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Lessons for Asia from Europe's History with Banking Integration

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Abstract

As Asia considers greater harmonization and integration of its financial systems, it would be well-advised to consider the experience of Europe, particularly the eurozone. There are many lessons to be drawn from Europe about how to implement such integration, mostly negative. It is particularly evident that moving to a currency union had major unanticipated consequences for the ability to manage integration of financial systems within the eurozone. Monetary union sharply reduced the ability of the member states of the eurozone to manage their macroeconomic and macroprudential policies to preserve financial stability.

Even setting aside these additional problems created by monetary union, Europe suffered substantial harm from integrating its financial systems so closely in many ways, while simultaneously establishing only very weak coordinating mechanisms among their national financial supervisors. It was also a mistake to forbid the European Central Bank from operating formally as a lender of last resort in a financial crisis.

Europe’s experiences should not dissuade Asia from seeking appropriate further harmonization and integration. However, they do argue strongly for Asia to take the kind of careful, step-by-step, long-term approach for which many of the countries within Asia are well known. In particular, Asia should only move forward to the extent that it is willing to take the necessary steps toward common supervisory approaches, information sharing, and cooperation in crises. Trying to have the benefits of integration without the responsibilities would be a recipe for future disaster.

JEL Classification: E44, F15, F36

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1. INTRODUCTION

As Asia moves toward increasing harmonization and integration of its national financial systems, it would do well to consider the lessons so expensively learned by Europe in its process of integration. Europe's history in recent decades reveals a mixture of the benefits of cross-border integration of banking systems and the grave damage inflicted on banking systems and national economies as a result of the manner in which that integration was achieved.

There are many differences between Europe and Asia, both in their banking systems and in their larger economies and political structures. However, the similarities of their systems and the issues inherent in any regional financial integration process make it worthwhile to review Europe's experience when planning Asia's future.

2. A COMPARISON OF EUROPEAN AND ASIAN FINANCIAL SYSTEMS AND THEIR REGULATION

There are some key similarities between the financial systems on the two continents. Foremost, both regions rely principally on banks to provide the necessary credit for their economies, unlike the United States, where markets and non-bank financial institutions predominate. Banks are responsible for about three-quarters of credit provision in Europe and likely even more in Asia, although the proportions vary across individual countries. In Europe, bank lending is complemented by financial market activities, principally bond issuance by large corporations and securitizations of mortgages. The same is true in Asia, although the degree of sophistication, scope, and size varies across the region, with only rudimentary markets in some Asian nations. Across Europe there is greater uniformity and a higher average level of market development.[1] (For readers who wish to learn more, Park [2011] provides much more detailed figures comparing the financial systems of the two regions, and others globally, than there is room to present here.)

Europe and the larger economies in Asia also share traits due to following global norms in key aspects of how they regulate their financial systems. They subscribe to the most important global financial agreements, such as the Basel Accord on Bank Capital and its successors (Basel II and 2.5) and they intend to implement Basel III. They also participate in the global coordination process that takes place through the Financial Stability Board (FSB) and other bodies, although European nations have been more active and more influential in these deliberations.

Partly due to this global coordination, and partly due to the dominance of the principles of market economics, the overall structure of financial institutions and practices is also broadly similar in Europe and Asia. In most economies, a small number of large banks dominate national markets, with medium-sized and smaller banks also playing important roles. But some countries, such as Germany and some other countries in Europe, have a strong system of savings banks and cooperative banks with large collective market shares that render their biggest banks less important.

[1] According to Park (2011: 21), "[Asian] short-term money and fixed income markets are often shallow and fragmented. Except in Japan and the Republic of Korea, local currency bond markets account for a smaller share of GDP than in the US or Europe. Although it is undeniable that growth has been phenomenal in terms of the size of local currency bond markets, this has been also driven primarily by the government bond markets. Development of the corporate bond markets has been considerably lagging behind that of government bond markets."

An area of significant difference is in the direct role of the state. State-owned banks have substantial, and in many cases dominant, market shares in many Asian countries. Many European countries have large state-owned banks, but their role tends to be significantly more limited than in Asia. In addition, many Asian governments are substantially more directive of their banking systems, at times to the extent of setting caps on or quotas for loan volumes and controlling deposit and lending interest rates. European governments have rarely taken such steps in the last several decades.

The formal structure of national financial regulation is also quite similar between Asia and where Europe stood prior to implementation of the financial integration measures described below.

3. DESCRIPTION OF THE INITIAL SITUATION: INDEPENDENT EUROPEAN NATIONAL BANKING SECTORS

In the early stages of the European Union[2] (EU), financial regulation was generally left to individual Member States. They were free to set their own rules, within the constraints of some trade agreements against discrimination toward foreign banks. There was considerable commonality of approaches across Europe, but different EU Member States had different rules and emphasized varying quantitative and qualitative measurements of financial soundness. In practice, they also varied in the extent to which supervisors intervened in decisions by bank managements, with the United Kingdom generally on the more free market side of the spectrum and some continental European countries employing a more *dirigiste* approach.

The responsibility for bank supervision varied,[3] with the central bank often doubling as the banking regulator, but sometimes playing an auxiliary role or even a quite peripheral one in non-crisis times.[4] (The central bank, in all cases, acted as the lender of last resort in crisis times.) When the central bank was not the main supervisor, an independent banking regulatory authority would often operate, sometimes with jurisdiction over other parts of the financial system, such as the insurance industry, but sometimes with authority only over banks.

