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Banking Union: Who Should Take Charge?

4.1 Introduction

Despite considerable scepticism and some opposition, a European Union (EU) scheme for a banking union for the euro area is taking shape. An EU Regulation for the Single Supervisory Mechanism (SSM) came into force in November 2013. In November 2014 the European Central Bank (ECB) will take over supervision of the 130 largest and systemically most important financial institutions in the euro area (see European Union, 2013a). Prior to November 2014 the ECB will carry out an assessment of the balance sheets of those institutions, with the intention of identifying and remedying existing problems: the so-called legacy issues.

It is generally agreed that there are four essential components of a banking union: a single supervisor, a single regulator, a single resolution mechanism, and a common system of deposit insurance. The schemes for the supervisor and regulator have now been agreed upon and passed into law. The European Commission put forward a proposal for a single resolution mechanism in July 2013. This proposal was discussed at meetings between the Commission and ECOFIN in December 2013. An agreement based on it is close and is likely to pass into law early in 2014 after negotiations with the European Parliament, despite several remaining points of contention between the Commission and ECB on the one hand, and various member states, notably Germany, on the other.

There is no common euro area system of deposit insurance as yet, but national schemes protect deposits of up to 100,000 euros. Changes were agreed in December 2013 intended to make these national schemes more similar and more robust.[1]

[1] The proposed modified directive requires the banks in each member state to pay into a fund that will hold 0.8 percent of covered deposits. This funded scheme replaces a variety of poorly funded or unfunded schemes. Bank funding replaces taxpayer funding or ex-post funding from the banking industry, and the time taken to receive payments from the scheme will be gradually reduced from 20 to 7 days. (European Commission, “Commissioner Barnier Welcomes Agreement between the European Parliament and Member States on Deposit Guarantee Schemes,” MEMO 13/1176, Brussels, 17 December 2013, http://europa.eu/rapid/press-release_MEMO-13-1176_en.htm.)

The push for a banking union actually revives an old idea that was not put into practice. In the original version of a plan for a central bank that would run a monetary union, the central bank had overall supervisory and regulatory powers. That demand met strong resistance, above all from the German Bundesbank, which worried that a role in maintaining financial stability might undermine the future central bank’s ability to focus on price stability as the primary goal of monetary policy. There was also bureaucratic resistance from existing regulators. In 1990, Jacques Delors noted that the European Commission approached the question of banking supervision with an “open mind,” and that the European System of Central Banks should simply “participate in the coordination of national policies, but would not have a monopoly on those policies.”[2] In October 1990, when the alternates (deputies) to the European central bank governors discussed the draft articles for the central bank statute, Bundesbank Vice-President Hans Tietmeyer restated the sceptical position of his institution, which worried consistently about the moral hazard implications of central bank involvement in supervision. If the central bank took on the responsibility of regulating, it would also deliver an implicit commitment to rescue banks should there be any bad developments that it had overlooked. Tietmeyer provided a neat encapsulation of the German philosophy of regulation:

> “This did not mean from the view of the Board of the Deutsche Bundesbank that the ECB should not support the stability of the financial system, but that it should never be written down; this would be moral hazard.”[3]

The ECB was thus not given overall supervisory and regulatory powers, and until the outbreak of the financial crisis in 2007/2008 this was not thought to be a problem (James, 2012).

4.2 Why the push for a banking union?

A banking union represents an unusually ambitious institutional change, shifting the responsibility for

[2] Committee of Governors, meeting 243, Basel, 13 March 1990.
[3] Committee of Governors, alternates meeting, 16 October 1990.

bank supervision and regulation to a central euro area institution, the ECB, and setting up a centralised fund for bank resolution. The arguments for it include:

- Fiscally weak governments and fragile banking systems have become too closely connected.
- Many banks operate across national boundaries within the euro area. For these banks, regulation and supervision is better done by one supervisor; resolution of such banks is cleaner and more quickly done by a single euro area authority than by national authorities attempting to coordinate with each other.
- National regulators have become too close to the banks they regulate, too susceptible to political pressure, too prone to delay intervention and have incentives to offload costs onto the euro area as a whole. Centralised supervision will be better supervision.
- There are euro area-wide spillovers from a bank failure in a member state; even small banks can have systemic effects.
- It is efficient to pool resources to provide insurance for the costs of bank failure, rather than having individual members states pay for failures that occur in each jurisdiction. Pooling resources addresses the problem of institutions that are "too big to fail" to some extent.
- If the ECB is to act as lender of last resort to euro area banks, it needs information on their solvency, the authority to supervise them, control and the ability to resolve failing institutions.

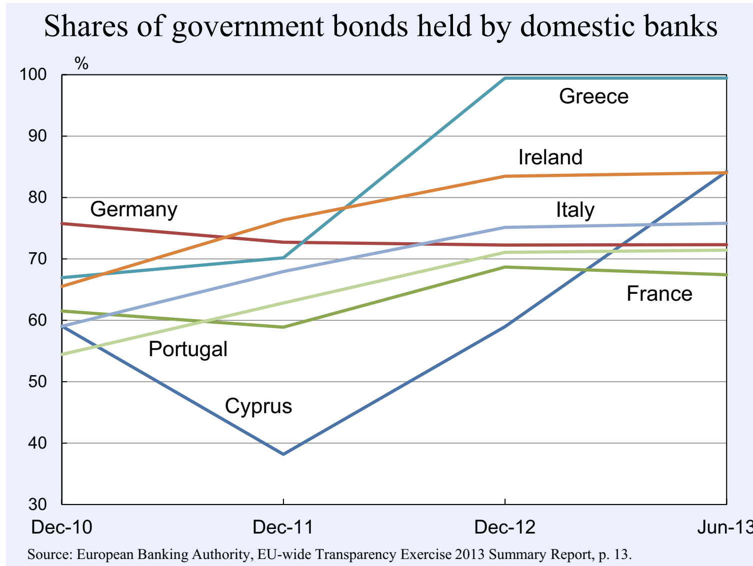
The principal arguments against a banking union are that:

- It is effectively not an insurance scheme, but an ex-post mutualisation of write-off losses of banks resulting from funding near bankrupt states and dubious real-estate projects in southern Europe and Ireland; while it is officially argued that the banking union will exclude the socialisation of write-off losses on legacy assets, such a socialisation may, in fact, have been the true reason why policymakers have recently pressed so urgently for the banking union.
- It places too much power and responsibility in the hands of the ECB, which itself is the largest creditor of the endangered banks. Having contented itself with below-investment grade collateral, the ECB will therefore seek resolution methods that shift the burden of write-off losses onto the taxpayers of the still-solvent states of the euro area.
- As the banking union promises even more mutualisation of bank debt in the future, it will artificially dampen interest spreads below differences in bankruptcy risks and encourage zombie banks to buy even more government bonds and zombie governments to unload even more debt on their local banking sectors, as both know that they can shift their problems onto other shoulders if necessary. This will further strengthen the problematic link between banks and their sovereigns.
- As the ECB is a technocratic institution that gives small and large countries the same weight in the ECB Council, it is likely to come up with biased resolution decisions, which necessarily imply a fiscal redistribution of wealth between the countries of the euro area that, if anything, would have been a genuine task of parliaments.

The argument that weak sovereigns and fragile banking systems have become too closely connected has been made repeatedly and evidence for it has accumulated since 2010. In cases where member states have bailed out their banking systems, the ensuing increase in their national debt has worsened or totally destabilised public finances. Ireland is a prime example: When it bailed out its banks in 2009 and 2010 national debt rose from 44.2 percent of national income at the end of 2008 to 91.2 percent at the end of 2010. Bank failures and publicly-funded recapitalisations have also worsened the public debt problems of Greece. The public finances of Cyprus were overwhelmed by the costs of re-organising and recapitalising its banks in 2012. Meanwhile, the government of Spain is refusing to accept EU funds to recapitalise the banking system unless this can be done in such a way as not to affect the national debt.

Conversely, in member states whose sovereign bond yields have soared to great heights in the financial markets, commercial banks increasingly invested their funds in local government bonds during the crisis. As Figure 4.1 shows, the bank-held government bonds of the crisis countries were not primarily held in internationally diversified portfolios, but as a sample of the world's largest 64 banks shows, they were concentrated in the portfolios of the respective national banks and remained concentrated there to an even greater degree when the crisis struck. Greek government bonds, which like the government bonds of Portugal and Ireland have been given non-investment grades by the rating agencies, are practically no longer held by banks outside Greece nowadays.

Figure 4.1



Source: European Banking Authority, EU-wide Transparency Exercise 2013 Summary Report, p. 13.

