EUROPEAN COUNCIL ON FOREIGN RELATIONS
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POLICY BRIEF

HOW TO COMPLETE EUROPE'S BANKING UNION

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SUMMARY

Europe sailed into the crisis without a banking union – with well-known results. The EU is now passing legislation to equip itself with elements of a banking union including a single supervisory mechanism centred on the European Central Bank and a single resolution fund that will be funded by the financial sector. The hope is that this new banking union will protect the eurozone from similar crises in the future, end fragmentation of banking markets in Europe, break the toxic links between problems in the national banking system and sovereign debt, and jump-start economic growth in the periphery.

This brief argues that the banking union that is now being finalised is a game changer. Common oversight at the EU level will make oversight failures more difficult to happen and partially level the playing field in financial markets. But although the resolution mechanism will be able to deal with the collapse of a couple of medium-sized banks or possibly even one of the larger banks in the eurozone, it will not be able to deal with a systemic banking crisis. Differences in financing conditions between banks in the eurozone's core and periphery will thus persist, making it hard to speak of a true single market, and may even worsen if spreads in government bond yields between the core and periphery increase again.

The euro crisis has revealed the weakness of the structures of eurozone governance and in particular the regulation, oversight, and resolution of financial institutions. The results are well known. More than €4.5 trillion in guarantees have had to be dedicated to keep the financial sector afloat.[1] As a result of the eurozone's inability to cut the toxic link between public and private debt and jump-start growth, public debt grew from 66 percent of eurozone GDP in 2007 to 92 percent in 2013.[2] Part of the problem was insufficient bank regulation, inadequate supervision, or regulatory forbearance. But the eurozone periphery also struggled to jump-start economic growth because of the fragmentation of financial markets and difficult financing conditions experienced by households and firms in crisis countries.

In the summer of 2012, the European Council asked President Herman Van Rompuy to draw up a roadmap for the achievement of a genuine Economic and Monetary Union (EMU), including a so-called "integrated financial framework" – in other words, a banking union.[3] The roadmap, delivered in December 2012 and endorsed by the presidents of the Eurogroup, the European Commission and European Central Bank (ECB), recommended the creation

1 Figure taken from "Opening keynote speech at the Conference on the Blueprint for a deep and genuine EMU" by José Manuel Barroso, European Commission – SPEECH/13/387, Brussels, 7 May 2013, available at http://europa.eu/rapid/press-release_SPEECH-13-387_en.htm.
2 Eurostat, General government gross debt – annual data, available at http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&plugin=1&language=en&pcode=teina225.
3 European Council Conclusions, EUCO 76/12, Brussels, 28–29 June 2012, available at http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/131388.pdf.

of a banking union in two steps.[4] In a first phase, supervision would be shifted from the national central banks to the ECB through a Single Supervisory Mechanism (SSM), national resolution and deposit guarantee frameworks would be harmonised, and an operational framework for direct bank recapitalisation through the European Stability Mechanism (ESM) would be set up. In a second phase, the banking union process would move on to set up a common resolution authority and an appropriate backstop to ensure that bank resolution decisions would be taken "swiftly, impartially and in the best interest of all".[5]

The banking union that is now being implemented is clearly a game changer. The supervisory structure for banking in Europe will change fundamentally in a way which was completely unimaginable only a couple of years ago, transforming a largely fragmented supervisory structure into a comprehensive European one. For large banks, the main point of reference will be a European rather than a national authority. But although the banking union is ambitious, there have been criticisms of the Single Resolution Mechanism and the related structure of the Single Resolution Fund (SRF). Some hope that, no matter how incomplete the banking union is, it can be completed over time, as new circumstances, even crises, challenge the insufficiencies of the current set-up. But others argue that the current set-up leaves the eurozone worse off than before.[6]

This brief explores whether banking union in its current form will deliver what policymakers have promised or, on the other hand, will prove to be a missed chance. It summarises the specific objectives that policymakers have connected with the project of banking union, examines the elements of banking union enshrined in current legislation and legislative proposals, and analyses whether this compromise will achieve the short-term and long-term objectives of banking union. Finally, it makes some recommendations about how to consolidate the considerable progress made so far. As banking union is an extremely complex project with hundreds of pages of regulation on which probably thousands of pages of detailed analysis could be written, this brief focuses only on the most contentious issues.

European integration and the objectives of banking union

Banking union is a huge step forward in European integration. While the single market for financial services has for a long time been part of the European project, European legislation had until recently most regulatory powers at the national level. While certain rules (such as capital requirements) were defined at the European level, implementation was left to national legislations and national regulators. National supervisory agencies focused mostly on the well-being of their national financial institutions and lacked a European perspective. National supervisors were often receptive to banks' concerns even when they were not justified. In the global financial crisis in 2008–9, for example, policymakers in EU member states rescued their own national banking systems without taking into consideration what their actions meant for others.

This is all now supposed to change. European policymakers have transferred to the European level a large share of control over their banking sectors, its regulation, its oversight, and ultimately, its rescue in times of crisis. This is especially remarkable as financial systems nowadays are often seen as vital for a country's national economic interests. Having at least one large bank that can be seen as a "national champion" is regarded by the larger member states as a precondition for the wider success of its business sector in a globalised world. In a sense, banking and credit is seen in the way that coal and steel was in the 1950s: the necessary foundation for successful economic development. Handing over control of this vital sector is politically as sensitive as ceding control of steel and coal in Robert Schuman's time.

Some observers actually see banking union as a catalyst for integration in other areas. The European Council sees banking union as the first and absolutely essential first step towards strengthening and completing EMU. Nicolas Véron argues that banking union cannot create a fully level playing field for banks in Europe without "further progress towards fiscal and political union".[7] Thus the significance of banking union can hardly be overstated. Once it is completed, the EU will create its own fiscal capacity – a way of "improving the resilience of EMU through the creation of a shock-absorption function at the central level".[8] Thus banking union is a roadblock on which further progress in European integration depends. Once it is passed, Europe will be able to move on to fiscal and macroeconomic co-ordination – the anteroom of political union.