There were also differences in other key parts of the regulatory framework. Most nations, and eventually all, had deposit guaranty systems to ensure that retail depositors, and sometimes other depositors, were protected in the event of a bank failure. However, there were great differences initially in the extent to which deposits were guaranteed, both by type of deposit and by amount, and in whether, and to what extent, the deposit guaranty systems were pre-funded through insurance premiums.[5]

Similarly, there was little uniformity in the mechanisms by which a troubled bank would be "resolved." This is the term of art used by banking experts and regulators to

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[2] Prior incarnations of the EU were known as the "Common Market" and, later, as the "European Community."

[3] European Central Bank (2010) provides a detailed discussion of the structure of national supervisory bodies as of 2010 and the trend of changes in recent years.

[4] There is a long history of academic work on the proper role of central banks in bank supervision. See, for example, Blinder (2010); Boyer and Ponce (2010); European Central Bank (2001); Goodhart (2000); and Peek, Rosengren, and Tootell (1999).

[5] European Commission (2010a) provides a very detailed review of the national schemes and their differences. European Commission (2010b) explains the proposals to harmonize the schemes more fully across the EU and their implications.

describe the actions to be taken when a bank has a solvency or liquidity crisis. It can include takeover by the state, forced sale to another firm, forced restructuring, mandatory recapitalization, or other actions. Some countries had carefully considered and formalized legal procedures, while others essentially used the normal insolvency procedures for non-financial firms, with an implicit assumption that ad hoc government and central bank actions would be taken for systemically important banks.

Cross-border banking existed even in the early days of the EU, and before then, although the system worked less smoothly and in a less uniform way prior to moves toward greater integration of financial services in the EU. Foreign banking groups could, with regulatory permission, establish a subsidiary to conduct their banking activities in a given country, in which case the subsidiary operated under the same rules as a purely local bank. Alternatively, the foreign banking group could set up a branch or branch network in the host country, with that nation's permission. In that case, the regulator primarily responsible for the safety and soundness of the institution was the home country regulator for the banking group, since that group was legally responsible for all deposits, debts, and other contracts. The host country regulator might, though, require that the branches maintain certain levels of assets and liquidity in the host country, effectively creating a quasi-subsidiary status for the bank. This gave the host country an ability to protect itself to at least a modest extent against potential supervisory failures by the home country regulators.

Prior to the creation of the euro, foreign currency risks were also more of a concern and were often quite actively managed and monitored by the authorities. Banks could borrow or invest in foreign countries and/or currencies, with the attendant benefits and risks. Local individuals and businesses might also choose to borrow in a foreign currency, usually in order to obtain a lower interest rate. Different countries displayed varying levels of tolerance for such borrowing and could, in the extreme, ban such activity. In yet earlier times, nations in Europe often had restrictions on currency movements, but these had largely vanished before the moves toward financial integration described in this paper.

4. IMPLICATIONS OF THE MOVE TO A SINGLE MARKET FOR EUROPEAN BANKING

As Europe moved from the looser Common Market and European Community toward a fuller European Union, a key area of integration was the push for a "single market" across Europe, in an attempt to increase economic efficiency and growth. The creation of a single market primarily took place on an industry-by-industry basis, since true market integration involved breaking down a host of specific technical barriers, including through agreement on standards and regulatory approaches. One of the main, and in many ways most effective, areas of integration was financial services.

The EU promulgated a series of laws, directives, and regulations on financial services that were binding across all of the Member States. These nations were required to incorporate the EU laws and rules into their own national codes and practices and the European Court of Justice served as the ultimate arbiter of legal disputes between Member States and between the EU authorities and individual Member States concerning these matters.

The EU moved a considerable way toward creating a true single market in financial services, with the national rulebooks and practices becoming similar. There remained areas of differences where individual countries might have additional rules, or variations on the European rules, or where supervisors interpreted the rules or their proper implementation differently. In particular, some countries remained more directive of their banks than others, often using moral suasion and/or political pressure when more direct legal means were unavailable. This could include pushing lending toward or away from certain industries or types of borrowers.

Supervisory structures changed very little as a result of the single market in financial services. Supervision remained very much a national activity, although all supervisors were bound to implement the EU rules. Some quite weak pan-European coordinating bodies were formed to monitor the banking industry and other parts of the financial sector and to talk through disputes between regulators, but they had very limited powers other than to encourage a consensus. Even this weak form of cooperation did not occur until 2004, when the Committee of European Banking Supervisors was formed, along with similar bodies for securities and insurance activities. Overall, national governments and central banks jealously guarded their supervisory prerogatives.

There appear to have been two main drivers for the maintenance of the supervisory status quo despite major changes in the degree of European integration. Part was clearly the standard desire by the supervisory bodies and national governments to retain power. Finance is a very powerful economic factor and the ability to influence the distribution of credit in the economy, sometimes down to the level of specific borrowers, was very attractive to those in power. On a less selfish basis, there also remained quite large differences between the economic, financial, and legal systems across Europe that encouraged national authorities to keep the right to make choices about financial regulation and supervision. Germany, for example, had a well-developed system of savings banks and cooperative banks which helped provide finance to its solidly performing sector of mid-sized and smaller manufacturing firms (the so-called *Mittelstand*). It was not eager to have bank supervision tainted by the views of countries with quite different systems. In France, the dominant large banks generally cooperated closely with the state on national priorities, creating still another system in practice. In the United Kingdom, London served as one of the two major global financial centers, and supervisors were strongly concerned to assure its dominance by operating in a manner that was viewed as both safe and friendly for international business. Smaller countries, of course, worried about being overwhelmed by common European approaches that did not take account of their own particular circumstances.

