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**Research Report**

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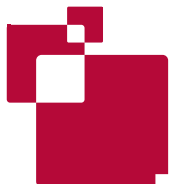
# THE CHALLENGES OF EUROPE'S FOURFOLD UNION

NICOLAS VÉRON

## Highlights

- Five years after the first tremors in Europe's banking system, what makes the crisis unique is the absence of a democratically accountable decision-making framework; there is an 'executive deficit' that compounds Europe's democratic deficit.
- The only way to resolve the crisis successfully is a sustained effort to achieve a 'fourfold union' agenda: banking union, fiscal union, competitiveness union and political union. Progress must be made in parallel on each of the four components.
- Successful progress towards banking union requires a combination of short-term action, including the establishment of a temporary resolution authority to identify undercapitalised banks and to restructure them, and longer-term measures, including the creation of permanent authorities for supervision, resolution and deposit insurance.

This Policy Contribution reproduces the author's statement delivered at the hearing on *The Future of the Eurozone: Outlook and Lessons* at the Subcommittee on European Affairs of the US Senate Committee on Foreign Relations, in Washington DC on 1 August 2012. Nicolas Véron (n.veron@bruegel.org) is a Senior Fellow at Bruegel and a Visiting Fellow at the Peterson Institute for International Economics. Insightful comments on a draft of this statement by André Sapir, Shahin Vallée and Guntram Wolff at Bruegel, and Martin Kessler, Ted Truman, Steve Weisman and John Williamson at the Peterson Institute are most gratefully acknowledged.



# THE CHALLENGES OF EUROPE'S FOURFOLD UNION

NICOLAS VÉRON, AUGUST 2012

**THE EURO AREA HAS MANY PROBLEMS** but the core of the current crisis, what makes it unique, is Europe's insufficient ability to make authoritative policy and political decisions for the region as a whole. To correct this weakness, Europe must build a fourfold union that would allow such executive decisions to be made. The four components are: (1) a banking union, (2) a fiscal union, (3) a competitiveness union, and (4) a political union, ie institutional reform to embed democratic accountability more solidly in decision-making.

The key issues for the euro area in this respect are:

- The deterioration of credit conditions in the euro area stems less from inadequate decisions than from an absence of decisions when they were needed. This 'executive deficit' is partly a consequence of the European institutions' lack of democratic accountability, often referred to as democratic deficit. It also contributes to a loss of European citizens' trust in those same institutions. The European Central Bank (ECB) is a partial exception to this problem but cannot make up for the lack of decisiveness of the other institutions.
  - Accordingly, profound changes must be made to Europe's institutional framework to make it effective in resolving the current crisis and preventing future crises. An authoritative European-level executive framework must oversee banking, fiscal and structural policies. This executive framework must be made accountable to Europe's citizens, and for this the European Parliament must become more representative and exert better control over policymaking. Those four components of banking, fiscal, competitiveness and political union will take several years to be completed. They are mutually interdependent and must be taken together, ideally in parallel increments. In particular, the completion of a banking union
- relies on federal deposit insurance which itself requires a credible supranational fiscal backstop. And without the democratic accountability provided by political union, no new integrated policy framework can be sustainable.
- Europe must also overcome its tendency to jump to permanent solutions, and acknowledge the need for pragmatic short-term actions that are tailored to the urgency of the crisis. Europeans have repeatedly tried to resolve long-term issues before deciding on short-term fixes, but that strategy is a luxury they no longer have. Specifically regarding banking issues, a proper crisis management and resolution system must be put in place before all longer-term institutional questions are answered.
  - Thus, leaders should establish a temporary euro area bank resolution authority, as none of the existing institutions has the skills and mandate that would allow it to perform the thankless task of identifying and restructuring failing financial institutions. A successful bank crisis resolution process will require temporary guarantees, including temporary central reinsurance of national deposit insurance systems by the soon-to-be-created European Stability Mechanism (ESM) or by a more robust future central financial instrument.
  - In the longer term, the euro area needs not only a single supervisory mechanism for banks but also a regionally based deposit insurance system and a central resolution authority for failing banks. The ECB can play a large role in this future framework but cannot be its only component. National bank supervisors will retain many of their attributes but their governance will need to change. Ultimately the banking union should cover all banks in the euro

area and possibly in other European Union member states, even though it seems likely that exceptions will be initially negotiated by member states to exclude some smaller banks from its oversight.

A breakup of the euro area would be disastrous for Europeans and to a large extent for the global economy. The choices facing Europe's leaders and citizens are daunting. Their slow pace of decision-making has exacted a heavy price from Europe's economies, societies, and families. Greece remains a burning concern. No one can be assured that the euro area would survive its disorderly exit; but there is still no clear enforcement framework available if its adjustment trajectory keeps veering off track, as it has repeatedly over the last two years. Investors have good reasons to be nervous.

Yet it is not too late for Europeans to take action to ensure the survival, sustainability and success of monetary and economic union.

The remainder of this Policy Contribution expands on these points and provides additional analysis.

### EUROPE'S EXECUTIVE AND DEMOCRATIC DEFICIT

Europe's systemic financial crisis has been going on for five years. Its start can be dated back to German top banking supervisor Jochen Sanio's reported warning on 29 July 2007 of "the worst banking crisis since 1931" while discussing the public bail-out of a medium-sized lender, IKB<sup>1</sup>. Since then, European banking policymakers have been in continuous crisis management mode but have never been able to bring the interbank market back to its normal state without exceptional government guarantees. As is well known, from late 2009 the banking fragility was compounded in the euro area by the growing unwillingness of market investors to lend to sovereigns, first Greece and later others, creating a mutually reinforcing 'doom loop' between weak sovereigns and banking credit conditions.

