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## Towards deeper financial integration in Europe: What the Banking Union can contribute

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Towards Deeper Financial Integration in Europe:  
What the Banking Union Can Contribute

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September 2014

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# Towards Deeper Financial Integration in Europe: What the Banking Union Can Contribute<sup>1</sup>

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August 2014

## **Abstract**

The European Banking Union is a major step forward in fixing major deficiencies in the institutional framework of the Euro area. The absence of effective banking supervision and resolution powers at the European level promoted excessive private risk-taking in the up-run to the Euro crisis. Effective private risk sharing once risks materialized has been hampered. A properly designed Banking Union facilitates and improves private risk sharing, and it is thus a necessary institutional complement to a monetary union. Yet, the institutional framework of the Banking Union needs further strengthening in three regards. First, the supervisory framework needs to ensure uniform supervisory standards for all banks, including those located in non-Euro area countries. Also, conflicts of interest between monetary policy and banking supervision need to be mitigated. Second, bank resolution suffers from a highly complex governance structure. Restructuring and bail-in rules allow for a high degree of discretion at the level of the resolution authority. We propose to introduce a statutory systemic risk exception, by which the exercise of discretion would be reduced, thereby strengthening the credibility of the bail-in. Third, in order to enhance the credibility of creditor involvement, fiscal backstops and ex-ante specified cross-border burden-sharing agreements are needed.

Key words: European Banking Union, Single Supervisory Mechanism, Single Resolution Mechanism, risk sharing

JEL codes: E02, E42, G18

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## 1 Introduction

The financial crisis has revealed the inadequacy of Euro area's institutional framework. Pre-crisis institutions promoted excessive (cross-border) risk-taking by the private sector but did not provide for regulatory mechanisms to enable sharing of risks that materialized. In June 2012, at the height of the crisis, political leaders of the Euro area declared that "it is imperative to break the vicious circle between banks and sovereigns", thereby marking the starting point of the Banking Union.<sup>2</sup> Since 2012, the three pillars of the Banking Union have been spelled out further: the Single Supervisory Mechanism as the most advanced pillar will become operational in November 2014; harmonized rules and centralized competencies in bank resolution have been agreed upon; basic conditions for a common financing mechanism for bank resolution have been clarified.<sup>3</sup> Before assuming responsibility for banking supervision, the European Central Bank (ECB) is conducting an examination of banks' balance sheets and risk profiles (comprehensive assessment).

The agreement on the Single Supervisory Mechanism (SSM) and on the Single Resolution Mechanism (SRM) is a fundamental step away from the original concept of the Single Market where supervision is executed by national authorities (*home country control*), following harmonized rules (*minimum harmonization*) and *mutual recognition* of supervisory decisions. In short, it is a fundamental step towards enhanced financial integration.

Yet, financial integration not only involves cross-border capital flows but also the sharing of potential losses. Hence, the Banking Union can contribute towards deeper financial integration by providing the key to more *private* risk sharing. It can provide an effective mechanism for the involvement of (domestic and international) private creditors of failing banks and the necessary allocation of losses according to the creditor hierarchy. This view contrasts sharply with the interpretation of the Banking Union as a mechanism for more *fiscal* risk sharing: because public finances are strained and because the distress of national banking sectors would additionally burden national budgets, many have argued that there is need for a common European backstop (de Grauwe, 2013; Goyal et al., 2013).<sup>4</sup>

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<sup>2</sup> See the summit statement of Euro area heads of state or government, June 29, 2012.

<sup>3</sup> These conditions include direct recapitalizations of banks by the European Stability Mechanism (ESM); a common European bank resolution fund (Single Resolution Fund); and further harmonization of deposit guarantee schemes (instead of mutualisation).

<sup>4</sup> The discussion about the Banking Union as a tool for more public sector risk sharing sparked a particularly intense public debate among German economists, see *Stellungnahme zur europäischen Bankenunion* ([http://www.macro-economics.tu-berlin.de/fileadmin/fg124/allgemein/Stellungnahme\\_zur\\_Europaeischen\\_Bankenunion.pdf](http://www.macro-economics.tu-berlin.de/fileadmin/fg124/allgemein/Stellungnahme_zur_Europaeischen_Bankenunion.pdf)) and *Aufruf von 283 deutschsprachigen Wirtschaftsprofessoren* (<https://www.statistik.tu-dortmund.de/kraemer.html>). One camp opposes the Banking Union due to

Enhancing the channels of private risk sharing is particularly important in a monetary union whose members have given up control over adjustment channels such as the exchange rate to mitigate asymmetric shocks. However, a monetary union of otherwise sovereign states may lead to situations where national supervision and resolution limits effective private risk sharing – i.e. the distribution of losses across regions and countries. The crisis in the Euro area has revealed that national supervisors were not able to prevent or to limit the build-up of (cross-border) risks in the banking sector before the crisis, and they were not able to coordinate effectively during the crisis. Bold steps towards improved crisis management were delayed by regulatory forbearance at the national level (ASC, 2012). National policymakers had incentives to shift risks of national banking sectors to the central bank. Potential losses in seigniorage profits would then be distributed to the member states according to their capital keys. To prevent a complete melt-down of the European financial system, the ECB acted many times as a lender of last resort (Hellwig, 2014; Cour-Thimann and Winkler, 2012). However, the ECB had to rely on the assessment of national supervisors that liquidity was provided to otherwise solvent banks with a viable business model.

By shifting the control over national banking sectors to the European level (SSM and SRM) and by establishing harmonized rules for the restructuring and resolution of banks (Bank Recovery and Resolution Directive – BRRD), the Banking Union has the potential to overcome these problems. Whether the Banking Union can in fact contribute to improved incentives for supervisors and a more orderly process of bank resolution depends crucially on its design. Therefore, in this paper, we take a closer look at the proposed legal framework of the Banking Union and identify several major shortcomings that need to be resolved.

First, establishing the SSM under the roof of the ECB has weaknesses. Because decisions on supervisory issues are ultimately taken by the ECB Governing Council, banking supervision and monetary policy tasks are not sufficiently separated. This gives rise to potential conflicts of interest. In addition, competencies are split between the ECB and national authorities. This entails the risk of diverging implementation of supervisory standards and insufficient supervisory powers at the European level. Moreover, non-Euro area member states cannot be integrated into the SSM in a satisfactory manner.

Second, the BRRD/SRM framework for bank resolution should be as comprehensive as possible in order to provide for a level playing field. Differential treatment of Euro area versus non-Euro area members, and of large versus small banks, should be minimized. Moreover, the governance structure in case of bank resolution is highly complex, making it unlikely that swift action will be taken to restructure an ailing bank. In the current framework,

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fears that it eventually will lead to mutual guarantees of all member countries for the European banking sector.

national governments might not be effectively prevented from taking discretionary actions aiming to protect domestic banks, thereby distorting risk premia.

The BRRD, which has been adopted in April 2014, harmonises the respective legal frameworks. Currently though, implementation at the national level remains uneven across Europe. In principle, the BRRD will enable creditor involvement of distressed banks whether they are supervised at the national or at the European level. For member states falling under the SSM, the SRM regulation establishes that resolution of large and potentially systemically important banks will be enforced by a central authority, the Single Resolution Board (SRB). The SRB can – among other instruments – apply the bail-in instrument and thus allocate losses to domestic and international bank creditors.

In any bank restructuring case, authorities need to decide how to allocate losses. Losses that are not covered by the private sector need to be covered through public sources. Hence, the rules that specify whether or not private creditors are bailed in are crucial. These rules, in turn, need to strike a delicate balance. On the one hand, they should be strict and thus limit the amount of public sources needed. On the other hand, strict bail-in may have negative effects on the stability of the financial system.

The BRRD addresses this conflict by allowing for a relatively high degree of flexibility for authorities in granting exceptions from bail-in. The decision to limit creditor involvement is not conditioned on an explicit mechanism how to provide public funds. Mechanisms for liquidity support during a bank restructuring process are particularly vague (Hellwig, 2014). The risk is that bank restructuring will again be delayed: if the resolution authority knows in advance that the financing of the resolution process is not ensured, it may refrain from initiating resolution in the first place.

Third, in order to enhance private-sector risk sharing, we propose developing the BRRD/SRM framework further by limiting exemptions from bail-in. This can be achieved by introducing a statutory “systemic risk exception”: deviations from bail-in would then be allowed only in exceptional circumstances and only after clearing high institutional hurdles such as, for instance, a strong majority among Euro area finance ministers. Any deviation from bail-in in case of a systemic crisis would thus require a stronger fiscal responsibility for stabilizing the banking system. Therefore, appropriate burden sharing arrangements between governments of member states need to be concluded. In the absence of a political union, a consistent approach would encompass ex-ante burden sharing agreements between governments for cross-border banks, backed by the possibility of governments to access the ESM under strict conditionality.

