Tectonic *Shifts*

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Euro sculpture reflected in puddle in front of ECB headquarters, Frankfurt, Germany.

ON June 29, 2012, the leaders of euro area countries set in motion what is now universally known as European banking union, or the transfer of banking policy from the national to the European level. The first step, the empowerment of the European Central Bank as the new supervisor of most of Europe's banking system, has a fair prospect of meeting—by late 2014 or early 2015—its stated aim of addressing the long-standing fragility of Europe's banking system. But banking union will not stop there, and its structural implications will unfold well beyond the transition to centralized supervision.

Europe's banking problem

Banking union was initiated to resolve a pressing problem. The euro area crisis highlighted the damaging vicious cycle of either weak government balance sheets, which undermined banks' soundness, as in Greece, or banks' weaknesses, which damaged government credit, as in Ireland. This linkage became a threat to the entire euro area and its financial system in mid-2011 and forced policy action in 2012. But the underlying problem of European banking system fragility long predates the outbreak of the euro area sovereign debt crisis in 2009–10.

This problem was generally denied throughout the first five years of the crisis. Many policymakers first claimed that banking weaknesses could be blamed on the U.S. subprime mortgage market, and then argued that fiscal mismanagement in countries such as Greece was to blame. This narrative was the conventional wisdom until 2012, especially in Germany and France, where policymakers used it to excuse homegrown sources of financial weakness.

However, the roots of Europe's banking problem went much deeper. The core of the problem was a misalignment of incentives of Europe's banking supervisors. EU countries and institutions, in the wake of monetary union in the 1990s, set themselves ambitious aims to remove cross-border barriers to entry in European finance. In reaction, national authorities tended to champion the protec-

Banking union is a long-term process that will dramatically reshape Europe's financial system

tion and promotion of their countries' banks to give them an advantage in an increasingly competitive environment, even when this entailed additional risk taking.

This form of "banking nationalism" effectively downgraded prudential concerns about risk accumulation. A striking example was officials' assent to the ill-fated takeover and breakup of the Dutch bank ABN AMRO in 2007, which contributed to the subsequent difficulties of other banks, including Fortis, Royal Bank of Scotland, and Banca Monte dei Paschi di Siena. More generally, banking nationalism goes a long way toward explaining the massive buildup of leverage and risk in many European banks' balance sheets in the decade preceding the global financial crisis.

The mismatch between the national scope of supervision and the European dimension of the financial system also explains the failure to address the fragile banking system from the outbreak of the crisis through 2012.

This failure was not for lack of adequate warnings, including from the IMF. Instead, it was a quintessential collective-action problem. Most countries were deeply reluctant to identify weak banks for fear of putting their banking sector at a disadvantage compared with those of neighboring countries, particularly in the euro area. The absence of a strong central authority resulted in paralysis or inadequate action. Successive Europe-wide bank stress tests in September 2009, July 2010, and July 2011 failed to restore confidence when their results quickly proved unreliable.

Watershed developments

Europe's unresolved banking problem then became a factor in the euro area's unfolding sovereign debt crisis.

The exposure of euro area banks, particularly in France and Germany, to Greek risk was a key reason why Greece's government debt was not swiftly restructured in early 2010. Later in the same year, similar factors led to Ireland's being barred from imposing losses on its failed banks' senior creditors, which compounded its fiscal deterioration. By mid-2011, contagion in the market for government bonds had reached two of the four largest euro area economies, Italy and Spain. In August 2011, even French banks were briefly denied normal market access to dollar-denominated liquidity.

An increasing array of investors and policymakers started to factor the possibility of a euro area breakup into their calculations, raising the possibility of a disastrous self-fulfilling prophecy. The pressure generated by this environment led to a number of major policy changes in key member states and in the European Union as a whole, all between mid-2011 and mid-2012.

In the United Kingdom, the flow of bad news from the euro area cemented the conviction that the country should isolate itself from the continent and not participate in additional institutional buildup. This shift was summarized by Chancellor of the Exchequer George Osborne's comment in July 2011 about the "remorseless logic" of political integration in the euro area, in which Britain would decline to take part. This marked a radical departure from decades of British participation in EU initiatives, even while attempting to moderate them—most recently the formation in 2010 of the London-based European Banking Authority.

In France, the banks' funding difficulties in August 2011 undermined the self-confidence of the financial community and its belief in an independent national banking policy. This psychological turning point helps explain France's strong promotion of banking union in 2012, even though it was a key opponent of supranational banking supervision during earlier negotiation of EU treaties, including Maastricht in 1992 and Nice in 2001.

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In Germany, the euro area turmoil compelled the European Central Bank to take unprecedented policy initiatives that broke the policy orthodoxy of the Bundesbank, and triggered the two institutions' parting of the ways. The European Central Bank had long been perceived as under a form of Bundesbank tutelage. However, after its crisis response led to the successive resignations of German central bankers Axel Weber and Jürgen Stark but was nevertheless endorsed by German Chancellor Angela Merkel despite Bundesbank dissent, it gained stature as an independent institution with a distinctive policy identity. This transformation arguably underpins the acceptance by all EU countries of the extension of its authority to banking supervision.