Half a decade is a long time in policymaking. In retrospect, the lack of proactive decision-making at the European level is striking. While the common depiction is of a crisis of the euro-area periphery, it can equally be described as a failure of the euro-area centre, by which I mean the mechanisms and actors that determine executive policy for the entire euro area as opposed to individual member states. Prominent among these are the European Commission, European Council of EU member states' heads of state and government, Economic and finance affairs (ECOFIN) council of EU member states' finance ministers, Eurogroup meeting of euro area member states' finance ministers, plus multiple ad hoc subsets of euro area countries and institutions, such as French-German and more recently French-German-Italian or French-German-Italian-Spanish meetings, the 'Frankfurt Group' in late 2011<sup>2</sup>, or the four remaining euro area triple-A-rated countries in early 2012<sup>3</sup>. There have been occasional misguided decisions, such as an ill-designed bank recapitalisation plan adopted in late October 2011<sup>4</sup>. But, on the whole, such policy errors of commission have been less damaging than the absence of decisions.

European institutions have long been criticised for their democratic deficit, and the crisis has revealed an equally gaping executive deficit. Moreover, these two feed each other: the lack of democratic legitimacy contributes to the paralysis of executive decision-making; and Europe's inability to solve its collective problems deepens citizens' distrust of its institutions. This is another kind of 'doom loop', political rather than financial, but no less damaging than the one between sovereign and banking credit. To be fair to the personalities involved, this failure must be seen as a systemic problem of inadequate incentives and institutions, rather than a shortcoming of individual leadership.

The insufficiently democratic nature of European decision-making has many aspects. First, European citizens lack equal representation in the

1. *Financial Times*, 'Germany rescues subprime lender', 2 August 2007.

2. This informal group included, in alphabetical order: European Commission President José Manuel Barroso; European Central Bank President Mario Draghi; Eurogroup Chairman Jean-Claude Juncker; International Monetary Fund Managing Director Christine Lagarde; German Chancellor Angela Merkel; European Commissioner Olli Rehn; French President Nicolas Sarkozy; and European Council President Herman Van Rompuy. See for example Peter Spiegel, 'EU presses Rome and Athens', *Financial Times*, 14 November 2011.

3. Finance ministers of Finland, Germany, Luxembourg, and the Netherlands held joint meetings in the context of the Greek debt restructuring negotiations. See for example *Associated Press*, 'Greek debt talks to stretch into weekend', 3 February 2012.

4. See for example Nicolas Véron, 'Banking federalism is key to the Eurozone's survival', *Emerging Markets* G20 Edition, 3 November 2011.

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*'EU institutions have been criticised for their democratic deficit; the crisis has revealed an equally gaping executive deficit. The lack of legitimacy contributes to the paralysis of executive decision-making; and Europe's inability to solve its problems deepens citizens' distrust.'*

European Parliament, a shortcoming cited in June 2009 by Germany's federal constitutional court as a key reason for Berlin not to surrender national fiscal power to Brussels. In addition, the European Parliament lacks control over financial and other executive decisions. Consequently, it cannot act "in such a way that a decision on political direction taken by the European electorate could have a politically decisive effect," and this constitutes a "structural democratic deficit"<sup>5</sup>. Second, the European Council, a key actor in Europe's collective executive decision-making, does not have a framework to ensure collective accountability. Its members, heads of state and/or of government, are exclusively accountable to their respective national citizens, but the Council as a whole is accountable to no one. The same shortcoming hampers the summit meetings of the euro area, as well as other intergovernmental formations such as the ECOFIN Council and Eurogroup. The European Commission is more strongly accountable to the European Parliament, but it has often been sidelined in the past five years (with important exceptions such as on competition policy). Third, when electorates in individual member states were consulted on successive treaty revisions by referendum, negative responses have not been answered by a change of orientation. The French and Dutch rejection of the 2004 constitutional treaty were followed by the reintroduction of a near-identical text as the Lisbon Treaty in 2007; the Irish were asked to vote again on the Lisbon Treaty in 2009 after first rejecting it in 2008. The democratic shortfall has been widely cited as a factor in the rise of populist anti-European parties in recent elections in several member states.

It might sound paradoxical to advocate stronger democratic accountability as a means to reinforce Europe's ability to make executive decisions. Democratic checks and balances, including parliamentary control mechanisms, are constraints on executive discretion. But the lesson of the past five years in Europe is that, in a region like Europe where the commitment to democracy runs deep, the absence of such checks and balances cripplingly inhibits decision-making as leaders do not feel empowered to take bold action for the region as a whole. Alternative history is always a perilous exercise, but it is likely that if proper European

executive decision-making and oversight processes had existed in the banking, fiscal, and structural policy areas during the past decade, the European systemic banking fragility could have been resolved as early as 2009 (as it was in the United States); a special resolution regime for all European banks could have been introduced early in the crisis, instead of a legislative discussion about it being started only in June 2012; Greece's sovereign debt could have been contained in early 2010; and the growth potential of Europe, especially of its southern member states, could have been bolstered. In other words, Europe's executive and democratic deficit has mattered hugely for economic outcomes and the inability to tackle the crisis, and will continue to do so.

It must be noted that the ECB is an outlier in this context. Central bankers are inherently less dependent than other policymakers on democratic accountability mechanisms to legitimise their decisions. Therefore, the ECB has been less paralysed than other actors by the weaknesses of democratic representation at the European level, and it has exercised its authority forcefully. But the ECB must be careful not to act much beyond the treaty-defined limits of its mandate. Its ability to fill Europe's executive deficit is thus limited<sup>6</sup>.

#### THE NEED FOR FOURFOLD UNION

A resolution of the current crisis must address these mutually reinforcing deficits of executive decision-making capability and of democratic representation and empowerment. The key executive functions that need strengthening are financial sector oversight, government financing and structural reform, which is why there is a need for a banking union, a fiscal union and a competitiveness union. In parallel, a transformed European institutional framework must provide democratic accountability, the political backbone of European integration, and address the concerns expressed in the above mentioned 2009 ruling of the German federal constitutional court. This institutional transformation can be called a political union as it would entail the recognition of a political space at the European level and not only in individual member states. Such a fourfold union is needed to resolve the euro area crisis over the medium term.

