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Governance: The Achilles' Heel of Banking Union

By Alessandro Leipold, 19 December 2013

This week has seen a succession of hectic meetings in Brussels, often deep into the night, in preparation of the European Council of 19-20 December. This summit is slated to finalize the shape of European banking union, the most momentous initiative since the creation of Economic and Monetary Union in 1989. It is worrisome that such weighty decisions are being taken in such a frantic, down-to-the-wire rush. Indeed, Italy's Finance Minister Fabrizio Saccomanni felt compelled, in a letter to his colleagues, to press that they not "hurry for a defective banking union, but rather take the time which may be needed to build a properly functioning one."

Fully reasonable advice, except that – given one deferment after another – time has virtually run out if the European Parliament is to legislate before the May 2014 elections. Matters have come to a head in this way also because discussions were long blocked by the protracted negotiations for the formation of the German government. The coalition accord, when it came, rather than opening new horizons, further restricted those that seemed already secured – in particular the possibility of direct bank recapitalizations by the European Stability Mechanism, now but a distant fantasy. The die now seems to be largely cast, and – judging from the Eurogroup agreement reached in the early hours of December 18 – the banking union that will emerge is removed not only from the aspirations of many but also the practical needs of the moment. Namely the need for a reliable framework for the conduct of the ECB's asset quality review, the need to reduce the eurozone's financial fragmentation, and the need to break – as so often vowed – the vicious link between sovereign and bank debt.

It is certainly regrettable that, on these issues, Ministers did not go further, taking up the suggestions put forward in Minister Saccomanni's letter. That said, it is a stretch to argue – as some do – that it would be preferable not to have a banking union at all rather than the one that is in prospect. Even with its limitations, the agreement does envisage a common European fund over time (admittedly, a decade), and many of the weaker points could be improved in that time span.

Provided, however, that the whole project is not derailed sooner by its most glaring shortcoming: a sorely inadequate governance framework for bank resolution. To paraphrase a well-known Maoist slogan, bank resolution is not a dinner party. It is, rather, a highly complex process that requires tough decisions on the distribution of costs between various claimants and taxpayers, sometimes in different countries – all in a very compressed time period, typically over a weekend when markets are closed. For resolution to occur in an orderly manner, without triggering runs on deposits or other panic reactions, and minimize resolution costs, it is essential that the decision-making process be nimble and swift, and conducted with discretion and operational independence. A well-functioning governance framework is, in other words, key to the success of any resolution mechanism.

It is here that the rubber hits the road. The effort to safeguard national interests while conferring a role to the European Commission has resulted in a system so complex as to be unworkable in practice. The decision-making process foresees a complicated round of consultations between a new "resolution board" (composed, mind you, of national representatives), the ECB, the European Commission, and the Council of Ministers – the latter having the last word. It has been estimated that, in the more complex cases, the decision to wind up a bank could involve up to 9 committees and 143 voters. Does anyone honestly believe that such a labyrinthine setup could ever deliberate rapidly in an emergency situation?

This underlying flaw was firmly censured by ECB President Mario Draghi at a European Parliament hearing on December 16, where he expressed his concern about the excessive complexity of the decision-making setup which, he noted, could make for a "very messy" process. A similar critique was advanced also by the head of the European Banking Authority, Andrea Enria, in an interview with the Financial Times in mid-November: "You need a European decision mechanism" rather than the usual committees; "committees in a crisis don't work." It is ironic that Europe should once again trip up on a governance flaw, given that it is by now generally recognized that the euro area crisis itself has largely been a crisis of governance.

Finally, good governance has broader implications, applicable also to Italy. There is indeed empirical evidence that reforms are implemented with greater success where a sense of ownership prevails, i.e., where reforms are accepted by an electorate who feels represented by the political class that implements them. The dearth of reforms in Italy has many causes, but one of these is no doubt a deficiency in governance that has dug the deep divide between Italian citizens and the political class. It is thus high time for an electoral reform that will restore the confidence needed for a program of equitable and shared reforms – essential for both the country and for its ailing economy.
alessandro.leipold@lisboncouncil.net