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Financial Crisis Management and the Development of the Banking Union in the EU[1]

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1. Introduction

Since World War II, Europe has pursued economic integration in many different forms. That pursuit has led to unification in the form of currency market arrangements, market integration, and the introduction of a common currency. However, the problems caused by integration, particularly those arising from the introduction of a common currency, have come to the fore since the financial crisis and the Eurozone crisis. To resolve these problems, Europe abandoned home country-based financial supervision regulations, which often led to disagreement, and established a banking union that unified these regulations within the euro area.

This study seeks to explain this banking union by examining the developments that led to the banking union's creation, including the origin of the EU, the financial crisis, and its after-effects. We also clarify the reasons for the delay in unifying financial regulations and provide observations on the costs of unification.

Section 2 opens with a synopsis on how the unification of the EU's markets and currencies has progressed and describes the unification of financial regulations. Section 3 describes the development and effects of the 2008 global financial crisis and the subsequent Eurozone crisis. Section 4 discusses the banking union in detail, and Section 5 concludes with observations on the costs of economic integration.

2. Economic Integration and Financial Crisis Management in the EU

2.1 A Modern History of Integration in Europe[2]

In this section, before we describe Europe's banking union in its final unified regulatory form, let us first take a quick look at the path that economic integration has taken in post-World War II Europe.

The European Community originated with the establishment of the European Coal and Steel Community (ECSC) in 1952. The ECSC was proposed by France as a way for France and Germany to stop

[2] This article references EU MAG (2013), Chapter 1 of Kawamura (2015), and the European Commission website.

warring with each other. Therefore, it was determined that going forward, France and Germany would jointly administer the coal and steel resources that had been deeply intertwined with their war efforts. The beginnings of economic integration in the EU may thus be said to originate from the desire to prevent war within Europe and allow Europe to function as an economic group. When the ECSC was established in 1952, Belgium, Italy, Luxembourg, and the Netherlands joined in addition to France and Germany. Those six nations became the European Community (EC) in 1967. Initially, there was an attempt to include the United Kingdom, but the negotiations broke down and the community was established without the UK. Afterward, the UK, Ireland, and Denmark joined in 1973; Greece joined in 1981, and Spain and Portugal joined in 1986.

Within that time frame, exchange rate and currency integration gradually progressed. Up until World War I, the British pound was the key currency, and Great Britain was the global economic power. In the inter-war period, the two great superpowers, the U.S. and Europe, divided the world between themselves. After World War II, the U.S. became the global economic power and the U.S. dollar became the key international currency. To counter the U.S. economic hegemony and build up the European economy so as to regain the economic upper hand, an increasing number of people believed that instead of remaining separated countries, it would be necessary to seek an integration of all of Europe's economies. The first proposal for a common currency was made by the European Commission in 1962; however, no specific proposal for an exchange rate arrangement was made until the Bretton Woods system collapsed.

When U.S. President Richard Nixon took the U.S. dollar off the gold standard in 1971, major nations shifted to a floating currency regime one after the other. During this time, the European nations vowed in 1972 to keep their exchange rates floating within 2.25% of each other. This resulted in an exchange rate system in which exchange rates among European currencies could only fluctuate within a band of 2.25% while European currencies' exchange rates vis-à-vis non-European currencies could float freely. This system was called the "snake in the tunnel" after the shape it made when plotted on a graph. However, as participating nations withdrew, rejoined, withdrew again, and so on and as the central rate was revised repeatedly, the system eventually became nothing but a formality.

After that, however, momentum resumed toward the adoption of a common currency for Europe. This led to the establishment of the European Monetary System (EMS) in 1979. The EMS was notable for creating the European Currency Unit (ECU, pronounced "ekyu"), predecessor to the present-day euro, and establishing the Exchange Rate Mechanism (ERM). Because the ECU was not a real currency but instead a unit of account, member-nation currency weightings were used to determine exchange rates vis-a-vis the ECU's value. In the ERM, a ±2.25% band (±6% for some currencies) was set up around a central rate. However, the British pound did not participate in this system until 1990.

