, we do not believe that this fiscal or quasi-fiscal function can be adequately addressed by an ex-ante burden-sharing rule, for example the ECB capital key or a variant of it, taking into account the size of each country’s banking sector. As this function would draw on fiscal resources, it is unlikely that this solution could be done without making intervention dependent on parliamentary approval in the participating states. Experience with assistance to states in distress has shown the limits of such schemes and the risks they represent to the credibility of the insurance. Burden-sharing arrangements are inherently less robust as they entail the risks that states, which retain the ultimate decision, will backtrack on commitments.

7. What governance and accountability?

Resolution of banking crises may involve the closing or restructuring of financial institutions as well as the commitment of taxpayers’ money. Often these decisions – whose economic and financial consequences can be huge – have to be taken in a context of imperfect information and under the pressure of time. The assignment of this responsibility to the European level therefore requires the creation of an effective governance structure, with implications not only for the institutions tasked with banking policy but also for European institutions more generally.

As discussed above, this structure could not rely solely on existing institutions such as the European Commission, the EBA and the ECB. The creation of one or several new institutions at the European level appears inevitable if a functioning banking union is to be established – even as the EU may still hope to avoid the unnecessary degree of institutional fragmentation that exists at the federal level in the US, with multiple supervisors overlapping for different categories of financial institutions. Furthermore, the potentially
distributional character of resolution decisions and the potentially large fiscal cost of banking crises call for political responsibility.

This could entail the appointment of a ministry of finance with responsibility for oversight of banking policy and crisis management coordination, as advocated by Trichet (2011). The ministry of finance would rely on the ESM for resolution matters. Equally important is the creation of an adequate framework of accountability to European citizens through a properly empowered European Parliament that would comply with the principle of equal representation, and also to a proper representation of the member states. Ultimately, the creation of a banking union will therefore require making progress with political union.

4 A POSSIBLE PATH TOWARDS SUSTAINABLE BANKING UNION

Recent weeks have seen the vision of a European banking union endorsed by an impressive array of European and international leaders. However, that vision is very distant from the current reality, and the path from here to there is bound to be bumpy. European leaders should avoid four major pitfalls in their forthcoming discussions on how to charter such a path.

- The first pitfall is to think that a long-term vision is sufficient to stabilise the situation in the short run. Lost investor confidence cannot be re-established only by presenting a compelling vision for the long-term future. More immediate initiatives are needed and they must also be consistent with the framework envisaged for the long term.
- The second pitfall is to believe that banking union can be separated from the other responses to the crisis. Both in the short term and in the longer term, banking policy choices are inseparable from those made in terms of fiscal policy and of political institutions. One might say that banking union and fiscal union are mutual complements rather than substitutes, and that both require a form of political union that goes beyond the current features of the EU. While short-term decisions must be made to the extent possible within the framework of current treaties and institutions, EU institutional transformation including both more democratic representation and accountability, and stronger European executive decision-making capability, is a necessary condition for the build-up of a banking union that could withstand future financial shocks.
- A third pitfall is to think that the introduction of a banking union now can be used as a way to distribute existing debt overhang in a number of countries across euro-area taxpayers in an un-transparent way. Banks in some countries are much more vulnerable than in others due to existing debt overhang. Implementation of measures to stabilise the financial system in the short term therefore involves decisions as to whether losses accumulated in some banks, and likely to result in injections of public money, should be borne by sovereigns on a country-by-country basis, or should be partially mutualised, or should be at least partly imposed on creditors of banks. These decisions should not be made in a way that hides them from the public. The current public information on banks’ true situation is highly imperfect, and national supervisors have strong incentives to retain privileged information and to hide banking losses in the hope they will eventually be mutualised. The crisis management and resolution approach should counter these incentives in a credible manner.
- A fourth pitfall is to believe that steps towards banking union can suffice to restore trust in deposits across the euro area. Trust in deposits is undermined by two factors: fears about a country’s exit from the euro area and concerns about the national-level guarantee of deposits as organised in the national deposit insurance system (DIS), assuming no change of currency. The first fear factor cannot be addressed with the instruments of banking policy, and can only be mitigated by an unambiguous political commitment to preserve the integrity of the euro area no matter what, including the continued membership of all its current member countries. Declarations until now have stopped short of this, often by stating the undesirability rather than the impossibility of country exits. Ultimately, an unlimited political commitment may be required to preserve the integrity of the euro area by replacing deposit withdrawal fully with ECB liquidity.
Against this background, the aim of the transition should be to provide a credible path to the new policy regime, to ensure that there is no vacuum or ambiguity in the assignment of policy responsibilities, to provide total transparency on any transfers resulting from legacy losses, to keep these transfers at a minimum level to the extent that this remains compatible with the preservation of financial stability, and to show commitment to act early so as to regain trust.