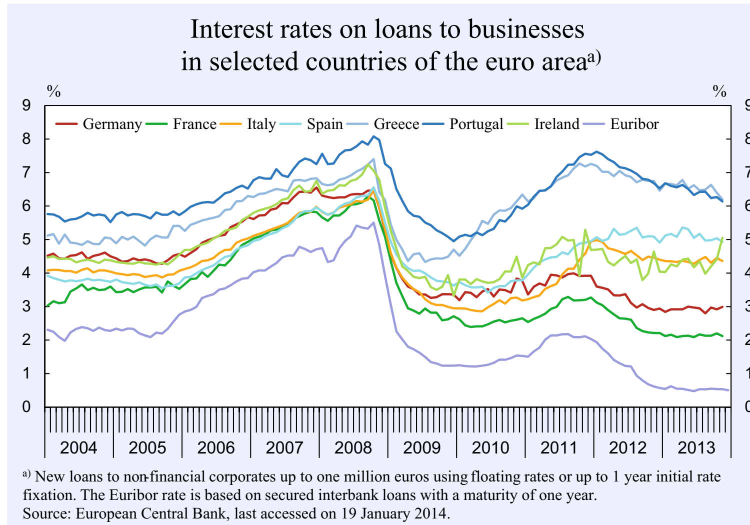
However, the problematic kind of symbiosis between banks and sovereigns goes further than is commonly reported. While sovereigns bail out the banks, and banks hold government bonds in exchange, the banks then typically use these government bonds as collateral when borrowing the funds they need for buying the government bonds from their national central banks. Thus, in fact, there is not only a bilateral link between banks and their sovereigns, but also a link between both of them and the respective national central banks, which are state-owned institutions. Due to the sharing of income from monetary operations, the potential write-off losses from lending to insolvent banks are, however, socialised among the participating central banks of the Eurosystem, and hence among the national governments entitled to collect the national central banks' profit distributions.

Despite this socialisation, the direct link between the banks and their own sovereigns has implied that the cost of borrowing faced by households and firms has risen in line with the interest on state bonds. This has led to higher borrowing costs for the private economy in the periphery than in the core, further deepening the recession there. The ECB has interpreted this phenomenon as an indication that its monetary policy is not transmitted effectively to the member states and used this failure as an argument to further expand the socialisation of risk by reducing the collateral requirements for its refinancing credit below investment grade. This, in turn, led to the huge TARGET2 imbalances that peaked at one trillion euros in summer 2012 (compare Sinn, 2014).

The linkages between the perceived financial robustness of governments and the borrowing costs of banks in the same country are illustrated by differences in interest rates on loans to businesses across the euro area in Figure 4.2. Before the crisis, in 2007, the gap between the highest rates (Portugal) and the lowest (France) was around 2 percentage points. In 2013 this gap was around 4.5 percentage points, with Greece and Portugal having the highest rates, while France remained the lowest. This data does not convey the full extent of the differences in credit conditions between euro area members, because it does not reveal the differences in the availability of loans, or the conditions under which loans were granted to businesses (as shown by the strength of their "business case" for the loan, for example).

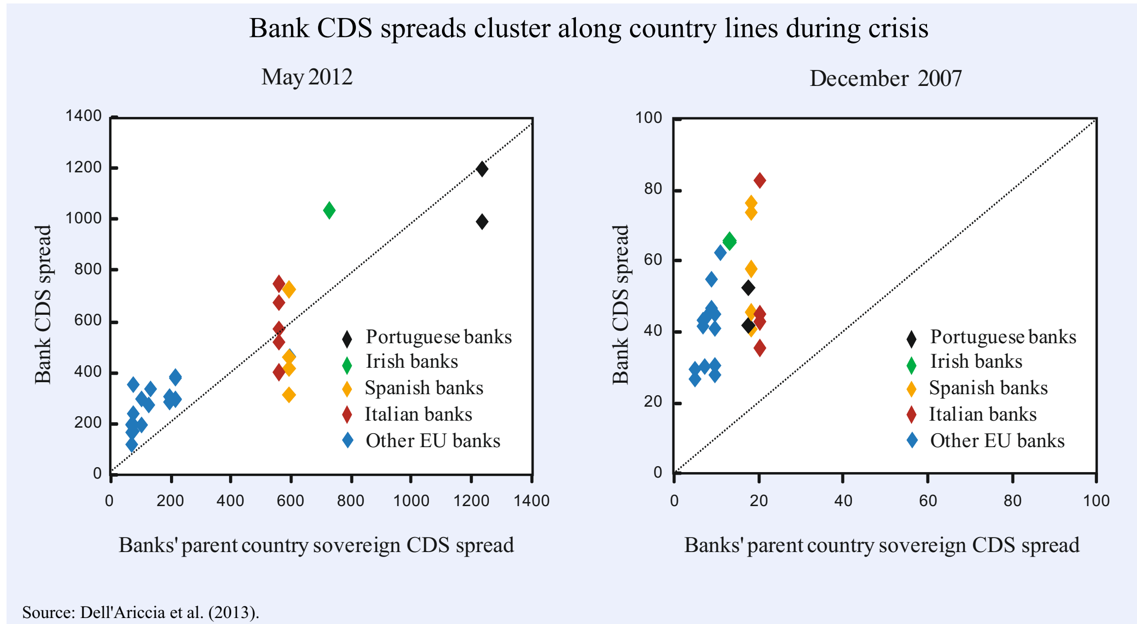
The same message is conveyed by data on credit default swaps (CDS), where there is a striking similarity between government CDS spreads and banks' CDS spreads. Some data are provided in Figure 4.3. In May 2012, CDS spreads on Spanish and Italian govern-

Figure 4.2



[a] New loans to non-financial corporates up to one million euros using floating rates or up to 1 year initial rate fixation. The Euribor rate is based on secured interbank loans with a maturity of one year.
Source: European Central Bank, last accessed on 19 January 2014.

Figure 4.3



Source: Dell'Ariccia et al. (2013).

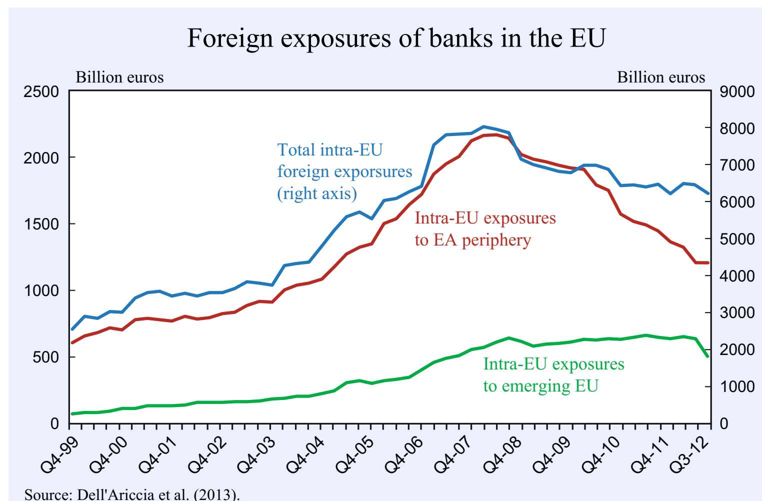
ments were just under 6 percent, and the CDS spread on banks in those two countries ranged between 4 percent and 8 percent, for Ireland the figures are 7 percent for government and 10 percent for banks, and for Portugal about 13 percent for government and 10–12 percent for banks. For Greece the figures were much higher. For other euro area countries (not facing public debt problems) the sovereign spreads were below 2 percent and the bank spreads below 4 percent. This contrasts with the pre-crisis situation in December 2007 when sovereign CDS spreads were low – all less than 0.2 percent – and the banks' spreads ranged from 0.25 percent to 0.85 percent.

More detailed analysis of the effects of the financial crisis on the costs and availability of funding for euro area banks is provided by van Rixtel and Gasperini (2013). Their data and analysis reinforce the message summarised here, namely that the gap between the highest and lowest costs of funds for banks across euro area states, and similar gaps in the costs of borrowing for their customers, have widened substantially since the financial crisis.

The variations in funding costs for banks, households and small firms across the euro area reflect the tendency of markets to differentiate between borrowers by their repayment probabilities, reversing the initial period of reckless lending and borrowing in neglect of the bankruptcy risks. It is revealed by the fall in cross-border exposure of banks in the EU since 2008 (see Figure 4.4). There has been a bigger percentage fall in intra-EU exposure to euro area periphery countries than in overall foreign exposures or exposure to emerging-EU countries.

Many commentators have remarked on the trend towards fragmentation in the euro area's financial markets. The *Financial Times* has argued that debt deleveraging will continue to hamper the euro area's recovery, as will its financial "Balkanisation," or the retreat of banks behind national borders, with large differences in interest rates paid by households and compa-

Figure 4.4



Source: Dell'Ariccia et al. (2013).

nies in various member states.[4] The euro area, says the *Financial Times*, remains a story of the "periphery" versus the "core." ECB president Mario Draghi was quoted as saying that:

> "Fragmentation is basically a little better than it was four months ago, but rather than observing dramatic improvements month by month, we are observing, by and large, a static situation."