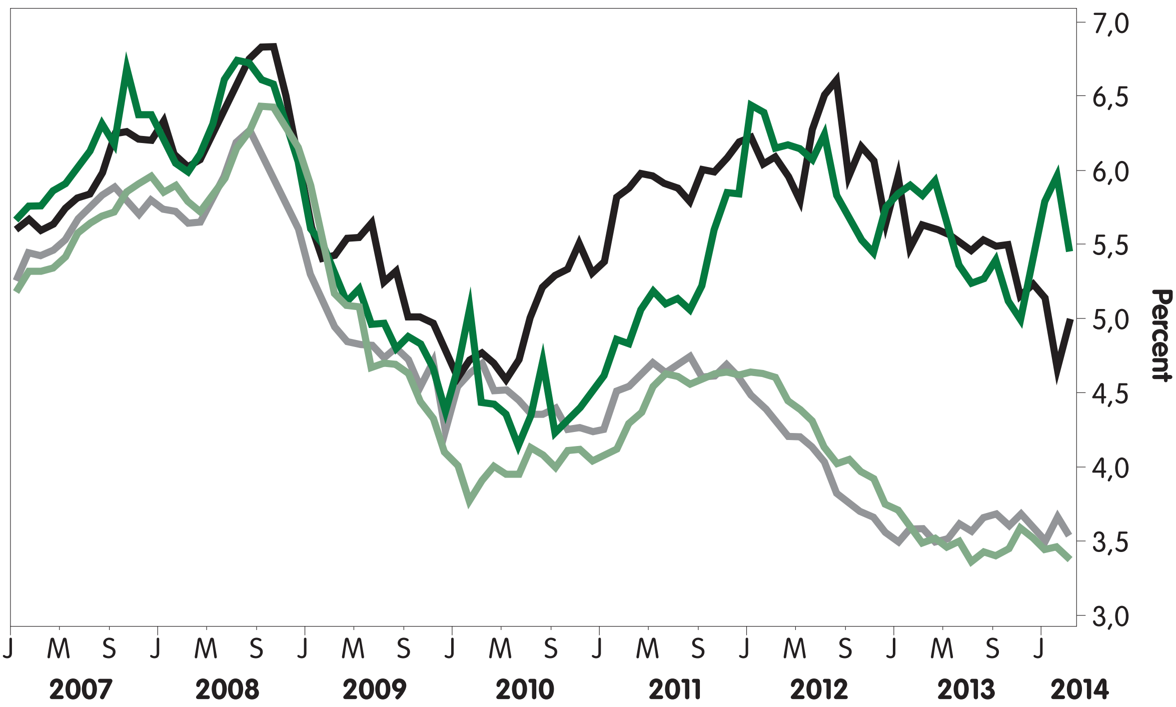
However, it is not clear that merely transferring a significant amount of power to the European level will solve the problems in the European banking sector. To judge how successful banking union will be, it is helpful to recall what policymakers actually intended to achieve through banking union. According to the European Commission's memo from 2012, the objectives of banking union are:

4 "Towards a Genuine Economic and Monetary Union", 5 December 2012, available at http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134069.pdf (hereafter, "Towards a Genuine Economic and Monetary Union").
5 "Towards a Genuine Economic and Monetary Union", p. 4.
6 See, for example, Wolfgang Münchau, who has gone as far as to conclude that the "economic consequences of what finance ministers hailed as a 'historic' decision will be substantially negative", pushing the eurozone into something similar to "1990s Japan [...], probably worse given the periphery's dire economic state". Wolfgang Münchau, "An exercise in prolonging a banking credit crunch", *Financial Times,* 22 December 2013.

7 See Nicolas Véron, "European Banking Union: Current Outlook and Short-Term Choices", Bruegel and Peterson Institute for International Economics, 26 February 2014, available at http://piie.com/publications/papers/veron20140226.pdf (hereafter, Véron, "European Banking Union").
8 "Towards a Genuine Economic and Monetary Union", p. 3.

Figure 1

Interest rates, loans to non-financial corporations (1 to 5 years, up to €1 Million)