5. Press release No. 72/2009 of 30 June 2009, 'Act Approving the Treaty of Lisbon compatible with the Basic Law; accompanying law unconstitutional to the extent that legislative bodies have not been accorded sufficient rights of participation', Federal Constitutional Court of Germany.

6. It may be noted that an early call for a stronger European executive policymaking capacity in the context of the euro area crisis came from then-President of the ECB Jean-Claude Trichet, 'Building Europe, Building Institutions', speech on receiving the Charlemagne Prize 2011 in Aachen, 2 June 2011.

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These labels, which echo the four 'building blocks' proposed by the President of the European Council in a landmark report published on 26 June<sup>7</sup>, are certainly formulaic and can encompass many possible options. Yet they are used here as a useful way to discuss the preconditions for crisis resolution.

Each component union can be seen as a response to lost trust in Europe's collective future – respectively, the evaporation of the interbank market and especially of cross-border interbank lending (banking union); the erosion of market demand for euro area national sovereign debt, which is increasingly perceived as carrying a credit risk (fiscal union); the doubts about euro-area countries' ability to generate dynamic economic growth (competitiveness union); and the growing cynicism about the undemocratic nature of European decision-making (political union).

In practice, a banking union would entail a common framework for banking supervision, crisis resolution, and deposit insurance<sup>8</sup>. A fiscal union would include the creation of a commonly issued debt instrument to meet investors' demand for a credit-risk-free asset (or 'Eurobonds', but actually there are many possible designs for such an instrument), accompanied by adequate central controls on national budgetary choices<sup>9</sup>. A competitiveness union would monitor, assess and coordinate structural reform policies at the national and European levels, including in areas such as insolvency legislation, financial regulation, service sector regulation and labour law, which have a major impact on the potential development of high-growth firms in Europe. A political union would make the European Parliament genuinely representative and able to exert due democratic control of relevant executive functions<sup>10</sup>.

All these steps are necessary to sustain the euro area's monetary union and to prevent the dissolution of the euro area, which, as Anders Aslund at the Peterson Institute among others has convincingly argued, is likely to be disastrous for

all parties<sup>11</sup>. A fourfold union would not by itself resolve the crisis. But it would effectively address the obstacles that have impeded progress in the past five years, and thus make crisis resolution a possibility that is not currently at hand.

Progress towards a fourfold union requires thinking about political obstacles, interdependencies and sequencing. National resistances vary depending on the component and the country. For example, banking union and fiscal union tend to be supported by troubled countries as a way to share their liabilities with stronger countries. Conversely, fiscally stronger member states tend to emphasise central control over banking, fiscal and competitiveness decisions as a precondition for liability sharing. Political union tends to be more easily envisaged by countries with a strong federal tradition, such as Belgium, Italy or Germany, than by those with a more centralized state, including France. Another impediment to establishing such a union stems from the fact that the European Union possesses a supranational legal and political framework that covers 27 member states<sup>12</sup>, but the euro area remains only a subset of countries.

Six non-euro area member states (Bulgaria, Denmark, Latvia, Lithuania, Poland, and Romania) are members of the Euro Plus Pact, a 2011 policy framework that can be seen as the existing basis for a competitiveness union. The European Fiscal Compact, which provides a possible basis for further fiscal union, includes all EU member states except for the Czech Republic and the United Kingdom. All EU member states participate in the London-based European Banking Authority (EBA) which would have a role to play in a future banking union. Most significantly perhaps, the European Parliament is an EU institution, as is the European Commission. One can imagine restricted formations in which only members of the European Parliament (MEPs) from euro area countries would have a right to vote, somewhat akin to the Scottish, Welsh, and Northern Ireland Grand Committees in the UK House of Commons, with possible

7. 'Towards a Genuine Economic and Monetary Union', Report by President of the European Council Herman Van Rompuy, Brussels, EUCO 120/12.

8. A possible blueprint was outlined before the last European Council meeting by Jean Pisani-Ferry, André Sapir, Nicolas Véron and Guntram Wolff, 'What kind of European banking union?' *Policy Contribution* 2012/12, Bruegel, June 2012.

9. One exploration of the policy options is in Benedic- ta Marzinotto, André Sapir and Guntram Wolff, 'What kind of fiscal union?' *Policy Brief* 2011/06, Bruegel, November 2011.

10. National parliaments may also play a role in strengthening democratic accountability, but cannot replace the European Parliament as the only assembly where all EU citizens are represented together.

11. Anders Aslund, 'Why a Breakup of the Euro Area Must be Avoided: Lessons from Previous Breakups', Peterson Institute *Policy Brief*, August 2012

12. This number will grow to 28 in mid-2013 with the planned accession of Croatia to the European Union.

observer status for MEPs from non-euro area countries. For all its importance, the euro area is embedded in the European Union and cannot envisage its institutional future independently from the Union as a whole.

The components of the fourfold union agenda are mutually interdependent. Because executive capability must be seen as legitimate, banking, fiscal or competitiveness union will not be sustainable without political union. Fiscal union is also necessary for a stable banking union, because a common deposit insurance system, even one funded by levies on the financial sector, must ultimately rely on a common and credible fiscal backstop. There is also a direct relationship between banking union and competitiveness union, as financial-system policy is one of the key areas in which Europe must introduce structural reforms to enhance its growth potential. These observations mean that none of the components of the fourfold union can be seen as a substitute for the others.

In terms of sequencing, progress of all four must occur in lockstep, or at least in parallel. For example, an incremental advance on banking union, such as that achieved at the euro-area countries' summit on 29 June 2012, requires further incremental steps forward on fiscal union to pave the way for a common deposit insurance system. Advances towards political union are needed to buttress the pooling of sovereignty entailed by a single supervisory and resolution authority, or by joint issuance of bonds by all euro-area countries. European leaders cannot afford to neglect any of these four components in the difficult steps ahead.