The view of the European Commission is that:

> "Swift progress towards a banking union is indispensable to ensure financial stability and growth in the euro area and in the whole internal market. It is a crucial step to overcome the current financial fragmentation and uncertainty, to ease funding conditions for vulnerable sovereigns and banks and break the link between the two, and to re-launch cross-border banking activity in the internal market to the benefit of both euro area and non-euro area member states. Building on the regulatory framework common to the 28 members of the internal market (single rulebook), the European Commission has therefore taken an inclusive approach and proposed a roadmap for the banking union with different instruments and steps, potentially open to all Member States but in any case including the 18 currently within the euro area." (European Commission, 2013)

Failures of cross-border banks and their resolution have highlighted the weaknesses of handling these issues at national level, when it is necessary to coordinate the actions of separate national regulatory authorities and find agreement on the distribution of the costs of resolution.

4.2.1 Complex and cross-border bank resolutions

The serial bailouts of Dexia provide an example of the problems for the authorities created by cross-border banks, the weakness of stress tests, and the difficulties of unravelling the complexities of the balance sheets of such institutions. Dexia, once the world's largest lender to municipalities, has been bailed out three times, in 2008, 2011, and 2012. In 2008, it had a balance sheet of 650 billion euros, including 125 billion euros in exposure to the United States sub-prime property market. To bolster Dexia's balance sheet, Belgium, France and Luxemburg injected 6.4 billion euros of capital. Further euro area debt problems led the same three countries to rescue Dexia again in 2011 with guarantees of 90 billion euros, following difficult negotiations between France and Belgium over the share that each would provide.[5] Despite its exposures to Greece, Portugal, and other governments, Dexia passed stress tests in July 2011 with flying colours. Its Tier 1 capital ratio was 10.3 percent, whereas the required ratio at that time was 6 percent. In November 2012, however, France and Belgium added 5.5 billion euros of additional capital. At the end of 2012 Dexia still had substantial exposures to various governments: France 8 billion euros, Italy 38.4 billion euros, Spain 24 billion euros, and the United States and Canada 35 billion euros. By July 2013, France had lost 6.6 billion euros on the Dexia bailouts (according to the *Financial Times*). It appears that in 2008, Dexia had reclassified 100 billion euros of trading assets as loans so that it did not have to mark them to market, hoping to hold them to maturity and avoid losses, meanwhile increasing the apparent strength of its balance sheet. But this did not occur. A 2013 report by the Cour des Comptes, the national auditor of France, is highly critical of Dexia's supervisors, firstly for their failure to anticipate the risks that Dexia faced, and subsequently for their failure to address the problems they found.[6]

The bailout of Fortis, which operated in Belgium, the Netherlands, and Luxemburg, is another example of the problems of cross-border resolutions.[7] Fortis emerged as an enormous banking, investment management and insurance conglomerate following a spate of mergers and acquisitions in the 1990s and 2000s, with a share value of 46 billion euros in 2006 according to *Forbes Magazine*. It was undermined by the costs of acquiring part of ABN-AMRO Bank in 2007. The Benelux countries put in 11.2 billion euros of capital and substantially nationalised the bank. Later, amid acrimonious disputes among shareholders and the governments involved, the bank was broken up and various parts of it were sold off.[8]

[4] R. Atkins (2013), "Eurozone: 'Balkanisation' Remains a Serious Concern for Currency Bloc," *Financial Times*, 20 November, http://www.ft.com/intl/cms/s/0/526bcafe-47a1-11e3-9398-00144feabdc0.html#axzz2r8K9YOR2.

[5] S. Neville (2012), "Belgium and France Take Control of Dexia," *The Guardian*, 8 November, http://www.theguardian.com/business/2012/nov/08/france-belgium-dexia.

[6] H. Carnegy (2013), "France's Losses on Dexia Bailout Hit €6.6 billion," *Financial Times,* 18 July, http://www.ft.com/cms/s/0/ff693d70-efb5-11e2-8229-00144feabdc0.html#axzz2oCYnJfYC.

[7] N. Tait (2010), "IMF Seeks Bank Crisis Agency," *Financial Times*, 20 March, http://www.ft.com/cms/s/0/7b3bf52e-33c0-11df-8b99-00144feabdc0.html#axzz2oCYnJfYC.

[8] A long and thoroughly referenced article in *Wikipedia* provides intricate detail of these disputes, http://en.wikipedia.org/wiki/Fortis_%28finance%29,accessed on 22 December 2013.

4.2.2 Lessons from the Spanish experience

The experience of Spain with the failure and recapitalisation of several savings banks – the Cajas – in 2012 illustrates the problems of having regulators who are too close to the institutions they regulate. Political pressures discouraged the Banco de Espana from acting more promptly; and the problem had grown much worse by the time it eventually did take action (Wyplosz, 2012).

The Spanish banking group Bankia collapsed in May 2012, by which time Spain was not able to borrow from the markets, forcing it to seek European help. Had the problems emerged sooner, when Spain had a low debt to GDP ratio, it would not have been necessary to resort to outside help. "The three most problematic Cajas (Bankia, CatalunyaCaixa and Novagalicia) had capital deficits (to be covered partly or fully by the taxpayer) of 54 billion euros – over 5 percent of Spanish GDP[...]" (Garicano, 2012). An external report by management consultants Oliver Wyman showed that the Cajas covered up losses through 2008, 2009, and 2010. A succession of failures starting in March 2009 revealed bigger losses than had been reported. Nevertheless, the Banco de Espana did not investigate the whole savings bank system. Garicano (2012) proposes four explanations: (i) Regulators do not like to expose their own previous errors; (ii) Dynamic provisions, while good for dampening cyclical fluctuations, enabled the losses to be concealed for longer, and the provisions were not actually big enough, amounting to only 3 percent of GDP at the height in 2004; (iii) Spain did not have an appropriate resolution framework until summer 2012; (iv), the main reason in Garicano's view, is the political control of the cajas: "[...] the supervisor, confronted with powerful and well-connected ex-politicians, decided to look the other way in the face of obvious building trouble."

The experience of the Spanish banks and Dexia shows that regulatory agencies tend to be close to bank interests and often do not operate in line with taxpayers' best interests. When banks have branches in various countries they need to be supervised by an international agency that operates under strict democratic control to protect the electorate against write-off losses. Experience also shows that supervision and resolution have to go hand-in-hand.

The European decision to introduce a banking union has largely been pre-empted by the ECB Council's decision to act as a lender of last resort to troubled banks in the euro area, helping them by underbidding the interbank market with refinancing credit at conditions in terms of maturity, interest rate and collateral requirements at which private banks were unwilling to offer interbank credit. TARGET2 balances accumulated as a result that peaked at 1,000 billion euros in summer 2012 in the GIPSIC countries,[9] as we reported in our previous reports (EEAG, 2012; EEAG, 2013). By its own statutes and the Maastricht Treaty, the ECB was not intended to be a lender of last resort; it was intended not to provide banks with implicit bailout insurance and not to encourage excessively risky behaviour. However, when the crisis came, it bailed out the banks and their sovereigns to avoid the bankruptcies that would otherwise have occurred. Taking these much disputed prior decisions as given, it is understandable that the ECB now wants to supervise the banks to minimise its own investment risk. While the potential write-off losses would be fully socialised among the euro countries because they would reduce the seignorage from monetary policy operations, the ECB certainly does not want its balance sheet to be fraught with the consequences of failed bailout operations. However, the ECB cannot perform the supervisory function effectively, because it has too little information about banks' situations; and it has no authority to close down or restructure insolvent banks.

> "Intervening as lender of last resort, the ECB would provide money without any control." (Wyplosz, 2012)

This may lead to a tragedy of the commons.[10] The national authorities have an incentive to delay acknowledging that banks are in trouble as long as possible, inviting the central bank to provide cheap refinancing credit to mitigate what appears to be a mere liquidity crisis. After the rescue, the liquidity crisis turns into a solvency crisis, but as the ECB has already been dragged in, the foreseeable write-off losses have already been socialised either directly, via the ECB's system of profit sharing, or indirectly via fiscal rescue schemes like the EFSF or ESM bailing out states, which bail out local banks and protect the ECB as their main creditor. Spain is an example of this sequence of events.

In the early stages of the development of a banking union, during 2012, plans for a single supervisory mecha-

[9] GIPSIC countries include Greece, Ireland, Portugal, Spain, Italy and Cyprus.