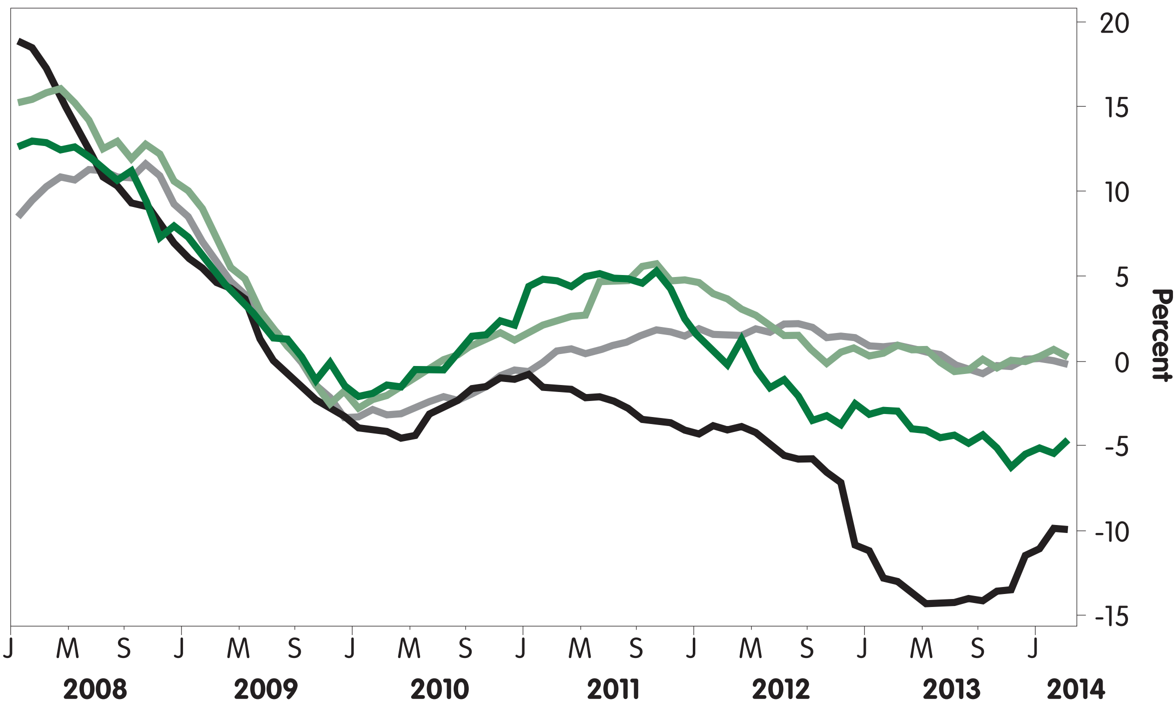


Italy France Spain Germany

Source: ECB

Figure 2

Bank loans to non-financial-corporations, index, year-on-year change



Italy France Spain Germany

Source: ECB

1. To break the link between member states and their banks;
2. To restore the credibility of the financial sector;
3. To preserve taxpayers' money;
4. To make sure that banks serve society and the real economy.[9]

The fourth objective is particularly vague. Usually, serving society and the real economy is understood as providing essential payment and credit services to the rest of the economy. In the context of the current crisis, it seems especially important to bring down elevated financing costs in the periphery relative to the core and thus to restore a level playing field in the single market for financial and banking services. This would in turn jump-start credit growth, especially in the crisis countries. Figure 1 shows how corporate interest rates on medium-sized loans continue to be much higher in Italy and Spain than in Germany and France, putting firms in the periphery at a permanent competitive disadvantage.

At the same time, as figure 2 shows, the amount of outstanding loans continues to decline in some of the countries of the periphery, depriving the corporate sector of funds for investment. A final goal of banking union is to take the pressure off other policy actors, especially the ECB. The ECB created new policy tools such as the Long-Term Refinancing Operations (LTRO) and widened the list of collateral eligible for refinancing in order to solve problems in the financial sector. The ECB's promise to buy government bonds of crisis countries through its programme of Outright Monetary Transactions (OMT) – as well as the June 2014 decision to lower the deposit rate into negative territory – can also be seen as a reaction to a dysfunctional financial sector.

Were it not for the banking sector crisis, economic growth in the euro area would be faster, there would be fewer doubts about debt sustainability, and therefore less need for ECB intervention. In Germany, in particular, the public is often very sceptical of central bank activities that can be interpreted as going beyond the narrow mandate of guaranteeing price stability. A banking union that would make some of these ECB activities redundant would hence defuse potential for political conflict between member states and institutions in the euro area.

Obviously, the goals listed above have two dimensions: a short-term dimension of crisis management and jump-starting economic growth; and a medium- to long-term dimension of preventing future banking crises. In the short term, the key challenges are breaking the link between sovereign debt and the national banking systems and restoring the credibility of the banking sector and thereby helping the periphery countries' economies to grow again. In the long term, the key challenge is how to protect taxpayers' money against the costs of repeated bank bailouts.

9 See European Commission MEMO/12/656, "Towards a Banking Union", 10 September 2012, available at http://europa.eu/rapid/press-release_MEMO-12-656_en.htm.

The state of banking union

The banking union as envisioned by EU policymakers consists of three elements: a single, supranational supervisory authority; a unified bank resolution scheme; and a deposit insurance scheme.

The Single Supervisory Mechanism

The regulation on the Single Supervisory Mechanism (SSM) puts the ECB at the heart of supervision of all banks in the euro area. All eurozone countries will be part of the SSM and other EU member states will also be able to opt in. From autumn 2014 onwards, the ECB will have overall responsibility for the supervision of all banks in the euro area and for the day-to-day oversight of all "significant" credit institutions, and it may at any time assume by its own decision responsibility for any less significant credit institution. Unless the ECB assumes this responsibility, national banking authorities will continue to supervise national banks that are not deemed significant. Credit institutions that have received direct public financial assistance either under a European Financial Stability Facility (ESFS) or an ESM programme will be mandatorily supervised by the ECB.

A credit institution could be deemed significant because of its size, its importance for the economy of the EU or any participating member state, or its significance in cross-border activities. The legal texts make it mandatory that a credit institution is deemed significant if the total value of its assets exceeds €30 billion or the ratio of its total assets over the GDP of the participating member state of establishment exceeds 20 percent and its total value of assets €5 billion. Out of the approximately 6,000 banks in the euro area, about 130 are expected to be directly supervised by the ECB.[10] While this number represents only 2.5 percent of the credit institutions in the euro area, the assets of these institutions represent roughly 80 percent of euro area banking assets.

Prior to the beginning of the ECB's responsibility for the SSM in November 2014, a "comprehensive assessment", or asset quality review (AQR), of the significant banks to be directly supervised by the ECB has been undertaken. During this assessment, the ECB will review in detail the balance sheets of these banks and will run stress tests to see what would happen to the capital base of these banks in case of adverse macroeconomic and market developments.[11] This exercise is supposed to make sure that member states assume the legacy costs of their banking systems and that all banks will be adequately capitalized before the ECB will assume responsibility for them. Hence, this will increase the credibility of the EU's financial system.

10 See European Central Bank, "Banking supervision", available at http://www.ecb.europa.eu/ssm/html/index.en.html.
11 For details on this process, including a list of included institutions, see the ECB's note on this procedure. See European Central Bank, "Note: Comprehensive Assessment", October 2013, Frankfurt, available at http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201310en.pdf.