#### SHORT-TERM AND LONG-TERM RESPONSES

Europe must pay equal attention to short-term crisis management and longer-term initiatives to build a more sustainable system. An exclusive short-term focus may worsen future problems. But a focus only on the long term, ignoring the most

urgent challenges, is no less dangerous.

This may sound self-evident, but is worth emphasising in the euro-area crisis context. Euro area leaders have often given the impression of focusing exclusively on long-term legislative and institutional reforms while neglecting more short-term aspects of the crisis. When they did take short-term action, they often sounded as if the result was final and there would be no further steps needed after the one just announced. Yet institutions take time and deliberation to change, while the crisis has a pace of its own, requiring an immediate policy response. Short-term responses must be undertaken despite the absence of a specific legal framework. Pragmatic adaptation is often required. By contrast, post-crisis reconstruction can be carried out after time is devoted to higher standards of consistency and accountability. Short-term emergency legislation is different from permanent legislative reform.

From this standpoint, the US and European responses to the 2008 crisis stand in striking contrast. A high point of financial turmoil was reached in the early autumn of 2008, following the bankruptcy of Lehman Brothers. Broadly speaking, the financial shock was of similar magnitude on both sides of the Atlantic, even though the initial apparent trigger had been the subprime crisis in the United States. In America, the sequence included a highly visible piece of emergency legislation (the Emergency Economic Stabilization Act, enacted October 3, 2008), which allowed the banking situation to be temporarily stabilised in mid-October through bank recapitalisations using the so-called Troubled Asset Relief Program (TARP). The next major step was a comprehensive programme of capital assessment and recapitalisation of the 19 largest banks (the Supervisory Capital Assessment Program, known as 'stress tests' and conducted from February to May 2009). Its completion resulted in a rapid return of the interbank market to normal conditions. Then, in mid-June 2009, the US government published a blueprint for long-term financial reform, which

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opened a phase of legislative deliberation concluding with enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act in July 2010. The implementation of Dodd-Frank through rulemaking by various federal agencies then started and continues, though with some delays. Several issues remain unresolved, including US housing market reform, but it appears fair to say that the United States first adopted short-term crisis management and resolution measures from October 2008 to mid-2009, and then followed by another sequence of long-term reforms.

By contrast, the European Union has persistently focused on long-term initiatives first, and to concede short-term action only under the irresistible pressure of events. This tendency results from the executive deficit described above, and the fact that long-term actions lend themselves to a protracted legislative process that EU institutions favour. To be fair, individual member states have carried out significant short-term actions, but their effectiveness has been diminished by the lack of adequate European-level coordination. For example, the summit of heads of state and government of euro-area members and the UK in Paris on 12 October 2008, initially helped stabilise markets, along with the near-simultaneous use of TARP in the United States for bank recapitalisations. But this initial success was not followed by system-wide monitoring and capital assessment in Europe, in spite of successive rounds of stress tests in 2009, 2010 and 2011, leaving the European banking sector fragile. A more recent case is the Euro Area Summit Statement of 29 June 2012, which contemplated the direct intervention of the European Stability Mechanism (ESM) to recapitalise banks in certain euro-area countries. It proclaimed the aim "to break the vicious circle between banks and sovereigns," but only "when an effective single supervisory mechanism is established"<sup>13</sup>. Taken literally, this is somewhat akin to deciding that firefighters can intervene to put out a fire only after architects and builders have completed their work of design and reconstruction of the firehouse.

To be more effective in the next phases of the crisis, the euro area should adopt more explicit short-term crisis management contingency measures, even if they are designed as temporary steps to be superseded by future permanent arrangements. This is particularly the case in managing the banking crisis and making progress towards the creation of a banking union.

### BANKING UNION: SHORT-TERM ASPECTS

Several analysts, including myself, have urged adoption of a federal framework for banking policy with centralised functions of supervision, crisis resolution and deposit insurance as essential to the stability of the European banking system and to the sustainability of euro-area monetary union<sup>14</sup>. Similar views have been advocated by the International Monetary Fund (IMF)<sup>15</sup>. Yet such analysis has long remained controversial inside the European Union. As recently as early June 2012, the European Commission proposed draft legislation on long-term reform of bank crisis management and resolution that envisaged no central deposit insurance, supervisory, or resolution authority<sup>16</sup>. However, the vision of banking union as an indispensable component of a sustainable economic and monetary union gathered remarkable momentum in the spring of 2012. It was forcefully advocated by IMF Managing Director Christine Lagarde in mid-April<sup>17</sup>, backed by ECB President Mario Draghi in late April<sup>18</sup>, promoted by newly elected French President François Hollande in late May in what can be seen as a significant departure from previous French policy<sup>19</sup>, and more cautiously yet unambiguously endorsed by German Chancellor Angela Merkel in early June<sup>20</sup>.

This momentum created the context for the previously mentioned Euro Area Summit Statement of 29 June 2012, which asked the European Commission to present proposals (now expected in September) for a 'single supervisory mechanism' to be established under Article 127(6) of the Treaty, implying an anchoring role for the ECB. The statement further creates the possibility for the

13. Euro Area Summit Statement, Brussels, 29 June 2012

14. In my case, relevant references include 'Is Europe ready for a major banking crisis?' *Policy Brief* 2007/03, Bruegel, August 2007; 'A solution for Europe's banking problem', with Adam Posen, *Policy Brief* 2009/03, Bruegel, June 2009; prepared statement on 'The European Debt and Financial Crisis: Origins, Options and Implications for the US and Global Economy', US Senate Committee on Banking, Housing and Urban Affairs, Subcommittee on Security and International Trade and Finance, hearing on 22 September 2011.

15. See in particular Dominique Strauss-Kahn, 'Crisis Management Arrangements for a European Banking System', keynote speech at the European Commission conference *Building a Crisis Management Framework for the Internal Market*, Brussels, 19 March 2010.

16. European Commission press release IP/12/570, 'New crisis management measures to avoid future bank bail-outs', 6 June 2012.