Europe subsequently experienced a surge of integration in various forms under the banner of the "1992 Single Market" initiative. The European Council started discussing an Economic and Monetary Union (EMU, which would include the adoption of a common currency) in 1988. The Delors Report of 1989 adopted plans for liberalizing capital movements, coordinating monetary policy, and introducing a common currency. The Maastricht Treaty of 1991 specifically provided for the establishment of the EMU. However, the ERM crisis (also called the pound crisis) struck in 1992, just as Europe was poised to actively embark on this path of market integration and introduction of a single currency. Seeing Denmark's failure to ratify the Maastricht Treaty as an opportunity, hedge funds exploited the requirement that ERM-participating nations continue intervening when their currencies exceeded the permitted bands of fluctuation, and they launched a series of sell-off attacks on various currencies. Although the currency authorities under attack continued intervening to prop up their own nations' currencies, the effect of these interventions was limited. Therefore, the UK and Italy had no choice but to withdraw from the ERM. A number of other countries also revalued their currencies vis-à-vis the central rate.

However, market integration progressed, and the European Monetary Institute (EMI) was established in 1994, which set up the framework for today's European Central Bank (ECB). The economic convergence criteria were also clarified and the common currency, the euro, was implemented by 1999. That being said, many were doubtful at the time about whether a common currency would, in fact, make its debut. Defying these doubts, a common currency was realized with the introduction of the euro in 1999.

2.2 Unification of Financial Regulations in Europe

As discussed in Section 2.1, Europe's economic integration was intended to prevent war within Europe and allow Europe to act as a unified region in terms of market, currency, and exchange rate integration. However, the regulations were unified only as and when necessary and not proactively. Serious regulatory unification would not happen until the global financial crisis and Eurozone debt crisis.

To understand the movement toward unifying financial regulations, let us briefly review the original setup of European financial regulations, primarily focusing on France and Germany. Germany has traditionally focused on indirect finance, where the banks have played a crucial role. Germany's post-war banking supervision took shape with the Banking Act of 1961. Under this law, the Federal Financial Supervisory Authority was responsible for regulating the banks' capital, large loans, and liquidity, and if a bank was not in compliance with the regulations, it could be barred or limited from providing credit or barred from making investments. Interest rates were liberalized in 1967, bringing on a further expansion in regulations. Because this liberalization occurred relatively early, the relevant regulations tended to be strict. In France, the system had been centralized for some time, with the primary doctrine being one of state control. However, financial reforms progressed as France entered the 1980s, and monetary policy shifted from one of regulating credit to one of manipulating interest rates. In addition, foreign exchange regulations were relaxed. Financial deregulation and the integration of the EC caused France's state-control doctrine to wither away.

According to Fujita (2015), European nations diverge widely in their attitudes toward regulation when it comes to financial legislation. The legal codes can be largely divided into civil law and common law. Civil law, which has its roots in Roman law, developed mainly on the European continent. It is characterized by an emphasis on statutory law, and such law is shaped primarily by university professors and other academics. Examples of nations that based their legal codes on civil law include Germany, France, Italy, and Japan. Common law developed mainly in England and spread throughout England's colonies. Common law emphasizes precedent as set by court judges and senior attorneys. Great Britain, the United States, Canada, and others based their legal systems on common law. We may then say that these different legal systems also influence regulations and even the development of finance.

In nations with civil law systems, bureaucrats usually consult academics when proposing new laws, but it is difficult to flexibly respond to the financial industry through legislation when that industry is always discovering and using new loopholes on a daily basis. Common law is considered to be more flexible and appropriate for free competition. The trade-off for this freedom is more stringent sanctions against financial crimes and more emphasis on shareholder protection.[3]

Differences between civil law and common law also extend to regulatory discussions; that is, whether regulations should be principle-based or rule-based. Japan's Financial System Council held this discussion shortly before the bankruptcy of Lehman Brothers.[4] As financial technology developed, more loopholes would be found, no matter how many rule-based regulations were put in place to deal with the new technology, and as these new technologies needed to be dealt with, regulations became increasingly complex and bloated. At that point, some consideration had been given to at least a partial introduction of regulations that would lay out clear principles to enable a flexible response. The UK regulatory system was held up as an example in discussions at the time. In other words, rule-based regulations are more similar to regulations based on civil law, whereas principle-based regulations are more similar to regulations based on common law.[5]

In Europe, regulations in the UK and France/Germany were originally based on different concepts. Therefore, Europe adopted a home-country regulatory system that would supervise the financial industry in a way that would consider the origins of each nation's

[3] The first chapter of Fujita (2015) provides an in-depth discussion about common law and civil law.

