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Europe's Imperfect Banking Union: Enough to End the Crisis?

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Investors and policymakers alike have grown complacent about the eurozone, comforted by the notion that the worst of the crisis is behind them. This is dangerous. While the risk of a disorderly sovereign default or eurozone exit by one of the member states has been significantly decreased, there is a lot of work left to do to achieve a lasting solution to the crisis.

The Eurozone crisis was labeled a debt crisis when Greece first turned to international creditors for a bailout in May 2010, but this label only barely scratched the surface. As other European countries were dragged into bailouts and recessions or depressions, it became apparent that it was also a political crisis, a social crisis, a growth crisis, and a financial crisis. Bickering politicians operating in their own national interests and restrictive European treaties precluding the outright monetary financing of states yielded a slow and protracted policymaking response to the eurozone crisis, which has still not solved many of its underlying causes.

With borrowing costs for governments in Spain and Italy—the eurozone's third and fourth largest economies—soaring to unsustainable levels in the summer of 2012, most analysts agreed there were two possible paths for Europe. Either the common currency area would fall apart, which would be hugely disruptive for the markets and (in the short term) dramatically difficult for those countries reissuing their own currencies, or it would have to become even more integrated.

Mario Draghi, the president of the European Central Bank (ECB), bought policymakers time to try to take steps toward political, fiscal, and banking union by announcing the central bank would do "whatever it takes" to preserve price stability in the common currency area. This commitment immediately removed the risk of a major eurozone country defaulting, so that policymakers could focus on fundamental institutional change.

The future of the eurozone depends on what policymakers do with this time. Some progress has been made on establishing a banking union, but both the process and design have been deeply flawed. The banking union as it currently stands will fall short of many of its goals and might prove only to be useful in the next crisis, not in definitively ending the current one.

Why Banking Union?

Policymakers have decided to establish a banking union before political or fiscal union. This is partly because it is the least contentious of the three; both core and peripheral countries are unwilling to cede the sovereignty to Brussels necessary to take steps toward a political or fiscal union for now.

It is also partly because of the importance of the banking sector for European economies. Whereas banking sector assets in the United States are around the same size as that country's economy, total assets of Eurozone banks are around 300 percent of the currency area's gross domestic product (GDP). European businesses are hugely reliant on banks for

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borrowing, which has been a problem over the past few years as banks have been forced to deleverage and so have stopped lending.

This problem has been made even more acute in the weaker eurozone countries by the fact that borrowing costs for small- and medium-sized enterprises (SMEs, which form the backbone of many European economies) have soared well above those for SMEs in the core countries. In order to get the eurozone growing again, banks must address the nonperforming loans (NPLs) on their books so that they start lending. Confidence must also be returned to the European banking sector so that borrowing costs for businesses across the region converge from current levels.

Perhaps the biggest reason for establishing a banking union as quickly as possible in the eurozone is to break the so-called "doom loop" between banks and sovereigns, whereby if one gets into trouble it brings down the other. This happened in Greece, where Greek banks loaded up on Greek government bonds and required massive recapitalization when the state had to restructure those bonds. This also happened in Ireland, when the country's banks were sunk by a bursting property bubble and the Irish government went bankrupt trying to bailout out the banks.

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Europe's banks and sovereigns have only become more intertwined since the Greek and Irish bailouts. This is partially because of three-year Long-Term Refinancing Operations (LTROs) the ECB offered in November 2011 and February 2012. Banks borrowed money from the ECB at extremely low rates and used it to buy national sovereign debt with much higher interest rates. Consequently, government bonds as a percentage of total banking assets have risen from around 5 percent in early 2012 to around 10 percent in Italy by the end of 2013, 6.3 percent to 9.5 percent in Spain, and 4.6 percent to 7.6 percent in Portugal.

Kicking the Tires of Europe's Banks

The first step toward establishing a banking union is for the ECB to look under the hood of the eurozone's systemically important banks and make sure they are healthy before the Single Supervisor Mechanism (SSM) takes over responsibility for overseeing the banks in January 2015. This will be done through an Asset Quality Review (AQR) to be completed by mid-2014 and stress tests conducted with the European Banking Authority (EBA) by November 2014.

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The difficulty of undertaking such an involved process in the time frame necessary should not be underestimated. In the United Kingdom, for example, an Asset Quality Review was conducted in 2012 that took four months. It only included eight banks, compared to the roughly 130 the ECB must examine. Arguably, the ECB is incentivized to be very stringent in the AQR to make sure all 130 systemically important banks for which the SSM has direct supervision are in good shape. But it is much more likely the ECB will err on the side of lenience.

One reason the AQR's results are likely to be flawed is that the approach is completely backwards. After the collapse of Lehman Brothers in the United States, the first step the US government took in running stress tests on the banks was to identify a huge amount of money available to recapitalize the banks if needed. In Europe, policymakers are first conducting the stress tests and then identifying the funds to plug any holes in bank balance sheets. Surely it would be easier not to find significant holes in bank balance sheets than work out how to fill them.