17. Christine Lagarde, opening remarks at the IMF/CFP Policy Roundtable on the future of financial regulation, Washington DC, 17 April 2012, available at [www.imf.org](http://www.imf.org).

18. Mario Draghi, introductory statement before the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 25 April 2012.



ESM “to recapitalise banks directly. This would rely on appropriate conditionality [for each relevant member state], including compliance with state aid rules, which should be institution-specific, sector-specific or economy-wide and would be formalised in a Memorandum of Understanding [between European-level authorities and the member state concerned].” This declaration has been rightly hailed as a policy breakthrough, but it also raises far more questions than it answers. As previously argued, the next steps will require careful thinking about the sequence and articulation of short-term and long-term initiatives, as well as about the interdependencies between action on the banking system and the other components of Europe’s ‘fourfold union’.

In the short term, policymakers need to think in terms of systemic bank crisis resolution. They could gain precious insight from consideration of the lessons from previous episodes of systemic crises in developed countries, particularly the US Savings and Loan crisis of the late 1980s, the Scandinavian crises of the early 1990s, the Japanese crisis until 2002-03, and the US financial crisis of 2007-09. The aim is to restore trust in the banking system, starting with the more systemically important banks. This necessarily involves willingness to acknowledge and share losses; a strong and well-empowered resolution authority; significant financial risk-taking by public authorities; and several phases, from the emergency prevention of contagion to the restoration of individual banks’ safety and soundness.

The starting point is that there are probably vast unrecognised losses in Europe’s banking sector and that the resolution framework must allow an adequate sharing of these losses among all relevant stakeholders, including private-sector creditors. At the same time, ordinary bankruptcy procedures are notoriously unsuitable for systemically important financial institutions. Some European member states, including some but not all in the euro area, have adopted special resolution regimes for banks. But so far, almost no senior unsecured creditors have been forced to take losses on financial institutions found insolvent in the European Union. Leaving aside a handful of tiny bank bankruptcies in northern Europe, the only exceptions have been two medium-sized

banks in Denmark (Amagerbanken in February 2011, and Fjordbank Mors in June 2011) but under a policy framework that was later amended so that subsequent situations would be treated differently. In most cases, even subordinated unsecured creditors of failed banks have been fully repaid, at great cost to the respective countries’ taxpayers. This stands in stark contrast to the US, where a handful of high-profile federal bailouts (most notably Bear Stearns, Fannie Mae, Freddie Mac and AIG) have rightly caused much public controversy, but senior unsecured creditors have been forced to take major losses on their exposures to dozens of depositary institutions, including large ones such as Washington Mutual, and medium-sized non-banks such as CIT and MF Global, not to mention Lehman Brothers<sup>21</sup>.

The European practice of fully bailing out all senior creditors, even of smaller banks, and many junior ones is clearly unsustainable. The aim to have adequate participation of senior creditors in the sharing of losses should become the driving objective of Europe’s crisis management and resolution approach. The ECB has recently signaled its acknowledgement of this reality, in a significant shift from its earlier policy positions<sup>22</sup>. However, most member states and the European Commission, ostensibly motivated by contagion concerns, still appear to defend the view that no losses should be imposed on any senior creditors even of failed banks<sup>23</sup>.

The best way to address the fear of contagion is to conduct the assessment of bank solvency on a system-wide basis, ie by including all systemically important banks throughout the euro area in a comprehensive, rigorous and consistent review of balance sheets and capital strength. This was the key to past successful systemic crisis resolutions, including in Sweden in 1992-93, in Japan (belatedly) in 2002-03, and in the US with the Supervisory Capital Assessment Program in 2009. Conversely, the fact that in the euro area, capital assessment and restructuring has been left to national authorities in spite of the high degree of cross-border market integration is a major reason why Europe’s banking fragility remains unresolved after half a decade of turmoil, three rounds of stress tests (2009, 2010, 2011), and the ill-fated ‘recapitalisation plan’ of October 2011. There is

19. Transcript of the President of the French Republic’s press conference in Brussels, 23 May 2012, available in French on <http://www.elysee.fr/president/les-actualites/conferences-de-presse/2012/conference-de-presse-de-m-le-president-de-la-13289.html>.

20. *Reuters*, ‘Merkel calls for body to supervise major EU banks’, 4 June 2012.

21. For a discussion of this contrast see Morris Goldstein and Nicolas Véron, ‘Too Big to Fail: The Transatlantic Debate’, in J.F. Kirkegaard, N. Véron and G.B. Wolff (eds), *Transatlantic Economic Challenges in an Era of Growing Multipolarity*, Peterson Institute/Bruegel Special Report 22 July 2012.

22. Interview with Mario Draghi in *Le Monde*, 21 July 2012.

23. Gabriele Steinhauser and Brian Blackstone, ‘Europe’s Bank Shifts View on Bond Losses’, *Wall Street Journal*, 16 July 2012.

considerable political resistance against a genuine system-wide approach to banks' capital assessment, particularly in countries such as France and Germany whose official positions are that their respective banking systems have been kept sound (notwithstanding past problems at banks such as IKB, Hypo Real Estate, WestLB and Dexia). But it might be the only possible approach that allows significant burden-sharing with senior creditors, an increasingly evident financial and political imperative, not to mention the moral hazard implications of open-ended taxpayer-supported bailouts.

Even if it remains impossible to approach resolution synchronously across the euro area, it is a clear lesson of the past few years that the resolution authority must be centralised. The most evident reason is that national authorities have failed on their supervisory duties in several member states, and have lost too much credibility to remain the main decision-maker on future restructuring, as in the case of Spain. Moreover, it is difficult to see how to build a perception of fairness in the treatment of controversial situations across several countries without having a single authority in charge for the entire euro area (or possibly beyond, assuming other member states would want to participate). Furthermore, bank resolution is an extremely time-consuming, skill-intensive and sensitive process that cannot possibly be coordinated across borders without an unambiguous centralisation of information and authority. Many of Europe's larger banks have significant cross-border operations within the European Union, and a centralised resolution process is the only practical way to balance the interests of home and host countries, as national authorities have powerful incentives not to cooperate in such cases. In addition, as some banking operations and assets are likely to be brought under temporary public ownership as a result of the resolution process, centralisation of their management and/or disposal would prevent ineffective competition among different national authorities to the collective detriment of taxpayers, and would help an orderly process of price discovery as assets are eventually sold back to the private sector. Finally, it makes operational sense to have expertise and skills concentrated in one central team rather than having it spread thinly across various member

states, both in terms of cost-effectiveness and more importantly of ability to attract talent and learn from experience.

