A Small Step Toward European Banking Union Regulation

Nicolas Véron explains that a European agreement on how to deal with insolvent banks moves the process of more unified banking regulation forward.

Steve Weisman: The European Parliament and European ministers completed marathon negotiations to produce legislation for a resolution mechanism or authority for the European banking system. Nicolas Véron of the Peterson Institute in Bruegel is here with me, Steve Weisman, to explain the significance of their agreement. Nicolas, 17 hours, they met. Did they produce a mouse or a dinosaur?

Nicolas Véron: That's a limited set of options, Steve. I would say the importance of this agreement is easy to overhype. You hear ministers and the European Union -- for example the French or Dutch finance ministers -- who say this is major achievement, it's a completion of banking union. Well, clearly, it's not a completion of banking union because banking union reasonably defined is a shift to the European level of the instruments of banking policy or, in other terms, breaking the now notorious vicious circle between banks and sovereigns that had been so damaging in the euro crisis. And this agreement does not do that much.

Steve Weisman: What does it do? Resolution is a term that is not completely understood by the lay public.

Nicolas Véron: Yes.

Steve Weisman: It refers to the disposition of banks that are basically found to be insolvent. Is that correct?

Nicolas Véron: Right. A bank resolution is an alternative process to a court order of insolvency to close a bank. Basically, that's what it is. It's an administrative process, not a judicial process, that allows the closing of a bank much more quickly and in a much more orderly fashion than if a bankruptcy court were in charge. This is something the US has had for many decades and the main actor here is the Federal Deposit Insurance Corporation, the FDIC. But believe it or not, Europe didn't have that. And therefore, in Europe, until this crisis in almost all member states, there was no alternative from either a disorderly court-ordered bankruptcy or a nationalization with bailout of all the creditors.

So, basically, what Europe is doing is something the US has done many decades ago, which is creating an orderly winding down process for banks. It does it both at the national level and at the European level. So, it's many different things at the same time.

Steve Weisman: This authority will encompass all the banks in Europe or just the systemic ones, the ones that are maybe too big to fail?

Nicolas Véron: Technically, it will encompass all the banks that are subject to the direct supervisory authority of the ECB under a single supervisory mechanism that has been agreed last year. So, it's a piece by piece —

Steve Weisman: How many banks is that?

Nicolas Véron: In practice, to start with, it will be 130 or so banks which are subject to the ECB's asset quality review [AQR]. Together, these banks probably represent more than three quarters of the European banking system, depending on how you measure it. It's the bulk of the European banking system. A number of smaller banks are excluded at this point, but might be included later in time because the ECB has the ability to include them unilaterally in its scope of authority. The short answer is, this covers the European banking system for most practical purposes. There are small exceptions, especially in Germany for political reasons, we can discuss, but it's pretty comprehensive in terms of coverage in the euro area.

Now, there might be other countries -- for example, Denmark, Romania, perhaps Hungary -- which are not in the euro area but which might want to join this banking union area: an intermediate category between the euro zone and the European Union of all 28 member states. We might need to get used to talking about the banking union areas that would be the sort of concentric circle. We'll know more by May or June this year about these early choices of joining.

The banking union is an open construct framework of the European Union. It's not just with the euro zone. And obviously, the UK, which is a key country in terms of the European financial system, would remain outside for the foreseeable future even assuming it stays inside the EU which obviously is hotly debated. So, it's very comprehensive in terms of coverage.

A I mentioned, last night's deal is limited because it's a hybrid. It's not really a single resolution mechanism. It's single in name only as they would say in the Republican Party. It's actually a very complex mixture of national and European authorities. And also in terms of financing, there is a thing called the Single Resolution Fund; but which is actually a mixture of national and European. And in any case, it's very, very limited in size. It's only €55 billion, which sounds like a lot of money but actually in the context of the European banking system is very little.

There are a lot of qualifications in terms of the progress this represents on the roads toward banking union, but I would say if you factor in also political constraints, this was clearly at the upper end of the range of realistically possible decisions.