It will be of particular importance to map a credible way to break the negative feedback loop between sovereign and banking sector fragility. Against this background, we suggest a graduated approach that preserves as much as possible the principle of national responsibility for restoring banking systems back to soundness before the move towards banking union, while ensuring that swift action is taken where it is needed. If this approach were to prove insufficient, responsibility for resolving the current banking crisis may be moved directly to the European level, either for those countries that are in greatest difficulty or, if this is insufficient to restore confidence, for all countries committed to banking union.

The premise for the graduated approach is that there should be a clean and neat separation between legacy problems, which fall under the responsibility of current resolution authorities – and the sovereigns backing them – and future risks, which are to be taken on by the new common European banking policy framework – and the funding scheme backing it. Mutualisation of the resolution and its cost should only be envisaged in the exceptional cases where the actual or potential fiscal cost of resolving the current crisis exceeds the capacity of the sovereign, and even in this case a cost- and risk-sharing arrangement should be devised with European partners.

At the same time a comprehensive, thorough and intrusive screening of all banks which would be included in the future banking union should be immediately performed by a European institution or delegated to an ad-hoc body under centralised control. This is because, once the perspective of moving supervision, deposit insurance and resolution to the European level is agreed, national authorities will have a strong incentive to conceal actual losses in the hope that any future cost will be mutualised.

These considerations lead to the following scheme, which is intended to minimise responsibility overlaps and to address incentive issues. The underlying principle is that there should be clarity of responsibility for crisis management, with primary responsibility at the national level and responsibility at the European level only if there is no workable alternative. In all cases, the principle of “he/she who pays, controls” will apply.

- Leaders of all euro-area countries, and possibly also of other willing EU member states, should establish a European Supervisor, which will act as the anchoring institution of the future banking union even though its operational build-up may take some time. As discussed in section 3, one possibility would be to empower the ECB with supervisory powers, the other alternative being to set up a new institution.
- In parallel, a special European Banking Sector Task Force, with an appropriate mix of public officials and private-sector specialists on temporary assignment would be created to help coordinate the immediate steps of crisis management. Posen and Véron (2009) highlighted the relevance of temporary crisis-management entities to address systemic crises, such as the Swedish Bank Support Authority in the early 1990s; since then, the broadly successful auto industry task force in the US (2009), as well as the restructuring of AIG by a special unit temporarily established within the US treasury, have provided additional examples of the usefulness of ad-hoc temporary bodies in systemic crisis management. The temporary task force would work in close cooperation with the ECB and with the new European Supervisor, if separate.
- In a unanimous statement, the leaders of participating countries should commit to comply with the steps described below, and should pass emergency legislation in their respective countries to confirm this commitment and to grant the Task Force full access to banks and supervisory information. Such legislation might also introduce the possibility for national authorities to impose losses on creditors in the context of a special resolution regime in those
countries which have not yet established one. To an extent this might anticipate the “bail-in” proposals recently made by the European Commission (European Commission, 2012).

• The Task Force would perform a rigorous capital assessment of the most important banks which are to be covered by the European banking union — eg those included in the 2011 stress tests. The European Supervisor, if already up and running at that stage, would help in this task and also engage in the complementary task of supervising smaller banks that would also fall within the scope of the banking union.

• One key feature of the capital assessment is the value to be attributed to portfolios of sovereign debt held by the assessed banks. Given current market conditions in the euro-area sovereign debt market, we believe these should not be assessed at market value in the context of the capital assessment, but that a reference value should be provided for the purpose of that assessment by a consensus view of the ESM and IMF:

• If a bank is found through this assessment not to meet applicable capital requirements, the national authorities, working in close cooperation with the Task Force, should take the appropriate measures.

• If the cost of carrying out such measures in a given country is found to threaten the sustainability of national public finances or their perception by financial markets, that country should request the support of the ESM. The conditionality of such support could include directions on the specific measures to be taken to restore the soundness of banks found to be undercapitalised or insolvent under the Task Force’s assessment, the determination of which may associate the Task Force itself.

• Communication of the capital assessments should be carefully coordinated and should not be envisaged before adequate progress has been made towards defining the approach for eventual bank restructuring and sovereign assistance. Assuming smooth establishment of the Task Force and sufficient resources and focus, the capital assessments and corresponding restructuring packages could be announced publicly at some point in the first half of 2013.

• In parallel, the permanent institutions of the banking union [supervision, deposit insurance and resolution authority as discussed in section 3] will be built up and will take over their responsibilities in relation to relevant financial institutions as soon as practical.

• The overarching principle should be to minimise the cost of resolution to taxpayers. Creditors should be forced to participate in the restructuring of insolvent banks to the maximum extent possible. The removal of current uncertainties about banks’ true balance sheet strength, and the simultaneous creation of the permanent institutions of the European banking union, should result in a marked improvement in funding conditions across the EU that would more than offset the effect resulting from creditor losses in banks found insolvent.

