Politics & Policy

Europe's Halfway Banking Reforms Have Run Out of Time

Scandals and failures will continue to plague the sector until it completes the unified regulation it promised more than a decade ago, including deposit insurance similar to that of the U.S.

By William R. Rhodes and Stuart Mackintosh
April 5, 2021, 10:00 PM EDT

Former Wirecard CEO Markus Braun prepares to testify at the Bundestag commission *Photographer: Pool/Getty Images*

Europe's banking sector continues to be shaken by scandals and failures. German public prosecutors are facing demands to bring charges against the German banking arm of Greensill Capital. Germany's financial regulator, BaFin, has been humiliated by the 3.5 billion euro Wirecard scandal. Serious money laundering cases involving large banks in many euro zone countries have shaken faith in Europe's bank regulation and oversight. Fixing this erosion of trust by completing the Banking Union is long overdue. Action is now urgent and essential.

Leaders in the euro zone responded to the 2008-2009 global financial crisis by committing themselves to a banking union that was to include reform of the regulation of the largest banks, action on bank resolution and common deposit insurance for the bloc's members. The rationale was sound: To ensure future financial and economic stability, the continent needed reforms to strengthen and regulate Europe's largest banks, which underpin about 70% of lending across the euro zone. Doing so would bring considerable economic benefits, we were assured. Yet more than a decade later the banking union is still unfinished. It's time to complete the task and make Europe, and her banks, better able to weather future economic storms.

Regulation and supervision in 2021 are centralized within the European Central Bank. Yet this change hasn't been smooth and today isn't the success it was meant to be; it's proving hard to oversee banks across so many cultures and economies. The ECB now has the regulatory responsibility for 119 banks, representing more than 80% of banking assets in the euro zone. But the central bank has fallen short on oversight on many occasions, when the banks and firms are not properly overseen by either the ECB or national regulators. We can see the evidence of this in the scandals in Germany, Estonia and elsewhere.

Europe's unfinished banking union, its regulation reform, and resolution of banks and financial firms have been a disappointment. There are too many instances where national oversight has been too limited, too cozy, and where ECB supervision has not caught failures until too late. In 2021 more needs to be done to ensure the ECB's authority and ability to act if it detects signals that banks are in trouble.

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European governments must stop viewing large banks as ‘their’ national banks that deserve special treatment, and view them instead as the hulking, sometimes systemically risky firms they are, requiring consistent oversight based on European norms and rules. Unfortunately, so long as bank chief executives know they can get special treatment in extremis from their home governments, additional risks and costs can mount. If that happens, the people who have entrusted their savings to these institutions should not bear the cost of those risks.

On deposit insurance, the euro zone has gone part of the way toward a banking union, but not far enough. In 2008-2009 we saw disparate national deposit insurance programs fuel bank runs as customers reacted to the financial crises by shifting money to more generous programs, causing bank runs to spill from one country to another.

European leaders have failed to accomplish their goal of a euro zone-wide deposit insurance program. The current system that provides backup to national programs is confusing and inadequate. German and French leaders worry that they will be left paying the bill for bank collapses in other countries. This is shortsighted. Establishing a single, coordinated deposit insurance program for the euro zone that is well understood by the public would be good for economic stability, not least by building consumer confidence in the health and security of the banking system. To this end, Europe can learn from the U.S. Federal Deposit Insurance Corporation (FDIC).

The U.S. program works smoothly and is paid for by the banks themselves, while reassuring customers that their deposits are safe. A euro zone program could also be paid for with charges on the banks themselves. The FDIC operates very smoothly in closing and reopening banks without causing panic – something it did 157 times in one year, 2010, as the effects of the global financial crisis played out. This was done without causing alarm, without losses to savings customers, and at no cost to the public purse. European leaders ought to copy this successful model. To be sure, an FDIC-type structure doesn't solve the problem of being too big to fail, but it does address the regional and national risks of small and mid-size bank failures cascading into one another, causing runs and widespread public panic.

This is the year that euro zone leaders, as they look across the financial risk landscape, should finally complete the banking union they aspired to more than a decade ago. That means strengthening coordinated supervision and regulation of large banks and financial firms by the European Central Bank. They must ensure that national regulators are not captured by their local champions. And Europe's leaders need to promote stability with a fully functioning euro zone-wide deposit insurance regime modeled on the U.S.

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