The Single Resolution Mechanism

In contrast to the SSM, the legislative process on the bank resolution scheme is not yet completely finalised. However, after lengthy negotiations between the European Council, the European Commission, and the European Parliament, compromise drafts have been agreed and are expected to be voted into law by the relevant European institutions through the standard procedure for European legislation over the summer of 2014.[12]

The unified bank resolution scheme known as the Single Resolution Mechanism (SRM) creates a centralised and uniform mechanism on how to deal with banks in difficulties. It builds on the Bank Recovery and Resolution Directive (BRRD), a set of rules that determine when and how national supervisors can wind down or recapitalise banks, known as the Bank Recovery and Resolution Directive (BRRD). However, while the BRRD applies to all credit institutions in the EU, the SRM comprises only eurozone countries and other EU member states that have joined the SSM. The SRM also introduces a common fund covering restructuring costs of banking union members. Because of the complex relationship between the BRRD and the SRM, they need to be analysed together.

Under BRRD rules, shareholders and certain groups of bondholders will in most cases have to accept a writedown on their claims ("bail-in") before public funds can be used ("bailout"). The goal of these common rules is to ensure uniformity in the member states' responses to bank failures and in particular to prevent the protection of bondholders in some countries while others take a hit when a bank fails. However, there is some flexibility in the rules: public funds can be injected into banks at times of "serious disturbance in the economy" or in order to preserve financial stability. At times of (impending) systemic crisis, national governments are allowed to grant "extraordinary public financial support" to banks not yet insolvent, for example in the form of guarantees for new lending or as a precautionary injection of capital.

The BRRD also requires all EU member states to build up national resolution funds amounting to at least 1 percent of insured deposits in 10 years, which will be financed by contributions by the national financial sector and used for resolving national banks in trouble or to contribute to the resolution costs of cross-border institutions. Building on these rules, the SRM creates a centralised resolution mechanism for eurozone countries and other SSM countries. Instead of national resolution funds, countries under the SSM will use a common fund (the Single Resolution Fund – SRF) to resolve troubled banks.[13] The SRF is supposed to reach 1 percent of insured deposits (expected to amount to roughly €55 billion) within eight years. In the meanwhile, the fund will be divided into national compartments for each SRM member which will be gradually mutualised and merged into a common fund.

While an initial proposal had asked for a mutualisation of 10 percent of the fund per year, according to the final political agreement 40 percent of the SRF will be mutualised in the first year, 60 percent in the second year, and this share will subsequently increase by 8 percentage points annually until full mutualisation is reached after eight years. For the transition period, bridge financing for single national compartments from other national compartments or outside sources is possible, but would have to be repaid by the concerned country's contributions. This means that if, during the transition period, banks in one member state need public funds to be rescued despite of the required bail-in, a significant share of the costs would have to be covered by that member state and would have to be recuperated from its own financial institutions.

Even after the eight-year transition period, the burden of financing the fund remains entirely with the financial sector. If contributions already paid in by the financial sector are not sufficient to cover the costs of rescue, the regulation stipulates levying ex-post contributions on the financial sector over a period of three years. While the fund is allowed to borrow from other sources, and member states have promised to develop a common backstop during the transitional period, it is far from clear how such a backstop should look like. In the meanwhile, there is yet no provision for injecting funds from national budgets or the EU budget into the SRM fund. Such injections instead would at the moment have to come on an ad hoc basis.

While the first legislative drafts on banking union included extremely complicated decision-making procedures for a potential bank resolution, these rules now are significantly streamlined.[14] The ECB has the right to initiate the resolution of troubled banks and the SRM executive board can push the ECB to do so. Proposals have to be evaluated by the European Commission and, in some contentious cases, the European Council as well.

Common deposit insurance

The least developed element of the banking union is common deposit insurance. Although the president of the European Commission has proposed such a deposit insurance scheme in 2012, it has not progressed very far. Countries with currently solid financial systems such as Germany did not want to have to pay for potential losses

12 This brief has worked with the draft legislative texts that were available in early May 2014.

13 Unlike the other elements of banking union, the European Council has proposed to construct the SRM partly outside the existing European treaties. Instead of opting for using either Article 114 or Article 352 TFEU for establishing the resolution fund, the Council has opted to negotiate a new multilateral treaty on the resolution fund. The European Parliament criticised this set-up but accepted it in the end.

14 The *Financial Times* has counted up to 100 votes having to be cast before a decision is finally taken and has provided a diagram of the decision-making structures. See Alex Barker and Peter Spiegel, "EU sets out framework for banking union", *Financial Times*, 11 December 2013; Alex Barker, "How to shutter a bank in Europe", *Financial Times*, Brussels Blog, 19 December 2013, available at http://blogs.ft.com/brusselsblog/2013/12/how-to-shutter-a-bank-in-europe/.

in other countries and wanted to protect the idiosyncracies of their national deposit insurance schemes. Instead, a new Deposit Guarantee Scheme Directive include minimum standards on how to set up national deposit insurance systems which are supposed to ensure that deposits up to a level of €100,000 will be protected in any case and at any time in every single EU member state.

Will banking union improve eurozone crisis management?

In order to evaluate the banking union compromise against the short-term goals of crisis management, one needs firstly to understand the reasons for existing problems in the eurozone financial system. Secondly, one needs to ask whether a completely centralised and uniform system for financial oversight, banking resolution, and deposit insurance could in principle solve these underlying problems. Thirdly, one needs to evaluate how far the current compromise will go in solving these problems.

