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Banking disunion

Some worrying signals from Cyprus and the Eurogroup's new chairman

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THE crisis in Cyprus has claimed its first scalp: Michalis Sarris, the finance minister, has resigned. He lasted less than five weeks, and is not the only person to blame for the mess. Indeed, some want another head to roll: that of Jeroen Dijsselbloem, the Dutchman who now chairs the Eurogroup of finance ministers. His offence? Perhaps to have spoken the truth. He presented the decision to force shareholders, bondholders and depositors in Cyprus's two biggest banks to bear losses as a model for future banking crises. Bail-outs by taxpayers had to be replaced by the bail-in of investors. Or, as Mr Dijsselbloem told interviewers, it was time for governments to start "pushing back the risks".

Markets swooned, prompting a hasty clarification that the Cypriot package was "a specific case with exceptional challenges". Vulnerable southern countries are furious at the implication that their depositors may be at greater risk than others. Small countries with outsized banking sectors, such as Luxembourg and Malta, were offended by Mr Dijsselbloem's suggestion that they should hurry to "strengthen your banks, fix your balance sheets". France even flirted with demanding Mr Dijsselbloem's resignation. Some German newspapers nicknamed him Dusselbloem, which translates roughly as Dimwitbloem.

All this has added to the confusion created by the botched €10 billion ($13 billion) rescue of Cyprus. An abortive first bail-out tried to tax all depositors, whether small and insured or large and uninsured. The second deal more sensibly imposed losses on investors and big depositors in the two most troubled banks, and protected all insured depositors. At best, the muddle betrays incoherent and improvised decision-making. At worst, it may show that the euro zone is turning away from its promised "banking union". The aim, agreed by European leaders at a summit last June, was to "break the vicious circle between banks and sovereigns" by entrusting financial supervision and crisis management to common authorities. Now, in the view of one gloomy Eurocrat, "we are

digging the grave of banking union."

Some dismiss Mr Dijsselbloem's remarks as careless musings, reflecting his role as Dutch finance minister, not as head of the Eurogroup. But critics say he risks pushing depositors and investors into fleeing banks in peripheral states. If so, he might be responsible for another "Deauville moment": the ill-fated Franco-German pact in October 2010 to impose losses on private investors in government bonds. That announcement caused panic in markets, helping to push Ireland and Portugal over the brink and initiating a second, more dangerous, phase of the euro crisis.

In truth, Mr Dijsselbloem is being blamed for the wrong reasons. He is right that bank creditors should take losses to spare the taxpayer. But through inexperience or just Dutch bluntness, he spoke out of turn. The Eurogroup is still debating common rules on bailing in bank creditors. One issue is the starting date. Germany and other creditors want the bail-in era to start in 2015; France and the European Commission seek a delay until 2018. Mr Dijsselbloem unilaterally declared that the future is now.

Strangely, his biggest sin has gone largely unnoticed. He all but repudiated a central commitment by euro-zone leaders that, once a single supervisor is in place, the common rescue funds could be used directly to recapitalise troubled banks. This would ensure that the burden of supporting weak financial institutions does not fall on weak sovereigns. The Eurogroup is supposed to draw up rules for such direct recapitalisation by June, with a view to activating the process next year. How far it should apply to "legacy" assets, and whether it can be enacted retroactively (eg, to help Spain or Ireland) are hotly debated. But Mr Dijsselbloem went alarmingly off track in suggesting that direct recapitalisation could be avoided altogether. "We should aim at a situation where we will never need to even consider direct recap."

This flies in the face of sensible crisis management. Any bank-resolution system, even if it includes a fund paid for by the banks, needs the taxpayer to stand behind it, as happens in America. Mr Dijsselbloem himself recently nationalised a Dutch bank and insurance group to prevent its collapse (junior bondholders were hit, but not senior ones).

Pull together or break apart

Breaking the circle between banks and sovereigns requires both the bail-in of creditors and some mutualisation of banking risk. Apart from a credible fiscal backstop (the current rescue fund may be too small) it also needs a common deposit-guarantee scheme. But Germany has back-pedalled on banking union ever since it was first mooted. The European Central Bank (ECB) eased the pressure for swift action with its promise to do whatever it takes to prevent the break-up of the euro. The Germans also worry about taking on new liabilities, especially before their election in September. A deal between ministers and the European Parliament on the new supervisor was almost finalised

last month, but Germany threw up eleventh-hour objections.

Yet the turmoil in Cyprus demonstrates why a credible banking union is so urgently needed. With a central supervisor and bank-resolution authority, its banking problems might have been mitigated, or addressed sooner and at lower cost. The capital controls imposed on the island might then have been unnecessary or less onerous, particularly if the ECB had the courage to provide liquidity to smaller solvent Cypriot banks.

As matters stand, a euro in Cyprus is no longer worth the same as a euro elsewhere. Borrowing costs for firms in southern Europe are already higher than in northern Europe. Now a well-run bank in southern Europe may be deemed less safe than a poorly run one in northern Europe. The euro cannot survive such fragmentation. Only a proper banking union can repair it.

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