There would turn out to be a high price to pay for maintaining this level of independence and flexibility in a market that was increasingly integrated in practice. However, the benefits of the status quo were too strong for national authorities to give up in the absence of a crisis.

5. IMPLICATIONS OF THE MOVE TO A SINGLE CURRENCY IN THE EUROZONE

Financial integration took a major step forward when European Monetary Union (EMU) was achieved with the creation of the euro as a measure of account in 1999 and its subsequent introduction as a currency with coins and notes, completely replacing the individual national currencies of the eurozone.

The creation of the currency union increased the extent to which actions in one part of the eurozone could have repercussions in other eurozone nations and should have encouraged still more integration of financial regulation, supervision, and deposit guaranty systems and other protections. However, it appears to have had only a minor effect on the choice of regulatory and supervisory structures. Once again, the status quo largely prevailed.

It is significant that the treaties creating and later formalizing the eurozone left the European Central Bank (ECB) with only a modest and indirect role in financial regulation, principally through a rather vague charge to watch over financial stability in the currency zone. In particular, the ECB was not set up to be a lender of last resort, as central banks normally are. That is, it is virtually uniformly accepted that a central bank has a responsibility to provide liquidity to temporarily illiquid banks that remain solvent, but are simply short of cash due to market conditions that make it impossible to obtain liquidity from other banks and the markets in the normal manner. However, this role was not transferred from the individual central banks of the eurozone member states to the ECB. Given the very thorough discussion of the role to be given the ECB, this was clearly not an oversight, but a political and policy decision. It seems to reflect the standard approach that has been used in building European integration, which is to start new European institutions with the minimum authority necessary or, often, not even that much authority. This approach is least threatening to the established authorities that it may eventually displace. In practice, subsequent problems, or even full-blown crises, underline the desirability of passing more power on to the new body. Many a European institution has begun quite weak, but grown to have substantial power.

EMU weakened national authorities in an important but indirect manner that may not have been obvious at first. It was well known that giving up national currencies would sharply reduce the policy options available for economic management of individual countries. However, there seems to have been much less discussion of what that would mean for management of the financial system. Thus, it became far harder for a country, such as Spain, to tamp down a boom that was being fed to a substantial degree by inflows of credit from foreign banks from within the eurozone. In prior times, interest rates could have been ratcheted up, and exchange rates allowed or encouraged to rise, dampening economic growth and reducing the attractiveness of continued fund inflows. Perhaps even worse, it eliminated the ability of national governments to rescue troubled financial systems by lowering interest rates or pushing exchange rates down, in order to directly improve the profitability of banks by widening their interest margins or to do so indirectly by aiding the national economy.

6. IMPLICATIONS OF THE EURO CRISIS

Starting as early as 2008, countries in the eurozone began suffering from a set of related crises that became known as the “Euro Crisis.” The most immediate problems related to confidence in sovereign debt, but this in turn reflected weak economic competitiveness, fiscal laxity, and bad governance in many countries of Europe, particularly those that came to be called the “periphery” or sometimes “the South.” These problems pulled in the rest of the eurozone, both through the need for financial assistance and by calling into question the long-term viability of the euro. Trade and financial links exacerbated the contagion and a general crisis of confidence ensued throughout the eurozone.

The Euro Crisis was caused in part by failures of financial market integration. In turn, the crisis seriously aggravated those ills, in a vicious circle. In Ireland, and to a lesser extent Spain, sovereign debt crises arose in large part because of the need to rescue failed banks. Ireland’s banking sector was huge in comparison with the size of the country, so that the hole to be filled turned out to be large enough to swallow the sovereign itself. The government initially stepped in to guarantee all the debts and deposits of the major banks, in an attempt to restore confidence. But the losses turned out to be much bigger than anticipated, well beyond the ability of the government of Ireland to support on its own. This threw the credit of Ireland itself into serious doubt, substantially raising the interest rates it had to pay for funding in the markets, which in turn raised interest rates for virtually everyone else in Ireland, including the banks. Further, government austerity measures went into effect to try to reduce the budget deficits. The economy, which was already troubled, sank into severe recession, putting the banks and the sovereign into even worse positions than they already were, in a classic downward spiral. The rest of the eurozone had to step in with a rescue package for the Irish government, once it proved unable to borrow in the markets at reasonable interest rate levels.

Spain suffered a similar problem with its savings banks, or "cajas," which had bet heavily on the housing bubble and also made many bad loans to well-connected locals. The size of the losses was not as large as in Ireland in relation to the size of the state itself, but there was a similar downward spiral with sovereign credit and bank credit.

In other countries, the linkages between banks and their national sovereigns worked initially in the other direction. Greek banks started out quite sound, but were dragged down by the collapse of confidence in the Greek government's ability to pay its debts, much of which was owned by the banks, and the ensuing economic depression that caused bad debts to soar. Italian banks experienced a much milder version of the same problems, with sound underlying banks hurt by the problems of their sovereign.

Over the course of the Euro Crisis, it became clear that the eurozone needed considerably tighter zone-wide integration of financial supervision, deposit guarantee systems, and resolution procedures and the funding for them. This parallels a recognition that currency union requires tighter integration across the wider economy and closer coordination of the political and bureaucratic structures that govern it.

