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# THE EBU HAS STABILIZED THE EUROZONE, BUT CRITICAL ISSUES OF REFORM REMAIN

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## Key Takeaways

- European Banking Union (EBU) has severed many of the interdependencies between banks and national authorities that nearly led to the unraveling of the Eurozone in 2011 and 2012;
- The main achievements have been the centralization of bank supervision in the European Central Bank (ECB), the partial centralization of bank resolution authority, and the bail-in principle for bank rescues, ahead of taxpayer money;
- Vulnerabilities for the common currency remain, however, in the persistence of nationally-based deposit insurance schemes and ongoing bank-stake linkages via bank holdings of sovereign debt.

## The Sources of Eurozone Instability

The media has long focused on the European economic crisis in recent years as one of debt. Indeed, starting with Greece's first international rescue in 2010, which was the harbinger of several other bail-outs for EU member states, the events together have been referred to most often as a "sovereign debt crisis." A more profound problem for the Eurozone, however, was the contradiction between introducing a common currency in 1999, the euro, in a context of ongoing "banking nationalism." Banking nationalism refers to the strong political connections between states and their domestically-managed banks. As early as 1993, Barry Eichengreen pointed out that this state of affairs effectively collectivized risk through the common currency, without simultaneously pooling responsibility for bank soundness—a recipe for instability.[1]

The political ties between states and banks that shaped the trajectory of the Eurozone crisis included first and foremost that bank oversight had remained at the national level. This meant that national supervisory and regulatory authorities could, and often did, favor their banks with regulatory forbearance. National overseers kept domestic banking markets dominated by domestic owners or managers by denying foreign entrants access, implemented "light touch" regulation, and/or fostered outward expansion of domestic banks. All the while states provided implicit or explicit guarantees for banks through the history, practice and expectation of taxpayer-funded bank bail-outs, if need be. Banks reciprocated by serving as tools of macroeconomic management to states (providing credit to certain constituencies or lending more in a downturn) and by channeling credit to states through the purchase of government bonds.

The political interdependencies between European states and their banks paved the way for Eurozone instability once the US financial crisis hit European shores in 2008. First and most obviously, national responsibility for bank bail-outs, without a Eurozone-wide bail-out facility, heightened the fiscal vulnerability of the hardest-hit states, giving investors fright. Second, bank lending to sovereigns also undermined the euro by linking the fortunes of banks and sovereigns through fluctuating bond prices, sowing further investor

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doubt. As states' borrowing costs rose, banks' balance sheets deteriorated in value, raising the specter of further bank bail-outs that Eurozone member-states could ill afford.[2] Third was the impairment of the ECB's monetary policy transmission. Given that Eurozone banking markets were nationally-fragmented, risk through banking sectors was concentrated rather than dispersed. Thus ECB rate-setting policy did not function, and crisis-stricken countries were unable to recover.[3]

## European Banking Union's Stabilizing Role for the Euro

To date, EBU and related measures have severed a number, but not all, of the political ties between banks and states enumerated above. In other words, having pooled risk through a common currency, EBU marks the beginning of an institutional reform process in which Eurozone members have also developed shared responsibility for bank soundness. The first elements of EBU were agreed at the height of the Eurozone crisis in the summer of 2012.

The most decisive and significant reform thus far was the centralization of bank oversight in the ECB through the Single Supervisory Mechanism (SSM), which came into full force in November 2014. The SSM has direct oversight over the Eurozone's largest banks covering approximately 85 percent of banking assets, while smaller banks are subject to indirect SSM control, mediated through national supervisory authorities. The SSM alone plays a substantial role in stabilizing the euro because it has effectively ended national supervisory and regulatory forbearance of the most important financial institutions. But related, if less remarked upon, is the fact that the ECB through the SSM is now the Eurozone's sole bank licensing authority. Licensing authority in the ECB stabilizes the euro in the longer term because national authorities are no longer able to restrict competition in their markets. Through bank closures and mergers, the ECB is therefore poised to end banking market fragmentation along national lines. Should risk concentration finally give way to substantial bank transnationalization and higher levels of foreign bank ownership in Eurozone member-states, the ECB's monetary policy transmission should be enhanced.

A second major innovation was the implementation of the Bank Recovery and Resolution Directive (BRRD). Technically outside the formal structure of EBU, the BRRD is nevertheless critical to re-casting bank-state ties in the European Union (EU) and stabilizing the currency because it stipulates that member-states must legislate alternatives to taxpayer bank bail-outs. Rather than draw on public money first in the event of a faltering bank, the BRRD requires that private investors be bailed in initially. This is a direct attack on the explicit and implicit guarantees that states have long held out to banks, severing an important component of traditional bank-state ties and making banks much more susceptible to market opinion and behavior, rather than to their home states. States, meanwhile, eliminate a major fiscal vulnerability by no longer acting as the first port of call to shore up a failing bank.

## Remaining Vulnerabilities for the Eurozone

EBU is not yet complete. Three major areas of reform remain. These are 1) the only partial centralization of bank resolution authority in the ECB and the insufficient mutualized resources for bank recapitalization or resolution; 2) the absence of a collectivized deposit insurance scheme at the Eurozone level; and 3) lack of agreement of bank lending to sovereigns. Because national policy discretion and sovereignty are at the core of each debate, we may not see further reform for some time—or ever. While centralized supervision in the ECB has gone some distance in allaying fears among key member states, including Germany, that mutualized schemes would mean fiscally strong states backstopping weak ones, skepticism persists.

These three issues in particular—resolution, deposit insurance and sovereign lending—challenge the euro's stability going forward because they are the remaining areas in which states' fiscal conditions could be damaged by home banks, and vice versa. With respect to resolution and deposit insurance, the problem is simply that states (and their taxpayers) could again be saddled with the costs of failing banks. State responsibility for banks in turn sows doubt in the currency because investors fear crisis-stricken countries cannot afford to stay in the Eurozone. Limiting bank lending to home sovereigns was also under discussion in 2016, but banks, particularly in Europe's southern periphery (Spain, Portugal, Greece and Italy) were still disproportionately exposed. To the extent banks remained hostage to states' fiscal profiles, international investor flight had the potential to again foment chaos.

Though the completion of European Banking Union is desirable from the perspective of stabilizing the euro, the domestic political costs of yielding so much national discretion over bank governance had also come into view by 2015 and 2016. To be sure, some of that discretion had been used to prop up and conceal poorly regulated banks. But bank-state ties have also been used to make sure states have adequate access to credit at reasonable cost. As the distributional consequences of full banking union become more apparent over time, the political struggle over banking union's final form promised to intensify.

# ENDNOTES

1 See Barry Eichengreen (1993). 'European Monetary Unification'. *Journal of Economic Literature*, Vol. 31, No. 3, pp. 1321-1357.

2 European Systemic Risk Board (2015). *ESRB Report on the regulatory treatment of sovereign exposures.* European System of Financial Supervision.

3 See European Central Bank, (2012). *Financial Integration in Europe.* Frankfurt am Main, ECB. Available at http://www.ecb.europa.eu. (April).

## About This Series

Korbel Quickfacts concisely explore the policy-relevant dynamics that characterize contemporary security challenges. The series is produced by the Sié Chéou-Kang Center for International Security and Diplomacy, a center of excellence within the Josef Korbel School of International Studies, University of Denver, with support from the Carnegie Corporation of New York. The views expressed are those of the author.

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