The ECB may be running the AQR, but national supervisors are heavily supporting the exercise as well. These supervisors have spent months working behind the scenes insisting to the ECB that their banks are healthy. That political pressure will continue throughout the exercise.

Most of the grunt work for the AQR will be carried out by consultants from the Big Four accounting firms—PriceWaterhouseCoopers, Ernst & Young, Deloitte, and KPMG. It will be an enormous task for the supervisors to come up with uniform definitions for things that must be measured as part of the exercise, such as "non-performing loans." But it will be an even bigger task to have those definitions implemented uniformly across Europe by consultants from four different firms.

These definition issues often result in errors. In the recent Irish AQR, for example, one bank questioned the initial results and insisted they be justified. Ultimately, many of the discrepancies could be explained by differing views of definitions and values. For an AQR to be accurate, it must be an iterative process, whereby consultants and banks communicate about assumptions made. The ECB's AQR is not expected to be iterative at all, so it will be rife with mistakes.

Consultants might also be tempted to mold the results of the AQR to protect their own reputations. The same four firms that will be awarded mandates for the AQR will have also audited the banks involved in the exercise. To ensure complete independence, a firm that was involved in the audit of a bank cannot be involved in the AQR for that bank. The AQR therefore creates a prisoner's dilemma for the Big Four firms. If Firm A audited an Italian bank in March and Firm B concluded in June as part of the AQR (using a lot of similar data and metrics to the March audit) that the same bank was in bad shape, it would damage Firm A's reputation. But simultaneously the two companies' roles could be reversed at a different bank. It might be better for all the accounting companies if they just play nice and agree with one another's audit results. While it is very unlikely this would be done in any kind of coordinated way, it could be in the back of the auditors' minds as they evaluate reams of data.

Finally, the banks themselves will be involved in the AQR. They clearly have an incentive to communicate to investors that they are in great shape so they have an easier time raising money in the markets. No one is supposed to know the results of the AQR until after the stress tests are conducted and the capital needs for each bank are announced. In reality, banks will leak results throughout the exercise, with investors trying to interpret the leaks and bet on failing and winning banks accordingly.

Getting off on the Wrong Foot

Arguably it is not all bad if the AQR's results are falsely optimistic. After all, if the ECB announced that a number of banks had significant capital holes or—even worse—needed to be wound down, the very tentative economic recovery in Europe would be immediately choked off.

There are two major problems with a too lenient AQR though. First, the reputation and credibility of the ECB and the nascent banking union would be severely damaged. We already saw this with the European Banking Authority (EBA), which has run two stress tests in Europe, both of which were widely scoffed at as being far too lenient. Credibility is the currency of central banks. If the ECB loses credibility because of the AQR, it will not only have trouble supervising banks, it may run into trouble carrying out its mandate of price stability as well.

Secondly, if banks are not forced to write down some of their nonperforming loans (NPLs), they will not lend. The economic recovery we are seeing in Europe will continue to be creditless, and will therefore be extremely sluggish. That will make it even more difficult for weaker countries to stabilize and begin to reduce their formidable public debt burdens.

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Breaking the Doom Loop

Whether banks are forced to write down NPLs in the wake of the AQR or not, they cannot avoid crystallizing losses for NPLs forever. When the SSM takes over supervision of Europe's largest banks in January 2015, policymakers must know what to do when these losses are accepted and a bank gets into trouble.

European policymakers have agreed on a roadmap, to take effect from 2016, for what to do when a bank balance sheet has a capital hole. First, banks are encouraged to raise their own capital in the markets. If this is not possible, banks must impose a loss on their creditors, amounting to up to 8 percent of the bank's liabilities.

This bail-in rule is the single most important development so far in the banking union. It means that banking debt no longer necessarily gets foisted onto the state's balance sheet by an immediate bailout. Instead, some investors will have to accept they took a risk and their gamble did not work out in their favor. Consequently, the doom loop between banks and sovereigns has been weakened.

However, it has not been broken. If a bail-in is insufficient to fill the capital hole, a bank can dip into national resolution funds (once they exist) or state resources for a bailout. While bailouts going forward will be capped at 5 percent of the bank's total liabilities, this still means some of the bank debt will go onto the state's balance sheet.

More importantly, the second half of the doom loop whereby failing states bring down their banking sectors has not been addressed at all. The ECB has hinted that it will penalize banks that are overly reliant on ECB liquidity in the upcoming AQR and stress tests. Consequently a number of banks have been paying back the three-year LTRO loans early in advance of the AQR. It is very unlikely the ECB will actually follow through with this though; the threat alone was meant to help push the euro lower.