[4] This is brought up in the Financial Services Agency (2007) as discussions on "better regulation."

[5] As for the debate in Japan after this point, the financial crisis deepened in 2008 with the Lehman bankruptcy, and there were few developments because international implementation of the Basel Accords began many countries started to strengthen their rule-based regulations.

regulations and the circumstances of its financial institutions, rather than forcing divergent regulations.

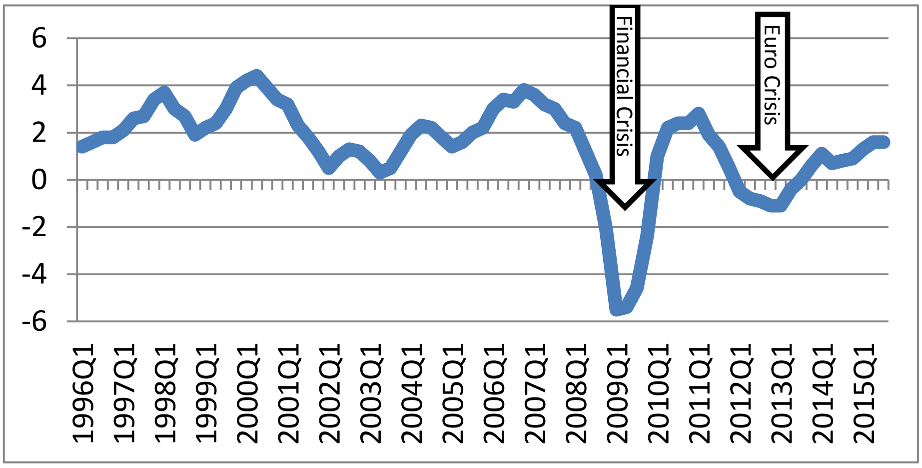
Specifically, the 1989 Second Banking Directive of the EU approved the principle of universal banking based on a single passport system, whereby approval gained in any one country would then apply in the other member countries, and the principle by which the home country that granted the said approval would be responsible for monitoring the institution receiving that approval. The Basel Accords were later introduced, which provided for global regulation of banks' capital adequacy ratios. The EU held discussions about how best to implement these in the Eurozone, and the Basel Accords have been phased into the Eurozone as capital requirement regulations.

3. The Financial Crisis and Euro Crisis and Their Effects

3.1 The Global Financial Crisis and Euro Crisis

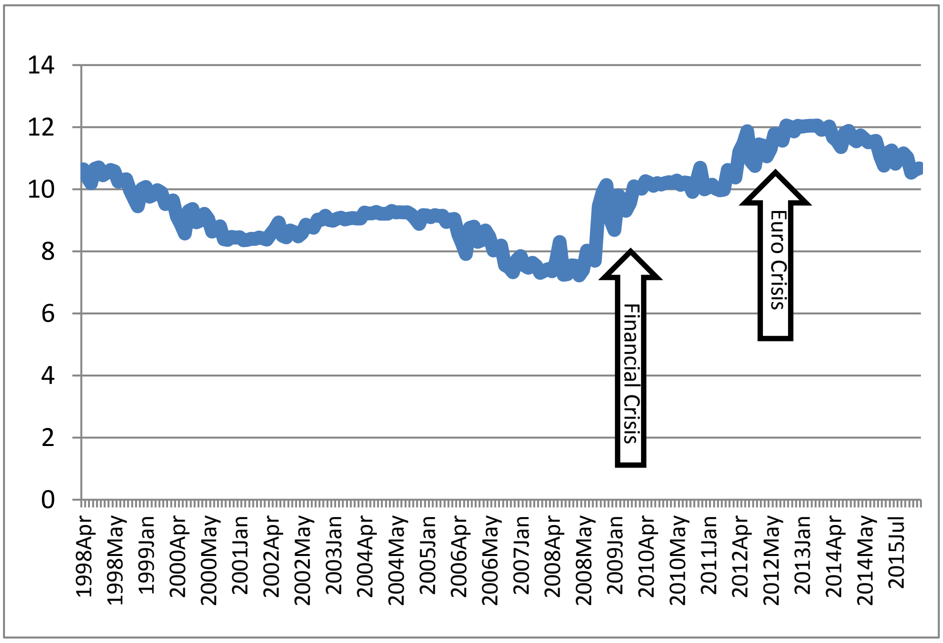
As markets and currencies were consolidating in Europe, so were the banks, which continued to merge. Major mergers include Dexia's 1999 merger with the Banque Internationale à Luxembourg, Bayerische Hypo- und Vereinsbank's 2000 merger with Bank Austria Creditanstalt, HSBC's 2000 acquisition of Credit Commercial de France, and Barclays Bank's 2003 acquisition of Banco Zaragozano. At the same time, cross-border banking transactions were growing as well. Blank and Buch (2007) used data from ten nations to compare transaction volumes before and after the euro's introduction. They found that the euro's introduction led to greater cross-border financial integration. Regardless, the home country system prevented any progress toward regulatory integration. Despite more intertwined cross-border relationships, the home country system permeated all financial regulations, including regulatory supervision as well as all rules concerning bankruptcy proceedings. This constituted a downside to the system when chaos reigned over the response to the euro crisis.

