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Eurozone banks must be an international concern

The way in which the Bankia – and other – cases have been managed over the past few weeks confirms that banking supervision in the euro area cannot continue to be implemented in a decentralised way. The incentives of the national authorities to free ride are simply too high and undermine the stability of the entire euro financial system.

The traditional argument put forward in defense of conducting prudential supervision at the national level is that supervisory authorities have to be accountable to taxpayers, who ultimately bear the economic consequences of bank failures. As long as bank rescue operations are financed by taxes collected at the national level, so goes the argument, supervision should remain national.

In a monetary union, however, the decisions taken by a national supervisor impact not only the country's residents but also the taxpayers and savers of the other countries. Recent events have shown how the uncertainties surrounding the restructuring of Bankia have negatively affected the banking system of the whole euro area and spread to other segments of the financial market, including in countries which had taken action with a view to put their own banking system in order.

The channel of transmission to the other eurozone countries has several dimensions. First, the contagion through the sovereign risk market increases government bond yields, thus also raising the implicit tax burden in other countries. Second, the high cross-border correlation of banking risk depresses the value of bank capital in other parts of the eurozone, fuelling a credit crunch. Third, if domestic funds are not sufficient to ensure adequate bank recapitalisation, as was the case for Greece, Ireland and Portugal, the European facility has to be tapped, which commits other countries' taxpayers.

Decentralised supervision in the euro area also provides incentives to underestimate risks and to shift the burden of adjustment to the other countries' taxpayers. The confidential nature of the information collected by supervisors on their respective banks is often used as a reason for not sharing it with the other countries, thus increasing the probability of underestimating the gravity of the situation and the cross-border implications of crises. Decentralised stress-tests have allowed for different amounts of rigour across countries, undermining the credibility of the entire European supervisory structure. The benchmarks and deadlines for recapitalisations have been set primarily with a view to accommodate national preferences rather than to restore stability across the board.

The current system of cooperation among national supervisors under the European Banking Authority is weak and has no sanctioning mechanism to avoid the risks mentioned above. It is paradoxical that while the governments of the eurozone member states have accepted to subject themselves to strict rules and to a sanctioning regime, as foreseen in the fiscal compact, national supervisors can operate with much fewer restrictions. As a result, the incentive to act is linked to market pressure, which experience shows as being the best recipe for doing too little too late.

The current decentralised system of supervision also puts an undue burden on the ECB. The latter relies on the assessment of the national supervisors to judge whether banks are solvent, and can thus be accepted as counterparties for monetary policy operations. This fuels the temptation by national supervisors to understate solvency risks and to address problems through the provision of central bank liquidity rather than capital increases. Only in countries under IMF-EU programme have national supervisors been requested to share all the required information. This may be a reason why resorting to an IMF-EU programme tends to be rejected, until it becomes unavoidable.

In a monetary union the supervisory authorities should give account of their actions – and inaction – not only to the citizens of their own countries but also to the others. In the current EU institutional framework, it's not clear how such an accountability can be ensured. Financial stability is still largely considered as a national responsibility, which is somewhat paradoxical in a single financial market with a single currency. The role of the European Commission is unclear. In theory, the supervisory and fiscal authorities of the other countries should put pressure on each other to ensure such accountability, but in practice they are reluctant to do so, fearing of having one day to abide by the same requirement.

The cost of such an inefficiency is mainly borne by the taxpayers.

The solution is to centralise bank supervision at the euro area level, especially for systemically relevant institutions. There are two ways to achieve this. The first is that the political authorities of the member states take the initiative and agree to implement a more efficient integrated supervisory system. The second way is that the ECB stops relying only on national supervisors and starts conducting its own assessment on the solvency of major banks, before granting them eligibility to monetary policy operations.

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