If a country cannot afford to bailout its bank, then around 50 billion euros of the European bailout fund, the European Stability Mechanism (ESM), can be accessed by the state for bank bailouts. This is meant to be an absolute last resort option, and most senior policymakers do not anticipate it ever being accessed.

Resolving Resolution Issues

Gone are the days of banks as bottomless pits for taxpayer money. If a bail-in and a bailout are insufficient to save a bank, it must be wound down. European policymakers agreed on a Single Resolution Mechanism (SRM) to achieve this, but it will be extremely difficult to actually implement.

A resolution board comprised mainly of national supervisors can decide to wind down a failing bank. This decision is then sent to the European Commission, which can accept or reject it. If the Commission changes the amount of resources to be drawn from the Single Resolution Fund or determines there is no public interest in winding down the bank, then the decision gets bounced back to the European Council.

There are two problems with this decision process. First, it could take days if there isn't immediate agreement on resolving a bank, and given how politically unpopular bank resolution is, agreement is unlikely to be immediate. If winding down a bank takes more than a weekend, bank runs and market panic will ensue. Second, the final word on bank resolution remains with the member states. This means bank resolution will continue to be subject to domestic political pressures, which is partly how Europe's banks got so sick in the first place.

Leaving the decision-making process aside, there are problems with how to fund bank resolution as well. The first port of call is national resolution funds that are built up by imposing a levy on the banks. These funds will gradually be merged over the course of several years to create a Single Resolution Fund (SRF) with 55 billion euros in it. There are two problems with the SRF. First, it will only exist in time to help in the next financial crisis rather than this one. Second, no one knows quite how it will be used or accessed. Those details are to be hashed out later. It seems likely that Germany (as the largest contributor to the SRF) will resist access to the common fund. If that is the case, the banking union will have failed to achieve one of its other main goals: burden-sharing across Europe's banks.

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Are Our Deposits Safe?

The final piece of banking union will involve establishing a Deposit Guarantee Scheme (DGS) in Europe. Creating a DGS was an immediate concern when deposits were flying out of the peripheral eurozone countries in the first half of 2012. As soon as Draghi reduced the probability of countries leaving the eurozone with his pledge to do whatever it takes, deposit flight slowed and in most peripheral countries reversed. With this development pressure on policymakers to agree on a DGS seemingly evaporated. When this author asked senior policymakers what happened to the DGS, the answer was always the same: there is already a DGS in Europe at the national level, and this will suffice for now.

But they are wrong. A DGS at the national level will not suffice. This was abundantly clear in Cyprus when the country turned to the IMF, ECB, and European Commission—the so-called troika of international lenders—for a bailout in March 2012. Cyprus' President Nicos Anastasiades admitted openly that the Cypriot government did not have the finances to guarantee deposits of up to 100,000 euros in accordance with its national DGS.

As long as the threat of a bank run seems remote, policymakers will put off agreeing a European-wide DGS. Germany has always been opposed to it, concerned that German taxpayers may one day be on the hook for failing Spanish or Italian banks. Most recently, the European Council agreed to discuss the idea of national DGS' borrowing from one another on a voluntary basis. It is hard to see any country volunteering to pay to guarantee another country's deposits.

Progress, but Far to Go

Progress has been made on banking union that could not have been anticipated even twelve months ago. The legislation of the SSM and the agreement on bail-ins in particular are significant steps forward. But significant problems remain. The AQR and stress tests are rife with opportunity for error, unintentional or otherwise. As the first real step of establishing banking union, it is important the ECB gets this step right. Even if all of Europe's banks are deemed healthy and this is really the case, there are also problems with how to address struggling banks in the future. What has been agreed so far does not constitute a full banking union, but rather a loose banking federation. The measures agreed fail to break the doom loop between banks and their sovereigns or fully mutualize risk among Europe's banks so that a euro deposited at the Bank of Cyprus is the same as a euro at Deutsche Bank.

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The next step in Europe's banking union is for the latest proposal to be adopted by the European Parliament and the EU member states in April. The European Parliament has been heavily critical of the measures proposed by member states on banking union throughout the negotiating process, favoring instead a more streamlined decision-making process for the SRM and faster mutualization of national resolution funds into the SRF. However, the European Parliament is keen to get a deal agreed before the European Parliament elections on May 25.

Having an imperfect deal is not necessarily better than having no deal at all, though. It is crucial that Europe gets its institutional infrastructure right. If the banking union goes through as currently crafted, Europe may not face any immediate negative consequences. However, Europe and its banks remain extremely vulnerable to events abroad, as banks that have invested in Ukraine can now attest. Even if shocks do not materialize in the short term, problems with the banking union will become apparent the next time there is a cyclical boom and bust in Europe. It would be better to set the right foundations for a real banking union now than face another crisis and be forced to fix European Union's institutional infrastructure in the midst of another banking meltdown.

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