[10] Compare Blankart (2012), Tornell and Westermann (2012), and Wyplosz (2012).

nism and a common regulatory regime met with general acceptance, while a single resolution mechanism seemed much more controversial, ran into greater opposition, and seemed far less likely to get off the ground. Some commentators feared that a half-baked banking union might emerge. They argued that a partial banking union may be worse than no union at all (Wyplosz, 2012). For example, in a situation where there is only a supervisor who only looks at large banks and no resolution authority or deposit scheme, a public debt restructuring would lead to bank failures, and the ECB would incur write-off losses from lending to local banks without having been able to constrain these banks' actions.

Basically, there are two ways out of the common pool problem. Either the Eurosystem's degree of loss socialisation is reduced or central control is enhanced. The former would imply a return to the system of harder budget constraints intended by the Maastricht Treaty whereby the ECB stops bailing out banks and their sovereigns with cheap refinancing credit provided to banks collateralised with below-investment grade government bonds. TARGET2 balances would be settled, in such a way that interest differentials would emerge reflecting differences in bankruptcy probabilities, and markets would be responsible for the allocation of capital to rivalling risky assets. Alternatively, the policy of undercutting market conditions to eliminate risk premia in interest rates would continue, but constraints would be imposed on banks and their sovereigns to prevent moral hazard, to ensure prudent lending and borrowing and to steer the allocation of scarce capital to rivalling uses. Intermediate solutions would, of course, also be possible.

The euro area countries, meanwhile, have agreed to lean very much towards the second option. The ECB will continue to act as a lender of last resort, but it will also act as a single regulator, supervisor and resolution authority. In addition, there will be a common deposit insurance system. Setting the new system up requires a transferal of powers from member states to the euro area authorities, which will imply the transfer of resources between countries. A revision of the Maastricht Treaty may possibly be needed to achieve this.

4.3 Banking union in the context of European Union policy interventions since the financial crisis

Proposals for a banking union emerged in 2012 after a long series of initiatives by the European authorities to address problems arising from the global financial crisis, the long recession that followed it, and the persistent problems of bank failure and unsustainable public debt in the euro area.

There have been four groups of initiatives. Firstly, schemes for lending to – or bailing out – governments that face problems with borrowing in capital markets; secondly, schemes for improving the supervision and regulation of financial markets; thirdly, attempts to revive the surveillance and coordination of fiscal policies; and fourthly, replacement lending by the ECB in terms of buying government bonds and providing refinancing credit at increasingly low collateral standards.

To assist euro area member states in financial difficulty, two temporary programmes were established, the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM), succeeded in October 2012 by the European Stability Mechanism (ESM), which has been set up as a permanent mechanism, enshrined in the Treaty Establishing the ESM and in a change in the EU Treaty, and is able to lend up to 500 billion euros. The ESM has so far agreed to loan 9 billion euros to Cyprus as part of a 10 billion euro package in May 2013, and 100 billion euros to Spain for the recapitalisation of its banking industry, agreed in late 2012, of which only 41.4 billion euros have been drawn to date. Previously the EFSF and EFSM had made loans, generally as part of larger support packages. These loans include 144.6 billion euros in EFSF loans to Greece made from 2010 onwards, loans to Ireland of which 17.7 billion euros came from the EFSF and 22.5 billion euros from the EFSM in 2010, and loans to Portugal of 26 billion euros each from the EFSF and the EFSM (parts of a 78 billion euro loan package agreed in 2011).[11]

At the same time as the establishment of these loan facilities for distressed governments, there has been a sequence of initiatives intended to improve banking supervision and regulation. In 2010, a European Systemic Risk Board was set up to deal with macro-prudential regulation, and three new European Supervisory Authorities (ESAs) were founded to deal with micro-financial supervision: the European

[11] *Wikipedia* has an informative and thoroughly referenced article on the various European rescue schemes (EFSF, EFSM, and ESM) and the loan packages that have been agreed, which can be accessed from http://en.wikipedia.org/wiki/European_Stability_Mechanism; compare also Ifo Institute (2014), *The Exposure Level – Bailout Measures for the Eurozone Countries and Germany's Exposure*, http://www.cesifo-group.de/ifoHome/policy/Haftungspegel.html.

Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA).[12] Together these authorities form the European System of Financial Supervision (ESFS). Meanwhile, banking regulation is being changed by the introduction of the Basel III capital requirements. The Basel III global regulatory standards on bank capital adequacy and liquidity were issued in December 2010. Based on these standards, the European Commission published a new Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD IV) in June 2013. Financial institutions will be required to apply the new rules from 1 January 2014, with full implementation on 1 January 2019. The EBA will be heavily involved in ensuring the implementation of the CRR and the CRD IV.

To address the issues that lead to high public debt in the first place, the EU has developed a Fiscal Compact to revive and reinforce the old Stability and Growth Pact (SGP), to reinforce the surveillance and monitoring of public deficits by the EU authorities, to improve coordination of fiscal policies, and to limit the size of deficits (European Council, 2012). This came into effect on 1 January 2013 for the 16 countries that had ratified it by that point, and for other countries on the date when they actually ratified it. Compared to the old SGP it imposes a tighter definition of a balanced budget, is more explicit about the speed at which an excessive level of public debt has to be brought down, and requires member states to establish an independent fiscal advisory council to keep the deficit under surveillance and guarantee that their fiscal position are in balance or in surplus, by the definition used in the treaty.

At the same time as these structural changes were introduced, the ECB has tried to ease monetary conditions in the crisis countries, to mitigate their recession, to keep inflation from going negative (thus slowing down or preventing the necessary realignment of relative prices), to ease liquidity and funding problems faced by the banks, and to make it easier and cheaper for governments to borrow. The ECB lending rate was brought down to almost zero in the wake of the financial crisis and has remained there. Long Term Refinancing Operations have been used to make banks more independent from the capital market. The balance sheet of the ECB has been increased several-fold, paralleling the effects of similar actions undertaken by the US Federal Reserve and the Bank of England. A relocation of refinancing credit through an aggressive collateral policy has reshuffled funds from those member states with an excess, mainly in northern Europe, to those with a shortage, mainly in the south (Sinn and Wollmershaeuser, 2012; Sinn, 2012 and 2014), via the bailout of banks and their sovereigns with public international credit.

Finally, in September 2012, the ECB announced that it would be willing to use Outright Monetary Transactions (OMTs) to buy the public debt of euro area members receiving assistance from ESM programmes in secondary markets under certain conditions and in potentially unlimited amounts. Before this announcement, yields on the debt of financially weak euro area sovereigns like Italy, Portugal, Spain and Greece, had periodically risen to high levels, typically after some piece of news had alarmed the markets, giving rise to fears that the public debt and banking crises may re-intensify. Repeated assurances from the European authorities were not able to quell such fears. There had been much talk of the EU needing a “big bazooka” to fend off any conceivable speculative attack on its public debt markets and banking systems. The OMT announcement finally achieved the desired effect of calming markets by offering investors free-of-charge CDS-like insurance when buying government bonds, and has continued to maintain stability.[13] Following the insurance offer, yields on Italian and Spanish government debt immediately fell to their lowest level for several months.

Despite all these efforts, problems remain. The measures outlined above leave much of the work of banking supervision and regulation in the hands of national regulators. The cost of recapitalising or winding-up, or of resolving failed banks by some other means, remains at the level of EU member states. There is a growing belief in the crisis countries that this is not satisfactory.

4.4 Proposals and political progress with banking union

4.4.1 Supervision and regulation

Official proposals for a banking union emerged from the European Council and the euro area summit meeting on 28–29 June 2012, and more detailed plans were set out by the European Commission in September 2012 when

[12] Council of European Union, “Financial Supervision: Council Adopts Legal Texts Establishing the European Systemic Risk Board and Three New Supervisory Authorities,” *PRESSE 303* 16452/10, Brussels, 17 November 2010, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/117747.pdf.

[13] This is seen as remarkable in some quarters, as not a shot has yet been fired.

the SSM was proposed (European Commission, 2012). The essence of this proposal was the plan that the ECB should have "ultimate responsibility for all specific supervisory tasks related to the financial stability of all euro area banks."[14] The proposal envisaged that national supervisors would "continue to play an important role in day-to-day supervision and in preparing and implementing ECB decisions." At the same time, the Commission proposed that the EBA should develop a Single Supervisory Handbook "to preserve the integrity of the single market and ensure coherence in banking supervision for all 27 EU countries."

The Commission set out an ambitious timetable for implementing a banking union, aiming for the Council and Parliament to adopt the plan by the end of 2012. According to this timetable, the SSM would have been in place by 1 January 2013, with the ECB able to "decide to assume" supervisory responsibilities over any credit institution, "particularly those which have received or requested public funding;" from 1 July 2013 all banks of major systemic importance should have been supervised by the ECB; and, from 1 January 2014, this mandate should have been extended to banks of all sizes.