Current problems in the euro area banking system

The first problem facing the eurozone is the way that problems in member states' banking systems threatened the sustainability of public finances. In Ireland and Cyprus, banking sector problems forced the countries to apply for full bailout programmes; Spain was forced to apply for more limited financial assistance for bank restructuring from the ESM. Even in countries such as Ireland and Spain in which public finances were sound, the costs of restructuring pushed sovereign debt levels to unsustainable levels and the market value of government bonds dropped. While this problem has been to a certain extent defused by the fall in sovereign spreads since the summer of 2012, a new round of market panic could set this vicious cycle in motion again. The second problem is the disintegration of financial markets in the euro area. As can be seen from national central banks' data on their national banking systems, cross-border lending in the euro area – in terms of both inter-bank lending and bank lending to corporations and households – has significantly declined since the euro crisis began in 2010. According to a number of studies, banks in some of the periphery countries have problems accessing wholesale finance.[15] This disintegration of financial markets has led to a large cross-country divergence of financing costs: banks in the periphery face higher financing costs than in Germany; the corporate and household sector in the periphery faces even higher costs. As Paul Taylor puts it: "The best managed Spanish or Italian banks or companies have to pay far more for loans, if they can get them, than their worst managed German or Dutch peers."[16] This distorts competition, hinders the periphery's economies from recovering, and endangers the competitiveness of the European economy as a whole.[17]

The key question is what lies behind this persistent (even if declining) difference in financing costs. There are four possible reasons for the way that corporations with nominally similar exposure to business-cycle risks and similarly structured balance sheets seem to be charged different interest rates depending on the country in which they are located. First, the risk of each country leaving the single currency varies. Second, creditors expect to be treated differently depending on how solid public finances are in each country. Third, regulatory ring-fencing by national regulators, especially in core countries, has forced financial institutions to lower their exposure to the periphery, thus depriving banks in the periphery of liquidity and capital. Fourth, information asymmetries could prevent banks from other countries from providing new loans to the corporations and households in question.

A third problem is low credit growth in the periphery, which is linked to the first two problems discussed above but is not entirely a consequence of them. Clearly, higher financing costs in the periphery than in the rest of the eurozone can be expected to lead to lower credit growth. Moreover, if banks are aware of the vicious cycle between their own government's debt and problems in the banking system, and they have observed high volatility in government bond yields and prices, it is rational for them to try to build an additional capital cushion. This would mean that until this cushion is built, banks would further refrain from lending. At the same time, however, weak credit growth in the periphery is probably also due in part to the deep and long recession experienced, which has made companies reluctant to borrow for investment purposes, made households reduce spending, and made the financial sector remain cautious about lending.

What a perfect banking union could do

Could a banking union in principle solve these three problems? The biggest and central issue to tackle is ending the vicious circle between problems in the banking sector, and national public debt as this nexus is also one of the reasons for the disintegration and fragmentation of financial markets in the euro area. The underlying reasons for this vicious circle are the national responsibility for national banking systems and the concentrated holdings of national government bonds by the respective member state's banks. The national responsibility for a nation's banking system has

15 See International Monetary Fund, "Country Report 12/137: Spain: Financial Stability Assessment", June 2012, available at http://www.imf.org/external/pubs/ft/scr/2012/cr12137.pdf.

16 Paul Taylor, "Analysis – Euro zone fragmenting faster than EU can act", Reuters, 9 July 2012, available at http://uk.mobile.reuters.com/article/topNews/idUKBRE86805Q20120709.

17 Sebastian Dullien, "Why the euro crisis threatens the European single market", European Council on Foreign Relations, October 2012, London, available at http://www.ecfr.eu/page/-/ECFR64_EU_CRISIS_MEMO_AW.pdf.

become more of a problem in a monetary union as there are theoretical and empirical indications that a single monetary union for a heterogeneous area with limited labour mobility will lead to much longer and deeper business cycles and potential bubbles in national real estate markets.

As the incidence of non-performing loans (and hence the potential costs for banking restructuring) correlates strongly with deep and long recessions, this emergence of such "super-cycles" also implies an increased risk of banking crisis, which cannot be entirely paid for by national governments. In addition, the integration of financial markets and concentration of financial sector activities which one would expect to happen in a single market (as some countries specialise in financial services) can be expected to lead to the growth of the financial sector of smaller countries until it becomes too large to be bailed out by the respective national government.

This problem can only be solved if one finds a way to clean up (and potentially recapitalise) a national banking system without excessively increasing the concerned member state's public debt. In a banking union, this could be done by shifting the costs of bank restructuring to an institution not fully and directly linked to a single member state's public finances. The obvious solution from an economic point of view (which, however, seems not to be viable politically in the EU) would be to create a European institution that bears the cost of restructuring all banks in the euro area. As in this case, one would need to make sure that no moral hazard occurs in the form that national supervisors neglect oversight, as they do not have to bear potential costs of bank restructuring. Supervision would therefore also need to be shifted to a European level.

There is also a good chance that a centralisation of the responsibility for potential restructuring costs would bring down the divergence of financing costs across countries: A transfer of the risks of national banking system restructuring to the European level would lower the risk of a unilateral exit from the eurozone. First, it would remove the risk that problems in a national banking system push a country into the situation where it has to apply for an ESM/IMF loan. Second, it would provide extra benefits from membership in EMU which might shift the balance of arguments for and against leaving the euro from the point of view of the national government and the national electorate in favour of staying in the currency union. Thus, it would also help to mitigate the second problem of disintegration of financial markets in the euro area.

Another element which is crucial for reinstating a level playing field for banks is the application of uniform rules for bank resolution so that bank creditors can expect to be treated the same all over the euro area. This would help equalise the financing costs for banks and hence bring down financing costs for non-financial corporations in the periphery. This argument is not only valid for the rules for winding down single banks, but also for the question of how to deal with systemic crises (for which the BRRD has an exception clause). In order to bring financing costs of banks in different countries closer in line with each other, investors need to be able to expect that even in cases of a national systemic banking crisis, they would be treated similarly across countries.