Figure 1. Nominal Economic Growth Rate in the Euro Area (%)



Source: Prepared by the author based on European Central Bank data.

Figure 2. Unemployment Rates in the Euro Area (%)



Source: Prepared by the author based on European Central Bank data.

The financial crisis that broke out in 2008 imposed grave effects not only on banks in the U.S. but also on banks in Europe. One reason for this is that Europe's universal banks had developed enormous securities businesses. In the aftermath of the crisis, both U.S. and European financial institutions were bailed out, and fiscal policies were quickly eased. In Europe, however, a sovereign crisis then emerged, known as the Eurozone crisis. When a new government came into power in Greece in 2009, it was revealed that the old government had been manipulating the country's financial metrics. This information was widely reported in 2010, triggering the Greek debt crisis. This crisis spread to other nations in situations similar to Greece. Although the background varied in each case, sovereign debt crises occurred in Ireland in the fall of 2010, in Portugal in 2011, and in Cyprus in 2013, producing a spike in long-term interest rates and throwing these nations' fiscal regimes into turmoil. The countries were subsequently bailed out, primarily by nations in the EU. Spain also received support in 2013.

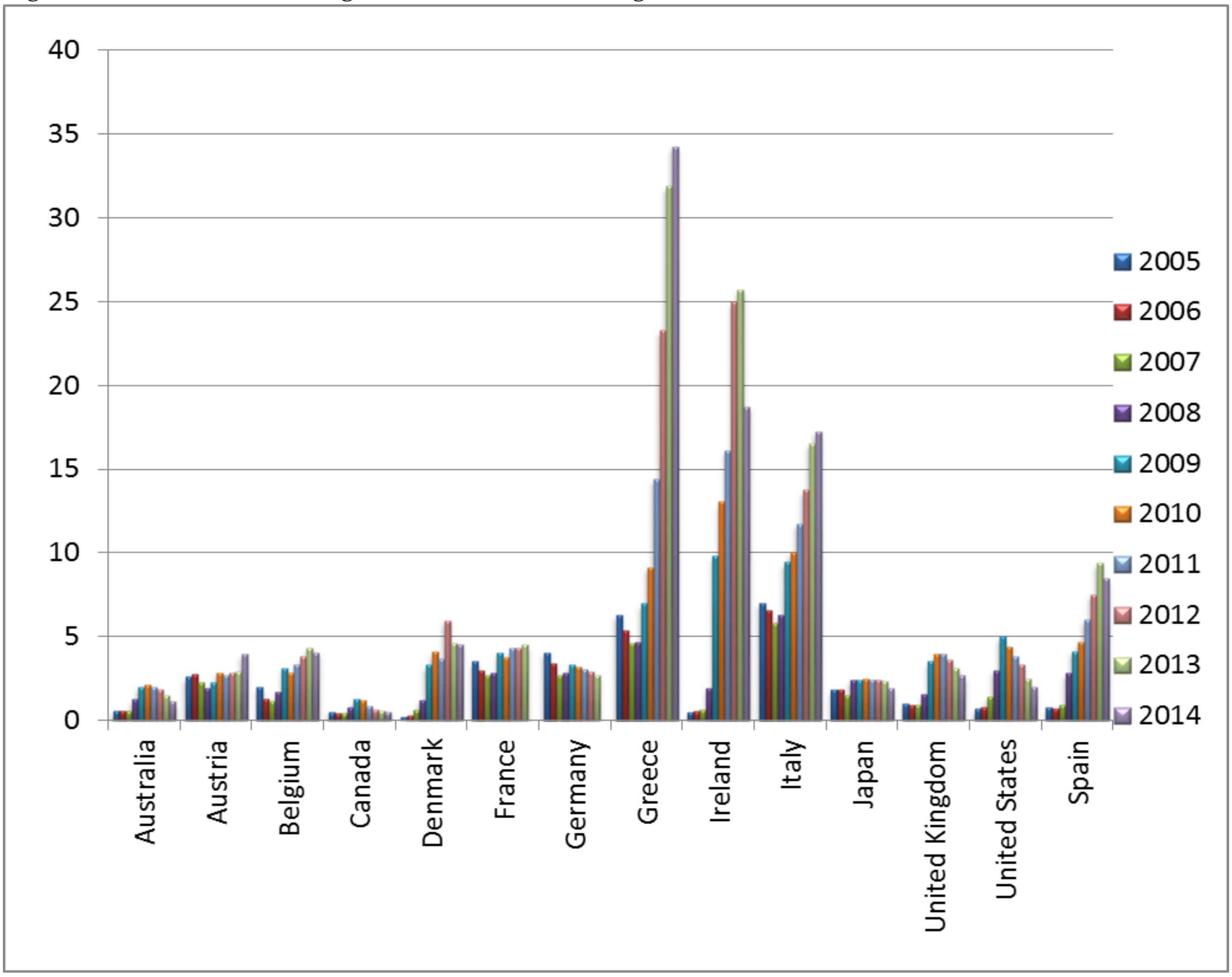