It's a constructive step, it's a positive signal. If there had been no deals, it was a risk that would have been very negative about the machinery being clogged basically and not being able to agree even though it's something very incremental. This is a bit for the specialist, but there was another piece of legislation called the Bank Recovery and Resolution Directive, which creates and harmonizes those resolution regimes in individual member states. And this had been taken hostage by the European parliaments in the negotiations. Now it can be published and will probably be published very soon and that's also progressed, it reduces legal uncertainty. It creates facts on the ground in terms of a more consistent policy framework for European banks.

All this is good. It's not a breakthrough. It's a positive step whereas the real make-or-break test of banking union is somewhere else. It's the so-called Asset Quality Review [AQR]. This is the comprehensive assessment of banks that the ECB is starting to conduct as we speak and this still lies ahead.

Steve Weisman: You anticipated my question, which is that this Asset Quality Review, which Americans might be more familiar with the term stress test, is getting under way for these 130 banks that you mentioned. Does this step that was just taken at least lay down some kind of mechanism in case the AQR finds that some of the banks are insolvent and at least under stress?

Nicolas Véron: Unfortunately not. It's a bit absurd in terms of timetable because even so, there is an agreement on a single resolution making this, I mean, it will not be in place when we have the results of the AQR. It sounds stupid or nonsensical. It actually has its own sort of internal logic, which is to say that AQR is dealing with legacy of the past, with the past supervisor and misjudgments of the member states, and it has to be done at the level of the individual member states. The European mechanism is only for the future. That's a sort of German reasoning, if you will accept oversimplifying this. It's a step-by-step saying we do supervision first with an AQR and dealing with banking restructuring but only national frameworks because this is national sense of the past if you will. And then in the future, we'll have a City on the Hill which is European, with the SRM.

Now, your question is about: how does the AQR looks at this point? I would say it looks reasonably good, but the more difficult part still lies ahead. It's too early to judge its ultimate success. And success of course will be measured ultimately in terms of how much confidence returns to the European banking system, how much the lending of banks to each other will return to conditions one might reasonably describe as normal, which is not the case currently, given to extraordinary intervention of central banks in the eurozone.

It's a difficult process because it's not just obviously about accounting and risk assessment. I mean, you mentioned Asset Quality Review Stress Test. There is a certain component, which is called the supervisory risk assessment which the ECB is doing, but has communicated very little about. And all these three elements together constitute what the ECB calls a comprehensive assessment, which is a technical term for what everybody calls the AQR. But the difficult thing is that if the ECB finds some banks to be severely undercapitalized, these banks will need restructuring or even be closed. And this will be done by national authorities with very little European solidarity, the more realistic take from the German government that I just explained. And this is potentially very painful both politically and possibly financially, depending on which member states you're talking about.

We don't know where the biggest problems will lie. Some people think it will be in the periphery -- in Spain, Greece, Portugal. Other people think it will be in the core -- in Germany, France. And Italy of course is somewhere in the middle. So, this remains to be seen and it hasn't escaped of course the attention of observers, of the chairperson of the new supervisory board which is the dedicated body and sides with ECB.

Mrs. Daniel Nui was until very recently in charge of supervising French Banks. Her deputy Mrs. Sabine Lautenschläger was until very recently in charge of supervising German banks. Mr. Draghi, the president of the ECB was until about two-and-a-half, three years ago in charge of supervising Italian banks. So, there are also issues of legacy which makes it even more complicated. And I think it will be a test to ECB's institutional strengths. I'm pretty optimistic that ECB can pass this test successfully but it will create a lot of tensions with member states. And therefore, it has to be monitored very closely. And as I said before, the most difficult phase still lies ahead; and therefore, it's too early to call it a success. Even so I would argue that the initial communication in spite of the ECB had been rather encouraging.

Steve Weisman: With all these balls in the air, I'm glad you're here to explain and juggle them. Thank you very much, Nicolas.

Nicolas Véron: Thank you, Steve.