Toward a Centralized European Banking Authority

Nicolas Véron argues that as Europe moves toward fiscal as well as monetary union, a federal banking authority should be created to force banks to install buffers against crises.

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Steve Weisman: Europe seems perpetually on the brink of disaster. Nicolas Véron, visiting fellow at the Peterson Institute for International Economics, has delivered some interesting Congressional testimony saying that this is not just a sovereign debt crisis, as it's widely seen in the United States, but also a banking crisis. What is being done to strengthen the banks as they face the possibility of more of turmoil in the bond markets?

Nicolas Véron: I believe the right way to look at this crisis is that it's a crisis of an incomplete currency union. We have a federal framework for monetary policy. There's been a lot of awareness recently that we need a federal framework for fiscal policy, which means probably some backing of individual member states from each other or from a central insurance capacity. But we also need the federal framework for banking policy, and that means that you cannot have a sustainable currency union if you have a series of faulty fragmented national banking systems. This is what to me is at the core of the current moment.

The European Union (EU) has been in a state of banking systemic fragility, let's call it that way. You may call it a banking crisis. Since 2007, it has never really been resolved. If you look at the U.S. in 2009, they have essentially resolved the banking crisis. Of course, there's a larger economy crisis still unfolding. But the banking system is restored to more or less normal state in 2009, maybe early 2010. In Europe, it has never been the case. There has been no such decisive action, and the reason for that is the lack of instruments that would impose that on a system-wide basis, which means a super national basis in the European case.

Steve Weisman: But there is a European Banking Authority participating in a stress test.

Nicolas Véron: I think the European Banking Authority, which was created on the first of January this year, is a very constructive move. It's something important or more accurately something that will become important. Even if you look at this year's stress test, the problem with these stress tests is that they haven't triggered a move towards recapitalization of the weakening central European banking system. They still have had benefits in terms of giving more transparency about the state of the big banks and the system -- and this goes to the credit of the European Banking Authority. I think this part about disclosure was much better done this year than in the current round of stress tests last year in July 2010, and this is not just because it was always improving. It's because the European Banking Authority has been able to make a difference. So it is helpful, but it's not enough. The European Banking Authority has limited power. It's a very small organization. It's not enough.

Steve Weisman: Its authority is over how many of Europe's banks?

Nicolas Véron: Technically you may say zero. I mean, the European Banking Authority doesn't have direct supervisory authority over any single financial institution. It has coordination capacity among the European supervisors. I mean, in crisis situations it may take additional competencies, but this is sort of loosely written in the legislation. So how exactly its powers will unfold in a full-blown crisis remains to be seen. But I think one of the things indeed that has to be done -- and sooner is better than later -- is giving the EBA (European Banking Authority) direct supervisory and resolution authority among the European banks. Even so, of course, much of that should be delegated back to national authorities to be done on the ground, but with a European mandate. And I think the fact that we have had national banking systems basically being addressed from a policy standpoint by national governmental authorities has been a big factor in the problem we're seeing right now.

Steve Weisman: Are any of these national government authorities more diligent than any others -- in terms of insisting that their banks recapitalize to prepare for a situation that might become even worse?

Nicolas Véron: I think there are countries where memories of recent crises were fresh and pro-active steps were taken. I think there are not many of those countries. But Sweden is probably a good example -- which had major systemic banking crisis in 1990 to '93, so that's recent enough for it to be very present in living memory. And there are countries in which the crisis has been already so catastrophic that a lot of the cleaning up has already taken place. This is certainly the case of Ireland. I think it's also to a large extent the case of the UK, outside of the euro area. It could be the case of other countries. They have been in a bit of an intermediate situation. They have started to address the restructuring of their banking system in a fairly muscular way, but I think they're far from complete and a lot still needs to happen on that count in Spain.

Other countries like Germany, France, Italy, have been to a large extent in denial in the reality of the problem. Even so, Italy perhaps less than France and Germany, because the Italian Central Bank has compelled some Italian banks to recapitalize -- perhaps in a more proactive way than some neighbors. But still, a lot needs to be done on these countries, of course. At this point the main risk factor is the sovereign debt crisis. It's difficult to quantify because it's so ridden with political risk factors. I mean it's basically about handling political risk.

I agree with some of the critics, some of the recent members of the IMF [International Monetary Fund]. The IMF has published its numbers about the capital means of the European banking system and they have based them on CD -- on the credit default swap prices. You may want to take these market signals with a pinch of salt, but still the core element remains that as there is a systemic crisis in Europe it means that the banking systems needs more capital than it currently has. It has to build these buffers otherwise we'll have the continuation of this period of distress, which is so harmful to Europe.

Steve Weisman: Are the banks waiting to see how the Greece situation is resolved? We know there's going to be private sector involvement, which involves haircuts for bond holders. But we also don't know the extent to which a more extensive hair cut might be part of a ultimate Greek solution. Are the banks waiting to see how much they will have to recapitalize once they know what the losses are going to be? Or are they just in denial? Or do they just not want to dilute their shares?