The 2008 financial crisis and the ensuing Eurozone crisis inflicted damage on every European nation. Looking at movements in nominal GDP in the Eurozone as shown in Figure 1, we see that GDP sank following the Lehman bankruptcy and fell again around 2012 as a result of the Eurozone crisis. Looking at Figure 2, we see that unemployment also jumped twice, once because of the financial crisis and once because of the Eurozone crisis.

3.2 Effects of the Crises

The onset of the financial crisis boosted the amount of non-performing loan held by financial institutions. Figure 3 shows movement of non-performing loan over time. We see that Greece, Ireland, and Italy were holding particularly large amounts of non-performing loan. Spain also had a considerable amount of non-performing loan. As of December 2015, the total amount of non-performing loan in Europe was still approximately one trillion euros, and the European Banking Authority (EBA) has indicated that banks' earnings are under pressure.

The EBA also conducts stress tests and asset reviews to comprehensively determine bank health. The EBA's stress test results published in 2014 showed that 25 (out of 123) banks had capital shortages and that in the adverse scenario, core capital ratios were potentially 4%, below the 8% hurdle rate specified by regulators. What became clear from the final results was that the amount of fund raising that the Italian banks needed had ballooned. This spurred the unification of regulations, expedited the resolution of bankruptcies, and stimulated the development of plans to prevent the next crisis.