Throughout the European Union, the previous doctrine that banks should never be allowed to fail, an explicit pledge by European leaders in mid-October 2008, was abruptly reversed. Until early 2012, even junior creditors of failed banks were protected by government action from any losses in almost all EU member states, no matter how small the bank. But by then it was increasingly evident that the protection of all creditors threatened government balance sheets and was politically unsustainable. In early June 2012, the European Commission proposed EU legislation based on the principle that creditors should take losses before taxpayer-funded bailouts can be considered. Meanwhile, the Commission's competition policy arm started imposing losses on junior creditors as a necessary condition for state aid to banks, in Spain in 2012 and as a generally applicable rule in August 2013.

In light of these developments, the initiation of European banking union in late June 2012 did not happen in a vacuum. It is best described as the most visible of a series of tectonic shifts generated by the unresolved European banking problem and subsequent euro area deterioration. It was itself described as a condition for the European Central Bank's later announcement of its

Outright Monetary Transactions program to buy government bonds. Together, these shifts resulted in considerable reduction of the perceived risk of a euro area breakup since mid-2012.

Prospects for resolution in 2014

Even so, as of early 2014, Europe's banking problem is not resolved—but this could change in the months ahead. The EU legislation to establish an integrated bank supervisory framework, now in force, foresees the November 2014 handover to the European Central Bank of supervisory authority over most of the euro area's banking system. It mandates in the meantime a comprehensive assessment of these banks by the European Central Bank, a process started in 2013 that is widely referred to as Asset Quality Review. In addition to the balance sheet assessment, this process includes a supervisory risk assessment and EU-wide stress test coordinated by the European Banking Authority.

The Asset Quality Review was initially seen by many as a relatively minor technical requirement; it is mandated only in a subarticle of the legislation's final section on transitional arrangements. But its practical effect is to front-load a politically challenging process of bank triage, recapitalization, and restructuring. The experience of past banking crises suggests that this process is essential for successful crisis resolution. Its consequences may include the revelation of more past failures by national bank supervisors; shareholders, taxpayers, and creditors taking a hit; and an end to "pretend and extend" lending to dubious borrowers, which may in turn trigger extensive restructuring of nonfinancial companies. So the review has rapidly moved up the European policy agenda and is likely to generate headlines throughout 2014.

The review process is as ambitious and risky as it is unprecedented. The European Central Bank had little prior experience supervising banks, but has devoted considerable resources to this task. It is fully aware that its credibility is on the line, as a future supervisor and more generally as an authoritative institution. But while the assessment process is in the hands of the European Central Bank, its consequences will also involve governments that must restructure banks deemed weak by the review. Restructuring may be disruptive, financially and politically, for individual countries, especially since there will be no financial risk pooling at the European level, at least as long as market conditions do not deteriorate dramatically. At this early stage of the assessment process, it is too soon to say which banks and countries are most at risk.

This suggests that the interaction of governments, national authorities that have overseen banks until now, and the European Central Bank will become increasingly tense as the review gets closer to completion. National governments will be influenced by banking nationalism and by innumerable links that tie them to their respective banking systems. In July 2011, these factors resulted in the failure of the bank stress test process, which severely undermined the credibility of the European Banking Authority. But the balance of interests is different this time. All euro area countries have a stake in the credibility of the European Central Bank as the central pillar of the euro's sustainability.

Uncertainty, and quite possibly market volatility, will mark the review until it is completed, probably in late 2014. The coordination of the bank restructuring process will be a key aspect, including the possibility of setting up a European joint asset management vehicle, or "bad bank," even if financial risks remain allocated to individual member states. All things considered, it appears more likely than not that the review will broadly fulfill policymakers' objective of restoring confidence in the European banking sector and thus resolving Europe's short-term banking problem.

Longer-term outlook

A successful review and subsequent restructuring of banks identified as too weak would probably start a gradual healing of Europe's banking system. If so, bank funding conditions could return to normal in the course of 2015, allowing the European Central Bank to gradually withdraw its extraordinary intervention tools applied since 2008. The review may also lead eventually to a wave of bank mergers and acquisitions, many of them on a cross-border basis, which would reshape the European banking landscape.

The review would mark neither the full separation of banks' and governments' balance sheets nor the completion of banking union. These require broader steps, including further integration of EU frameworks for fiscal policy and political accountability, often referred to as fiscal and political union. Such union would pave the way for a genuinely integrated system to resolve bank crises and a pan-European deposit insurance system that would ultimately sever the financial link between banks and governments. The timing of such steps, if they occur at all, is impossible to forecast.

Nevertheless, the single banking supervisor could trigger a number of structural transformations over the next decade, depending on future European Central Bank policy decisions. Many banks' governance models, which are currently shaped by national or subnational political and legal contexts, may be affected. Non-European banks may enter the European retail and commercial banking market. Europe's financial system may become more diverse and less dependent, as it now is, on banking intermediation. The geography of wholesale market activity and financial centers in Europe may change. And governments, no longer able to fund themselves by harnessing domestic banks, may have to become more disciplined.

As this tentative list illustrates, Europe has just started a long journey of discovery. Banking union amounts to a regime change for European finance. Even as prospects for the first step are reasonably encouraging, it will be a long time before the implications for Europe's financial stability and economic prospects can be comprehensively assessed. ■

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