Nicolas Véron: Well, no bank wants to dilute its shareholders, I think, at least no listed banks. But some of the banks we are talking about are not publicly listed. And the consensus may be a bit different for these. I think that it's always painful to dilute shareholders. I think the situations are very different from one financial institution to another, and this is difficult to observe right now because even after the stress test, we still lack some of the really useful comparative information on risks and situations in terms of balance sheets.

I believe we still -- even for a situation that is less dire than it was a year ago -- we still haven't had comprehensive process of putting all the banks on the table, looking at which are strong, which are weak, and identifying the weak links with a pretty good degree of accuracy -- which is exactly what the U.S. Supervisory Capital Assessment Program's stress test did in the spring of 2009. In Europe it's more complicated because there are many more banks and there is this national diversity. This is why I am talking about instruments to do that. We need a European authority to do that without having to rely on national authorities, which defend our national champions. This is crucial. As long as we don't have this centralization of the process, I think we'll make some progress but only limited progress because it's really a necessary condition.

Steve Weisman: Some kind of fiscal centralization for all of the euro countries was unthinkable a year ago. Now it's being discussed even by the Germans. They don't love it, but it's being discussed. What phase are we in [on a centralized banking authority]?

Nicolas Véron: I think it's really parallel in many dimensions. One, it was unthinkable. It will have to become thinkable because it has to be part of the solution, and at some point as reality hits, and you will have to consider things that were unthinkable.

Second, we shouldn't confuse short-term crisis management with a long-term framework. In fiscal terms that means in the short term won't have eurobonds. But we need some gap financing, bridge financing, for the countries that need it and cannot access the market in sustainable terms. So that's all the talk about leveraging the EFSF [European Financial Stability Facility], and giving it access to ECB [European Central Bank] liquidity. But that's only a small gap solution. A long-term solution has to be something more organized. There's all this discussion about Eurobonds. But everybody knows that this requires time to be put in place. But you need both. You need to think about the long-term framework and to have the short-term arrangement that can bring a degree of trust back into the marketplace.

In banking, it means we need the longer term a centralized process for supervision and resolution of financial institutions in Europe. It will take time to put in place. In the short term we need something akin to what the U.S. did with the Resolution Trust Corporation in 1989 when it resolved the savings and loans crisis. We need an organization, a trust corporation, if you call it that. A European [entity] that will do the dirty work of looking at the weak links, forcing them [the banks] to recapitalize, and if they cannot they will take over the assets and resell them at some point. So basically they're doing the work of crisis resolution.

Steve Weisman: And how far are we from that?

Nicolas Véron: We're too far. I mean it's not discussed enough in policy circles. There's a sort of laziness in policy circles, which consists of saying, well, banks need recapitalization. But they're not thinking far enough in my opinion at this point about how this will have to be done in terms of what sort of policy instruments do we need for that. I think frankly the sort of Resolution Trust Corporation approach has to be the approach because you need specific skills to do that. You need people who have an experience of restructuring. You need a whole culture that can be formed on a temporary basis.

There are good precedents, not only in the U.S. with the R.T.C. but what Sweden did in 1993, what Germany did with the privatization of the East German companies. Even though it was very painful, at some point you need somebody to do the dirty work of surgical intervention and restructuring. And better give it to a temporary authority because these guys are not going to make friends. But it can be done and it should be prepared.

The last but important common feature between the fiscal side and the banking side -- fiscal federalism and what I would call banking federalism for the EU -- is that this is a big transfer of sovereignty from the national to the European level. And it can only be made sustainable (and here I'm speaking of the medium to long term) if there is a big change in EU institutions. The EU institutions right now are simply not democratic enough. They don't provide accountabilities. They don't provide executive decision-making capability to be transferred this huge power.

At the same time you have to envision the sort of underpinning, re-engineering of the entire EU political institutional framework if you want these steps to be taken because otherwise it won't happen. And this is what the German Constitutional Court has said in its successive judgments. But they are right. I mean, you cannot have this transfer of sovereignty if you don't have a much more robust, resilient, and accountable institutional framework at the super national level.

Steve Weisman: And popular support, at least popular understanding.

Nicolas Véron: It's chicken and egg, right?

Steve Weisman: Right.

Nicolas Véron: At this point there is no trust in public opinion because of EU authorities. But I also believe there is a keen awareness in most member states that there are a number of problems that the national level hasn't been able to solve very well. So actually I think there is more readiness for this form of exit from the crisis than national political environments tend to believe.

Steve Weisman: The leadership elite…

Nicolas Véron: Yes.

Steve Weisman: …at least is beginning to think of it.

Nicolas Véron: And I would argue in the population. I think people are aware that we cannot continue the way we have done so far.

Steve Weisman: Nicolas, thanks very much.

Nicolas Véron: Thanks, Steven.