The proposals gave the ECB very wide-ranging responsibilities and powers:

> "The ECB will become responsible for tasks such as authorising credit institutions; compliance with capital, leverage and liquidity requirements; and conducting supervision of financial conglomerates. The ECB will be able to carry out early intervention measures when a bank breaches or risks breaching regulatory capital requirements by requiring banks to take remedial action."

In the event these proposals were not put into effect according to the Commission's timetable. They were finally agreed in October 2013, and the ECB will assume ultimate responsibility for supervision of all euro area banks on 4 November 2014 (European Union, 2013a). The ECB will directly supervise the largest and most internationally active banks, with the option to take over direct supervision for the others in cases where it believes this to be appropriate, while the national authorities will be in charge of the day-to-day supervision of smaller banks. The banks under direct ECB supervision are those with assets worth over 30 billion euros, those whose assets exceed 20 percent of the host country's GDP, those located in a country that has requested or received assistance from the EFSF or ESM, or those which are among the three largest financial institutions in a country.

While the SSM appears to give the ECB many powers that were previously held by the EBA, the EBA is to continue to exist, and it will be responsible for developing the "single rule book" that will guide the regulation and supervision of banks in the euro area. The European Parliament and the Council of the European Union have passed a regulation amending the role of the EBA and setting out its interactions with the ECB with its new roles (European Union, 2013b).

4.4.2 The Single Resolution Mechanism

In July 2013 the Commission proposed a procedure for resolving – winding-up – failed banks with a "Single Resolution Mechanism" (SRM) and a "Single Bank Resolution Fund" (SRF), see European Commission (2013). The Commission argues that the SRM will bring important benefits, as compared with a network of national procedures and funds. They argue that:

- Strong central decision-making will ensure rapid and effective decisions being made, avoiding uncoordinated action, minimising negative impacts on financial stability, and limiting the need for financial support;
- A centralised pool of bank resolution expertise and experience will deal with bank failure better than individual national authorities with fewer resources and experience;
- The SRF will pool resources across countries and protect taxpayers better than national funds, and provide a level playing field across participating member states;
- The SRF sidesteps problems of coordinating the use of national funds;
- The SRF eliminates the dependence of banks on sovereign creditworthiness.

It is proposed that the SRM commences operations in January 2015. The proposed legal basis for the SRM is Article 114 of the Treaty on the Functioning of the European Union (TFEU), "which allows for the adoption of measures for the approximation of national provisions aiming at the establishment and functioning of the internal market."

[14] European Commission (2012), "Commission Proposes New ECB Powers for Banking Supervision as Part of a Banking Union", *Press release* IP/12/953, Brussels/Strasbourg, 12 September, http://europa.eu/rapid/press-release_IP-12-953_en.htm.

Under the proposal, a Single Resolution Board (SRB) will be set up to prepare and monitor resolution decisions centrally, which, it is asserted, will command the confidence of member states that the resolution process is of a high quality and is impartial (particularly as regards the local effects of resolution decisions). The resolution process will be initiated by the European Commission.

The Commission argues that its proposal satisfies the principal of subsidiarity because resolutions of failing banks create spillovers across national boundaries. Undertaking them at the European level allows such resolutions to be performed consistently across countries, following the same set of rules, and internalises what would otherwise be external effects (spillovers). It is claimed that the SRM will be able to exploit economies of scale not available to national procedures; and that national resolution procedures that may differ from one member state to the next might undermine the stability and integrity of the single market.

> "Whilst the establishment of the Single Supervisory Mechanism ensures a level playing field in the supervision of banks and diminishes the risk of forbearance, the SRM ensures that when a bank failure occurs, restructuring can be carried out at the least cost, creditors receive fair and equal treatment, and funding can be quickly deployed to its most productive use across the internal market."

The proposal contains provisions for resolving an institution by (i) selling all or part of it to another viable institution (the sale-of-business tool); selling part of the resolved institution temporarily to another (the bridge institution tool), typically creating a "good bank;" (iii) selling impaired assets to a public body to manage them (the asset-separation tool), typically the case of the "bad bank;" (iv) bailing-in creditors of the institution (the bail-in tool); that is, imposing losses on shareholders, bondholders, depositors (those deposits that are not protected by the 100,000 euro deposit guarantee schemes) and other creditors.

The intention to "bail-in" creditors has been loudly trumpeted. It is cited as a means of eliminating or reducing the costs to taxpayers and reducing moral hazard, improving the incentives of the owners of and lenders to banks to more closely monitor the latter's activities, and encouraging banks to take fewer risks, as their cost of capital will become more sensitive to the riskiness of their portfolios. The cost of resolution should to be borne by the creditors of the failed institution and the banking sector. The Commission, the SRB and the national resolution authorities should organise bank resolutions so as to minimise the need for extraordinary public support.

However, the bail-in tool is hedged about with restrictions that may, in practice, limit its usefulness. Losses will be imposed on creditors in reverse order of seniority, which is unexceptionable; but several classes of creditors are automatically exempted from bail-in. These classes include: covered deposits; secured liabilities including bonds; liabilities to employees in the form of wages, salaries and pension benefits; commercial claims for goods and services critical for the daily functioning of the institution; liabilities to a payments system with a remaining liability of seven days; and inter-bank liabilities with an original liability of less than seven days. Furthermore, additional liabilities may be excluded in exceptional circumstances. The question is: what fraction of the institution's liabilities can be bailed-in? Will there be sufficient funds to absorb the losses on the asset side and resolve the institution without needing outside assistance?

Implicit in the Commission proposal is that at least 8 percent of an institution's total liabilities and own funds should be available to be bailed-in.[15]

[15] The availability of sufficient own funds and aggregate liabilities for bail-in is mentioned at least three times – on two of which occasions the figure of 8 percent is given – in the Commission's proposal of 10 July 2013 for the SRM and SRF (European Commission, 2013):

(i) In the Explanatory Memorandum, page 13, is the following paragraph: "The primary objective of the Single Resolution Fund is to ensure financial stability, rather than to absorb losses or provide capital to an institution under resolution. The Fund should not be considered as a bailout fund. There might be however exceptional circumstances where, after sufficiently having exhausted the internal resources (at least 8 percent of the liabilities and own funds of the institution under resolution), the primary objective could not be achieved without allowing the Fund to absorb those losses or provide the capital. It is only in these circumstances when the Fund could act as a backstop to the private resources."

(ii) In the preamble to the proposal, paragraph 45 states that: "To avoid institutions structuring their liabilities in a manner that impedes the effectiveness of the bail in tool, the Board should be able to establish that the institutions hold an aggregate amount of own funds, subordinated debt and senior liabilities subject to the bail-in tool expressed as a percentage of the total liabilities of the institution, that do not qualify as own funds for the purposes of Regulation (EU) No 575/2013 of the European Parliament and of the Council16 and of Directive 2013/36/EU of 26 June 2013 of the European Parliament and of the Council17, which institutions should have at all times."

And (iii) in the proposed regulation itself, Part II, Title 1, chapter 3, Article 24, paragraph 7 provides "The [Single Bank Resolution] Fund may only make a contribution referred to in paragraph 6 provided that the contribution meets both the following criteria: (a) a contribution to loss absorption and recapitalisation equal to an amount not less than 8 percent of the total liabilities including own funds of the institution under resolution, measured at the time of resolution action in accordance with the valuation provided for in Article 17, has been made by shareholders and the holders of other instruments of ownership, the holders of relevant capital instruments and other eligible liabilities through write down, conversion or otherwise; (b) the contribution from the Fund does not exceed 5 percent of the total liabilities including own funds of the institution under resolution, measured at the time of resolution action in accordance with the valuation provided for in Article 17."

Nevertheless, resolution will sometimes require funds that the failed institution itself and its creditors are unable to provide. To meet these needs, the Commission proposes a SRF so that any costs incurred in connection with the use of the resolution tools that are not borne by the shareholders and the creditors of the institution under resolution will be borne by the financial industry. The Commission is at pains to emphasise that the Fund is not supposed to be a bailout fund, but is only there to ensure financial stability, not to absorb losses or provide capital to an institution that is being resolved. The argument is that the existence of a fund that can, if necessary, provide a back-stop for dealing with a failed institution, removes the danger of contagion from one institution to another, and from one member state to another. This positive spillover effect of the fund provides a justification for its being based on contributions from all of the participating member states. Pooling resources in the fund also allows for a much bigger fund to be amassed and provides better insurance. The proposal states that:

> "Since losses from any future shocks in the banking industry are likely to be concentrated at a specific moment of time in some Member States, a common European private backstop mechanism, as opposed to national backstops taken individually, will be more effective in absorbing such shocks through ex-ante and, in extreme cases, ex post contributions from the whole Euro-area banking industry. Therefore, by pooling resources at the European level, the Fund will provide a bigger "firepower" and will increase the resilience of the banking system. At the same time, spreading extraordinary ex-post contributions evenly across banks in all participating Member States will reduce the level of such contributions for each bank, limiting any pro-cyclical effect of such contributions.
>
> Moreover, a mechanism where loss absorption reaches beyond national borders can effectively break the vicious circle of the interdependence between the banking crisis in a given Member State and the fiscal position of the sovereign. In this manner, the current burden on some Member States would have been mitigated if a Single Resolution Fund had existed since the start of the financial crisis."