In our view, financial backstops make creditor involvement more credible and thus strengthen private risk sharing. Consequently, financial backstops – common bank resolution fund and national fiscal backstop – are the last rather than the first resort. A common resolution fund should safeguard the independence of the resolution authority in enforcing creditor

involvement and in providing additional financing for the restructuring or resolution of a distressed bank. Moreover, in a systemic crisis, national fiscal backstops together with ex-ante burden sharing agreements are needed when deviations from the strict bail-in rules might be warranted for reasons of financial stability. Yet, deciding whether or not a crisis is or might become systemic requires high institutional hurdles to limit potential moral hazard.

The remainder of this paper is organized as follows. We begin by discussing the Banking Union as a mechanism to strengthen cross-border risk sharing among private actors once risks materialize (Section 2). Against this background, we provide a summary and discussion of the current legal state of the Banking Union proposal (Section 3). Given that key elements of the Banking Union still await implementation, Section 4 discusses the transition into the Banking Union. Section 5 concludes.

## 2 Risk Sharing and the Banking Union

Assessing, monitoring, and allocating risks are the core functions of financial intermediaries such as banks. Therefore, the merits and the design of a Banking Union for Europe need to be discussed in the context of these core functions and in the wider context of risk sharing in a monetary union. In this section, we give a short summary of risk sharing through financial markets (Section 2.1), we discuss stylized facts of European banking markets before and during the recent crisis (Section 2.2), and we lay out how the Banking Union could improve risk sharing and thus contribute to a better functioning of the monetary union (Section 2.3).

### 2.1 National and International Risk Sharing

In order to discuss the implications of the Banking Union for risk sharing in Europe, it is useful to start from the benchmark model of risk sharing. In a setting where markets are perfect and complete – an Arrow-Debreu world – risks are shared efficiently within and across countries by holding a portfolio of state-contingent securities – Arrow-Debreu securities – that insure completely against idiosyncratic, i.e. country specific income shocks. Thus, consumption growth should be less volatile than national output growth.

In the real world, a complete market for Arrow-Debreu securities does not exist. Features of these securities can be replicated only imperfectly by existing financial assets. In this respect, distinguishing between equity-like and debt-like financial instruments is useful. These instruments have different features with regard to the insurance of risks ex ante, i.e. before the actual risk event has materialized, and ex post, i.e. after the realization of risks. Perfect ex ante insurance is possible only in the complete markets setting with equity-like securities. In this case, insurance takes place *before* the actual state of the world is revealed. When upside or downside risks materialize, pay-offs are adjusted accordingly. In credit markets, in contrast, only ex-post insurance is possible: *after* a bad shock to income has been realized, agents can



borrow against their future income in order to limit the impact on current consumption. Losses are assumed following a clear hierarchy: if a debtor becomes insolvent, any losses that cannot be covered by equity holders should in principle be distributed to creditors as well. For this risk sharing to be effective – both within a national setting and across border –, however, effective mechanisms to facilitate loss absorption of creditors need to be in place though.

How effective can risk sharing through financial markets be? Answering this question is particularly important for the Euro area which, in contrast to the United States is a monetary union without a political union. Therefore, risk sharing through fiscal policy is much more limited. An answer needs to take into account that fiscal insurance schemes allow for risk sharing as well. Accordingly, empirical studies that estimate the degree of risk sharing within sovereign states decompose the risk sharing into three distinct channels. Two of these are (financial) market based – cross holdings of financial claims and credit markets that allow inter-regional savings and borrowing –, while the third channel works through fiscal transfers or fiscal insurance.

Empirical evidence on the channels of risk sharing through financial markets (capital market and credit market) in existing monetary unions can provide a first answer to this question. Empirical estimates of the combined contribution to inter-regional risk sharing are in the range from 50-60 % with a maximum of 62 % for the U.S. (Asdrubali et al., 1996), followed by Sweden with 59 % (Andersson, 2008), and 53 % for Canada (Balli et al., 2012). For Germany, risk sharing through financial markets has become more important over time with 36 % until 1994 and 68 % after 1995 (Hepp and von Hagen, 2013). While the exact numbers should certainly be taken with caution, they yet show the potential of risk sharing through markets.

The contribution of fiscal policy to inter-regional risk sharing is smaller even in monetary unions with a political union. Estimates are lowest for the U.S. with 13 %, followed by 20 % for Sweden, and 27 % for Canada. The German numbers again vary over time with 54 % until 1994 and 11 % after 1995. This provides support for the view that a well-functioning financial market is a prerequisite to efficient risk sharing in the Euro area (Hoffmann and Sørensen, 2012).

How do banks enter the stage? The European financial system is a bank-based system with banks allocating funds within and across countries. In a benchmark model with perfect and complete markets and perfect risk sharing, there is no scope for banks as intermediaries (Freixas and Rochet, 1997). Introducing incomplete markets by assuming, e.g., adverse selection, information asymmetries and transaction costs, explains the existence of banks.

A typical bank has a state-contingent portfolio of assets on its balance sheet with varying risk and pay-off schedules. However, banks typically finance the asset side with deposits and other debt instruments with returns that are not directly linked to the state of nature (while typically

being partly insured by implicit or explicit deposit insurance). Only a small share of the liabilities is first-loss-absorbing equity. For example, the leverage ratio of large banking groups in the Euro Area was around 3 % at year-end 2008 and increased to around 4,2 % at end-March 2014 (ECB, 2014a).<sup>5</sup>

Whenever a tail event materializes and if equity has been completely wiped out, a hair-cut on debt instruments becomes necessary, eventually making these instruments also state contingent. Therefore, economies with banks resemble features of a bond economy in which perfect risk sharing cannot be achieved in the sense that consumption cannot be decoupled from the risk of future changes in income.

Given these limitations of bank-based financial systems in terms of risk sharing, it is crucial that debt-like instruments can and will be transformed into loss absorbing financial instruments in the case of bank distress. A Banking Union with a unified supervisor and a single resolution authority is a necessary pre-requisite to enforce ex-post risk sharing across countries if tail events materialize. In this case, creditors of banks should absorb losses according to their seniority.

Yet, in a monetary union without centralized control over fiscal policy, national policymakers have incentives to shift the costs of banking distress to the European level. Consider a banking system that falls into distress, be it because of idiosyncratic risks that materialize or be it because of its exposure to a large macroeconomic shock.

In case of smaller domestic banks which mainly fund themselves with national deposits, deposit insurance should be able to cover the losses and to protect domestic depositors. Other creditors would assume losses according to standard insolvency procedures. But as soon as a larger number of banks is affected, policy makers would tend to refrain from dealing with bank distress. They may fear that losses are too large to be covered by the deposit insurance system, and they may fear the political backlash resulting from bank restructuring at a larger scale.

Moreover, the crisis affected also large banks with significant international operations and with a relatively low share of domestically insured deposits. Banks with a high share of wholesale funding have been hit particularly hard. Hence, any debt restructuring involves junior and senior unsecured creditors, such as bondholders, holders of interbank claims and uninsured depositors. In this case, the exact degree of involvement of domestic creditors is unknown ex ante. When tail risks materialize and question the solvency of (some) domestic

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<sup>5</sup> The respective numbers for the CET1 ratio are 7 % at year-end 2008 and 10,4 % at end-March 2014 (under Basel III rules).

banks, this uncertainty significantly reduces the incentives of national governments and regulators to restructure or to wind-up a bank and to impose losses on creditors.

Consequently, national governments might be tempted to declare issues in their banking sectors as being merely issues of illiquidity, thereby avoiding the restructuring or even resolution of these banks. Distressed banks without a viable business model would thus remain in the market and resort to funding from the central bank which, as a lender of last resort, would stabilise national banking sectors. The banks, in turn, may gamble for resurrection by investing into high-risk, high-return assets (Freixas et al., 2004). This incentive is particularly pronounced if the solvency of individual banks – as a necessary precondition to access central bank liquidity – is monitored by national supervisors and regulators.

In sum, the existence of a bank-based financial system within a monetary union of otherwise sovereign states may lead to a situation where effective private risk sharing – the distribution of losses across regions and countries – is limited. Risks are ultimately shifted to the central bank's balance sheet, without distributing the losses among private investors. Losses are not revealed, but implicitly distributed over time, and they may partly be borne by the central bank. In the next subsection, we provide some evidence that this channel is not merely of theoretical nature, but played an important role during the crisis in the Euro area.