The most obvious need for integration is in the mechanisms for dealing with troubled financial firms and the funding for them. Individual eurozone member states that run into serious economic problems no longer have the means on their own to handle wide insolvencies across their financial systems. They do not have a national central bank with unlimited ability to create funds and therefore an ironclad capability of supporting the banking system if they choose to do so. There is no ability to credibly promise to do "whatever it takes," as Federal Reserve Chairman Ben Bernanke did in the United States. In turn, their fiscal systems are generally not strong enough to counteract widespread losses in the financial industry, particularly as the problems with their banks are almost certainly mirrored by troubles in the wider economy, which they have given up many of the tools to control.

The eurozone, on the other hand, remains very strong when viewed collectively. Its fiscal condition is better than the United States at the moment, in that its debt levels are roughly comparable and its annual budget deficits, in the aggregate, are less than in the United States. The markets retain confidence that the eurozone governments and the ECB can handle any fiscal issues that arise, including banking problems, as long as the resources of the whole zone are available. The real market fears have revolved around a political judgment that the currency zone might not stand together behind each of its members, fears that proved true with Greece, where private holders of government debt were forced to take heavy losses.

Therefore, it is critical that the eurozone moves to a system where it is clear that, at least in the more extreme cases, the currency zone as a whole will fund the necessary restructuring of the financial industry in the hardest hit countries.

Similarly, there is a danger that depositors will lose confidence in the national deposit guaranty schemes of one or more countries, leading to a major bank run. The potential for such a run has been considerably increased by EMU, since it is now far easier and less expensive to move deposits between countries within the zone. There is no need to convert funds between national currencies, as long as the funds are moved within the eurozone, and part of the integration brought about by "single market" initiatives is the ability to easily transfer funds within the EU.

Thus, one of the biggest concerns about the Greek situation has been, and remains, that a change in the political situation at home or elsewhere in the eurozone sparks fears of a Greek withdrawal from the eurozone. Depositors would then pre-emptively move their funds out of the Greek banks, and out of the country. Such a run could be so massive that the Greek banks would run out of funds and exhaust the capacity of the Greek central bank to provide the needed liquidity without emergency assistance from the other central banks that participate in the Eurosystem.[6] Such aid might not be politically feasible if there is a high level of concern that Greece might in fact withdraw from the euro and simultaneously default on many of its obligations. This fear is particularly likely to exist since the trigger for the underlying concerns would almost certainly be a major political rift between Greece and the other eurozone countries.

Without that aid from other eurozone central banks, the banks in Greece would either have to default or be propped up by the issuance of Greek government certificates that would function as a new quasi-currency, since the government would not have enough euros to fill the liquidity void. The certificates would likely be theoretically convertible to euros and be of short duration, but the ability to honor those promises would be dependent on an ultimate resolution of the political crisis with the rest of the eurozone. Unless and until that happened, Greece would effectively be operating with a mix of euros and its own new currency, in the form of the certificates. This could quickly escalate to the point where the government felt it needed to take the full step of pulling out of the eurozone and switching entirely to its own currency.

When the member states still had their own currencies, they could run into similar crises of confidence. However, they had many more tools to surmount the challenges, including the ability to: issue currency as needed; devalue the currency to make transfers to other countries less attractive and return of previous transfers more appealing; impose exchange controls to limit flows; and take a range of other steps to put their economy on a sounder footing.

Integrating the national deposit guarantee schemes into one larger system would make bank runs less likely, even though it could not fully eliminate the worst panics, where Greeks, for example, might grow so concerned that their euros would be redenominated into drachmas that they moved their funds out of the country altogether. (There are a variety of practical constraints that make it infeasible to guarantee depositors against such a redenomination and devaluation. The most obvious is that the cost could be extremely large and therefore politically impossible to commit to pay. In addition, it would effectively be a huge subsidy for any withdrawing nation, providing an incentive to do exactly what the eurozone does not want.)

Developing a common resolution fund, either as a backstop to national funds or as the primary guarantor for the eurozone as a whole, would provide the security that debt

[6] The Eurosystem is the monetary authority of the eurozone.

holders and depositors not covered by deposit guarantees would need.[7] They still might have to take some losses, according to a pre-agreed formula, but they would at least know that the underlying mechanisms would be funded as needed by a body that could call upon the resources of the eurozone as a whole.

A common resolution fund and related rules would also help with the thorny and important problem of resolving cross-border banking groups. Currently, there are still quite different rules in the different jurisdictions that need to cooperate in such a resolution and there is no effective mechanism to determine how to share out any losses across the borders.

In theory, supervision could be left at a purely national level, but there is little willingness by the stronger countries to fund guarantees unless they are confident that a high quality of supervision is being exercised over the banks. This effectively requires pan-European, or at least pan-eurozone, standards and a European body with sufficient powers to enforce those standards or to exercise them directly.

Lapses in national supervision were less critical to other countries prior to the advent of the euro. As noted, the risk of contagion was much lower, in large part because individual national governments and their central banks were in a considerably better position to tackle any national banking crisis that developed. They were also potentially at less risk of a crisis triggered by excessive inflows of funds from lenders in other countries.

7. CURRENT STATE OF AGREEMENT ON EUROPEAN BANKING UNION

There has long been an intellectual consensus among financial experts that Europe needed to move to a more integrated system of bank supervision and pan-European guarantee mechanisms. However, such moves appeared to be a pipe dream until the Euro Crisis became truly severe and the financial markets sent a clear message that the interlinkages between banks and sovereigns were a prime source of concern. As a result, European leaders announced at a summit in June 2012 that they would move to a “banking union” to complement monetary union and what is increasingly a political union.