Figure 3. Non-Performing Loan as a Percentage of Loans



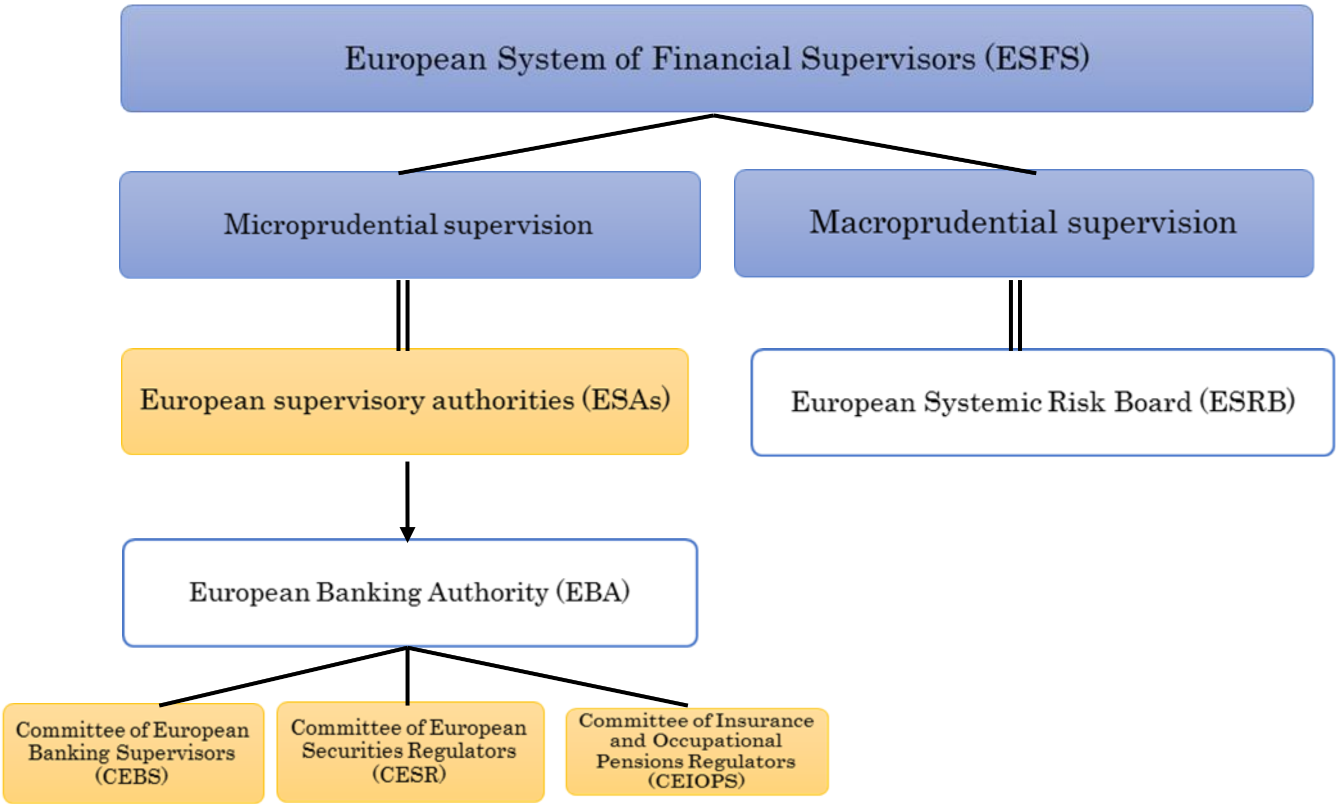
Source: Prepared by the author based on World Bank data.

4. Development of the Banking Union

After the financial crisis, Europe overhauled its system of financial supervision (see Fig. 4). However, because microprudential supervision was only concerned with cash flow for dealing with crises, these changes were largely characterized by the introduction of new macroprudential supervision, so no drastic reforms were put into place.

As the effects of the Eurozone crisis, which started with the Greek crisis, propagated and spread throughout Europe, the sovereign debt crisis worsened so much that it became critical to separate the financial crisis from the sovereign debt crisis. During the 2013 Cyprus debt crisis, observers also began to see the limits of adopting a home country supervision system for those countries that were using the euro as a common currency. This led to the first real steps toward a banking union framework.