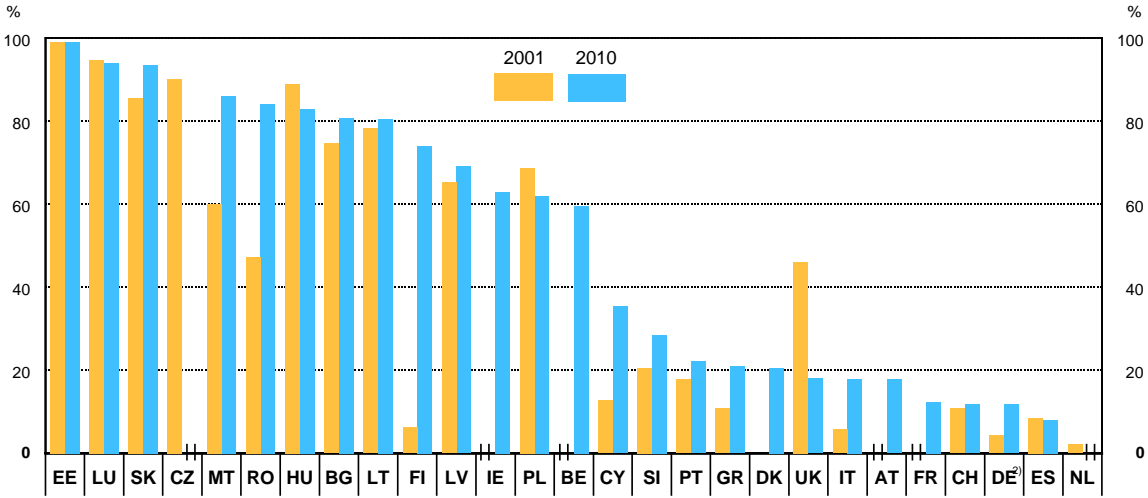
## **2.2 Taking Stock of Europe's Financial Markets and the Banking Sector**

The integration of financial markets is a powerful tool for enhanced risk sharing. Prior to the financial crisis, financial market integration in Europe had indeed progressed rapidly. In the Euro area, integration had become much deeper compared to global trends. In principle, increased integration of financial markets can have benefits in terms of a better allocation of capital across countries and improved risk sharing. Yet, financial market integration in Europe has been excessive in two ways. First, the overall increase in foreign liabilities – private and public – in some countries in Europe has expanded to unsustainable levels that even exceeded the countries' debt-servicing capacity. Second, financial market integration in Europe has primarily taken the form of increasing international borrowing and lending through banks. Equity market integration and cross-country ownership of equity has been more limited.

### *2.2.1 Cross-Border Equity Ownership of Banks*

In the banking sector, cross-border equity ownership varies widely across European countries (Figure 1). The countries of Eastern Europe clearly stand out, as large parts of their banking sector are owned by foreign banks. Also, countries hosting international financial centers such as the UK or Luxembourg have high shares of cross-border ownership of banks. To the extent that equity owners of these banks bear losses in times of crisis, this tends to reduce the domestic impact of shocks hitting national banking sectors.

**Figure 1: Foreign Ownership of Banking System Assets<sup>1)</sup>**



1) Percent of the banking system's assets in banks that were foreign-controlled (where foreigners owned 50 % or more equity) at the end of the year. AT-Austria, BE-Belgium, BG-Bulgaria, CH-Switzerland, CY-Cyprus, CZ-Czech Republic, DE-Germany, DK-Denmark, EE-Estonia, ES-Spain, FI-Finland, FR-France, GR-Greece, HU-Hungary, IE-Ireland, IT-Italy, LT-Lithuania, LU-Luxembourg, LV-Latvia, MT-Malta, NL-Netherlands, PL-Poland, PT-Portugal, RO-Romania, SI-Slovenia, SK-Slovakia, UK-United Kingdom.- 2) For 2001: As of 31 December 2002

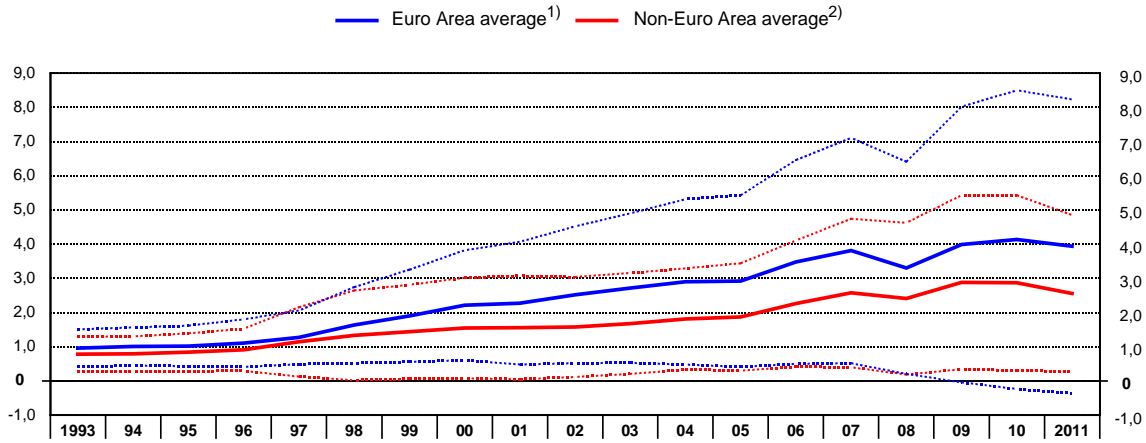
Source: World Bank

Spain is a case in point. Here, inward cross-border ownership of banks has been limited, and many real estate loans have been issued by regional, domestic banks. Therefore, the scope for distributing losses to international equity owners and, eventually, creditors has been limited. Losses had to be borne mostly by domestic investors. Moreover, fearing that a bail-in of international creditors would undermine the stability of financial markets and cause contagion, policy makers have even refrained from sharing the burden of bank distress. This has been the case, for instance, in Ireland. In Spain, losses have been imposed on holders of hybrid debt instruments only which, in turn, were largely held by domestic investors. The Baltic States with high shares of inward cross-border ownership in banking, in contrast, have shifted some of the losses to foreign investors as well (Goodhart and Lee, 2013; Gros, 2012).

*2.2.2 International Capital Flows*

Financial integration in Europe has also been dominated by debt rather than equity finance. Figure 2 shows that, before the crisis, (gross) cross-border liabilities relative to GDP have increased significantly in the Euro area, and this ratio also increased much more compared to non-Euro area countries. In the Euro area, these external liabilities have been dominated by fixed income liabilities, i.e. by borrowing from banks and the issuance of bonds.

**Figure 2: External Liabilities to GDP**

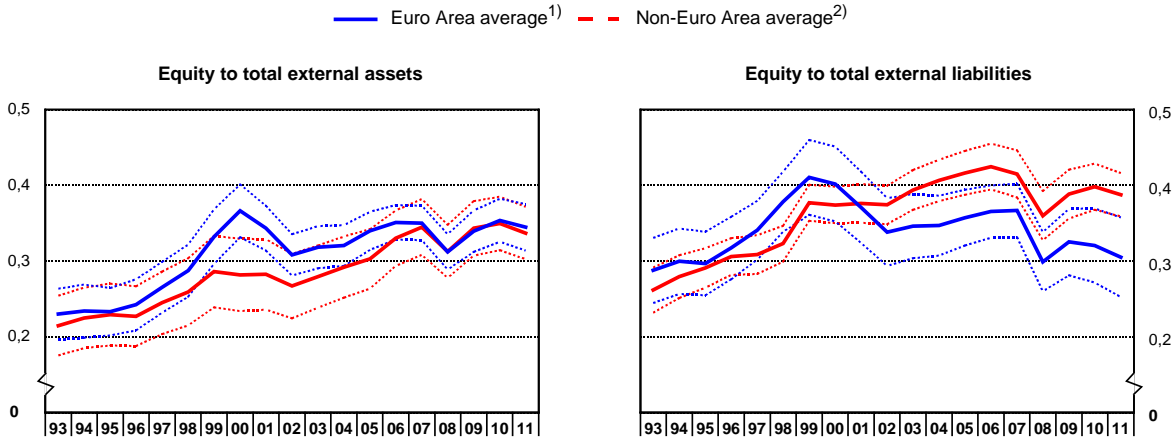


1) Euro Area: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Spain.– 2) Non-Euro Area: Australia, Canada, Cyprus, Czech Republic, Denmark, Estonia, Hungary, Iceland, Israel, Japan, Korea, Latvia, Lithuania, Malta, Mexico, New Zealand, Norway, Poland, Singapore, Slovak Republic, Slovenia, Sweden, Switzerland, United Kingdom, United States. Dotted lines denote the average  $\pm 1$  standard deviation.

Source: Updated and extended version of dataset constructed by Lane and Milesi-Ferretti (2007)

There is also a notable difference between Euro area and non-Euro area countries in terms of how much equity financing took place (Figure 3). Even though equity became more important up until the introduction of the Euro, fixed income assets played a major role in the process of financial integration since the introduction of the Euro.