Banking union is a term of art, meaning different things to different people. However, virtually everyone agrees that it includes at least: common financial regulation; a common supervisory approach; coordinated deposit guarantees; and an integrated approach to resolution of troubled financial institutions. Little more needs to be done on the first point, common regulation, since the EU already mandates a high level of commonality in this regard. (The discussion of banking union presented here is necessarily cursory. A much fuller review is contained in Elliott [2012].[8])

The geographical scope of the banking union will be the entirety of the eurozone, plus any other nation in the EU which volunteers and is accepted as a participant in the union. This leaves an awkward set of issues of how to coordinate with the European Banking Authority (EBA). The EBA coordinates bank supervision in the whole EU, but

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[7] Proposals for more integrated resolution mechanisms are contained in European Shadow Financial Regulatory Committee (2012), Huertas et al. (2012), and Schoenmaker (2012) as well as in some of the more comprehensive analyses of banking union referenced earlier.

[8] See also Beck, ed. (2012); Millar (2012); Pisani-Ferry, Sapir, Veron, and Wolff (2012a); Pisani-Ferry and Wolff (2012b); Sapir, Hellwig, and Pagano (2012); Speyer (2012); and Veron (2012), for other views.

has been held until now to a quite limited role, since its ability to order national supervisors to do anything is very constrained.

Europe chose to tackle supervision first, even though it is logically the least pressing concern in relation to the Euro Crisis, dealing as it does with the prevention of future troubles and not with the resolution of existing problems. This prioritization appears to be the result of two factors. First, setting high supervisory standards is viewed as a prerequisite in Germany and some of the other fiscally strong nations for obtaining political support for measures that would cost money. Second, and related, supervisory changes are not “money” issues in the short-term, unlike deposit guarantees and bank resolution schemes, where the public can immediately see the potential for taxpayer payouts.

The European Commission proposed a plan[9] in September 2012 for implementing a common supervisory approach across the banking union and this plan was modified and accepted by European leaders in a summit at the end of 2012. The ECB will take over as the ultimate supervisor for all banks, but will effectively delegate the supervision of most banks to existing national supervisors, in the ordinary course. The largest banks, however, will be overseen directly from Frankfurt by an ECB team that will coordinate as necessary with national regulators. The ECB will theoretically be subordinate to the EBA, which is charged with creating a “single supervisory handbook” that will bind the ECB as well as other EU supervisors outside of the banking union. In practice, however, most observers expect the ECB to dominate the EBA in situations where there may be conflicting views.

European leaders have pushed off most decisions about deposit guarantee schemes until later. The first step on deposit guarantee systems will be to harmonize them so that they operate under the same rules. Following that, it is likely that a reinsurance mechanism will be set up under which a national deposit guarantee fund would absorb the first losses, followed by contributions from that nation’s government, with yet higher levels of losses covered by pooled funds from national deposit guarantee systems across the banking union. The reinsurance approach would provide for recovery through premium payments over time, with the possibility of a central fund being built up in advance through regular reinsurance premiums.

8. UNRESOLVED ISSUES WITH EUROPEAN BANKING UNION[10]

There are many critical issues about banking union which have not yet been decided by European leaders, sometimes because they are technical and require coordination with other decisions or need more analysis, but often because they are too politically difficult. Some of the key unresolved issues are:

In practice, how should responsibilities be divided between the ECB and national supervisors?

Europe’s leaders have agreed that the ECB will have the ultimate authority over all banks in the banking union. (This decision came despite strong arguments from Germany, in particular, that banks such as their savings and cooperative banks should be exempted from ECB oversight altogether on the basis of their smaller size and their

[9] European Commission (2012). See European Council (2012) for the response of the national leaders to this proposal.

[10] Parts of this section are adapted from Elliott (2012).

purportedly safe business models.) However, national supervisors will remain and will shoulder the day-to-day responsibilities for most banks, given their existing infrastructure, accumulated expertise, and local knowledge. For the largest banks, the ECB will develop centralized oversight out of Frankfurt, coordinating with national supervisors as is deemed appropriate.

There is logic to this particular division of labor, although other approaches were possible. Whatever its merits, though, there are many questions about what it will mean in practice. Will central ECB officers insist on reviewing in detail all significant decisions by national supervisors, either prior to or after their implementation? To what extent will central ECB officers visit banks in person, rather than relying on national supervisors? How detailed will the instructions be that are given to the national supervisors? Will national supervisory personnel be brought into an ECB career path, serving rotations perhaps in multiple countries and in Frankfurt? Depending on the answer to these and other questions, the role of the ECB in Frankfurt could be bigger or smaller, and more or less effective.

A particularly important practical point will be how effective the ECB is in resisting local political pressures and avoiding "group think" about banks within national markets. These two goals are critical to gaining benefits from the move to a European level of supervision. For this reason, there are distinct risks in what appears to be an informal compromise that the ECB will have supervisory powers over the German cooperative and savings banks, but will not involve itself in practice unless something appears seriously wrong. There is too much danger that this will produce a quasi-immunity, leaving oversight in the hands of supervisors more exposed to political pressures.

Will the banking union cover any other financial institutions?

There has been relatively little discussion of the potential systemic risks represented by non-bank financial institutions in Europe. This does not appear to be a serious threat at the moment, and it therefore may not be worth the political difficulties to spotlight this issue. However, the new institutional structure should be designed bearing in mind the possibility that serious systemic risks could develop outside of the banks over time.