The intention is that the fund will hold at least 1 percent of the covered deposits in the banking system of the participating member states. The Commission argues that this should be sufficient, provided that creditors are bailed in to the extent of at least up to 8 percent of the total liabilities and own funds of the institution under resolution. This would correspond to a fund of around 55 billion euros, based on 2011 data on banks and an estimate of covered deposits in the euro area. The Commission envisages a 10 year transitional period before the fund reaches its target level, possibly up to 14 years if it has to make large disbursements in the interim period. This means annual contributions from the banking industry to the fund of around 5.5 billion euros a year. After the build-up phase, the banks would have to make contributions as their contribution basis grows or if the fund is whittled away by disbursements.

> "[…] Contributions will be calculated in line with the Bank Recovery and Resolution Directive on the basis of banks' liabilities excluding own funds and covered deposits, and adjusted to their risk profile. This means that banks which are financed almost exclusively by deposits will in practice have very low contributions. Of course, these banks will contribute to national deposit guarantee schemes."

While many of the features of the Commission's proposal described above have survived negotiations among member states and the Commission in December 2013, and are likely to survive further negotiations with the European Parliament in 2014, the proposals for providing funding for bank resolutions before the SRF is fully established (which will not be until 2026), and the proposed procedures for arranging a resolution, were the subject of much debate and argument. An agreement was reached on 18 December 2013.[16]

In the ten-year period between 2016 and 2026, while the SRF is being accumulated, the funding of bank resolutions (beyond what can be achieved by bailing-in shareholders and other creditors) will fall partly on (a) the resolution fund of the country in which the resolved bank is located, and partly on (b) the collective resolution funds of all the other member countries of the SRM. The proportions will gradually shift from (a) to (b) over the ten year period. At the end of the period, the separate national funds (or

[16] Council of the European Union (2013), "Council Agrees General Approach on Single Resolution Mechanism," *PRESSE* 564, 17602/13, Brussels, 18 December, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/140190.pdf and European Commission (2013), "Commissioner Michel Barnier's Remarks at the ECOFIN Council Press Conference," *MEMO* 13/1186, Brussels, 19 December, http://europa.eu/rapid/press-release_MEMO-13-1186_en.htm?locale=en.

compartments, as the official documents describe them) will no longer exist, and the fund will be fully mutualised.

The SRF may, of course, not be big enough to cover the costs of bank resolutions, not only during the build-up period 2016–2026, but also in the steady state thereafter. Where then will the resources be found? A so-called back-stop to the SRF is needed, and the form it should take was one of the hotly contested issues at the December 2013 ECOFIN meetings. The plan is that, during the build-up period, financing will come from "national sources backed by levies on banks, or from the European Stability Mechanism, in accordance with agreed procedures."[17] During this ten-year period, a common backstop will be developed, which will come into operation "at the latest after 10 years," and which will allow the SRF to borrow, and recoup the costs by imposing more levies, including ex-post levies, on the banking sector.

How will bank resolutions be triggered? Who gets to decide on the form of resolution (i.e., whether it involves splitting an institution into bad and good banks, selling off all or parts of it to other banks, winding it up, and bailing-in creditors)? And who pays? The proposed mechanism seems baroque and cumbersome. The resolution of a bank can be triggered either by the ECB notifying the SRB that a bank is failing or is likely to fail, or by the SRB itself; and the SRB will then draw up a scheme for carrying out the resolution. Decisions by the SRB will come into force within twenty-four hours of their adoption. However, the Council of the EU is able to object to or demand changes.

The proposed SRB itself is a complex body. Most resolution plans would be drawn up by a relatively small body, the "executive session" of the SRB, consisting of the executive director, four full-time appointed members, and representatives of the member states involved in the resolution. If, however, the resolution was big enough, then the "plenary session" of the SRB would be responsible for the decision; and a two-thirds majority of board members representing at least 50 percent of contributions (to the SRF) would be required.[18]

According to current plans, the SRM will come into force on 1 January 2015 and its provisions for bailing-in bank creditors and resolving failing banks will apply from 1 January 2016. What happens in the period before 1 January 2016? In this period, the resolution of failing banks and the problems revealed by the ECB Comprehensive Assessment will fall on national resources, and countries will be able to apply for assistance from the ESM "in accordance with agreed procedures."

4.5 Issues, problems and controversies

Following the agreements reached on the SRM and the SRF in December 2013, the media and commentators have been quick to assess the European Banking Union as an unwieldy affair, a typical European compromise, and at best, a partial success. The long transitional period (until 2026), before the costs of resolution will be completely mutualised, partly addresses the legacy issue. It delays the ex-post separation of the banking sector from the state of the public finances, but encourages the separation insofar as it reduces the possibilities of national governments selling their debt to their domestic banking sectors, thus making it a community problem that would later have to be solved with international fiscal transfer schemes aimed at stabilising insolvent states to avoid the losses from bank recapitalisations. The resolution procedure is complex, slow, and involves too many people. The SRF is tiny, and the ability to impose losses on bank creditors is limited by the long list of exemptions from bail-in.

4.5.1 Legacy problems

One of the issues that plagues the set-up of a banking union is the existence of undiscovered problems (non-performing loans, asset portfolios that have fallen greatly in terms of value etc.) in the balance sheets of euro area banks, problems that exist prior to the date

[17] Council of the European Union (2013), "Council Agrees General Approachon Single Resolution Mechanism," *PRESSE* 564, 17602/13, Brussels, 18 December, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/140190.pdf. See also Council of the European Union (2013), "The Statement of Eurogroup and ECOFIN Ministers on the SRM backstop," 18 December, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/140206.pdf.

[18] The SRB will feature an executive director, four full-time appointed members, and representatives of the National Resolution Authorities of all the participating countries. All these individuals will be involved in a plenary session of the SRB. "The plenary session would be responsible for decisions that involve liquidity support exceeding 20 percent of the capital paid into the fund, or other forms of support, such as bank recapitalisations, exceeding 10 percent of funds, as well as all decisions requiring access to the fund once a total of 5 billion euro has been used in a given calendar year. In these cases, decisions would be taken by a two-thirds majority of the board members representing at least 50 percent of contributions."

on which the banking union takes effect, and which will require banks to be re-capitalised, shut down, merged, or dealt with in some other way. There is a clear incentive for member states not to reveal such problems before the inception of a banking union, in which case they would have to pay for the costs themselves. On the contrary, they will have every incentive to keep quiet until a later date once the banking union is obliged to undertake the necessary resolution and the costs can be shared across the union. The legacy issues are the same as pre-existing medical conditions, which a new private medical insurance policy would refuse to cover. As Buch and Weigert (2012) observe:

> "Legacy problems obstruct the transition to a new long-run institutional structure in many ways. For example, enforcing the Fiscal Compact would require significant improvements in fiscal indicators in some countries. In addition, as long as banks carry non-performing assets on their balance sheets and as long as losses on these assets have not fully been acknowledged, introducing pan-European deposit insurance would amount to the introduction of an insurance system after the insured event has already happened. This would entail severe moral hazard problems. Hence, a consistent and credible framework for bank resolution and restructuring must be a core element of a banking union. Yet, progress towards financial sector reform to date has been slow, and key elements of the reform package are unlikely to be introduced in the near future. In this sense, "legacy" problems not only refer to debt overhang but also to delayed financial sector reforms."

The EU regulation establishing the SSM discusses legacy issues in some detail. In theory they will be dealt with by the asset quality review – The Comprehensive Assessment – undertaken by the ECB between late 2013 and October 2014 (European Central Bank, 2013). The assessment will include three elements: a supervisory risk assessment, an asset quality review and a stress test. The assessment will cover 130 institutions, which together account for 85 percent of euro area bank assets. The supervisory risk assessment will examine inter alia the banks' liquidity, leverage and funding. The asset quality review will examine asset valuations, the classification of non-performing loans, valuation of collateral, and provisions against losses. The stress test will be a forward-looking view of banks' ability to absorb various shocks and will be performed in collaboration with the EBA.

