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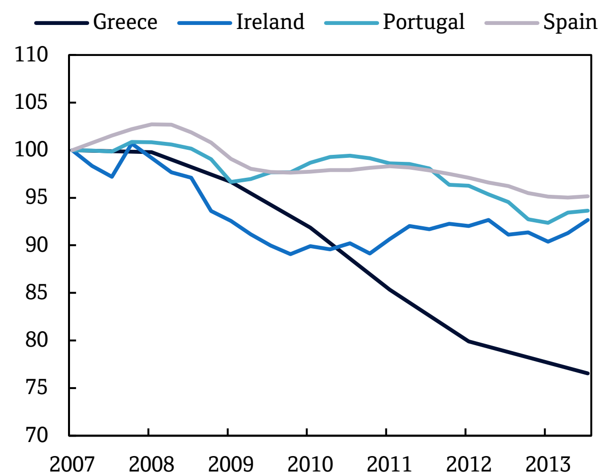
The Eurozone Takes A Final Step Toward a Banking Union

The Eurozone took another important step two weeks ago to create a banking union. Eurozone leaders agreed to delegate the responsibility of supervising banks to the European Central Bank (ECB) starting next year and create a unified system for handling banking crises. Going forward, this will ensure that the risk of another Eurozone financial crisis is reduced and the link between the resolution of banking crises and sovereign debt is diminished. It also represents another important step to strengthen the credibility of the Euro.

Following the global financial crisis, most of the Eurozone banks found themselves highly exposed to the economic downturn and in need of public support to restore their financial viability. This was particularly true in countries where the banking sector had high exposure to the housing market as in Ireland and Spain. Overall, European banks are estimated to have incurred losses approaching EUR1tn between the outbreak of the crisis in 2007 and 2010.

With the economic downturn and the housing market turning sour, many banks found themselves illiquid or outright insolvent. It was then up to the public sector to rescue them in what has come to be known as the "deadly embrace." The European Commission approved EUR4.5tn in state aid to banks between October 2008 and October 2011, a sum which includes the value of taxpayer-funded recapitalizations and public guarantees on banking debts. This put a heavy burden on already weak public finances and pushed up sovereign debt ratios. Ultimately, the impact of the banking and sovereign debt crisis was to drag down both the Eurozone private sector through lower bank credit and the public sector through higher fiscal deficits and debt, leading to the longest Eurozone recession in history.

Real GDP of Selected Eurozone Countries
(2007 = 100)



Sources: EUROSTAT, International Monetary Fund and QNB Group analysis

In order to avoid another costly banking crisis, the Eurozone decided to move ahead with a banking union. In June 2012, the European Commission agreed on a proposal for a harmonized bank recovery and resolution mechanism. The proposal was further strengthened two weeks ago under pressure from the European parliament to give more autonomy to the ECB in supervising and intervening in problem banks, together with sufficient resources to inject liquidity when needed.

Under the current agreement, the ECB will take over the regulation and supervision of

Eurozone banks starting in 2015. Non-Eurozone countries, like the United Kingdom, are not part of the current agreement as they have no voting power on the ECB Board. However, they can potentially participate through a separate association agreement.

The Eurozone agreement requires that all banks comply with the same regulatory standards and be subject to the same strict supervision. This shift in responsibility for bank oversight to the ECB will inject an element of impartiality in an area that too often in the past was left to national regulators (with strong interference from their own governments) to adhere to.

The agreement also provides for strong powers for the ECB to intervene in problem banks. The ECB can impose on banks to raise their capital, if it deems that banks are not sufficiently capitalized to withstand an economic downturn according to certain stress test scenarios. In addition, the ECB President is also given large leeway to determine whether a bank is insolvent and force it into liquidation, something the European Parliament insisted upon. In order to provide the necessary financial means to intervene in problem banks, a EUR55bn Euro Bank Resolution Fund will be established over the next eight years through government contributions and bank levies. The Euro Bank Resolution Fund will also be allowed to borrow from capital markets to increase its balance sheet.

In sum, the agreement to move to a Eurozone banking union is a welcome step. The banking union will finally create a Eurozone-wide level playing field for banks to compete under a single regulatory environment. National governments will no longer be able to interfere in the supervision of banks. More importantly, the establishment of the Euro Bank Resolution Fund will finally break the deadly embrace that caused so much harm to the Eurozone in the last few years. Overall, the creation of a banking union represents another important step to strengthen the credibility of the Euro.

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