**Figure 3: Composition of External Assets and Liabilities**



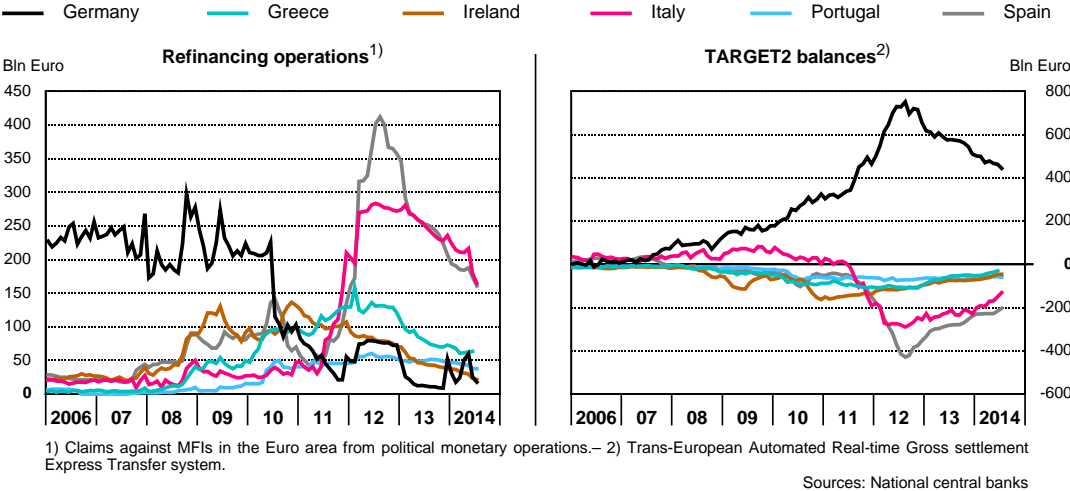
1) Euro Area: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Spain.– 2) Non-Euro Area: Australia, Canada, Cyprus, Czech Republic, Denmark, Estonia, Hungary, Iceland, Israel, Japan, Korea, Latvia, Lithuania, Malta, Mexico, New Zealand, Norway, Poland, Singapore, Slovak Republic, Slovenia, Sweden, Switzerland, United Kingdom, United States. Dotted lines denote the average  $\pm 1$  standard deviation.

Source: Updated and extended version of dataset constructed by Lane and Milesi-Ferretti (2007)

Since the beginning of the financial crisis, the trend toward greater financial market integration has reversed, and markets have become increasingly fragmented (ECB 2012; Rose and Wieladek, 2011). To some extent, political and regulatory incentives have prompted banks to scale back foreign activities. European Union state aid procedures require banks to close foreign affiliates (European Commission, 2009; Zimmer and Blaschczok, 2012). Political pressure to stabilize domestic lending might have played a role as well.

As most of the cross-border holdings of assets were located within the banking system, the “retreat” of international creditors shifted most of the risk to the balance sheet of the ECB who refinanced those national banking sectors that had accumulated significant international liabilities to banks in other Euro area member countries (Figure 4, left). The situation in Europe resembled features of sudden stop episodes observed previously in emerging markets (Merler and Pisany-Ferry, 2012). As a result, ECB refinancing operations substituted private credit flows, which is also reflected in the fact that TARGET2 balances between national central banks skyrocketed (Figure 4, right; Deutsche Bundesbank, 2014a). This increasing fragmentation of private markets witnesses not only the profound crisis of confidence in European financial markets, but also the weak ability of risk sharing through financial markets.

**Figure 4: Refinancing Operations and TARGET2 Balances of Central Banks in the Euro Area**



In sum, the crisis in the Euro area has revealed severe flaws in the design of the European monetary union. Private and public borrowers had incentives for excessive borrowing. Banking supervision has been ineffective with regard to containing the build-up of risks on banks’ balance sheets and it may, in some cases, have delayed early crisis resolution due to regulatory forbearance. Risks of banks and sovereigns have become more intertwined. This, together with a missing framework for coordinated cross-border resolution of distressed banks, has created incentives to shift risks to the European level and especially to the ECB through its refinancing operations.

**2.3 The Role of the Banking Union**

At its core, the Banking Union starting at the end of 2014 can be defined as a set of institutions that establishes supranational competencies in the supervision and resolution of banks, together with a mechanism to finance bank resolution and restructuring. Any discussion of the Banking Union must keep in mind the general institutional set-up of the European Union as it is enshrined in the European treaties. This is particularly important as

the responsibility for essential areas of economic policy, including fiscal policy, lies with the national member states. This can be seen as a maintained obstacle to the integration of financial markets in Europe and the adoption of a European perspective when dealing with distressed banks (Hellwig, 2014). Yet, in contrast to the Banking Union, serious steps towards political union (including the centralization of budgetary powers) are not likely to be taken in the foreseeable future.

What can and what should we expect from the new set of institutions which will be established by the Banking Union? To answer that question, it is useful to separate an ex-ante and an ex-post perspective, i.e. the process of risk-taking, its allocation in the banking system, and its materialization.

From an ex-ante perspective, the immediate prospects of an optimally designed Banking Union lie in better risk detection and crisis prevention. Centralization of supervision is useful for three reasons: first, a European body is better suited to develop a European-wide view of risks for financial stability arising from the banking sector. Second, centralization helps to overcome coordination problems between national bank supervisors. Third, a central supervisor is more independent from (national) politics and thus in a better position to weigh long-run goals (financial stability) against short-run (political) costs. With hindsight, a central supervisor might have been better equipped to prevent the massive accumulation of private debt that many observers consider as the main cause of the crisis in the Euro area. At the same time, it remains to be seen whether a European supervisor will be able to withstand focused lobbying pressure at the European level.

With regard to ex-ante risk sharing, the prospects of the Banking Union are less apparent. As regards the deeper integration of equity markets, the role of the Banking Union is limited. However, to the extent that decentralized banking supervision forms an obstacle to cross-border M&As or holdings of equity within the banking sector, the centralization of bank supervision might play some role. For example, greater distance of supervisors from national interests might make M&A activity in the banking sector less dependent from national interests.<sup>6</sup> Moreover, a more uniform approach to the enforcement of supervisory standards might reduce the costs of regulation, thus making the establishment of pan-European banks more attractive. Finally, a European supervisor might facilitate the transfer of capital between

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<sup>6</sup> The idea of growing “national champions” in Germany in the mid-2000s delivers a good example of political motives in bank M&A activities (Hakenes and Schnabel, 2006). See also ASC (2014) for a discussion of national-champions policies.

subsidiaries of cross-border banking groups with greater ease, thus allowing for a more smooth absorption of losses in one country by subsidiaries in other countries.<sup>7</sup>

From an ex-post perspective (when bad states of the world have been realized), centralized bank resolution and common financial resources come into play. Providing financing for distressed banks by using a common pool of resources enables some (fiscal) risk sharing across countries. However, given the current state of political integration, it is much less obvious how such a common pool should be organized. Almost by definition, dealing with systemic crises requires a policy response that entails a temporary, large-scale risk transfer from banks' balance sheets to the public sector.<sup>8</sup> Ultimately, the public sector can credibly commit to such a transfer only if it is able to raise a sufficient amount of taxes over time.

In the context of the Euro area or of the European Union, such an approach would require a central budget, and consequently, a political union. From today's perspective, progress on this front is likely to be limited in the near future, and the Banking Union can thus not be designed under the assumption of significantly higher fiscal integration. In the absence of political union, any attempt to mutualize the member states' contingent liabilities for their banking systems immediately raises concerns of moral hazard: in the foreseeable future, national governments will remain in charge of essential areas of economic policies that have the potential to impact directly the balance sheet of the domestic banking sector. Insolvency legislation for households and firms can be taken as an example. Cross-country variation in insolvency regimes can significantly affect the default probability of borrowers and recovery rates (Davydenko and Franks, 2008).

At the same time, preserving full national liability is neither time consistent nor is it consistent with centralized supervision. Bank supervisors make mistakes. National governments will be reluctant to pay for bank failures that originated in misconduct of the European supervisor. Even more importantly, the centralization of banking supervision requires the centralization of bank resolution, and consequently, common resources for bank resolution. The basic logic is that bank supervision can be effective only if the ultimate threat to put a bank under

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<sup>7</sup> In 2009, the German legislative bodies passed an amendment to the Federal Banking Act (KWG), granting the German bank supervisor (BaFin) early intervention powers with regard to the restriction and prohibition of payments between group subsidiaries. In this context, the dispute on transfer payments of German subsidiary HVB to its Italian parent Unicredit highlights the potential for tensions when bank supervision is organized at the national level, see *Börsen-Zeitung, Aufsicht begrenzt aktiv den Abfluss von Einlagen ins Ausland*, January 10, 2013; FT.com, *Bank union to free €7bn of capital for UniCredit from German unit*, November 13, 2013.

<sup>8</sup> Laeven and Valencia (2012) estimate the gross fiscal costs of previous systemic banking crises since 1970 at around 10 percent of the affected country's GDP (median costs related to bank recapitalization measures). For the Euro area, the corresponding figure would be about Euro 950 billion and thus far outside the scope of common funds that can reasonably be envisaged.



resolution is credible. Credibility can be best achieved by shifting the competencies for bank resolution from the national to the European level and, consequently, to make the resolution authority financially independent from national governments.

Turning back to the risk sharing perspective, a common pool of resources could act as a shock absorber. However, given the restrictions discussed above, one should not expect too much.<sup>9</sup> In dealing with bank distress, the far more realistic option is to focus on no-bail-out policies, i.e. policies that respect private contracts and enforce the distribution of losses whenever bad states materialize. As documented in the previous section, much of the European financial integration has taken place in debt markets and, in particular, in the markets for bank debt. Hence, policies that facilitate the smooth assumption of losses by debt holders of distressed banks have the potential to substantially increase the risk-sharing capacity across countries.

If properly designed, the Banking Union can enhance this capacity in two ways: first, by establishing appropriate resolution procedures the Banking Union might enable public authorities to technically deal with failures of even large and complex banking firms. These procedures would allow for the continuation of business operations critical to financial stability while, at the same time, equity is wiped out and the debt of distressed banks is written down and/or converted into equity (bail-in).