What European-level body should handle the resolution of troubled banks?

There is a range of options for a resolution authority: (1) the ECB; (2) the European Stability Mechanism (ESM); (3) the EBA; (4) a new deposit guarantee fund; (5) a new resolution authority; or (6) an arm of the European Commission.

The best option seems to be a new authority, possibly with combined responsibility for resolution and deposit guarantees. Resolution activities can require committing taxpayer funds, especially in a severe crisis. They also entail allocating losses across various parties. Both attributes match very poorly with the political independence and technical nature of central banking activity, which is why the ECB would be a bad choice. On the other hand, the ESM does have fiscal and distributional responsibilities, but is probably too closely tied to the national governments and with too cumbersome a decision structure. The EBA both lacks the clout to enforce the necessary tough decisions and is too closely tied to its supervisory role, which might taint its ability to take resolution actions that put previous supervision in a bad light. A new authority would not have any of these disadvantages. The deposit guarantee function is closely related to resolution, which might make a combination in the same authority natural, although this would not be free of conflicts.

To the surprise of many, the initial proposal of the European Commission in July 2013 was for the sixth option, to give the ultimate powers to itself. There would be a new Resolution Board, based in Brussels, which would issue non-binding recommendations for the Commission's consideration. In practice, the commission would be unlikely to overrule the board, but it could. This creates a major political hurdle to the proposed structure, since many, particularly in Germany, are reluctant to hand such power over to the commission. However, it appears to resolve the constitutional issue that it is hard to find another body that can take on this role without amending the EU's basic laws, which would be time-consuming and face a real danger of failure. The political obstacle is worsened by a voting structure in the board that would effectively allow the Brussels-based representatives to overrule the representatives of the national authorities.

There will almost certainly be major changes to the proposal before it is accepted and there is some risk that legislation will not be passed before the European Parliament elections of May 2014, after which the proposal would have to be reconsidered by a new parliament and a new commission.

Who will run the European deposit guarantee fund?

A new authority is almost certainly the best answer, for essentially the same reasons as just discussed for a resolution authority. It appears likely that this will be the case in practice, if there is indeed a banking union-wide body. If Europe's leaders decide to rely on a reinsurance mechanism instead as a way of bringing the national systems together, the organization that will run that fund, which might even be within the ECB, is likely to have only limited powers since its duties would be primarily technical.

How will the losses from insolvent or restructured banks be divided?

This breaks down into two questions. Who pays for losses that already exist, whether recognized or not, and how will the cost of future losses be divided? The right answer on past losses is fairly clear: they should be evaluated transparently and then explicitly divided up. In particular, the troubled countries of the eurozone should not expect to slip the losses from their banks onto the books of the new European deposit guarantee or resolution funds as a backdoor subsidy for their national governments. Explicit aid may be appropriate; implicit aid in this manner is not. Future losses are best dealt with through a system of prefunding, in which premiums are charged to the covered banks. Ideally, the premiums would be risk-adjusted so that banks that present more of a risk of a future rescue must pay more.

All of the preceding is focused on the losses that taxpayers end up bearing. However, one of the keys to an effective resolution regime is to maximize the extent to which any losses are borne by shareholders and debt holders. This excludes unsophisticated depositors, who should be protected both for their own sake and to avoid damaging bank runs. There appears to be strong political agreement around a recent European Commission proposal for common rules on loss-sharing, which largely match the approach in the US and, indeed, in most bankruptcy law in advanced nations.

How will the supervisory and guarantee/resolution bodies divide their responsibilities?

There will be a number of ways in which supervisory and guarantee entities can affect each other, including through potentially overlapping roles. There is an inherent tension between the supervisory body that is responsible for avoiding banking problems and the bodies that bear the losses if they do occur. In practice, supervisors tend to be very loath to put banks into resolution, partly because it tends to reflect poorly on them so there is a natural impulse to postpone the evil day. There can also be regulatory capture, even if only at an intellectual level. Because of these concerns, some countries such as the United States give formal supervisory powers, or their effective equivalents, to the deposit guarantee/resolution authorities.

The Federal Deposit Insurance Corporation (FDIC) in the United States is a secondary or tertiary supervisor for all insured banks, giving them the ability to force managements to take certain actions even if the primary supervisor disagrees with the necessity. It is unusual for the FDIC to act in contradiction to the beliefs of a primary regulator, but they can and have done so in the past. Europe will need to decide what review or oversight powers their guarantee funds and resolution mechanisms will have. It seems desirable that such funds have some ability to interact with managements well prior to a bank being put into resolution. This would aid in the transition to a resolution, as well as keeping the ECB and national supervisors on their toes in the ordinary course of supervision.

What will be the impact of the United Kingdom remaining outside of the banking union?

Leaving Europe's dominant financial center, the City of London, outside of the banking union raises serious concerns. There is a real risk that two supervisory regimes will develop in practice, one in London and the other on the continent. This could encourage regulatory arbitrage, where activities shift to whichever locale provides the lighter regulation for that activity. Moreover, there is also a risk that a single regime develops, but that it is the ECB's supervision that effectively annexes the rest of the EU. A single supervisory regime for Europe would be good, but only if it has the right governance structure, so that all concerned can defend their viewpoints and their interests. Having a eurozone entity effectively dictate overall EU policy is not appropriate and would ratchet up tensions with the United Kingdom sharply, especially given the often quite divergent views of finance and its regulation that are espoused by that nation as compared to the continent. In the worst case, tensions of this nature could help push the United Kingdom to leave the EU.