From an economic point of view, this conclusion would also call for a centralised approach and a centralised source of funding for dealing with a systemic banking crisis. As long as national governments ultimately have to pay for the resolution and restructuring of their respective financial system, the current situation of their national finances will influence the way they deal with banks in difficulties. A country with more fiscal leeway will be able to bailout the whole banking system, while a country with a high public-debt-to-GDP ratio will not be and hence will be more inclined to put a larger burden on bank creditors.

One needs to make clear here, however, that a centralised fund that is able to deal with a systemic banking crisis not only at a national level but potentially also on a eurozone level would need to be very large or at least have access to large sums of funds in order to defuse fears of insufficient funds in times of panic. The US Troubled Asset Relief Program (TARP), which is widely credited with bringing the turnaround in the US banking crisis of 2008, had an initial volume of $700 billion; the German bank rescue package of 2008 had a volume of €500 billion. While certainly better regulation might reduce the capital needs in times of crisis, a European fund (dealing with a banking system significantly which, measured by its total assets, is much larger than the one in the US or Germany) would need to have access to similar magnitudes of funding in order to deal with a serious continent-wide banking crisis.

The large size of a potential resolution fund is important so that there cannot be any doubt that banks getting into trouble later in a crisis will be treated differently from banks prior rescued due to financial constraints of the resolution authority. If such doubts existed, bank creditors would have an incentive to cut their lending to banks as soon as crisis indications emerge, causing a process very similar to that described in basic economic models of bank runs.[18] As the problem of low credit growth in the eurozone periphery seems at least partly linked to the differences in financing costs between core and periphery in the euro area, this centralised restructuring set-up could be expected to also help alleviate credit contraction in the periphery.

Having such a centralised mechanism for supervising banks and dealing with bank failures in place would also help reverse the disintegration of financial markets in the euro area in two other ways. First, it would help restore confidence in the banks: since a centralised regulator would have funds available to wind down insolvent banks, there

18 Douglas W. Diamond and Philip H. Dybvig, "Bank Runs, Deposit Insurance, and Liquidity", the *Journal of Political Economy*, 91 (3), June 1983, pp. 401–419.

would be much less suspicion about regulatory forbearance. This increase in trust would especially help banks that have a fundamentally sound balance sheet but are located in a member state with precarious public finances. Second, it completely solves the problem of regulatory ring-fencing. Here, it is clear that today national supervisors responsible for a national financial system neglect the negative externalities their narrow focus causes in other countries. If these decisions are moved to a supranational supervision agency, it can be expected that this agency takes these negative effects on other countries into account.

Since these elements together would recreate a level playing field for banks and financial services, they would also lay the necessary conditions for a return to credit expansion in the euro-periphery and hence contribute to the third problem, the low credit growth in the crisis countries. Thus one can clearly see how a perfect banking union would be able to solve the problems of the financial sector and hence deliver on the goals policymakers have defined.

However, this analysis suggests that a common deposit insurance, as envisioned as part of banking union, is not really necessary to fulfil the objectives. If a transfer of potential restructuring costs is provided and common rules for bail-in including non-insured deposits are established, national deposit insurances with common standards would be sufficient. It would then be clear that retail deposits are protected from any bail-in. Depositors could expect equal treatment no matter in which country the bank in which they hold their deposits is located. Thus there would be no reason any more for asking for differentiated risk premiums on deposits.

The current set-up: inadequate for a systemic crisis

So how far does the current set-up go towards solving these problems? There are some reasons for optimism that the ECB's responsibility for banking supervision will improve confidence in the financial system. There was some scepticism about the transition to the SSM and in particular about the way the assessment of the banks' balance sheets would be conducted.[19] But the ECB clearly has an interest in solving the problems of all the banks it will take over supervision for before the transition to the SSM in autumn 2014. The professional conduct of the AQR has led to a shift in market sentiment from scepticism towards increased trust. As a result, a number of banks have successfully raised capital in recent months as confidence in the eurozone's financial system has increased.[20] This has the potential to contribute to levelling the playing field between banks in different member states again. Regulatory ring-fencing may also now be a problem of the past.

However, the picture is less positive for the SRM, which falls short of the theoretical requirements of a framework that could solve the problems in the European financial sector. In particular, because of the size of the SRM fund and the lack of a fiscal backstop, the current compromise does not break the toxic link between public funds and the banking system. In a systemic banking crisis, financial institutions are unlikely to have sufficient capital left to finance a levy to fund a bank restructuring. A levy large enough to recoup these costs would mean that any investment in the banking sector basically becomes less attractive. Since investors would anticipate this problem and become more reluctant to provide a troubled banking system with fresh capital, more public capital would be needed to resume lending and to help the economy overcome a recession, which usually goes hand in hand with a banking crisis.

This problem would be most acute during the transition phase towards the common SRM fund. The principle that resolution funds are separated (through "national compartments") and that each country is hence mostly responsible for cleaning up its own banking system could be problematic. A banking crisis which would deplete most of a single country's banks' capital and which is solved through the SRM mechanism would mean that the country concerned would need to ask its financial institutions for new ex-post contributions, weakening this nation's surviving banks further and putting an additional wedge between their cost of doing business and other eurozone countries' banks operating costs. This would result in the exact opposite of reinstating a level playing field in the single market for banking and financial services.

However, the basic problem would remain even after the fund has been built up fully. Under the BRRD, it would be possible for member states to inject further public funds in a systemic crisis. But this would only reinforce the existing link between problems in the banking sector and the sustainability of member states' public debt. Moreover, as there are only vague rules on how and when to inject these additional government funds, it can be expected that member states with sound public finances will be more generous in their bank bailouts than those with precarious fiscal situations ("the poor bail in while the rich bail out"). As investors can be expected to realise this difference, it banks in countries with weak public finances are likely to continue to have to pay higher interest rates for their wholesale finance, jeopardising the aim of recreating a level playing field.