Second, the Banking Union, by centralizing resolution powers at the European level, can make the bail-in of bank creditors more credible. The superiority of centralization over national approaches becomes particularly apparent in the context of a monetary union: from a national perspective, politicians (and bank supervisors) favour neither bail-ins nor bail-outs, which gives rise to regulatory forbearance. Barth et al. (2012), for instance, provide vivid evidence of such regulatory forbearance and the disincentives of governments to provide fiscal backstops in their account of the savings and loan crisis. Incentives not to act are intensified by expectations that eventually the central bank, driven by concerns about financial system stability, will act as lender of last resort and continue to provide liquidity to ailing banks. These mechanisms might be best set off by delegating resolution powers to a central authority sufficiently independent from national interests.

Therefore, a properly designed Banking Union can be considered as a mechanism to manage small and medium-sized banking crises. In particular, the new institutional set up should also enable the authorities to deal with individual failures of larger cross-border groups. In this way, the Banking Union can mitigate the dynamics of future banking crises and lower the likelihood of a “deadly embrace” between sovereigns and banks. However, the Banking

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<sup>9</sup> The decided plan for a “Single Resolution Fund” with a volume of about Euro 55 billion underlines this expectation. The current legislative proposals for the Banking Union are discussed in more detail in Section 3.

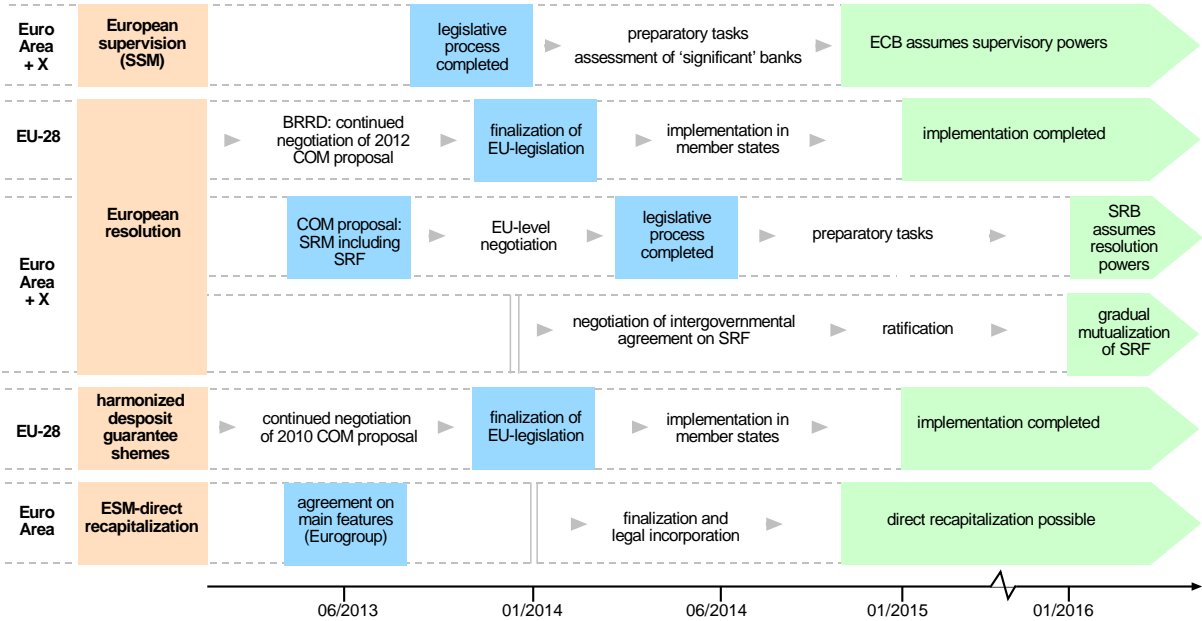
Union itself will not suffice to handle a systemic crisis. By definition, a comprehensive bail-in of bank creditors can make things worse and destabilize the financial system. Moreover, a mutual transfer of banking risks to the public sector’s balance sheet of member states is not a realistic political option. Consequently, there is a need to define an “emergency exit”, which clarifies the responsibilities of the European level and national governments in case of a systemic event.

In the following section, we relate our conclusions on the role of the Banking Union to the legal background, as given in several European directives, regulations and communications. Some parts of the legislation still await implementation, while other parts have already entered into force.

### 3 Legal Background of the Banking Union

The Euro area summit on June 29, 2012, marked the starting point for the Banking Union. Heads of state or government decided to establish centralized competencies for banking supervision and, once established, to extend the scope of the ESM to direct recapitalization of banks. This can be viewed as a turning point in EU financial market policy which, until then, had been guided by the principles of minimum harmonization, mutual recognition, and home country control. In the following months, policy makers reached further agreements on what should constitute the Banking Union (Figure 5).

**Figure 5: Political Roadmap to Banking Union**



Glossary: BRRD Bank Recovery and Resolution Directive, COM European Commission, ESM European Stability Mechanism, SRB Single Resolution Board, SRF Single Resolution Fund, SRM Single Resolution Mechanism, SSM Single Supervisory Mechanism.

These general agreements were translated by the Commission into two new regulations: one governing the SSM (adopted in autumn 2013)<sup>10</sup>, and one governing the SRM (adopted in April 2014 by the European Parliament).<sup>11</sup> The SRM regulation will be complemented by an intergovernmental agreement on the transition from national bank resolution funds to the SRF (Council of the European Union, 2013a). Moreover, the finance ministers of the Eurogroup agreed on the main features of the ESM direct recapitalization instrument (Eurogroup, 2013). This agreement still awaits formal incorporation into the ESM framework. Even when most elements of the Banking Union will be established in European and national law, it will take some time to become fully operational. The gradual move to a common resolution fund will not be completed before the year 2024.

### **3.1 European Bank Supervision: The Single Supervisory Mechanism (SSM)**

#### *3.1.1 Legal Framework and Governance Structure*

The SSM consists of the ECB and the supervisory authorities of participating member states.<sup>12</sup> Whereas the ECB is responsible for the overall functioning of the SSM and directly supervises the largest credit institutions, the national authorities continue to supervise institutions classified as being “less significant”.

The supervisory powers of the ECB include the granting and withdrawal of banking licenses (including those for less significant institutions), the monitoring of capital and liquidity requirements as well as early intervention and sanctioning powers.<sup>13</sup> The ECB also has responsibility for “less significant” institutions in the sense that national authorities are

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<sup>10</sup> In a broader sense, harmonized rules and standards for banking supervision in the EU (“Single Rule Book”), recently amended by the CRD IV package, also belong to the concept of a Banking Union. In the following, we stick to the core elements of the Banking Union, namely the centralization of decision-making powers and the use of common financial resources. Therefore, we also spare out the discussion of the amendments of the EBA regulation following introduction of the SSM, see, for example, Verhelst (2013).

<sup>11</sup> The SRM regulation is closely associated with the Bank Recovery and Resolution Directive (BRRD) which harmonizes – and in many cases introduces for the first time – a standard set of rules and procedures for bank resolution in the EU member states. The main parts of the BRRD will be incorporated in the SRM regulation and thus becomes directly applicable. This reduces the scope for national interpretations when implementing the directive. In the following, we refer to the SRM regulation as voted in the European Parliament on April 15, 2014.

<sup>12</sup> In case that the central bank does not constitute the national supervisory authority, both the supervisory authority and the central bank represent the participating member state in the SSM and have one common vote in the Supervisory Board.

<sup>13</sup> The application of macroprudential instruments generally falls under national responsibility. However, the ECB, after consulting the national authority, may apply *stricter* measures. For instance, it may require higher countercyclical capital buffers.

obliged to perform their supervisory tasks in line with regulations, guidelines and general instructions issued by the ECB.

Scope of direct ECB oversight: An institution is defined as being “significant” if its total assets exceed Euro 30 billion or 20 % of the home country’s GDP. Moreover, the ECB as well as national authorities may assess individually the significance of institutions falling below these thresholds. Based on this assessment, the ECB may assume direct oversight over these institutions or the national authority may propose to the ECB to do so. In any event, the ECB directly supervises the three most significant institutions in each country. Moreover, direct ECB oversight will apply to institutions receiving direct financial assistance from the ESM. Apart from these provisions, the ECB may assume direct oversight of less significant institutions only “when necessary to ensure consistent application of high supervisory standards”.<sup>14</sup>

Governance structure at the ECB: Decision-making at the ECB involves three bodies. The division of power is mainly determined by the intention to assign powers to a European supervisor without changing the EU treaties. Under Article 127 (6) TFEU, the ECB can assume supervisory functions for Euro area countries, but this also implies that the ultimate decision making body will be the ECB Governing Council and mandatory supervision does not cover non-Euro area member countries. This has led to the following governance structure of the SSM:

- The ECB Governing Council has the ultimate decision-making power.
- The Supervisory Board adopts draft decisions with simple majority, with each board member having one vote. The Supervisory Board comprises a chair, a vice-chair, four representatives of the ECB and one representative from the supervisory authority of each member state participating in the SSM. It is supported by a Steering Committee. Draft decisions will be deemed adopted unless the Governing Council objects to the draft decision within 10 working days.
- When the Governing Council objects a draft decision of the Supervisory Board, the draft decision is negotiated in the Mediation Panel. Members of the Mediation Panel are chosen by the participating member states among the members of the Supervisory Board or the Governing Council. Each member state chooses one representative. Decisions are taken by simple majority with each member having one vote. The SSM regulation does not specify a time limit for the mediation procedure. However, the Mediation Panel cannot overrule the Governing Council. The Governing Council always has the final vote.

