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Banking Union in EU: Cure-all Drug for Distressed Banks?

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In the wake of the financial, economic, and sovereign debt crisis, the EU introduced a variety of initiatives to deal with the effects of those crises and to enhance the economic governance, particularly of the euro area. A more recent initiative - and still a work in progress - envisages a Banking Union (BU), which is open to all member states, but is mandatory for the member states of the euro area. The first stage of the BU, the Single Supervisory Mechanism (SSM), is already in effect. Here, the job of the ECB is to supervise and regulate 130 large monetary financial institutions – banks and various deposit receiving institutions - across the euro area.[1] *The SSM is supposed to be followed by the next component, the Single Resolution Mechanism (SRM), scheduled to come into force in 2015. A third component, the European Deposit Insurance scheme, is still being discussed, but has not yet been decided on as well.*

What a European Banking Union promises to ameliorate

A Banking Union is a big concept; however with a closer inspection the Single Resolution Mechanism is at the heart of the whole scheme.[2] It does not come as a surprise that it is a hotly discussed part of the emerging BU. Basically, the BU has assumed a centralized oversight role on the European bank companies and the branches of non-EU banks operating in the EU; it is about to centralize the decision making process on the winding down of failing banks and to hedge taxpayers from bearing the cost of bank resolutions. The latter was stressed by all institutions involved in designing a BU, foremost by the European Commission and the "Four Presidents," who insisted that Europe should get rid of the vicious circle in which weak sovereigns and weak banks found themselves a few years ago.

The idea of a SRM operates like this: if a bank is in distress and has to be closed, then the ensuing cost must be borne by the stakeholders, who are bailed-in according to a predefined order. The bail-in tool is supposed to involve the owners and creditors, and to a certain extent, even depositors: shareholders, subordinated bondholders, senior unsecured creditors, as well as uninsured account holders. The latter means that as deposits up to a certain threshold are exempt, only deposits beyond that limit would be bailed-in in the case of a bank resolution. The limit is planned to be set at 100,000 euros EMU wide.

The owners and certain classes of creditors should absorb losses of up to 8 percent of the liabilities;[3] if this is not sufficient, another 5 percent are to

[1] The ECB defines MFI as resident credit institutions the business of which is to receive deposits and/or close substitutes for deposits from entities other than MFIs and, for their own account (at least in economic terms), to grant credits and/or make investments in securities. See ECB, Definitions on Specific Terms Used, https://www.ecb.europa.eu/stats/pdf/money/mfi/mfi_definitions.pdf??1bb17bb3939ed54de233c530f47853ff

[2] For a comprehensive overview of the Banking Union: components, timing, participating institutions and more see for example EU Commission, Single Market/Banking Union, http://ec.europa.eu/internal_market/finances/banking-union/index_en.htm

[3] Under the Capital Requirements Regulation and Directive (CRR/CRD IV banks have to have a minimum Common Equity Tier 1 (CET1) ratio of 4.5 percent and to set aside

be provided by an insurance fund called Single Resolution Fund (SRF). The SRF is part of the SRM and is meant to serve as a financial backstop so public money is not called to foot the bill of the resolution. If things do not go awry the total of 13 percent of the liabilities covered should do and leave the sovereign, i.e. the taxpayer, untouched. The proponents of an EU-wide BU believe the economically costly bail-outs of the past will not be needed in future.

Elevating the responsibility for banks to the European level: the ultimate solution?