The hope is that the new oversight structure together with tightened capital requirements under the Capital Requirements Directive IV and Basel III will firstly make systemic crises very unlikely in the future and secondly limit bailout funds necessary in case public support becomes necessary. But history tells us that tightening the supervisory structure does not prevent crises for ever. There is also a danger that a large bail-in in a large, closed economy such as the eurozone, in which banks often lend to other

19 See, for example, Silvia Merler and Guntram B. Wolff, "Ending uncertainty: recapitalisation under European Central Bank supervision", Bruegel, 17 December 2013, available at http://www.bruegel.org/publications/publication-detail/publication/806-ending-uncertainty-recapitalisation-under-european-central-bank-supervision/.
20 See Véron, "European Banking Union".

banks, could exacerbate a crisis. A large-scale bail-in might hit confidence as the economy is sharply contracting and lead to a surge in non-performing loans and hence to more problems in the banking system.[21] Finally, member states that could afford to recapitalise their financial institutions beyond the regulatory minimum could have an incentive to do so in order to promote economic growth.

The other hope is that the European Commission's state-aid rules will limit differentiated treatment of banks in different member states. Again, while it might be true that this provision might be a safeguard against the worst excesses of protecting a national champion in the banking sector in normal times, history suggests that it will not be sufficient in a crisis. Even the tightened rules of the European Commission allow for exceptions to the bail-in principles when measures "would endanger financial stability".

Thus, while the SRM fund might be adequate to deal with a banking crisis should only a few dozen billions of euros be needed, it would be inadequate to deal with a systemic banking crisis at either the euro area level or in one of the larger member states.

The banking union compromise and long-term stability of the banking system

Beyond these pressing questions about whether banking union can help to defuse the current economic crisis in the euro area looms another question: To what extent will this new set-up be able to achieve the medium- and long-term goals of preventing future banking crises and protecting taxpayers' money?

Preventing new banking crises

Prior to the global economic and financial crisis of 2008–9, the problem in the EU (and the eurozone) was that national regulators applied supposedly similar rules to banks in different jurisdictions in widely different ways. With hindsight it seems that some smaller countries neglected oversight in order to attract business from other euro area countries. This resulted not only in regulatory arbitrage, which sometimes caused costs to the taxpayer in other countries (such as the case of the Dublin-based subsidiary of the German HRE bank, Depfa, which amassed huge losses that ultimately resulted in the nationalisation of HRE), but also in excessive lending in some parts of the periphery that led to real estate bubbles in some countries.

In theory, the SSM might solve this problem. A single institution supervising all banks may be expected to apply the rules in a more uniform way. A centralised supervision authority would have less interest in either creating competitive advantages for individual national banking systems or showing regulatory forbearance in case of emerging new problems in a country's banking system. However, it remains to be seen how well the SSM will really work in the long run. In particular, it is not clear whether the ECB will be able to detect systemic problems in national banking systems that stem not from "significant" credit institutions directly supervised by the ECB but rather from smaller institutions under the auspices of national banking authorities. "Insignificant" institutions can collectively create significant macroeconomic and banking system problems – for example, a real estate bubble.

Protecting taxpayers' money

In order to protect taxpayers' money in the future, the banking union should aim to prevent future excesses in the euro area banking system and to prevent public money being given overly generously to bailout bank shareholders or creditors. The ability of the new SSM to prevent future excesses in the banking systems of the euro area is subject to the issues discussed above. The new rules on mandatory bail-in seem at first sight a safeguard against taxpayers having to pay for banks' misbehaviour. After all, according to strict bail-in rules, bondholders and uninsured depositors would have to come up with some contribution in the case of bank defaults before public funds can be used.

However, even if a stricter bail-in regime lowers the probability of direct injection of public funds into ailing banks, it is open to debate whether this will really save taxpayers' money. In most banking crises, the indirect effect of the crisis on GDP growth and tax revenue is much larger than the direct cost of bank recapitalisation. Introducing bail-in rules could have a measurable detrimental effect on economic growth and might actually even amplify the divergence in financing costs in the euro area. Bailing-in can be expected to make finance through instruments that are themselves subject to being bailed in more expensive. Introducing this at a time of very different cyclical and euro-exit risks between eurozone countries can be expected to increase these costs disproportionately in countries with already weak banking systems. Thus the danger is that, by protecting taxpayers' money, a crisis can in the end become more expensive.

Half-full or half-empty?

Looking at all these details, one can ask whether the glass is now half-full or half-empty. Clearly, banking union improves the situation in some significant ways. Perhaps most importantly, shifting responsibility for supervision from national supervisors to a truly European one may improve confidence in the financial system. Together with the AQR, this will disperse doubts about the solvency and capital position of some financial institutions. The new

21 Thus, because of these macroeconomic feedback loops, even if one finds out that the new capital rules and provisions of the BRRD would have made capital injections unnecessary for most of the banks recapitalised in the past crisis, one should be careful to draw conclusions for the future in a world of required large-scale bail-ins.

structure can be expected to end regulatory ring-fencing by national regulators. There will now be clear rules about what will happen if a couple of medium-sized (or even a large) banks get into trouble and have to be wound down. After a transition period, the costs of such rescues will be borne by a European fund rather than by member state governments. To a certain extent, this will level the playing field in European banking markets.