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<sup>14</sup> See Art. 6 (5b) SSM regulation.

Cooperation with non-Euro-area member states: Because non-Euro-area-member states are not represented in the ECB Governing Council, their incentives to take part in the SSM are limited. Therefore, the SSM regulation offers the non-Euro-area-member states wishing to participate in the SSM (opt-in) a safety net. This includes the possibility to opt-out and not be bounded by supervisory decisions of the SSM. The opt-in comes in the form of cooperation agreement between the member state wishing to join the SSM and the ECB. To this end, the ECB acquires the right to address the national supervisory authority, which is obliged to follow the guidelines of the ECB and adopt any supervisory measure requested by the ECB. In turn, the supervisory authority is granted a seat and voting rights in the Supervisory Board.

Non-Euro-area-member states may terminate the cooperation on their own initiative three years after the opt-in. Another possibility to opt-out arises when the member state disagrees with a draft decision of the Supervisory Board. Then, the member state may resolve the cooperation immediately, and it is not bound by the final supervisory decision based on the concerned draft decision. In both opt-out cases, the member states may re-enter into cooperation after three years.

Termination or suspension of the cooperation on the ECB's initiative is possible when the member state does not comply with the cooperation terms any more or if the national supervisory authority refuses to adopt supervisory measures requested by the ECB. Moreover, the ECB may terminate or suspend the cooperation when a member state expresses disagreement with an objection of the ECB Governing Council to a draft decision of the Supervisory Board. Regardless of the ECB's decision to terminate or suspend the cooperation, the concerned member state will not be bound by the final supervisory decision based on the amended draft decision.

### *3.1.2 The SSM and Financial Integration*

Once established and fully operational, the SSM will constitute a major step towards deeper integration in Europe. However, the current design of the SSM limits its effectiveness in terms of enhancing financial integration and private-sector risk sharing for two main reasons.

First, financial market integration benefits from common supervisory standards. Hence, if separation along the significance criterion becomes too strict, supervisory standards at the European and the national level may differ. In this regard, a European-wide harmonization of rules might not suffice. Empirical evidence from the U.S., for instance, shows that supervisors operating at the federal level apply stricter standards than those at the state level (Agarwal et al., 2012). In Europe, the comprehensive assessment of banks' balance sheets, which is conducted by the ECB before taking over responsibility for the SSM, relates to 128 Euro area banks being classified as significant (ECB, 2014b). These banks represent a significant share in Euro-area bank assets, and restricting the exercise to these banks has

certainly been necessary to limit administrative bottlenecks. Yet, due care should be taken that this distinction should not become permanent, which would entail the risk of diverging implementation of supervisory standards.

Ensuring centralized supervision of banks that are deemed to be “less significant” banks is also required to address the issue that common exposures to macroeconomic shocks can be a source of systemic risk in the banking system. The recent experience in Spain or the savings and loan crisis in the U.S. during the 1980s and 1990s, for example, show that large banking crises can originate at banks that generally are not considered as being “systemically important”.

Second, the case for Banking Union as an institutional mechanism for ensuring improved private-sector risk sharing can not only be made for the Euro area. Instead, the issue of cross-border risk sharing arises for the entire Single Market and in particular for countries with a high share of foreign banks (Figure 1). Yet, in its current form, the SSM distinguishes between Euro area and non-Euro-area member states. As long as the ECB Governing Council is the ultimate decision-making body, incentives for participation in the SSM are limited and participants will insist on maintaining the various opt-out options. Therefore, appropriate changes of the EU treaties should be considered, which would also enable a better separation between monetary policy and banking supervision, thereby alleviating concerns about conflicts of interest between these tasks (Deutsche Bundesbank, 2013a; GCEE, 2012).

### **3.2 European Bank Resolution: Single Resolution Mechanism (SRM)**

The second pillar of the Banking Union – centralized competencies in bank resolution – is defined by the SRM regulation. It establishes a new European agency (Single Resolution Board, SRB) as a central decision-making body with regard to resolution planning and initiating resolution procedures. In particular, the SRM regulation sets out the competencies and responsibilities of the SRB in relation to the European Commission, the Council of Ministers, the ECB and the national authorities responsible for bank resolution. Moreover, the SRM regulation introduces a common fund for financing bank resolution measures which is funded by contributions of banks (Single Resolution Fund, SRF).

#### *3.2.1 Legal Framework and Governance Structure*

Coverage of countries and banks: The coverage of the SRM in terms of countries is determined by a country’s participation in the SSM. Hence, the SRM covers Euro area members and those member states entering cooperation within the SSM on a voluntary basis. Consequently, if these member states decided to opt-out, they also would leave the SRM. Similar to the SSM, the SRM regulation draws a line between “significant” and “less significant” institutions: the SRB is responsible for the functioning of the SRM, but its decision-making powers relate to significant institutions (those covered by direct ECB

oversight) and cross-border groups only. An exception is granted if resolution action includes the use of the SRF. Then, the SRB exercises resolution powers regardless of an institution's "significance". Furthermore, analogous to the SSM, the SRB may exercise these powers "when necessary to ensure consistent application of high resolution standards".

Governance structure in case of bank resolution: The governance structure of the SRM is substantially shaped by legal concerns about the extent to which resolution powers can be delegated to a European *agency* (the SRB). Due to these concerns, two EU *institutions* – the Commission and the Council – have been given a say. Moreover, the governance structure reflects the desire for national representation when funds of the SRF are tapped. Therefore, in addition to five full-time members of the SRB and representatives of national resolution authorities of countries directly involved in the resolution case, all other representatives of the national resolution authorities vote in case the use of the fund exceeds certain minimum thresholds.<sup>15</sup> Placing a bank under resolution then involves the following steps:

- The power to initiate resolution action lies solely with the SRB. Upon notice by the ECB, or on its own initiative, the SRB assesses whether resolution action is warranted (that is, if an institution is likely to fail, no alternative options are available to prevent the failure, and public interest is given). If so, the SRB adopts a resolution scheme, which places the entity under resolution and determines the resolution tools as well as the use of the SRF.
- If the resolution action involves public funds or the SRF, the SRB, before adopting the resolution scheme, is supposed to await a state aid decision of the Commission.
- After adoption of the resolution scheme, the SRB immediately transmits it to the Commission. If neither the Commission nor the Council of Ministers objects within a period of 24 hours after the transmission, the scheme enters into force.
- The Commission has generally the right to object to the discretionary aspects of the resolution scheme, but it needs to involve the Council of Ministers in two cases: first, when it assesses that there is no public interest. Second, when it wishes to modify the amounts of the SRF to be used substantially. In both cases, the Commission needs to approach the Council within a period of 12 hours after transmission of the resolution scheme by the SRB. The Council, in turn, may act only upon proposal of the Commission.

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<sup>15</sup> National representatives are involved when the resolution case requires more than Euro 5 billion support from the SRF (Euro 10 billion in case of liquidity support measures). When the total use of the fund within the last 12 month exceeds Euro 5 billion (Euro 10 billion in case of liquidity support measures), they become involved in any resolution decision during that year.

- Objections of the Commissions and/or the Council need to be incorporated into the resolution by the SRB within a period of 8 hours. However, when the Council denies that public interest is given, the failing bank is wound up in line with national law.
- Once entered into force, the resolution scheme is implemented by national resolution authorities. If these fail to do so, the SRB has the power to directly address orders to the bank under resolution.

Financing of resolution measures: The proposed legal framework for bank resolution aims at shifting the financial burden of bank resolution from the public sector to the private sector. Two instruments are envisaged to achieve this goal: first, as in regular insolvency proceedings, bank creditors shall be forced to bear losses, even if the resolution, for reasons of financial stability, aims at maintaining the failed bank or parts of it as a going-concern. To this end, claims of creditors are in principle written down and/or converted into equity (via the bail-in instrument). Second, resolution measures shall be financed by a common fund (SRF) with contributions being raised from the banking industry.

In practice, the application of the bail-in tool is part of the resolution scheme adopted by the SRB. Hence, it is at the discretion of the SRB (and the European Commission) whether to use the instrument or not. Moreover, it is a discretionary decision which classes of liabilities are exempted from the application of the bail-in tool and to what extent. In this regard, the SRM regulation (based on the BRRD) allows for the exclusion or partial exclusion of liabilities from bail-in. Some classes of liabilities such as covered deposits, secured liabilities, and interbank liabilities with original maturities of less than seven days are generally excluded from the bail-in.