Following this Comprehensive Assessment, some banks may be required to take action. This includes recapitalisation, profit retention, issuing equity, re-orientation of funding sources, asset separation and sales of assets, as appropriate. Banks will be required to have a ratio of Common Equity Tier 1 capital of 8 percent of risk-weighted assets. As risk-weighted assets often only account for a fifth of all assets, given that banks' lending to other banks and government is privileged with risk weights of only 0.2 and zero respectively, this is an extremely soft constraint that cannot be expected to really lead to prudent banking.

The December 2013 agreement on the SRM and the SRF between the Commission and the Council makes clear that the costs of dealing with legacy problems should be met by the member states where the failing banks are located. In the period between 2016 and 2026 after the bail-in principle has begun to apply, but before the SRF is fully funded, the share of costs that are mutualised gradually increases, from zero in 2016 to 100 percent in 2026. If the states cannot bear the costs, they can borrow for that purpose from the ESM under the usual conditions: Borrowing countries will need to provide fiscal and structural adjustment plans and have them approved.

ECB President Mario Draghi has said that some banks need to fail the stress tests, to establish the tests' credibility.[19] There is much fighting talk about the rigour and transparency of the Comprehensive Assessment, but recent past experience with stress tests is not encouraging. On many occasions banks have passed with flying colours, as in the case of Dexia, detailed above, only to be felled soon afterwards by some unrevealed problem or unanticipated financial shock. The effectiveness of this Comprehensive Assessment in weeding out legacy problems will be essential if the suspicions of governments in northern Europe that the banking union is another means of passing the costs of bank failures in the southern periphery (Spain, Portugal, Greece, Cyprus, Italy, and Ireland) onto them are to be dispelled.

Estimates of the capital shortfall that might be revealed range between 50 billion euros and 600 billion euros (Merler and Wolff, 2013). These figures put the smallness of the SRF, and indeed the ESM, into perspective. If capital shortfalls turn out to be large and occur in countries that already have problems with

[19] M. Steen (2013), "Draghi's Blunt Warning on Bank Stress Test," *Financial Times,* 23 October, http://www.ft.com/cms/s/0/a27d75d0-3bb5-11e3-b85f-00144feab7de.html.

high public debt and deficits, they may cause more instability in the financial markets in the short and medium-term.

4.5.2 Need to build new institutions and capacity

New euro area institutions will be needed and additional capacity, as well as extra skilled personnel in supervision, regulation etc.

> "Creating a new pan-European supervisor 'from scratch' is a daunting task and a very expensive one too, especially given the EU's current state of fiscal finances. The infrastructure that needs to be put in place and the highly skilled employees that will need to be hired in such a short period of time should not be taken lightly." (Ioannidou, 2012)

The ECB needs to recruit several thousand people to staff its new departments responsible for supervision and regulation. The process is taking place in 2013 and 2014, with many regulators being hired from national regulatory agencies. The ECB will work in collaboration with established national bodies. This nevertheless represents a major challenge and it remains to be seen how successfully effective departments can be assembled.

4.5.3 Conflict of interest at the ECB

One of the arguments in favour of moving to a euro area regulator is that it will avoid regulatory forbearance. The regulator will be less likely to be influenced by local concerns and lobby groups.

> "Moving supervision to a European level will also increase the distance of supervisors from powerful national lobbies, reducing the scope for regulatory forbearance. As the financial crisis highlighted, there is a tendency by national supervisors to side with their troubled banks in hiding information from the public and other supervisors, delaying the recognition of losses, postponing corrective measures, and resulting in larger eventual losses. The lack of sufficient independence of some national supervisors from the executive (in combination with insufficient and explicit powers to intervene) magnifies this problem. This problem is also at the heart of the current vicious cycle between bank and sovereign risk." (Ioannidou, 2012)

However, as a counter argument, there is an issue that the ECB may face a conflict between its pursuit of macroeconomic stability and its objective of financial stability. The pressure to maintain financial stability may induce the ECB to create more liquidity, or do so on easier terms, for the banking system, to promote financial stability, even at a time when macroeconomic stability demands tighter monetary actions. Monetary policy is usually countercyclical, while regulation and supervision tend to be pro-cyclical. The ECB may prove a more forbearing regulator than a local one. There is evidence from the US Fed to support this idea. The ECB may need to erect Chinese Walls between its different activities.

Moreover, there is the problem mentioned at the outset, namely that the ECB is the banks' biggest creditor and would therefore directly suffer write-off losses should a bank fail and be resolved. While this fact may induce the ECB to be a tough regulator in the future, it will surely tend to make it a soft regulator in the present when setting up stress tests to uncover hidden write-off losses from legacy assets. Unfortunately, it must be feared that the ECB will turn a blind eye to the legacy debt problem and seek solutions that sweep the true problems under the carpet until after the socialisation scheme is in operation.

On the positive side, it can be argued that information obtained from bank supervision activities may improve macroeconomic forecasting.

> "Problems in the banking sector may serve as an early indicator of deteriorating macroeconomic conditions." (Ioannidou, 2012)

There remains the unanswered question of whether the new arrangements give too much power to a single institution, which is not democratically controlled and in which the small countries, for whom the incentive to free ride on community funding is by definition bigger than for big countries, enjoy disproportionate voting rights in ECB decision-making.

4.5.4 Getting the banks to pay

The official aim of a banking union is to reduce the burden on the taxpayers of resolving failed banks, and getting the banks themselves or their creditors to pay. Imposing losses on shareholders and other creditors as far as possible through the bail-in tool is an essen-

tial plank. It is reinforced by the 55 billion euro SRF, fed by the proceeds of a levy on banks. However, some banks may fail and need resolution well before the fund is up and running and the fund may be insufficient to meet the costs, even if all of the legacy problems have been funded separately.

Some commentators argue that a levy on banks will act as a tax on banking, raising the cost of intermediation. Activity may be diverted into other channels, which may be less efficient and also prone to crises and breakdowns, just as much as banks.

> "Banks will pass on much of the tax, dependent on market structure, to other creditors in the guise of lower interest rates, higher charges and fewer services to depositors, and higher rates and charges to borrowers. In short, bank spreads between deposit and lending rates would rise." (Goodhart, 2012)

Arguably there are difficulties with any scheme of imposing a levy on banks. *Ex post* levies tend to fall on prudent banks that avoided failure at a time when they and the whole banking system were weak. *Ex ante* taxes may be set in such a way so as to discourage risky behaviour, and thus act both as an incentive to good behaviour and as a way of funding future recapitalisations. The possible problem here is that, having paid the tax in advance, banks may feel entitled to a bailout (recapitalisation) and even to have their shareholders bailed out, rather than be liquidated or taken into public ownership. Goodhart (2012) writes that while academics may argue for *ex ante* taxes, bankers prefer *ex post* levies and they are more likely to win the argument.

Various methods of bailing-in bank creditors are not costless, at least from the point of view of the banking industry. Calls on unsecured bond-holders through "CoCo" bonds (Contingent Convertible) may raise the price banks have to pay to raise long-term funding. It is worth noting, however, that even CoCos do not prevent costs from arising for taxpayers, since many unsecured bank bonds are owned by pension funds and insurance companies.

While it is true that imposing a levy on deposits will raise banks' operating costs, and that banks will pass these costs on to borrowers and depositors, this is no bad thing. Quite the opposite: it is as things should be. These changes in banks' funding arrangements are intended to correct for externalities: costs that banks have been imposing on the rest of society to bail out and recapitalise failed institutions. Requiring banks to base a larger fraction of their funding on equity rather than debt, requiring the use of CoCos, and imposing a levy on banks to pay for a resolution fund, are actions that will reduce the likely future calls of the banking industry on the rest of the economy and reduce the amount of volatility in economic activity caused by banking panics and failures. Correcting externalities generally moves the economy closer to an efficient allocation of resources. The cost of banks' raising equity has been subsidised in the past by the implicit bailout guarantee. Without it, this cost would have been higher. If, as a result, the cost of the services provided by banks goes up, this is merely removing the effects of a subsidy that should not have been there in the first place (Sinn, 2003a; Sinn, 2003b; Sinn, 2010, chapter 4; Admati and Hellwig, 2012).

The banks have often claimed that raising capital requirements, as is happening alongside the banking union proposals under Basel III and the EU's CRD IV, is costly, as the required return on capital is much greater than the yield on bonds. It has been claimed that higher capital requirements will cause funds to be tied up, sitting idle and unable to be loaned out to businesses. However, these arguments are simply wrong. They are dealt with at length by Admati and Hellwig (2012), Miles (2013), and Miles et al. (2012).