These points alone cannot be overstated. The banking union compromise that has been reached will lower financing costs for Europe's financial sector and hence make it more competitive globally. This will enable European banks to provide European businesses with credit and other financial services more effectively and hence can be expected to make a contribution to the recovery of the European economy. In addition, together with the increased capital requirements, the new supervisory structure should make banking crises less likely in the future, even if it will not completely prevent them. Even if public funds might still be needed to solve a systemic banking crisis, this is a huge step forward in protecting taxpayers' money – especially as, in the past, the indirect costs of banking crises due to lost output and tax revenue often have been much higher than direct costs of bailing out banks.[22]

However, the new framework clearly is not designed to deal with systemic crises – whether a systemic crisis in one of the larger member states or a systemic crisis in the euro area as a whole. The funds available are simply not sufficient and there is no clearly defined fiscal backstop. This may not be a problem in the near future. With the eurozone economy recovering, non-performing loans can be expected to drop and the balance sheets of banks in the periphery can be expected to improve. With more robust balance sheets, the difference in financing costs might further fall to a point where it is barely recognisable. But if the recovery falters, this virtuous circle could become a vicious circle again. This gap in the banking union's architecture also risks perpetuating the differences in financing conditions between core and periphery countries, which will further delay a return to pre-2008 output and employment levels in the crisis countries.

Thus banking union is a big step forward – it is clearly much better than having no banking union at all. But it clearly needs some more adjustments before it really can deliver all that it has promised. Given this evaluation, and given how far the legislative process has progressed, it would not be advisable to block the banking union. But to make it more effective and to lower the risk of the eurozone spiralling back into crisis, some improvements should be made during the five-year term of the European Commission. In particular, the eurozone should:

Shift responsibility for extraordinary public financial support to the European level

The difference in investors' risk assessment of banks in the core and in the periphery will not completely disappear as long as one can expect banks in the core be treated differently in times of crisis than those in the periphery. The current clause on the application of "extraordinary public financial support" will guarantee that there is a risk of differentiated treatment. However, getting rid of this possibility altogether, as demanded by some members of the European Parliament, is not a solution either. In a systemic crisis, it is not reasonable to expect the banking system to survive without public support.

An economically sound solution would be to endow the European level with the sole ability to grant extraordinary public financial support. This power could be given to the European institutions on the basis of the regular legislative process, so that the European Commission would initiate and the European Council and European Parliament would have to agree and the ECB could be heard. There would also have to be clear standards on when and how support can be given. This would be a large step towards recreating a level playing field in the eurozone. The discussion could be linked to the review clause in article 32 of the current version of the BRRD, which asked the European Commission to review the need for the clause on extraordinary public financial report by the end of December 2015.

Link the fiscal backstop to the European Stability Mechanism and the discussion of fiscal capacity

However, shifting the responsibility for extraordinary public financial support to the European level would not solve the issue of insufficient funding of the ERM fund. In fact, having the power to decide on extraordinary support would create the need for access to even larger funds. As discussed above, if the fund is supposed to deal with systemic crises in the banking system, it also would need to have access to funds independent from the contributions of the financial sector.

One possibility here would be to allow the ERM fund to borrow from the ESM under preferential conditions. This would be especially important in times of systemic crisis when the long-term solvency of the ERM is called into question, because most banking system capital is wiped out and private investors are unwilling to bet on the ERM fund being able to recoup costs for bank restructuring through ex-post contributions from the financial sector. Another possibility would be to link the ERM fund to the debate on the euro area's fiscal capacity, which is due to be back on the agenda in the autumn of 2014. If the discussion of the euro area's fiscal capacity leads to a discussion of specific taxes for the euro area, one could try to construct a fiscal backstop for the ERM from these revenues.

22 On the costs for the German economy, see Sebastian Dullien and Christiane von Hardenberg, *Der Staat bezahlt die Krisenzeche*, WISO-Diskurs, Friedrich-Ebert-Stiftung, Bonn, 2011..

Make sure the economic recovery is not derailed

Given that the banking union is incomplete and leaves the euro area vulnerable to a relapse into the vicious circle of deteriorating confidence in a single country, rising financing costs for its banking sector, and hence a relapse into recession, it is important to prevent any downside risks to the recovery until the banking system has strengthened its balance sheets and the necessary additions to the banking union architecture have been made. For macroeconomic policymaking, this means that one should err on the side of caution. For the ECB, this means doing everything in its power to prevent deflation, which always creates a heavy burden on the financial sector. For fiscal policy, this means that all the leeway in giving the crisis countries time to reach their deficit goals should be used to prevent abrupt fiscal shocks.

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Acknowledgements

This brief was supported by a grant by Santander to ECFR. We are grateful to Alejandra Kindelán, José María Robles Fraga, Antonio García del Riego, Lara de Mesa and Antonio Cortina for their continuous support and for having given us complete intellectual freedom to work on the topic. The views expressed in this brief are those of its author and in no way compromise or prejudge Santander's position on any policy or legal issue.

We would like to thank those who shared their views with us during our research, including officials from the European Commission, the European Central Bank, the European Parliament, representatives of EU member states, representatives of national financial supervisory bodies and private sector specialists. Special thanks go to the participants of two valuable workshops in Madrid and Berlin on an earlier paper on banking union who provided very valuable insights. In the context of these workshops, we also would like to thank Spain's Instituto de Crédito Oficial (ICO) for hosting our meeting in Madrid and especially Román Escolano and Mónica de Linos for facilitating this invitation. For the meeting in Berlin, we would like to thank Stiftung Mercator for hosting us in their project centre. Special thanks also go to the Spanish Ambassador to Germany, Pablo García-Berdoy, for inviting us to organise a joint dinner debate at the Embassy.

Within ECFR, thanks go to José Ignacio Torreblanca, who was involved in securing this project from inception to completion and has provided invaluable guidance to the project. Last but not least, our editor, Hans Kundnani deserves thanks for making sure the ideas in this paper are now (hopefully) intelligible to a non-technical readership.

In addition to those supporters mentioned above, we would like to thank Steven Heinz, Stiftung Mercator and Zennström Philanthropies for their support of the ECFR Reinvention of Europe Programme.

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ISBN: 978-1-910118-07-8

Published by the European Council on Foreign Relations (ECFR), 35 Old Queen Street, London, SW1H 9JA, United Kingdom

london@ecfr.eu

Design by David Carroll & Co davidcarrollandco.com