An Ever Closer European Banking Union

Nicolas Véron discusses key upcoming steps in what he sees as a central aspect of European integration—and one key to preventing another financial crisis.

Unedited transcript of interview recorded December 21, 2015.

Pedro da Costa: Hi, I'm Pedro da Costa, Editorial Fellow here at the Peterson Institute for International Economics. I'm here with Nicolas Véron, Visiting Fellow and expert in European banking. Thank you for joining me.

Nicolas Véron: Thanks for having me.

Pedro da Costa: Absolutely. So you've written a lot about the European banking union and you think it's kind of gotten short shrift in the public debate. Can you tell us a little bit why you think it's a big deal, rather than just an idea without an actual concrete …?

Nicolas Véron: Well, as you know, economists don't really have a model for the banking sector. That's a big flaw in general equilibrium modelling, and, I think, in the case of banking policies, I tend to see it in very clear-cut ways, like banks will need a bailout in a crisis. So who provides the money, and if the money is still national, that means there is no European banking union. For a European banking union, you need bailout money to be European. I think this is the mainstream critique of the European banking union, that's being insufficient.

Pedro da Costa: Okay.

Nicolas Véron: I think it omits a number of the dimensions of this debate. So what does banking union do? At this point, the main thing it does is that banking supervision has been pulled at the European level for Eurozone countries, so it's being done by the European Central Bank, the ECB, and so authority has been transferred from the national authorities to the ECB in this crucial area of banking supervision completely.

So the ECB is entirely in charge. It's actually a very centralized system. It's more centralized than in the US, because in the US regional Feds are in charge, for example, Wells Fargo is supervising San Francisco. In the Eurozone now, and this has been live for more than a year now, since November 2014, the person who makes the supervisory decision is in Frankfurt, for all banks in the Eurozone, there is some delegation for the smaller banks.

Pedro da Costa: So you see this as another example of integration.

Nicolas Véron: It is an extraordinarily powerful integrationist policy move that has been implemented, again if you look only at supervision. Of course there are huge resistances, and [inaudible 0:02:10] actions, and you can imagine that many people in the national authorities are not entirely happy with this, but it has happened, and it's changing behavior.

We're seeing a supervisor that is tougher, that treats all banks in the Eurozone with a much more consistent set of policies, and that is changing the political economy of banking. So basically we used to have arrangements at a national level, not unlike in the US, but in many cases more pronounced, whereas there would be some capture of the national political communities by the banking communities, or the politicians would use the banks, and have deals with the banks to use them to direct lending to politically preferred sectors, et cetera. And supervision was one of the main instruments of these linkages between political communities and banking communities.

Pedro da Costa: Do you think that once you Europeanize this, you take away those national linkages?

Nicolas Véron: You take away an enormous number of links which really matter in the real world, even though they're not in economic models, and that makes also the idea of market discipline in banking, which is always intrinsically problematic – the idea that you will avoid bailouts in a crisis, that you will have discipline of creditors, bail ins, and the like. Europe has not proved that it has migrated to this model, but it has made many steps in that direction. And the fact that you have a centralized supervision, which will be much more independent from local political pressure is really a game changer. And we see that in a number of concrete observations.

Pedro da Costa: And now, what's the next major step to implementation, and what are the likely sticking points in terms of the national governance?

Nicolas Véron: So the supervision is only one part of the banking policy framework, and you also need a credible framework for crisis resolution, which includes what the jargon calls bank resolution, which is an alternative, an administrative alternative to court-ordered bankruptcy, to take into account the systemic risk that goes with banking activity …

Pedro da Costa: Allowing too big to fail institutions to fail basically?

Nicolas Véron: Yeah, basically an orderly, what the current US jargon calls an orderly liquidation, and that vocabulary we can discuss, but that's how it's described in Dodd-Frank. So basically having the possibility to close a bank without bailing out all the creditors, and without having the sort of uncertainties that would go with a judicial process, so that's resolution. And then you have something that goes with resolution, but that's separate, which is deposit insurance, and the fact that depositors would be reimbursed at least up to a certain threshold if something happens.

So both of these are a part of the banking union debate, but the resolution part is much more advanced in the deposit insurance part. So for resolution, there is a next step in a number of days now, on January 1, 2016 where we basically have the main point of transition between the national framework for resolution powered to European framework. So in practice, there's an organization which had been created a year ago in Brussels, called the single resolution board, which in a way will act as a European counterpart to the FDIC in the US, the Federal Deposit Insurance Corporation, in its capacity as resolution authority. And you'll remember that the FDIC has closed more than 500 banks in the last decade. So the single resolution board will be in charge of this, it's a big new responsibility for this new European institution for banks in the Eurozone.

Of course, because the transition is in January, coming soon, we don't know how it will play up, and the funding arrangements for resolution are a big uncertainty. So there are a number of things that had been put in place, which I will not describe in detail, very convoluted as usual in Europe. But the big question to make it simple is if we have future cases of banking crisis, who will pay for the losses that will be uncovered? There are basically three categories, it can be the creditors, and the claimants on banks, including depositors, those which are not insured for example, national pots of money, or European pots of money. And the distinction between national and European pots of public money, taxpayers if you will, is crucial because in the crisis, the linkage between banks and national sovereigns, so-called bank sovereign vicious circle, have been really the engine of the crisis. What has fueled the contagion was this linkage of banks going wrong, and sovereigns going wrong, and banks going even more wrong, et cetera. So the idea that resolution funding in the future would become European, what Europeans now call risk sharing, that's the current code for that, is very important in terms of financial stability. It's also of course, very contentious, because it means that taxpayers in country A, might be liable, at least partly, for a problem that arises in country B.

Pedro da Costa: The mutualization problem.

Nicolas Véron: The mutualization problem, and there is huge political resistance in Germany against that. And that is part of the resolution debate, and of course, it's a big part of the deposit insurance debate because each European member state has a deposit insurance system that are pretty harmonized from one country to another now, but they're not mutualized. So basically the trust in the deposit insurance depends on the trust in the national sovereign, and as we have seen, sovereigns can fail in the Eurozone.

So that's a big issue, and that means that a deposit in country A doesn't really have the same level of trust as a deposit in country B, which is a very significant factor of fragmentation – unthinkable in the US. So this is where the current debate is. We'll have a number of things kicking into force on January 1, but we keep the very large uncertainty on who will pay for future bank failures, and only time will tell. We'll have to observe how the system works in practice.

Pedro da Costa: Okay, thank you very much.

Nicolas Véron: Thank you.