Since for a given loss, weaker bail-in of creditors generally means more recourse to the SRF, the use of the SRF has been made to some extent conditional on a minimum level of loss absorption of shareholders and creditors: capital shortfalls that arise from the exclusion of liabilities may only be closed by funds of the SRF when the contribution of shareholders and creditors to loss absorption and recapitalization amounts to at least 8 % of the banks' total liabilities. Moreover, the funds of the SRF may not exceed 5 % of the banks' total liabilities.<sup>16</sup> These conditions apply more generally when funds of the SRF are used and when losses of the bank under resolution are being passed on to the SRF.<sup>17</sup> Furthermore, a lower bound for the bail-in of creditors has been anchored in the revised rules for state aid procedures, which

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<sup>16</sup> The 5 % limit may be exceeded in exceptional circumstances. In this case, all unsecured and non-preferred creditors (except from depositors) need to be bailed in.

<sup>17</sup> In this regard, the text of the regulation seems to leave plenty room for interpretation, since it is not clear which measures involving the SRF fall under this provision.



condition the approval of state aid on the bail-in of junior creditors (European Commission, 2013).<sup>18</sup>

The SRF constitutes the second layer that insulates public households from resolution financing. Therefore, it should not simply be regarded as the next level in the hierarchy of funds covering resolution costs, when loss absorption and/or bail-in of shareholders and creditors do not suffice or are refrained from. Rather, the common fund may back up the ex-ante credibility of resolution action. It ensures that sufficient funding is available in order to keep those parts of the institution under resolution operable that are critical for the stability of the financial system as a whole. In particular, the bail-in tool and the SRF should not be considered as substitutes but as complements, where the availability of one instrument (the SRF) increases the probability of the other (the bail-in tool) being used.

The target volume of paid-in financial resources for the SRF will be 1 % of deposits covered by deposit insurance of banks falling under the SRM. Accordingly, the target volume is expected to amount to about Euro 55 billion. The paid-in resources will be financed by a bank levy. An individual institution's contribution will reflect its relative size (the institutions' share in aggregate liabilities excluding insured deposits and equity) and its risk profile. It is envisaged that extraordinary contributions – at a maximum three times the regular annual contribution per year – may be raised ex post, if paid-in financial resources do not suffice to support a specific resolution action. Furthermore, if both regular and extraordinary contributions do not suffice, additional funding such as borrowing from public sources or the market may be sought for.

In addition to these provisions, the Euro area finance ministers agreed on a transition period where funds available in the SRF are assigned to national “compartments”.<sup>19</sup> At the beginning of the transition period, financial resources needed for resolution will be drawn mostly from funds collected in those member states directly involved (where the parent company and subsidiaries of the institution under resolution are located). In the course of the transition period, the use of national funds will gradually decrease, while the use of funds collected in other member states will gradually increase. At the end of the transition period, the compartments will be resolved, and national funds will be merged. If the available funds do not suffice during the transition period, only those member states directly involved in the

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<sup>18</sup> It is still unclear to which extent future bail-outs by national governments may, in effect, hold off resolution action of European authorities (and thus a potentially stricter bail-in of creditors; see Council of the European Union, 2013b).

<sup>19</sup> The transition regime has been spelled out in an intergovernmental treaty, which still awaits ratification by the member states (Council of the European Union, 2013a, c).

resolution of a bank and its subsidiaries will be required to raise extraordinary contributions and/or seek additional funding from other sources.

### *3.2.2 The SRM and Risk Sharing*

The Banking Union can potentially make a significant contribution to improved risk sharing by providing of an effective resolution regime for banks. Hence, a common resolution fund and bail-in tools that force bank creditors to take the downside risk of a debt contract are reasonable steps into the right direction. However, in order to be effective, a resolution regime should be able to operate swiftly in times of crisis. In this regard, the potentially complex decision-making process for placing a bank under resolution raises serious concerns (Deutsche Bundesbank, 2014b; Gros, 2013). In an optimistic scenario, the SRB will file a resolution scheme which enters into force within 24 hours. However, potential objections of the Commission and the Council may lengthen the decision-making process, hereby creating uncertainty among market participants, and providing scope for political interventions. Moreover, decision-making within the SRB might be complicated by the fact that representatives of member states will be involved at several stages of the process.

A second concern is that the bail-in tool leaves a wide array of discretion to the resolution authority. The BRRD/SRM framework seeks to limit the exercise of discretion by linking the use of the bail-in tool to the use of the SRF and the granting of state aid. However, the explicit formulation of minimum requirements might be mis-interpreted as an upper bound to the volume of debt to be bailed in. The result may be an interpretation of “flexibility” in terms of discretionary exemption from bail-in and a tendency to shield bank creditors from losses. In case of a systemic crisis, when deviations from bail-in might be justified, in contrast, there might be even too little flexibility. As a consequence, restructuring may not be started at all. Moreover, national governments might still initiate a future bail-out of domestic bank creditors as the current framework does not exclude the possibility of “preventive recapitalization”. Such recapitalization measures might circumvent resolution and restructuring procedures under the auspices of the SRM. To be sure, any public financial assistance would need to comply with state aid rules. Yet, these are typically less rigorous because they demand only the involvement of holders of junior debt. Hence, the proposed framework bears the risk of inefficient crisis management and of harming the ex-ante credibility of the bail-in paradigm.

These shortcomings could be addressed by establishing a truly independent European resolution agency insulated from national interests and political pressures (Deutsche Bundesbank, 2014b; GCEE, 2013, 2012). One way to complement lean governance structures with stricter rule-based decision making could be institutional structures that incorporate elements of the statutory systemic risk exception in the U.S. (GCEE, 2013; Goyal et al. 2013). In the U.S., resolution must adhere to the principle of resolution at least cost to the deposit

insurance fund. Therefore, the resolution authority (Federal Deposit Insurance Corporation – FDIC) generally enforces full loss assumption by bank shareholders and creditors. Exceptions are tolerated only in a systemic crisis and only if all interested parties agree. However, the hurdles to invoke such an exception are very high: the systemic risk exception requires two-third majorities of the Boards of the FDIC and the Federal Reserve System as well as the approval of the Treasury Secretary after consultation of the U.S. President.

Introducing a statutory systemic risk exception in the context of the SRM would imply a mandatory and comprehensive bail-in of bank creditors unless strong majorities within the SRB and among finance ministers of participating member states object. This also implies that, whenever the hurdles of the systemic risk exception are taken, all parties involved have to agree ex ante on the distribution of costs that result from not bailing in bank creditors.

### **3.3 The Emergency Exit: Backstop Arrangements**

From a crisis management perspective, a well-designed Banking Union could provide a credible and stabilizing framework for handling failures of an individual institution or even several institutions at the same time. However, the Banking Union in and of itself cannot be expected to deal with a systemic crisis, which, by definition, affects large parts of the financial system.

Taking the emergency exit in such a situation will, ultimately, require the mobilization of fiscal resources. Dealing with insolvent financial institutions falls under the responsibility of the resolution authority which, in turn, needs fiscal backing to implement appropriate crisis management measures. The central bank may act as lender of last resort for the merely illiquid parts of the banking system.

Yet, fiscal backstop arrangements are the least developed area of negotiations between policy makers at the European level. The current state of play is an announcement of EU finance ministers demonstrating their willingness to establish a backstop for the SRF (Eurogroup and Ecofin ministers, 2013). According to the statement, different backstop arrangements are foreseen during and after the transition period when the paid-in financial means of the SRF do not suffice:

- During the transition period (before national compartments of the SRF are merged), recourse will be taken to national resources or the ESM, including existing ESM instruments (financial assistance to *governments*) as well as the (prospective) direct recapitalization instrument (financial assistance to *banks*).

- The ESM direct recapitalization instrument foresees that, in a systemic crisis, up to Euro 60 billion of ESM funds may be used for capital injections if the affected governments are not able to cover capital shortfalls in national banking systems.<sup>20</sup>
- After the transition period, the SRF will be allowed to borrow. It is envisaged that repayment will stem from collecting additional (ex-post) contributions from the banking industry.

Note that borrowing of the SRF will be limited by the ability of the banking system to repay these loans ex-post. What will happen after the transition period, if the amount the SRF can borrow does not suffice to cover capital needs in a systemic crisis, is a question which has not been addressed yet. Given that the member states still have comprehensive responsibilities for fiscal and economic policy, additional financial means would ultimately have to be provided by national governments. For such arrangements to be credible, governments should commit ex ante to do so. This would require explicit burden-sharing agreements for cross-border banking groups. These agreements could be based, for instance, on the importance of the parent and subsidiaries for the member states' banking sectors, which would determine each government's share in resolution costs (Goodhart and Schoenmaker, 2009). Thus, the “emergency exit” could rely on a network of national fiscal backstops rather than on an extended pool of common resources. The ESM would provide credit to member states that are unable to fulfil its commitments from the burden-sharing scheme, but it would not serve to recapitalize banks directly (GCEE, 2013, Ch. 4). Yet, the scope of bank-specific cooperation agreements so far has been limited to procedural aspects, such as the exchange of information between authorities involved (IMF, 2014).