Should the above approach run into difficulty, particularly if national authorities fail to cooperate adequately and/or if the banking/sovereign feedback loop leads to further market dislocation, additional steps might be considered.

This might happen at the level of one individual country under assistance from the ESM. If the management and resolution of the national banking situation appears beyond the financial and operational capacity of that country, then it should accept the direct and early transfer of responsibility for its banking system to the European level in anticipation of the future banking union. In such an event, the European Banking Sector Task Force should be empowered to be the resolution authority for that country, and would rely on the ESM’s resources, with appropriate channels of accountability. A limited involvement of national fiscal resources may still be needed to mitigate moral hazard. This might entail, in particular, the direct purchase by the ESM (or a special vehicle under the ESM) of equity or other instruments issued by banks of the country in question, in accordance with restructuring plans negotiated by the Task Force on behalf of participating member states acting collectively.

If even this proves insufficient, leaders might consider further expansion of the role of both the ESM and of the European Banking Sector Task Force, and consider a move to put all participating countries’ banking systems under the Task Force’s resolution authority to address any risk of intra-

14. We assume that the ESM will be in place shortly and will be the instrument of intervention in the time-frame envisaged for bank crisis management. If there are delays in the establishment of the ESM, the European Financial Stability Facility (EFSF) should be mobilised instead, with appropriate adjustments to its mandate if needed.
system contagion. The system-wide approach would help the Task Force to maximise the possibility of imposing burden-sharing on the insolvent banks’ creditors, even though it might not be possible to have a uniform approach across member states concerned given differences in legal frameworks. To the extent that the use of public money might be necessary, the Task Force should negotiate a combination of national fiscal resources and ESM, depending on each country’s or bank’s specific situation. This would inevitably give rise to recrimination about differential treatment, but the assumption here is that credible alternatives for restoring the European banking sector back to soundness would be scarce.

If circumstances warrant it, a more centralised approach may also be applied to restoring trust in deposits and protecting them not only against the risk of failure of individual banks, as national DISs already do, but also against the risk of the national government itself failing to backstop the DIS. The current financial rescue scheme with the EFSF/ESM does this only implicitly and indirectly by providing financial assistance to countries that request it. Depositors in the countries in question could, however, fear that the national DIS would be subordinate to other claims against the government even though so far bank creditors have made only modest losses if any, and all deposits have been spared loss. Moreover, trust in the willingness to move towards a more integrated banking union could be increased by introducing a partial re-insurance of DIS that would establish a direct link between the ESM and the national DIS. Moral-hazard effects could be dampened by requiring that, if the national DIS were to draw on ESM support, then future additional levies would be imposed on banks headquartered in the relevant member state. The advantage of such a “deposit reinsurance” scheme at the European level is that it would show that a concrete step towards a true banking union was being taken while at the same time having a mechanism to reduce moral hazard. This could increase overall confidence in the willingness of Europe genuinely to move forward towards a banking union, as it would be strong concrete signal of a move towards a federal element of banking union.

Consensus on such initiatives is not going to come easily, and their implementation is riddled with numerous major execution risks and moral-hazard concerns. But these will have to be measured against the downsides of inaction and the risk of further market dislocation, and eventual possible euro-zone unravelling. The path towards a banking union cannot possibly be smooth, and is likely to be a white-knuckle ride at times. But for Europe, the alternatives are clearly worse.

5 CONCLUSION

The euro crisis is now in its third year and there is still no end in sight. The main reason for this situation is that, although much has been done since 2010 (in fact since 2007) to quell the crisis, some of its root causes have been left largely unattended. In particular, no mechanism has been put in place to address the feedback loop between sovereigns and banks that plagues a number of euro-area countries. The problem is that putting in place the necessary mechanism would involve transforming the euro area into a full-fledged monetary union with a fiscal and banking union. In turn, this would require agreement on sharing sovereignty, mutualising risk and creating European-level accountability channels that would amount to creating a political union.

Although nothing short of such political union might ultimately be sufficient to ensure the long-term viability of the monetary union, it is equally clear that it will take significant time to achieve even under the most optimistic assumptions. What appears possible, however, at this juncture is to take a decisive step forward by creating a banking union. This step would not only help to address directly the negative feedback loop between sovereigns and banks. It would also demonstrate that the euro area has the political will to draw the lessons from the crisis and to move towards a stronger framework that preserves the full integrity of the current monetary union. In turn this would have major beneficial effects on the current crisis by dramatically shifting expectations and anchoring them on more favourable ground.

We fully realise that, given the current circumstances, it will be economically and
politically difficult to agree on a design for the banking union and even more difficult to take the necessary first steps that are outlined in summary form above. Yet we also believe that the current circumstances make it imperative that a banking union be created and that concrete steps be adopted rapidly. Clearly, not all choices can be made in the short term, but the sequence we have outlined in this paper could allow a quick start to this long process. Conversely, failure to take the necessary decisions could greatly endanger the viability of the monetary union.

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