The argument that banks holding more capital causes resources to be kept idle and unable to be loaned out, appears to confuse the asset and liabilities side of the balance sheet. It may be true that if a bank holds more of its assets in the form of cash or reserves, then fewer funds are loaned out. But equity and debt are liabilities of the bank, and as such, they constitute alternative means of funding its lending activities. Using a greater proportion of equity to debt does not cause resources to be kept idle. Miles (2013) shows that the margin of banks' lending rates over the interest paid on the bonds they issue has not changed systematically; and despite large increases in leverage over long periods of time in the UK and US, there is no evidence of their using less equity and more bonds having lowered the margin. The appearance of a high required return on equity is given by the market value of banks' equity being much less than their book value. But this, in fact, means that financial markets set a lower value on the value of the banks' assets than is attributed to them by the conventions of accounting (Merler and Wolff, 2013).

Lastly, the cost of equity capital is lower than it may seem because having more equity lowers the riskiness of the returns both to the bank's bonds, and to its existing equity, and therefore lowers the returns on the bank's existing liabilities.

Consequently, there are good reasons for requiring banks to fund their operations with a considerably higher ratio of equity to debt.

4.5.5 Sovereign debt on banks' balance sheets

One of the links that binds the fortunes of the banking sector to the state of the public finances in the host state is the large fraction of the banks' assets that consists of sovereign debt. Data from the ECB show that, at the end of August 2013, over 10 percent of Italian banks' total assets were government bonds, as compared with 6.8 percent at the beginning of 2012. The corresponding figures for Spain are 9.5 percent and 6.3 percent; for Portugal 7.6 percent and 4.6 percent. Most of the increases are in bonds issued by the banks' own governments. Government bonds had grown to 5.6 percent of total euro area bank assets at the end of August 2013 from 4.3 percent at the beginning of 2012.[20]

The attraction of sovereign debt for the banks is that no capital needs to be held against it. Government bonds are not risk-weighted. Banks have been able to obtain liquidity from their central banks at very low cost, through the ECB's recycling of reserves from northern to southern Europe, which they have been able to invest in higher yielding sovereign bonds. This is another means by which banks have been able to raise profits and improve their balance sheets (insofar as they retain these profits, rather than distributing them). It is a substantial hidden subsidy to the banking industry.[21]

To break this link, rules may be needed to limit banks' exposure to particular borrowers and types of asset; the risk-weighting of sovereign debt needs to be reconsidered; and a third element is that fiscal deficits need to be brought under control so to reduce the supply of these assets.[22]

[20] C. Thompson and P. Jenkins (2013), "Bank Exposure to EU States' Bonds on Rise," *Financial Times*, 13 October, http://www.ft.com/intl/cms/s/0/9b6fb558-3270-11e3-b3a7-00144feab7de.html.

[21] To indicate the scale of the subsidy, if the banks can invest 1 trillion euro of reserves (the approximate size of the TARGET2 balances) which costs them 0.25 percent, in sovereign debt at 6 percent per annum, the profit is 57.5 billion euro per annum.

[22] J. Weidmann (2013), "Breaking the Sovereign-Banking Nexus," *Financial Times*, 1 October, http://www.bundesbank.de/Redaktion/EN/Standardartikel/Press/Contributions/2013_10_01_weidmann_ft.html.

4.5.6 Concentration, competition, and Too Big to Fail

The belief that some banks are too big to be allowed to fail, and therefore had to be recapitalised by governments, has contributed to public debt problems since 2007. However, the changes that have taken place, recapitalising banks, forcing through consolidations, mergers and takeovers, have increased concentration in banking and have effectively made the phenomenon of banks being too big to fail worse, not better. Despite the de-leveraging undertaken by banks, it is still true that the banking systems of many countries have gross assets worth several times their country's GDP, particularly in small economies, so their governments, already heavily indebted, would not be able to recapitalise them in the event of a major failure, without increasing national debt to unsustainable levels.[23]

4.5.7 Sovereign default risk, re-denomination risk, and other risks affecting borrowing costs

Breaking the bank-sovereign link is not an end in itself, of course. Some see the ultimate goal as making the cost of borrowing for households and enterprises independent of the state in which they are located in the euro area. The cost of borrowing for households and firms should be the same throughout the euro area, they maintain, so as to achieve an efficient allocation of resources across it. If there were a single market in banking, a household or firm would be able to borrow from any bank in the euro area, not necessarily one located in the same member state. The cost of borrowing would then reflect the risks associated with the loan the household or enterprise wanted to take out; and bear no relation to the risks of default by the government of the member state in which the household or enterprise is resident.

This view implicitly assumes that the European nation states have already been dissolved by creating a European federal state with a joint budget and a joint tax system. In fact, however, this is not the case and cannot be anticipated – through monetary or fiscal policy measures, decided by technocratic bodies stretching their mandate – changes which ought to require a change in the EU Treaty. As long as joint fiscal responsibility through a joint tax system and federal budget has not been created, a state, its banks and its companies are sitting in one boat and mutually sharing idiosyncratic country risks.

[23] G. Tett (2013), "Insane Financial System Lives Post-Lehmann," *Financial Times*, 12 September, http://www.ft.com/intl/cms/s/0/e622fa00-1bbf-11e3-b678-00144feab7de.html.

If there is a possibility of the member state in question leaving the euro area, then there may be an increased chance of the borrower in question being unable to repay, or of the loan being redenominated into a new currency, and this will affect the cost of borrowing. There may be a possibility of additional taxes being imposed on a borrower in a member state in fiscal difficulties, or of interest payments being taxed. These payments will and should also affect the cost of loans, so as not to water down responsibilities, not to distort the allocation of resources and not to create incentives for excessive risk-taking.

4.6 Conclusions

In principle, a banking union is a natural development for the euro area, further integrating the banking industry across member states and moving in the direction of completing the single market. If the euro area was an association of similar countries, symmetrically placed, the problems of implementing a banking union would be relatively straightforward. Among a group of basically similar countries disturbed by shocks that are to some degree idiosyncratic, but with large banking industries, with some financial institutions that are too big for an individual country to recapitalise, were they to fail, and with many financial institutions operating across the region and beyond, a suitably designed banking union could contribute to greater financial stability. It would involve no ex ante redistribution between countries. There may be some redistribution ex post depending on where bank failures occurred. But largely it would operate as a mutual insurance scheme, spreading risk through the region, and pooling resources needed to resolve the problems caused by failed banks.

The clear problem is that the euro area is very far from being such a symmetrical arrangement among similar states. Indeed, some members of the euro area have sound public finances and relatively well-supervised and regulated banks; while others have highly precarious, if not actually unsustainable, public finances and, to varying degrees, fragile financial industries with potentially large exposures to non-performing loans and other assets that are actually worth less than their recorded values and are overly-exposed to the sovereign debt of the country in which they are located. While the second group of countries are the likely beneficiaries of a banking union, and are keen on establishing one, the first group of countries are less enthusiastic. There is the prospect that the banking union may simply take resources from sound banking systems in the north to bail out unsound banking systems in the south.

By reducing the costs of funds for banks in the south, the banking union may have the effect of also reducing the costs of public borrowing for southern euro area states, and reducing the financial pressure on them to restrain public borrowing and make their finances sustainable.

The extent to which this problem emerges in practice depends on how a banking union is implemented. A key factor is how "legacy problems" are defined and dealt with. If there is a forensic examination of the balance sheets of all the banks in the euro area and a thorough identification of all the institutions in need of recapitalisation, resolution or closing down before the banking union comes into force, so that all these costs could be borne by the member states in question (or by existing provisions for lending to member states such as the EFSF and the ESM) and not mutualised through the banking union, the problem of the union being a scheme to transfer resources might be avoided. However, this is obviously unlikely to happen. The identification of legacy problems is likely to be highly imperfect and massively contentious. It will meet with fierce resistance in the troubled southern periphery countries, and, unfortunately, the ECB, the southern banks' largest creditor, can hardly be expected to have an incentive to pull the hidden write-off losses out from under the carpet.

The effects of the banking union will also depend on how effectively bank supervision and regulation is conducted after it has been set up, as well as on how the fiscal policies of member states evolve. The SSM is intended to ensure common standards of supervision and regulation across the union. There is less likely to be a persistent transfer of resources via the union to countries with a history of less rigorous supervision, the more uniformly the SSM can be applied.

To the extent that fiscally weak sovereigns are linked with fragile banking systems because banks buy up sovereign debt to use it as collateral for ECB funds, the risk weighting applied to sovereign debt by the regulator will be important. Clearly treating sovereign debt as risk-free has been inappropriate and needs to be changed. Banks in countries with fragile banking systems need to hold more diversified portfolios of assets. Finally, the rigour with which the EU Fiscal Pact

is applied in future will affect the European Banking Union. The smaller the amount of public borrowing by heavily indebted states, the lower the likelihood of banks in those states overloading their balance sheets with the local sovereign's debt.

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