PISM | POLSKI INSTYTUT SPRAW MIĘDZYNARODOWYCH
THE POLISH INSTITUTE OF INTERNATIONAL AFFAIRS

BULLETIN

No. 141 (594), 20 December 2013 © PISM

Editors: Marcin Zaborowski (Editor-in-Chief) ● Katarzyna Staniewska (Managing Editor)
Jarosław Ćwiek-Karpowicz ● Artur Gradziuk ● Piotr Kościński
Roderick Parkes ● Marcin Terlikowski ● Beata Wojna

An EU Banking Union: How Damaging Will the Comprehensive Assessment of Banks Prove to Be?

Paweł Tokarski

With deficiencies in the eurozone's banking sector a constant source of trouble for the common currency, the European Central Bank is beginning a comprehensive assessment of eurozone banks. This is an important practical step towards a banking union but is extremely challenging due to the scale and complexity of the undertaking. Following an earlier EU banking assessment which turned out to paint too rosy a picture, the ECB's efforts are a key test of the credibility of a banking union and the sustainability of the euro. After completion of the review, an even more difficult task may be a series of costly and complicated resolution actions against some banks.

The crisis in the euro area cannot be traced solely to infringements of EU economic-governance rules or to profligate fiscal policies (prior to the world's financial meltdown, Spain and Ireland actually had a debt-to-GDP ratio far below the required 60% benchmark). Rather, it was due to high *private* debt-to-GDP levels, sustained by massive north-south capital flows and compounded by asset bubbles and poor economic conditions, which damaged banks and caused sovereign governments to step in. Eurozone governance was thus shown to lack effective financial-supervision mechanisms despite free cross-border capital flows, and as the dust settles four years on, banking-sector problems have been identified as the most significant challenges for the eurozone in the past, present and future.

For this reason, it is no exaggeration to say that the ECB saved the euro. The ECB's injection of cheap liquidity into the banking sector allowed banks to service their debts (these were the so called LTRO, Long Term Refinancing Operations) and its announcement of a new bond-buying programme in September 2012 reversed negative trends in the sovereign-debt sector. Yet, these actions had a downside. Many banks simply used this new liquidity to buy up newly-profitable government bonds without revising their business models. As a result, the share of sovereign debt in bank assets increased massively, enmeshing sovereign governments and banks even further. A clean-up in the banking sector is now the only means to bolster deteriorating market sentiment.

Towards a New Banking Supervision. Eurozone members are still struggling to create a supervisory system capable of handling their largest banks. After difficult talks, the first component of this banking union, the Single Supervisory Mechanism (SSM), has finally been approved. In a year's time the European Central Bank will therefore take responsibility for supervising the largest eurozone banks. In the interim the ECB, in cooperation with the European Banking Authority (EBA), national supervisory authorities and private firms specialising in audit and asset evaluations, will review the financial health of the 128 largest eurozone banking-groups representing 85% of SSM-members' assets.

In October, the ECB explained the methodology behind this "comprehensive assessment." Since increased information about the capital shortages of banks is a pre-requisite for the clean-up, the aim is to find out more about banks' balance sheets and identify structural weaknesses in the sector. The review will therefore consist of three elements: a supervisory-risk assessment (liquidity, leverage and funding), an asset-quality review, and a so called stress test. The exercise is the most challenging of its kind ever performed in Europe's financial sector, comparable globally only to the U.S. experience in the aftermath of the global financial meltdown.

An earlier review by the European Banking Authority, the crisis-born body that coordinates cooperation between national supervisors, shows how risky the venture is. The EBA quickly lost much of its credibility after performing

a stress test which was later undermined by events. Other financial markets, underwhelmed by the quality of any new exercise, might block out suspect European banks. And yet, governments and the financial-sector lobby will still be tempted to water down the review. The probability of leaks is certainly lower at the ECB than the European Commission, but interested parties can nevertheless count on a steady flow of information. Even if they do not use this information to interfere with the review, any speculation about capital shortages may cause instability on the markets.