The commission's proposal attempts to ameliorate this issue by cementing the EBA's legal position as the overseer of the supervisory framework for banking in Europe (particularly by making it the author of a "single supervisory handbook" that would bind the ECB and all other supervisors in the EU) and by offering a new voting structure in the EBA to protect non-members of the banking union. The intentions are laudable, but it is not clear that either step will be very effective. Unfortunately, there is no obviously superior answer, given the United Kingdom's unwillingness to join the banking union or the eurozone. There will simply be a major source of potential conflicts that will have to be managed carefully over time. Given goodwill from all concerned, it should be workable, but that premise may not always be fulfilled.

How will timing and transition issues be resolved?

Once the overall design choices are made, there will be a host of critical issues to be decided about the timing of changes and the transitional arrangements from now until the new structures are fully in place. These are too numerous and technical to discuss at length in this paper.

9. LESSONS FOR ASIA FROM EUROPE'S HISTORY OF BANKING INTEGRATION

It is possible to have considerable financial integration across borders within one region

Most of the lessons from Europe are negative ones, pointing out errors to avoid. However, it should be noted that Europe did develop a significant level of cross-border financial integration. This worked quite well during the good times, even though the ensuing crisis showed that there were important flaws in the overall design of supervision and support mechanisms.

It is better to design financial integration outside of a crisis environment and with a realistic long-term plan in mind

Sometimes it is impossible to push through the political obstacles to change without the impetus provided by a crisis. However, crises inevitably warp the responses, as is very evident in Europe's current decision-making processes. Crises also tend to politicize policy issues to a greater extent and financial issues are ones that can easily be seized upon by unscrupulous or misinformed politicians and commentators pushing an unrealistic agenda. Leaders in a number of key Asian countries are known for being able to take the long view. This is an area that would benefit from such a rational, long-term approach that has been too absent from Western regulatory deliberations in the wake of the Global Financial Crisis and the Euro Crisis.

Incremental steps lead to pressure for further incremental steps

Planners must be careful to take account of the momentum that almost inevitably develops to take further steps in the same direction. This can be harnessed for good purposes, but it can also inadvertently lead policymakers to overstep or to move before they are ready. This is most evident in the decision to create EMU. It grew out of both successful earlier steps, including the increasing reality of a single market in a broad range of services, including finance. But, it also grew out of unsuccessful attempts at currency stabilization through such failed efforts as the Exchange Rate Mechanism. The logic of a single market, and the successes attendant upon it, pushed for more integration. The failure of other methods of stabilizing currency rates pushed for a bold step if one were to keep trying for such stabilization.

Currency union has far-reaching effects and should only be undertaken when it truly makes sense

A discussion of the pros and cons of EMU and where it should go from here is largely beyond the scope of this paper. However, the existence of the currency union is too fundamental a contributor to the problems from flawed financial integration not to underline the importance of undertaking currency union only when nations are ready. At that time, it is also critical to create a union that can deal with the inevitable disparities and even crises that are likely to develop at some point.

Currency union should be complemented by national macroprudential policies

The combination of closely integrated financial systems across a region and the loss of national interest rate and exchange rate tools because of currency union makes it all the more important to be able to use other measures to ensure the overall safety of the financial system in each country. If Spain had used strong macroprudential measures during the build-up of its housing bubble, it might well have held down the extent of that boom, despite the large sums German and other banks were willing to employ in Spain. Equally importantly, it could have ensured that the banking system was resilient enough to handle the shock when the bubble burst. This would have aided Spain significantly as the Euro Crisis unfolded, since its banking problems hurt the overall economy and its sovereign credit very considerably. This, of course, assumes the willingness of the appropriate authorities to use their macroprudential powers; having the formal authority has little value in itself.

National and supranational authorities need to watch for wider systemic risks

As a complement to national macroprudential policies, it is also important that authorities watch for sources of systemic risk that can cross borders in Asia and globally. Information and decisions need to be shared across the region, as necessary to spot and contain risks. The Spanish housing bubble, which affected Spain directly and Germany indirectly, is a good example of a case in which cross-border information sharing and actions would have been helpful.

The Asian Development Bank, the International Monetary Fund, and other regional and global bodies could play an important role here, including the Basel-based institutions such as the Bank for International Settlements and the Financial Stability Board.

A “single market” requires regionally integrated banking supervision

The appropriate level of supervision is of the entirety of a core market, whether national, regional, or global. As long as Asian markets remain national, even if somewhat connected, national supervision of their financial systems remains viable. However, the nearer Asia comes to a closely integrated financial market such as Europe has had for some years, the greater the potential for lax supervision by one country to create serious repercussions for others in the single market. There are also risks of regulatory arbitrage if different supervisors handle aspects of banking in different manners, even if each supervisor has the same “average” level of toughness. If one supervisor is relaxed about traditional lending while another is relaxed about securitization, the integrated nature of a single market is likely to lead banks to move their activities to take advantage of the most relaxed supervisor for each type of activity.