#### 4 Managing the Transition

Re-designing the institutional architecture for the European banking system should reduce the likelihood of future banking crises and make future crises more manageable. However, the burden of the global financial and Euro area crises still weighs heavily on the balance sheets of European banks. Capital ratios are low and non-performing loans have risen sharply (Acharya and Steffen, 2014; GCEE, 2013). In some of the peripheral countries, banks expanded their investment in government bonds of their home country, thus aggravating the nexus between bank and sovereign risk (Deutsche Bundesbank, 2013b; GCEE, 2013). Uncertainty about the valuation of the banks' assets is high, as indicated by price-to-book ratios well below one in many European countries (ECB, 2013b; GCEE, 2013).

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<sup>20</sup> The direct recapitalization instrument has been agreed on in general, but final provisions have not been published yet. Also, incorporation in the ESM framework will require adoption by national parliaments (Eurogroup, 2014, 2013).

Hence, policy makers are confronted with the challenges of cleaning-up banks' balance sheets, restoring investor confidence, and eliminating obstacles to economic recovery emanating from a weak banking system. At the same time, the transition to the Banking Union requires a thorough assessment of the banks' health status. Existing problems should ideally be disclosed before the start of the SSM. Otherwise, the ECB might be held responsible for any problem occurring later on, giving rise to reputation risks from the start.

To examine the status of banks falling under its direct oversight, the ECB in autumn 2013 has started a comprehensive assessment (ECB, 2013a). This procedure is executed on a bank-by-bank basis and comprises three steps: an overall risk assessment, including leverage, liquidity and the funding situation; an asset quality review, which evaluates selected assets considered as particularly risky or opaque; and a stress test, which aims at checking the resilience of banks under hypothetical adverse conditions. The ECB sets the framework for the comprehensive assessment and assumes a coordinating role, while the execution rests with the national banking supervisors. Both, the ECB and the national authorities, employ external consultants and auditors. At the end of the procedure, banks will have to fulfil a capital ratio of 8 % (common equity tier 1), which is 3.5 percentage points higher than what is required under the Basel III regulation. The ECB announced to enforce corrective action measures at those banks falling short of the capital requirements.

To our view, if successfully implemented, the comprehensive assessment can be an important step in overcoming the problems in the European banking sector and in facilitating a smooth transition to the Banking Union. Ideally, the assessment will bring clarity to investors who then may decide to provide the capital needed. When market funding is not available, a scope for government intervention can arise: if concerns about contagion bar the way to regular insolvency proceedings, bridge funding from public sources might be warranted in order to facilitate an orderly restructuring and/or the market exit of the banks concerned. Given that there is legal uncertainty about the availability of the bail-in instrument to be employed before 2016, the success of the comprehensive assessment crucially depends on the availability of fiscal backstops. Without backstops, the disclosure of capital shortfalls might cause stress on financial markets. Hence, the absence of backstops could create an incentive for forbearance and undermine the credibility of the comprehensive assessment. At worst, market participants could deem the results as being non-credible, and the uncertainty surrounding the valuation of bank assets would continue.

Consequently, the ECB repeatedly pointed out the need for ex-ante backstop arrangements (ECB, 2013a, 2014c; Mersch, 2013). European policy leaders are aware of the problem stating that “member states will make all such arrangements, including the establishment of national backstops, ahead of the completion of this exercise [i.e. the comprehensive

assessment]” (Council of the European Union, 2013d; European Council, 2013). Nevertheless, no visible progress has been made on this issue.

It is important to bear in mind that the purpose of backstops is not to increase public risk sharing, but rather to enhance the credibility of private-sector risk sharing. Hence, the principles of resolution financing would remain intact: capital needs should be covered by (1) loss absorption of shareholders and/or bail-in of creditors; (2) bank resolution funds; (3) national public funds; (4) ESM assistance to governments. However, because the European-wide framework for bank resolution is not yet in effect, the outcomes of the comprehensive assessment will have to be dealt with by coordinating national responsibilities according to the following principles.<sup>21</sup>

- In order to avoid competitive distortions in the market for bank funding, a uniform bail-in approach across member states is warranted. Common rules for the write down of shareholders’ claims and for the bail-in of creditors should thus ideally be in place. This does not rule out the possibility of a bail-in under national legislation, as has been demonstrated by the Spanish and Cypriot cases.
- When the results of the comprehensive assessment are revealed, finance ministers and EU bodies may agree on a “systemic risk exception”, depending on the outcome of the assessment and on financial market conditions. However, any joint ex-ante announcement to go easy on bank creditors would unnecessarily reduce flexibility and reinforce bail-out expectations built up in the past, making it even harder to counteract these expectations in the future.
- Resources from (national) bank resolution funds will be very limited, given that the volume of paid-in contributions is still relatively low in many countries. Ex-post contributions and borrowing against future contributions will be restricted by the ability of European banks to generate future earnings. Following the pecking order of resolution costs, public resources might thus be needed. Therefore, by establishing national backstops, governments of individual member states should make appropriate provisions. These include commitments to provide public funds, conditions under which these funds can be used, organizational and legal provisions to make the funds available, and burden-sharing agreements for cross-border banking groups.

If the funding needs exceed the capacities of national backstops or if the full use of the existing backstops would endanger a member country’s market access, the country could file for ESM assistance. Given evident moral-hazard concerns, ESM funds should be used for loans repayable by member states, but not for direct recapitalization of banks. The conditions

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<sup>21</sup> See GCEE (2013), Ch. 5, for a more detailed discussion of backstop arrangements.

of the ESM program would be targeted at banks rather than at member states. This aims at reducing moral hazard, given that key policies affecting banks' balance sheets remain under national control. Hence, it would serve to align liability and control. The focus of such a procedure would be on the restructuring and on ensuring an orderly market exit of banks, in line with the objectives of the agreed SRM/BRRD legislation.

## 5 Conclusion and Discussion

Many view the Banking Union as a complement to monetary union because it enhances public-sector risk sharing: if individual governments cannot support the restructuring and possible resolution of distressed banks, pooling of fiscal resources might become necessary. According to this view, the Banking Union would be justified because of a lack of common *public* backstop schemes. We, in contrast, see the justification for the Banking Union first and foremost in the need for more effective *private* sector risk sharing. Before the crisis, excessive (cross-border) risk-taking has taken place. Once risks materialized, the necessary loss absorption of creditors has been largely deferred.

Instead, through its unconventional policy measures, the ECB has supported large parts of the European banking system, and it has – implicitly or explicitly – assumed additional risks. In fact, distinguishing illiquid from insolvent banks is even more difficult without adequate supervisory powers at the European level. The root cause of these developments is the absence of effective institutions that enable the enforcement of private-sector risk sharing.

If successfully implemented and fully operational, the Banking Union can help curing the weaknesses in the design of the monetary union. Supranational competencies in bank supervision and in bank resolution as well as appropriate financing mechanisms can limit the built-up of excessive risks in the private sector, enable more effective management of future banking crises, and strengthen private channels of risk sharing.

However, we have identified several shortcomings of the agreed legal framework of the Banking Union. Because many of these shortcomings are rooted in the boundaries of European primary law, changes of EU treaties are necessary.

The first shortcoming concerns the Single Supervisory Mechanism. In the current setting, separation between supervision and monetary policy is insufficient as, ultimately, decision-making power rests with the ECB Governing Council. Also, a more complete Banking Union, organized around strong and independent European authorities, separated from monetary policy and insulated from the political sphere, would encompass all banks and EU member states.

The second shortcoming concerns the Single Resolution Mechanism. Because of the importance of private sector risk sharing, bail-in rules offering too much discretion to

resolution authorities are a serious concern. An approach similar to the systemic risk exception in the U.S. could effectively limit the scope for discretion and strengthen the credibility of creditor bail-in. The bail-in of creditors along a clearly specified creditor hierarchy would then be the rule, and exceptions would be tolerated only in a systemic crisis and only after clearing high institutional hurdles.

The third shortcoming concerns the need for more explicit fiscal backstops and burden sharing agreements. These can enhance the credibility of the creditor involvement rather than serving as a channel for enhanced public sector risk-sharing.

Obviously, the Banking Union is no panacea, and it needs to be supported by additional reforms of the micro-prudential framework for banks. Bank equity was insufficient to buffer losses during the crisis, capital requirements were highly pro-cyclical, risk weights were inadequate and served to misalign incentives (Admati and Hellwig, 2013; Admati et al., 2011; Favara and Ratnovski, 2012; Haldane, 2012). Many regulatory reforms have been underway<sup>22</sup> but we see two more main areas which require further regulatory action:

First, regulatory privileges for government bonds, such as zero-risk weights and exemptions from large exposure rules should be phased out. These privileges have contributed to the increasing exposure of many European banks to government debt, thus aggravating the bank-sovereign nexus. Second, fostering the integration of equity markets in Europe and lifting existing barriers to the cross-border ownership of equity should be of high priority. Ultimately, cross-border equity ownership is the most effective channel for risk sharing across countries.

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<sup>22</sup> See GCEE (2013, 2012, 2011, 2010) for an overview.



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