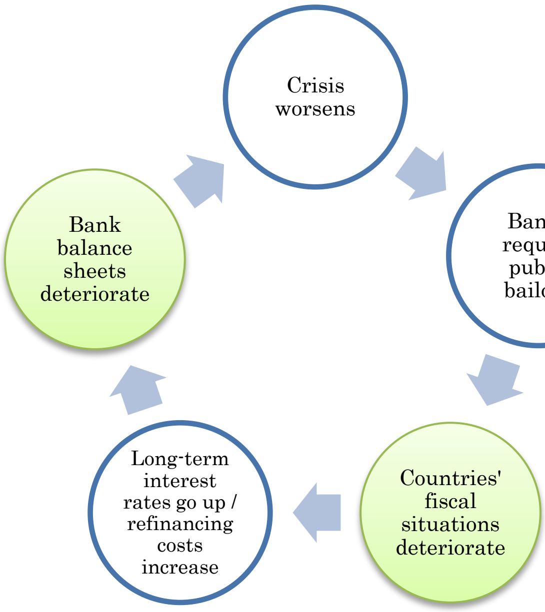
Figure 4. Financial Supervision System in Europe, Post-Financial Crisis



4.1 Background of the Banking Union Framework

A problem that arose after the financial crisis (and particularly after the Eurozone crisis) was the phenomenon whereby a banking crisis would cause the government bond prices to collapse, which would then lead to a currency crisis for the euro, in turn harming the balance sheets of banks in the Eurozone (which held a lot of euro-denominated debt), which would then cause further depreciation of the value of euro-denominated debt issued by other countries. Another problem was a vicious circle of financial and fiscal crises. As shown in Figure 5, in the event of a financial crisis, the government will use public funds to rescue problem banks, thus worsening the nation's fiscal stability and leading to a vicious circle in which government bond prices collapse and long-term interest rates spike (i.e., a sovereign debt crisis), which further damages banks and exacerbates the crisis. Not only do publicly funded bank bailouts aggravate the crisis, but the taxpayers providing these funds consider this an unwelcome proposition, thereby creating a major issue.

Figure 5. Post-Financial Crisis Vicious Circle



Source: Prepared by the author based on charts from the European Commission website.

The banking union framework originally proposed in May 2012 by the then-European Commission President, José Manuel Barroso, clearly specified that this would break the vicious circle between banks and sovereign debt. This framework also aims to prevent potential crises, to rapidly respond to problems as they arise, and to protect not only depositors but also taxpayers in an attempt to maintain the health and stability of Eurozone banks.

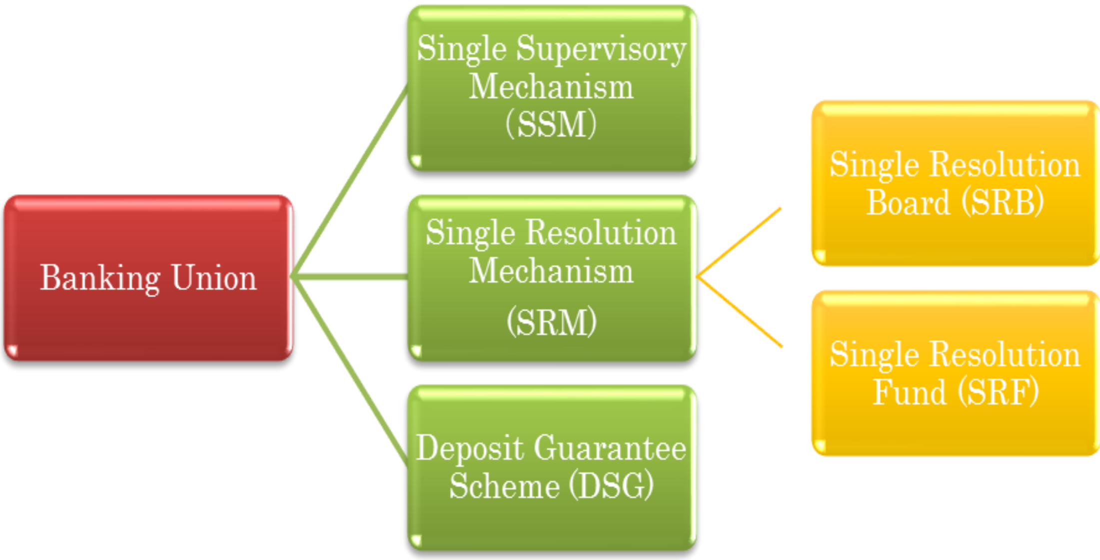
The framework for the banking union was approved at the EU summit in June 2012, and the unification of banking regulations and supervision plus a rulebook on handling bank failures were proposed by the Economic and Financial Affairs Council (ECOFIN) in September 2012. It was thereby determined that the ECB would supervise all Eurozone banks. This was because of the dire need to unify a supervisory authority over banks so that the European Stability Mechanism (ESM) would be able to inject funds directly.

