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Banking union: Mind the gaps ☆

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ABSTRACT

This paper reviews the various mechanisms and rules that have been proposed to create a banking union in Europe. We argue that the banking union is a promising solution to the Eurozone crisis because it completes the unification of the Euro currency, forms a solution to both the financial and monetary fragmentation of the Euro zone financial markets and helps break the vicious cycle created by domestic banking system impairments and the sovereign debt crisis. We underline the shortcomings and hurdles to attaining a fully-fledged banking union, and the hazards created by the inconsistencies between the phasing-in of the sequential programme decided by European member states. Various suggestions are made to fill the gaps created by the current architecture: establishing a shared-bailout rule to absorb the remaining losses, simplifying the organisation of banking groups and creating a truly federal deposit insurance scheme.

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1. Introduction

The institutions governing the Euro that were chosen in Maastricht in 1992 established a separation between the management of the currency (a centralized monetary policy in the hands of the Euro system) and the supervision and resolution of impaired banks (which remained a national jurisdiction). This choice was not the preferred outcome of the experts that prepared the institutional leaps enacted by the Maastricht treaty. Yet they did not have the ear of their governments and the subsidiarity principle prevailed. As the crisis has shown us, this was a very costly mistake, which reveals a deep misunderstanding of the essence of money. The governments had forgotten that money is not a commodity but an institution, a set of rules that constitutes a system and ensures the viability and consistency of decentralized economic decisions. The European sovereign debt crisis provides the opportunity to remedy the original flaws in the institutional design decided in Maastricht (Aglietta and Brand, 2013). Under the pressure of soaring yields, between June 2012 and March 2014 the heads of states and governments decided to put the Eurozone back on track by creating a banking union to complete the Euro monetary system, i.e. a system of federal authorities dealing with banks. But as always, the devil is in the details. This paper argues that although the banking union is a step in the right direction, the current architecture may still endanger the financial stability and the sustainability of the monetary union. We therefore propose remedies to fill the gaps left by the governments in between the various schemes that form the banking union.

The legal basis that the European banking union was built on relies on a change in the interpretation of the articles 114 and 127 of the treaty, regarding the functioning of the European Union (TFEU article 127 §5 and §6).[1] This reinterpretation allows federal institutions to step in concerning banking matters. The banking union consists of a combination of 3 pillars that forms a system: (i) a Single Supervisory Mechanism (SSM); (ii) a Single Resolution Mechanism (SRM) and (iii) a single deposit insurance scheme (Goya et al., 2013; Beck, 2012).

The SSM is an organisation formed with representatives of the ECB, the European Commission and the supervisory authorities of participating member states. It monitors all credit institutions – with special treatment applying to systemic banks, which are directly supervised by the ECB – and it is asked to provide unified and high-quality supervision standards.

The SRM refers to the set of rules governing the treatment of impaired banks in an orderly manner and the rules used to share the losses in the event of default, in order to preserve financial stability and so to avoid financial market turmoil. Prior to the crisis, most European governments lacked resolution tools, leaving liquidation or bail-out as the only options. The SRM is built on the principle of successive lines of loss-absorption devices: private sector involvement through bail-in of creditors and then a resolution fund financed by the banking industry (called the Single Resolution Fund) and, ultimately, by the taxpayers.

The deposit insurance scheme aims to guarantee that one euro deposited in any European bank will be reimbursed to depositors in the event of the failure of the bank, without any haircut (up to a limit of 100,000 Euros).

In our view the architecture of the banking union must reflect that the sustainability of the monetary union depends on a greater acknowledgement of the role of banks in money creation and the European governance should reflect this. We argue that the single currency will not be irreversible without a political leap to a form of political federalism. If the banking union ends up being completed by a truly federally-backed single resolution mechanism and a federal deposit insurance, it will force member states to move forward and will hence truly consolidate the Euro area.

The remainder of the paper is organised as follows. Section 2 deals with the incompleteness of the European monetary union without a banking union. Section 3 advocates that the banking union is a

[1] Article 127 §5 and §6 reads as follows: "5. The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system; 6. The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings." See http://eur-lex.europa.eu/legal-content/FR/TXT/?uri=CELEX:12012E/TXT

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