No existing institution is well equipped to assume this role of euro-area resolution authority. The ECB, in addition to not having the relevant skills directly at hand, cannot assume the politically contentious responsibility of bank resolution in a manner compatible with its jealously safeguarded monetary policy independence. The European Banking Authority, in addition to not having the relevant skills directly at hand either, is ruled out given its governance structure that makes it too dependent on member states and by its location in the UK, a country that has unambiguously refused to participate in any effort towards banking union. The European Financial Stability Facility (EFSF) and soon-to-be-established ESM are small structures with no expert banking specialist staff, and even more than in the case of the EBA may lack the independence from member states to ensure the impartiality of the resolution process. The European Commission has built valuable experience through the implication of its directorate-general for competition (DG COMP) in most bank restructurings over the past years under the European Union's state aid control policy, and its involvement in the 'troika' that negotiates conditionality with countries under assistance programmes, including in the recent case of Spain. But it is questionable whether the task of restructuring may conflict with the Commission's many institutional constraints, and whether its staffing by general-purpose civil servants is compatible with the need for specialised skills in the resolution and restructuring tasks.

This suggests that in the short term the best way to achieve a resolution authority at the euro-area level might be to create a temporary, dedicated structure with wide latitude to recruit specialised staff, both from the private sector and through secondment from national or European public authorities. In addition, bank restructuring and resolution is a thankless task, and those who will perform it will gain few friends, an observation which also favours a temporary structure that can ensure maximum independence and impartiality. There are precedents that suggest that this can be an effective approach to systemic crisis resolution,

including the US Resolution Trust Corporation (1989-95), the Swedish Bank Support Authority (1993-96), or, in the case of systemic issues beyond the financial system, the *Treuhandanstalt* that restructured and sold the former German Democratic Republic's state-owned enterprises in 1990-94, or the US Presidential Task Force on the Auto Industry that coordinated government policy on Chrysler and GM in 2009. While none of these experiences passed completely smoothly, they all suggest that a temporary, well-empowered task force structure, obviously with adequate provisions for accountability and transparency, would represent a credible and well-suited response to the short-term challenge of European bank crisis resolution.

This leaves open the question of future ownership of those institutions that the temporary resolution authority would find insolvent following in-depth balance sheet assessment. In legal terms, those countries that do not currently have a special resolution regime for banks should pass emergency legislation to create one, and those that have one might also need emergency legislation to empower the temporary resolution authority at the euro-area level. Failed banks will generally need to be taken over by public authorities, but there might be no uniform framework by which public authorities will become equity owners. One can imagine a combination of national government ownership and ownership at the European level (specifically by the ESM as suggested by the euro area summit statement of June 29), depending on countries and individual bank situations. This should logically be negotiated by the temporary resolution authority together with the imposition of losses on relevant categories of creditors (excluding, of course, those which are covered by explicit guarantees). While these negotiations should be conducted with a sense of impartiality and evenhandedness across the euro area, differences in legal environments, banking structures and fiscal positions make it unadvisable, and arguably impossible, to adopt a one-size-fits-all approach.

Beyond this, crisis resolution and restructuring will necessarily involve significant financial risk-taking by public authorities – but these have to be compared to the current open-ended explicit and

implicit commitments of support to the financial sector that exist at the level of individual member states. Here again, banking policy cannot be considered in isolation from the other components of fourfold union.

This is most obvious as regards the protection of retail deposits, and more generally the prevention of further capital flight, particularly in the more fragile countries. As previously argued, European policymakers should refrain from a blanket and permanent guarantee of all bank liabilities, but they could and should do more to reassure depositors. Deposit data in Europe tends to be only disclosed with a lag, and is far from complete, but the available evidence suggests that deposit flight is occurring, at varying pace, in several euro-area countries. This is very dangerous for financial stability and should be addressed decisively. It would be irresponsible for policymakers to delay taking action until it is forced on them by a fully-fledged retail bank run.

Three main factors appear to motivate deposit flight: a fear of currency redenomination and devaluation in case of euro area exit; a fear of inability of the government to fulfill its deposit insurance commitments; and for larger depositors, concerns about their deposits above the insured threshold in case of failure of the bank in which they are held. Addressing the first concern involves reassuring euro-area citizens that there will be no forced or disorderly exit from the currency union: the crucial case here, in the next few months as in the recent past, is obviously Greece, and to say the least, euro-area leaders have not done enough to remove uncertainties about its future status. To address the second concern, the ESM, when it is in place, should provide a temporary and unconditional guarantee of national deposit insurance systems across the euro area, at least until progress has been made towards comprehensive bank crisis resolution and possibly until a federal euro-area deposit insurance system is in place. Such 'deposit reinsurance' should be temporary because it creates questionable incentives for member states, but might be a necessary step to achieve the euro-area leaders' "imperative to break the vicious circle between banks and sovereigns". The third concern could be addressed by targeted temporary guar-

antees until the completion of a credible, system-wide process of bank assessment as previously described.