Several questions remain unanswered. One is how banks' exposure to sovereign debt will be valued. According to the Basel-III rules that the ECB intended to apply, bonds are to be considered risk free. In reality, not all government bonds can be treated as safe assets (indeed, the next LTRO should contain mechanisms preventing banks from investing in sovereign debt). And yet, eurozone governments have been buoyed by demand for bonds from private banks and have an incentive to portray them as safe. A related challenge is the scale of the assessment operation and the need to involve national authorities. Experience shows that national authorities can be blind to complex operations, such as hidden toxic derivatives, which are right under their nose. The question is how to create a credible central system despite the unavoidable reliance on national supervisory authorities.

Challenges Ahead. Even more important, though, is what happens after the assessment: the supervisory system should have the capacity to resolve failing financial institutions so that the markets know it is capable of dealing with any fall-out from the review. Yet, the EU still lacks credible national and EU-level safety nets. Finance ministers held last minute talks on a Single Resolution Mechanism for restructuring or winding down failing banks and creating a resolution fund, on 18 and 19 December. Berlin held out for a less-centralised system than that proposed by the Commission, with strong involvement of national resolution mechanisms and national funds. Moreover, a separate inter-governmental treaty on the cross-border use of national funds has emerged as a precondition for the creation of a central fund.

It is a positive sign, ahead of tense negotiations expected for 2014, that the Council and the Parliament managed on 11 December to achieve a compromise on a Bank Restructuring and Resolution Directive (so called bail-in rules). Under the terms of the Directive, from 2016, the private sector will itself have to cover losses of up to 8% of bank liabilities before national or eurozone assistance applies. This system should certainly save some taxpayer money, but question marks still remain and there are potential loopholes in the system, such as so called preventive recapitalisations, which may use public money. Furthermore, it seems that financial assistance from the European Stability Mechanism will be more difficult to secure, as some national parliaments, including the Bundestag, will now be required to give the green light.

In short, the banking union is slowly emerging. Yet, the system's complex and hybrid nature raises questions about its effectiveness under time pressure. This could already be put to the test by the comprehensive assessment, which will coincide with the broader Basel-III process to shore up the capital base of banks world-wide. The conjuncture is a tricky one and could have an adverse effect in some eurozone countries, not least when it comes to firms' access to credit. After all, the SME sector in several eurozone countries is already struggling to gain access to loans, which in turn impacts in a negative way on economic growth and employment.

Poland's Perspective. A banking union poses an important dilemma for Poland and other non-eurozone CEE countries. On the one hand, efforts to reduce instability and fragmentation in the eurozone's financial sector, not to mention supervisory costs, are in everyone's interests. Such moves spread the benefits of the eurozone's single monetary policy through greater market integration and create macro-prudential tools to prevent uncontrolled cross-border capital flows. And yet, Poland's support for stronger European supervision cannot be unconditional. Bank ownership in CEE is dominated by large eurozone banking groups, and there is some fear that the EU's new supervisory system will give more weight to the interests of big eurozone banking groups than to their subsidiaries in Central Europe.

Warsaw must clearly push for the design of the banking union to be more inclusive towards the future euro area members and provide a level playing field between "ins" and "pre-ins" concerning not only participation in the decision-making process and access to information, but also the bank recapitalisation tools. The extension of an EU balance-of-payments mechanism tasks for the recapitalisation of non-eurozone banks, as proposed in the Hübner Report and currently under discussion by finance ministers, is a reasonable option, but it is difficult for Berlin and London to swallow. Both capitals argue that extending this assistance on a pre-in's banks could create the risk of moral hazard. Poland must therefore highlight the fact that the banking sectors in most of the CEE states look much more stable than their euro area counterparts, as well as its own efforts to boost its fundamentals.

The Polish banking sector, the largest in the region, has come through the crisis without any major problems, and its foreign-owned banks are thus at risk principally from instability in their mother countries. Nevertheless, although the country's deposit-guarantee system is better than in many eurozone states, and the country's financial supervisory commission enjoys respect, this may not be sufficient. One should remember that a national guarantee system is only as strong as the sovereign government behind it. Poland's debt-to-GDP ratio is expected to shrink due to the changes to the private pension scheme, yet it is still above the levels of Spain and Ireland before the global financial meltdown. Therefore, among the tasks for Poland's new finance minister should be a general review of public expenses beyond the terms laid down by the Excessive Deficit Procedure.