4.2 The Banking Union Mechanism

Figure 6 is a broad representation of the banking union framework.[6] The first aspect is the Single Supervisory Mechanism (SSM), which ECOFIN agreed to in December 2012. This mechanism concentrates all bank supervisory authorities in the euro area in the European Central Bank (ECB). The SSM's supervision encompasses all EU member-nation banks. Although banks from countries outside the Eurozone will be supervised directly by authorities in their respective jurisdictions, they can also fall under the SSM's supervision if they choose. Joining the SSM thus allows banks to receive bailout funds from the ESM, which do not have a time limit like those from the ESFS. The SSM began operations in November 2014.

Next is the Single Resolution Mechanism (SRM), a unified mechanism to resolve bank failures established in the EU in January 2015. It is led by the Single Resolution Board (SRB) and administers a Single Resolution Fund (SRF). The SRB began partial operations in January 2015 and is fully functional as of January 2016. It not only deals with bankruptcy resolution but also prevents bank failures through early intervention.

Figure 6. The Banking Union Mechanism



[6] Sasaki (2013) already described this in some detail, so this study will only describe the concept briefly.

The European Deposit Insurance Scheme was announced in November 2015 and will insure deposits of up to €100,000 until 2024. Because this deposit insurance was one of the last measures to be implemented within the banking union framework, we can now consider the structure of the banking union to be more or less complete. There are two ways to handle a financial crisis. One is the traditional bailout, in which public monies are injected into an ailing financial institution, making the bailout a taxpayers' burden. The other is the bail-in, in which depositors, creditors, and shareholders share the losses by taking a haircut on the value of their deposits, forgiving debt, making concessions on repayment, and so on. Japan, the U.S., and Europe have followed the traditional way of thinking that because financial institutions have a public purpose, they exert a broad influence over the economy as a whole and, therefore, tax proceeds should be used to rescue troubled institutions. However, criticism from taxpayers often makes it difficult to inject funds quickly. Further, the bail-in method was introduced at the time of crisis in Cyprus, when large depositors had to provide funding because it was not possible to increase the public deficit. This bail-in concept has been fairly well-received in Europe. Although it has so far been difficult to reach an agreement on deposit insurance, it seems the spread of this kind of bail-in concept has led to smoother proceedings.

5. Conclusion

Before the global financial crisis and the Eurozone crisis, financial regulations in the Eurozone were primarily based on the principle of home-country supervision. For that reason, although there were some unified international regulations, such as the Basel Accords, each nation would respond separately and carry out its own regulatory supervision vis-à-vis such regulations as the Basel Accords, even if these regulations applied to a number of countries. This is because each nation's financial sector and financial regulations differ, in addition to other issues like country-specific political problems. However, the breakout of the crisis meant that the use of a single currency, the euro, forced governments to provide public funds, and as sovereign risk spread, the need for a unified regulatory regime grew. This accelerated efforts to establish a banking union.

The difference in the areas covered by the Eurozone and EU complicated matters regarding the scope of the unification. Other obstacles cropped up as well, including the difficulty for some nations to maintain a uniform level of supervision, to obtain funding for deposit insurance, and so on. When the euro was introduced as the common currency, or when the idea of an optimum currency area was being considered, not much thought seems to have been given to the costs that might be incurred as a result of unifying such regulations or that might be incurred by not unifying such regulations. However, it is now clear that the costs of not unifying regulations are significant; therefore, the regulations should be unified. Going forward, further thought should be given to the issue of supervisory regulations as well as the pluses and minuses of market and currency integration.

Buch and DeLong (2004) analyzed cross-border bank mergers. According to them, although the number of bank mergers is relatively small compared with mergers in other industries, this is due to the difficulty in obtaining information and the differences in regulations. Therefore, as the banking union advances and the capital markets become more integrated, it is likely to facilitate more bank mergers in the EU and enable more restructuring of the banking sector. In a broader sense, a pairing of currency unification with regulatory unification could conceivably promote more cross-border activities. We should consider these points in future debates over optimum currency areas and/or regional currencies.

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