Finally on the sequencing, several successive steps will be needed and policymakers should preserve as much flexibility as possible in their intervention framework. Even under the most optimistic assumptions, it would take at least 2-3 months to build a temporary European resolution authority; 3-4 more months to reach a comprehensive system-wide assessment of the balance sheet and capital positions of the most important banks (which would represent a sample comparable to that of the 2011 stress tests, say between 60 and 90 banks); and one or two additional months to negotiate the outline of restructuring packages for those banks found insolvent, which might number in the double rather than single digits. As a consequence, the disclosure of capital assessments, which can only be made once adequate backstop plans have been defined for failed institutions, could hardly happen before February or March 2013, and possibly not before the late spring of 2013 at the earliest, with a long period of prolonged uncertainty in the meantime. Even after that, it will take many months if not years to complete the restructurings. As illustrated by multiple recent cases including WestLB, Fortis, Dexia, RBS and others, resolving or restructuring problem banks in Europe is almost always a protracted and legal-risk-ridden process. This long sequence will be difficult to manage, and will require very careful and professional communication towards the financial community and the wider public.

### BANKING UNION: LONGER-TERM ASPECTS

In accordance with the 29 June 2012 euro-area summit statement, euro-area policymakers have started discussing the long-term design of their future banking union even before having set the key parameters of short-term crisis management and resolution. In this context, essential choices will have to be made shortly about the future institutional framework. The only indication so far is an

anchoring role to be played by the ECB, consistent with the statement's reference to article 127(6) of the Treaty on the Functioning of the European Union, which states that "The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings."

A proper banking policy framework includes several dimensions, including regulation, supervision, resolution, deposit insurance, competition and consumer protection. In the European Union, regulation is mostly defined at the EU level, through legislation (directives and regulations) and binding technical rules which are increasingly prepared by the EBA and other European Supervisory Authorities, even though the European Commission retains decision-making authority in the current framework<sup>24</sup>. While this framework is somewhat clumsy, its reform is not a necessary condition for the establishment of a banking union. Competition policy is conducted under a time-tested integrated policy framework, in which the European Commission's DG COMP plays a pivotal role together with national competition authorities. Consumer protection might require further convergence, including as part of a future economic competitiveness union, even though this has not yet been considered an urgent concern by most European policymakers. This leaves supervision, resolution and deposit insurance as the key areas for which leaders need to start designing a viable future framework now.

As previously observed, the inherent political nature of bank resolution authority makes it unlikely that such authority could be temporarily or permanently granted to the ECB, even assuming a separation of teams and a dedicated governance framework within the institution. This is especially true in the European context of a weak central

24. here are however multiple exceptions to the principle of a 'single European rulebook' for banking regulation, as illustrated among others by the UK debate over implementation of the recommendations of the Independent Commission on Banking, or Vickers Commission. Moreover, corporate law applicable to banks remains exclusively national, a situation which may require modification with the creation of a permanent European resolution authority. Banks across the EU will also need to continue to adapt to different national tax systems for the foreseeable future.

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executive and problematic democratic accountability, which advises against delegating excessive discretionary power to the ECB. The ECB itself has signaled that it had no appetite to assume the inherently controversial task of bank resolution, including by stressing that the future banking union framework should allow the ECB to act “without risks to its reputation”<sup>25</sup>. Thus, it appears inevitable that the long-term framework will include a European resolution authority separate from the ECB, and also most likely separate from all other currently existing institutions for the reasons developed in the previous section. However, it is desirable that the resolution authority should be able to have close interaction with the ECB, particularly in times of crisis. For this reason it should preferably be located in Frankfurt, as geographical proximity would help in this respect even as the two institutions would remain separate.

The supervisory function has synergies both with the lender-of-last-resort role of the ECB, and with resolution authority. If the June 29 decision is to be implemented, the ECB will develop supervisory functions of its own in any case. It is likely that the resolution authority will require a supervisory mandate as well, as is the case with the Federal Deposit Insurance Corporation (FDIC) in the United States<sup>26</sup>; as in the US, it could be coupled with the deposit insurance function, even though a formally separate deposit insurance fund could be envisaged as well. Some overlapping of supervisory functions across two or more European institutions should of course be kept to a minimum to avoid duplication of some costs and complexity, but its existence should not necessarily be seen as a problem in itself: situations of overlap exist in several jurisdictions including the United States (Federal Reserve/FDIC/Office of the Comptroller of the Currency) but also Japan (Bank of Japan/Financial Services Agency) and Germany (Bundesbank/BAFin). If the euro area is to avoid such overlap, its leaders may need to envisage a change from the 29 June decision and a buildup of the supervisory function entirely outside of the ECB even though adequate operational links with the central bank should be established, as is the case in Australia, Canada, China, Sweden and Switzerland among others.

National supervisors would continue to exist in a

future banking union, at least in a first phase. The European principle of subsidiarity, according to which a European authority should perform only those tasks which cannot be performed effectively at the national level, suggests in particular that the supervision of most local banks should remain in their scope, and they could be delegated other tasks by the European supervisor(s). However, their mandate and governance will need to be adapted to the new, more integrated approach. To be consistent with the euro area's claimed “imperative to break the vicious circle between banks and sovereigns,” at least some of their functions should be placed under the authority of the European supervisor(s) rather than of the respective national government as is currently the case, with possible corresponding changes in terms of their accountability framework. Conversely, one can imagine a role for national supervisors in the governance of the new European-level authorities, including possibly of the new supervisory function within the ECB, a possibility made arguably easier by the fact that many of these supervisors are part of the National Central Banks that participate in the Eurosystem together with the ECB itself. However, appropriate lessons should be drawn from the experience of the EBA and other European Supervisory Authorities, suggesting that such role should not be exclusive. Officials with a European as opposed to national mandate and accountability, as is the case of members of the ECB's executive board, should be prominent in the key decision-making bodies, unlike the situation of the EBA where the so-called supervisory board, which in spite of its name is in charge of most key executive decisions, is composed exclusively of national representatives. In line with previous arguments about political union, strong channels of accountability should be built vis-à-vis the European Parliament.

