Plans for a banking union may not be enough to tackle the eurozone's economic crisis.

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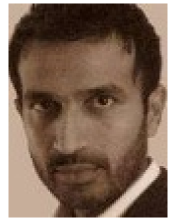

*Many commentators advocate a banking union as a partial solution to the eurozone crisis, arguing that it will break the 'vicious circle' between weak banks and weak sovereigns***.** *Looking at the current role of the European Stability Mechanism,* **Sony Kapoor** *and* **Charles Goodhart** *write that a banking union may prove ineffectual because equity cannot be injected into weak banks or be used to tackle past losses, and could not be used without a sovereign guarantee. Instead of potentially increasing their liability, they propose that sovereigns should be shored up so they are better able to support weakened banks.*

After a year in which European Union policy makers spent much time obsessing about banking union, it is time to take stock of the discussion. The question today is not about the intellectual case for a more unified approach to bank regulation and supervision within a single-currency area such as the eurozone. That case is still strong. Rather, it is about if what is being pedalled as a 'banking union' will deliver the goods — whether it will help tackle the economic crisis that still looms large over Europe or not. Evidence is now stacking up that it will not.

The EU's banking union was sold as a means to break the "vicious circle" connecting weak banks and weak sovereigns — and to do so quickly. As a way to mitigate the risks that troubled banks pose and weak sovereigns pose to each other, however, the plan is looking more ineffectual by the day. Although the European Stability Mechanism (ESM) can inject capital into struggling banks, a number of caveats apply.

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The first is that equity can only be injected into viable banks, and not the "bad banks" that various states have set up to wind down problem assets and reduce uncertainty in the financial system. The problem here is that it is exactly in these bad banks that losses are likely to arise. Under the current plan, these losses would need to be absorbed by the member states in question, adding significantly to their government debt.

The second is that equity injections are not allowed to tackle "legacy losses." Given that large losses have already materialised and been recognised in banking systems in Ireland, Spain and Cyprus, this severely limits the usefulness of any direct injection of ESM equity. In fact, it's fair to say that if we did not have a legacy-asset problem, the euro crisis would not exist.

The third and perhaps most pernicious element is that equity injections would not be made without a sovereign guarantee indemnifying the ESM against any losses. That means the risks of such an exercise still lie fully with the sovereign. The only thing this will accomplish is that crisis countries' reported debt-to-GDP ratios will look a bit lower than if those countries had been forced to borrow money and rescue

banks on their own. While this "off-balance sheet accounting" could have fooled markets 10 years ago, it will not work now.

What of the risks to banks posed by weak states? First, there is the on-going exposure of banks to macroeconomic risks in their home countries which is hard to mitigate. Equally important, national governments continue to provide, in various forms, explicit and implicit guarantees to banks. If the credit of a state such as Spain or Greece is in doubt, depositors in those countries can no longer rely on those governments' deposit insurance programmes, for instance. Hence the importance of the plan for a pan-European deposit-guarantee programme — which now seems to have been kicked into the long grass.

The fragility of the current construction can be seen by the fact that, if a German bank with branches in Spain were to launch an advertising blitz offering Spanish depositors the safety of German-government deposit insurance, there is little that supervisors could do to stop tens of billions of deposits leaking away from even the stronger Spanish banks.

In the immediate aftermath of Lehman's collapse, many EU states launched schemes that allowed their banks to issue state-guaranteed bonds. More than €700 billion of such debt was issued by 2010. The expiration of these schemes, and doubts about the creditworthiness of certain sovereigns, led the European Banking Association to propose a pan-European funding-guarantee scheme. This was considered politically unpalatable by stronger member states, and the credit crunch necessitated the European Central Bank's two Long-Term Refinancing Operations (LTRO). But banks used a significant portion of LTRO funds to increase their holdings of home countries' government bonds, particularly in troubled EU economies—thereby reinforcing the link between sovereigns and banks.

While it is easy to think of weak banks in sovereigns with strong economies, it is almost impossible to visualise a scenario where banks thrive in a troubled home economy. Even under the best case scenario of the on-going banking union discussions, weak sovereigns and troubled banks will stay locked in a dance of death. Yet, European policy makers continue to waste their time on something that is now a banking union in name only. Focusing on providing low-cost funding support to troubled sovereigns as they undergo structural adjustment may be a better use of their scarce time and resources.

Shoring up troubled sovereigns would help reduce macroeconomic risks and improve the credibility of implicit and explicit sovereign support. Restoring growth is the best way to change the dance of death to a dance of life, where a strengthening economy and healthier banks reinforce each other. It's time to move on from the sham the banking union discussion has now become.

Note: The anointment of the ECB as the supervisor for the largest eurozone banks can help with the present crisis if it cracks down on national regulatory actions which may be sensible individually but collectively problematic. In a bid to safeguard their national banking systems, many European regulators have been leaning on banks to hoard liquidity and minimise exposure to crisis-hit countries. This has accentuated the eurocrisis. The ECB would presumably be able to crack down on these actions. However, it is certainly not necessary to go through the political contortions that a banking union entails, in order to mitigate such problematic behaviour. The European Commission already has the authority to take action and a 'comply or explain' letter sent to national regulators is a first step in this direction.

This article first appeared at the Re-Define blog.

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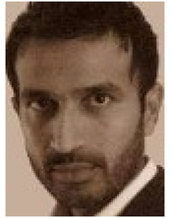

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