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THE BOTTOM LINE

Banking union crucial for eurozone survival

[BARCELONA] The line of credit to Spain from fellow eurozone governments may help to stabilise a fragile banking system, at least in the short term, but it is a missed opportunity. Spain's banking crisis provides a perfect opening to move towards a European banking union.

In the medium term, help to Spain will merely reinforce the link between the sovereign and the banks' problems, causing even greater fragmentation in the European banking market and pushing Spain closer to potential insolvency by increasing its debt burden. By contrast, a direct equity stake in Spanish banks taken by an appropriate eurozone investment vehicle would decouple bank and sovereign risk. It would represent a decisive step towards unified European banking supervision, which could imply easier liquidation of non-viable institutions.

Such a move would also contribute to banking integration if the equity stakes were eventually sold in an open EU-wide auction. The issue is whether such a vehicle, and the appropriate control mechanisms for assisted banks, can be established in a short time-frame.

A banking union is a necessary condition for survival of a monetary union that is unable to implement a strict no-bailout policy for member countries. Such a union should be understood as a centralised bank supervisor, resolution authority (RA), and deposit insurance fund (DIF), at least for systemically important and cross-border institutions, as well as a unified rule book for prudential supervision. There are, however, four major issues that must be confronted in order to move ahead with such a banking union.

First, a significant degree of fiscal integration is required, since an effective European RA requires a burden-sharing agreement among countries. In the eurozone, where there is no single Treasury, a DIF and RA should be financed with levies on banks, with a backstop agreed among the governments before a crisis strikes. Indeed, insurance cannot be arranged once a crisis has erupted, because solvent countries and banks will not, and should not, pay for insolvent ones. A European DIF would address the next crisis, but not this one, though a European RA could start functioning with funds from the European Stability Mechanism (ESM).

The second issue that must be resolved is the design of the DIF and RA. A case can be made that both functions should be integrated within a single agency, which should have three main characteristics:

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- ◆ Levies or insurance premia on banks should be calibrated to the perceived risk positions of institutions according to market indicators such as credit-default spreads. Flat premia would merely induce cross-subsidisation of risky banks by safe ones.
- ◆ Following the FDIC model, the agency should be bound by a prompt corrective-action procedure to avoid the regulatory forbearance that we have witnessed so many times in banking crises.
- ◆ The agency should limit taxpayers' exposure by wiping out shareholders and subordinated debt holders if needed in a restructuring procedure.

The third issue concerns whether the scope of a banking union should be the EU or the eurozone. A banking union is not strictly necessary for a high degree of financial-market integration. Countries that want to participate in the banking union but not in the eurozone face a dilemma, because they will have to move towards fiscal union (via burden-sharing) even if they do not wish to join the euro. This dilemma is particularly stark for the UK.

Finally, a banking union is not sufficient for the monetary union to survive. Indeed, there is no European deposit insurance fund that could sustain a run on deposits in Italy. To cope with this type of sovereign risk, a high degree of political and fiscal integration is needed.

Europe's financial crisis has led to a re-nationalisation of banking systems across the EU, with bailout policies in countries like Ireland, Belgium, the Netherlands, the UK, and now Spain contributing to the trend. The European Central Bank's (ECB) massive refinancing operations to provide liquidity to the financial system have also strengthened the link between sovereign and bank risk.

The naive belief that integrated European regulation and supervision would follow financial integration has proven to be false. There are now only two options: integrate ahead of markets – that is, give the ECB supervisory powers for systemically important and cross-border institutions, unify prudential rules, and create an RA with money from the ESM – or permit the current disintegration process to continue and await the euro's relatively quick demise. – *Project Syndicate*

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