In relation to the above arguments about the role of national supervisory authorities, the European supervisory, resolution and deposit insurance authorities should have competence not only over those financial institutions that are systemically important at the European level (or E-SIFIs, to mimic the current jargon of the Financial Stability Board and Basel Committee on Banking Supervision, which identifies G-SIFIs as financial institutions that are systemically important at the

25. Jörg Asmussen, ‘Building deeper economic union: what to do and what to avoid’, speech at the European Policy Centre, Brussels, 17 July 2012

26. The FDIC is the primary supervisor of only a subset of depositary financial institutions in the US, but has backup supervisory authority over all others and is a prominent member of the US supervisory community.

global level, and D-SIFIs as those that are systemically important at the domestic level). It should also cover smaller banks, even though most operational duties related to these could and should be devolved to national supervisors. This would also help maintain, or rather establish, a competitive level playing field across the banking union. It is likely however that some member states will try, at least in a first phase, to negotiate exceptions for sections of their respective banking systems with particularly strong links with local and regional environments. Such exceptions from the general framework of banking union, which would also encompass separate deposit insurance systems, appear unadvisable from the standpoint of policy consistency and effectiveness, but may be inevitable to reach a political consensus at least in an initial phase. They may concern the German *Sparkassen-Finanzgruppe*, with the possible exception of the *Landesbanken* within it, and perhaps also Germany's cooperative bank system (*Volksbanks* and *Raiffeisenbanks*, and *DZ-Bank*). Whether other exceptions will be sought by member states other than Germany remains to be seen.

In terms of geographical scope, the generally adopted working assumption is that the banking union would be identical in perimeter to the euro area. However, it can also be envisaged that its perimeter would be wider and include some EU member states that may not join the euro area in the short term, say Poland or Denmark. This would create additional complexity and potential risks, but it is technically conceivable and may be ultimately determined by political considerations. Under this scenario, common supervisory and resolution authorities might span different currency areas (the euro area being by far the largest) and be linked to different deposit insurance funds, as it appears difficult to envisage how a single deposit insurance fund could span multiple currency areas. The opposite option, of a banking union that would include some euro-area countries but not all, is harder to imagine.

This brief and incomplete enumeration shows that many different parameters remain to be discussed in order to put in place a consistent permanent institutional framework for the future banking union. In this context, it is to be hoped that pragmatism will prevail and that direct financial intervention by the ESM in individual banks will be unlocked before all these parameters are set, in order to allow swift and effective crisis management and resolution. However, it is also desirable that euro-area leaders achieve consistency between their short-term and long-term planning, and that an early version of a future European supervisor can be set up rapidly and provide continuity of approach beyond the short-term phase and beyond the possible lifetime of a temporary resolution authority, if such an option is indeed chosen.

#### OUTLOOK

Even under optimistic assumptions, the situation in the euro area will remain affected by high levels of market volatility. Many observers and investors have gradually lost hope in the euro area's ability to resolve its problems. They are not encouraged by what they perceive as a state of denial affecting several senior European policymakers, about both the severity of the region's problems and the need to maintain or regain investors' trust to resolve them. In their narrative, the euro area is too diverse to survive as a monetary union, and centrifugal forces are too strong to be contained.

I share the view that Europe's current institutions are not strong enough to contain such forces indefinitely, but the European Union is and remains a work in progress and is capable of change. The completion of a fourfold union would create a much more robust and resilient framework that could enable decisions to repair investors' trust and keep centrifugal forces in check. Arguments that Europe is too diverse for stronger central institutions to exist do not hold up to scrutiny. India is one example of a fairly stable democratic polity whose internal historical, social,

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economic, religious, ethnic and linguistic diversity is greater than in the European Union, let alone the euro area. Among more advanced economies, Canada and Switzerland are other examples of stable, yet diverse and multilingual democracies. Many pessimistic observers underestimate the extent to which well-designed political institutions can tie different communities, provided there is a desire to hold together.

European integration has been a process of political innovation from the start. There is no precedent, and still no equivalent elsewhere in the world, for the kind of supranational institution-building that has been going on in Europe since 1950. Even though parallels might be drawn with some cases of constitution of federations, particularly the United States in the 1780s and Canada in the 1860s, these cases are too different from Europe to have any predictive relevance. As with all innovation, success can neither be taken as given nor considered impossible.

In the specific case of the euro area, powerful 'de facto solidarities' exist and make the bloc more resilient than superficial observation might suggest. These solidarities are of a different nature from those involved in earlier steps of European integration, and are often ill-understood including in the European economic policy and research community itself, as the noisy debate about so-called Target2 imbalances among Eurosystem central banks, among others, has illustrated<sup>27</sup>. They are particularly strong in the case of Germany, the euro area's pivotal member state.

Nonetheless, Greece remains the litmus test of

whether the euro area will hold together, and the outcome there is hard to predict. Euro-area leaders, including Greece's, might come to the conclusion that further transfer of economic sovereignty by Greece to the euro-area level is the only way to prevent a disorderly dislocation. If this happens, the issue of European institutions' democratic accountability, in other terms the political union agenda, will gain even more urgency than is currently the case. Similarly, if a legal impasse is reached as the consequence of future rulings of Germany's constitutional court about crisis management initiatives, a major strengthening of the democratic underpinnings of EU institutions might be the only way to overcome the court's reservations against more transfer of decision-making towards the supranational level.

There is no easy, simple or painless way to resolve the euro-area crisis successfully. An enormous effort of adjustment and transformation lies ahead, in addition to the substantial sacrifices already incurred by Europe's member states and citizens. Achieving a fourfold union as described here is indispensable to avoid a disorderly and disastrous euro-area breakup. Time and stamina will be needed. The changes involved are significant, but not impossible. The European Union does not have to become a 'superstate' to overcome the crisis, and will remain a hybrid in which component nation-states play an irreducible role. The fragmentation of Europe's financial, economic and social space that has occurred since the crisis started is damaging and worrying, but has not reached a point of no-return beyond which it could not be reversed. The euro area faces daunting challenges, but is far from condemned to failure.

27. See for example Isabelle Kaminska, 'That\* Target2 presentation', *FT Alphaville*, 27 June 2012.