Currency union would require much closer integration of financial supervision and guarantees than would lesser integration steps

As Europe discovered, entering a currency union very substantially raises the importance of an integrated regional approach to bank supervision and financial support. Financial entities within a currency zone will inevitably develop much closer cross-border links as the economic costs of doing so drop sharply and the gains from following business across borders rise. The links may be through lending across borders, or through purchases of banks in other member states, or investment into new or expanded subsidiaries in other countries, or simply more transactions with other foreign financial firms. This increases the risk of contagion substantially. It also makes it harder for national supervisors to control what goes on within their borders. Furthermore, the loss of key national economic policy tools makes it much more difficult to respond on a national basis to any financial crisis that may develop within a country’s borders.

As a result, it is critical that a currency zone has common supervisory mechanisms and, even more importantly, common mechanisms for dealing with troubled financial firms. Deposit guarantee systems need to be integrated into a single system or need to have a strong, clear reinsurance or mutual guarantee arrangement so that depositors know that the whole zone stands behind their deposits, up to the guarantee limits. Similarly, there needs to be a common resolution approach, with clear rules and with a funding arrangement that spreads the burden across the currency zone, at least for costs exceeding a certain level.

It might be possible for a nation which is large in relation to the size of the currency zone, and is fiscally quite sound, to do without the common mechanisms. However, such a country could easily suffer significant damage from the troubles that might strike one of the smaller member states in the absence of such guarantees, as Europe has demonstrated with the contagion from Greece, Ireland, and Portugal. Germany, the economic powerhouse of the eurozone, has clearly suffered major economic damage from the contagion and knock-on effects of troubles on the periphery.

The role of a regional central bank in a currency zone must be carefully thought through

Central banks are always important, but their role in financial regulation can become even more complicated in a currency union. Hopefully, any currency union that is eventually adopted in Asia will be carefully constructed to complement economic and monetary integration with the right level of political integration. However, the situation of the eurozone is an example of what can go wrong in this regard.

First, the ECB was designed with the intention that it not be a lender of last resort, which is unrealistic in a context in which the level of integration has become the eurozone rather than simply existing within national borders. As noted, national central banks are simply not in a good position to act as such a lender given the high level of integration within the eurozone.

Second, the ECB is being given major supervisory powers in part because of the example of the many national systems in which central banks play important supervisory roles. However, there is insufficient recognition of how very different the environment is in the eurozone as a whole as compared to national structures. In particular, European nations have strong governments that can easily act as a counterweight to a central bank that loses its way. In fact, the danger is probably more in the direction of excessive government power relative to the central bank, threatening the independence of monetary policy. But, the ECB is the dominant actor in the eurozone, even without the addition of the supervisory powers it will be receiving. The European Parliament is not yet strong enough to strongly push back if the ECB follows a mistaken path, nor is the European Commission. The joint weight of eurozone national governments, perhaps orchestrated through the European Council, could be sufficient to adjust the ECB's course, but this is highly dependent on obtaining a consensus within an often-fractious body, one that would be likely to be even more divided in a situation where the ECB stood firm.

Nations in an integrated financial market should avoid economic nationalism in a time of crisis

The Euro Crisis demonstrates that the breakdown in the flow of credit across borders that occurs when banks and their national supervisors revert to a "home bias" ends up harming all the members of the single market. This effect is doubtless strongest when financial integration is combined with currency integration, but it would occur even without monetary union. For example, German banks had lent large sums of money into Greece, Spain, and other peripheral European countries. When they pulled their funds back home as a result of regulatory pressure and a shortsighted view of their own self-interest, it severely harmed the borrower countries. That harm rebounded on Germany as the Euro Crisis accelerated, damaging confidence, trade, and the overall economy across Europe, including Germany.

Close financial integration requires careful coordination of each major aspect of interactions between the authorities and the financial sector

Europe is in the process of demonstrating the disadvantages that come with trying to create a "banking union" without paying sufficient heed to the linkages between the different aspects of that union.[11] Ideally, this level of financial integration should be created with simultaneous designs for regulatory integration, supervisory integration,

[11] See Verhelst (2012) and Lannoo (2012) for criticisms of the piecemeal approach.

coordination of deposit guarantee arrangements; and integration of mechanisms for resolution of troubled financial firms. They each interact with each other, so it is a mistake to design them as if they were truly separable.

If political processes mandate that agreement be reached on one or more elements before consensus can be reached on the entirety, it would be wise to proceed in the opposite order to what Europe is doing. If one must choose, the systems to deal with market and supervisory failures—resolution mechanisms and deposit guarantee schemes—should be designed before the supervisory mechanisms which are intended to minimize the usage of these emergency measures. With those mechanisms clearly in mind, it would be possible to design a better supervisory system to complement them.

10. AREAS FOR FURTHER RESEARCH

There is clearly room for further research to expand and refine these lessons for Asia, including the obvious one of examining the direct parallels with specific historical and proposed steps in Asia. It would also be useful to have updated analyses of the political factors that led Europe to make the choices that it has in regard to financial integration, as there are likely implications for other regions considering the same issues. Beyond that, ideally, comparative economic analysis of a range of integrated financial systems would allow us to judge the relative performance of different approaches. Unfortunately, it is difficult to think of another example of a highly integrated, regional financial system beyond Europe, except those within a single nation.

Defining "research" more broadly to include considered, logical analyses of the options and their advantages and disadvantages, one of the areas of highest importance is the daunting one of designing cross-border resolution mechanisms. Even aside from the question of regional arrangements, good resolution mechanisms would be highly useful in a world in which financial institutions and markets cross borders so readily.

There is also a paucity of analysis of the optimum ways to combine regulation, supervision, deposit guarantees, and resolution mechanisms, especially in a cross border context.

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