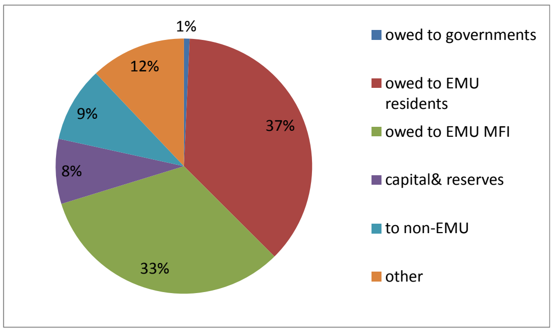
As far as the first part of the scheme is regarded, with the involvement of owners and creditors, these proposals sound appealing to the public. After all, the European public was enraged, because of the costly bail-outs of the financial sector across Europe and was calling for a burden shift at the expense of the "bankers" themselves, i.e. the holders of bank equity and the big investors. As mentioned above, small creditors, i.e. depositors, are protected by EU law up to the decent amount of 100,000 euros (in some countries like Germany an even better protection is offered as well).

The devil hides in the details, and this applies fully to the banking industry too. It must be borne to mind that there is no clear-cut separation between the bad and the good guys in modern banking. Here is why: The balance sheet of a bank displays on both, the left and right sides of the ledger, assets, and liabilities related to other banks. In the euro area, roughly 30 to 35 percent of the balance sheet of the aggregate banking system is occupied by those positions. According to the ECB Monetary Statistics, out of 29 trillion euros aggregate balance sheet of the EMU credit institutions by July 2014 some 9 trillion were amounts owed to other credit institutions. This translates into a share of over 33 percent[4], see Graph 1. Therefore prominent investors in a given bank are other banks (whether in the same member state or not).

additional tier one and tier two capital to meet a basic requirement of 8 percent capital ratio as currently recommended by the Basel Committee on Bank Regulation (Basel III). Under the Asset Quality Review, banks were required to have a minimum Common Equity Tier 1 (CET1) ratio of 8 percent. Under the stress test baseline scenario, banks were required to maintain a minimum CET1 ratio of 8 percent; under the adverse scenario, they were required to maintain a minimum CET1 ratio of 5.5 percent. See ECB, AGGREGATE REPORT ON THE COMPREHENSIVE ASSESSMENT, Executive summary, October 2014, https://www.ecb.europa.eu/pub/pdf/other/aggregatereportonthecomprehensiveassessment201410.en.pdf?29596b3046a55bbf19b4ed6ef01e97e6 .

[4] ECB, Statistical Data Warehouse, Table Aggregate Balance sheet of euro area Credit Institutions, at http://sdw.ecb.europa.eu/reports.do?node=1000003506

Graph 1: Aggregate balance sheet of the EMU credit institutions; liability side by July 2014 – amounts owed



Source: European Central Bank

In case a member bank of the BU is about to fail and the losses must be borne by its creditors, a cascade of events will be set in motion. Let's assume the creditors of First Bank in country A are small retail depositors claiming 50 percent on the liabilities of the bank, and First Bank in country B which is claiming 35 percent of the liabilities. The remainder would be debt securities held by non-banks, own capital and reserves, and other liabilities. Let the creditors of First Bank in country B be retail depositors in B and First Bank in country C having the same shares in the liability of the bank, and so on.

If First Bank in country A would go bankrupt, then a chain reaction is likely to be triggered (see Graph 2). The losses of First Bank in A will be assumed by the retail depositors in A and by First Bank in B (insured depositors would be reimbursed up to the amount of 100,000 euros though). In B, First Bank's losses will be assumed by its countrymen depositors and by First Bank in C; the reaction can go much farther down the chain, but it will come to a halt ultimately in country N - the host of the last participant in the banking system considered. Certainly the small depositors in all countries will incur losses (although they may be partly compensated by their governments or by various deposit insurance schemes). Still, the daunting outcome would be that all banks would fail, because of mutual dependence. This would be very likely if the losses of each bank in each country are large, e. g. exceeding 13 percent, and if the smooth transmission of the shock is not disrupted. This may happen to a bank in spite of all the care by its management not to over-leverage or over-expose the bank. (It is even possible that poorly managed First Bank in Country A recovers as investors appreciate the clever handling of its distress and inject new capital into it; the system makes it possible to pass on its bad loans and burden them onto a remote agent, which it does not even have business with!)

Apparently, having the owners and creditors to serve as an ultimate backstop produces contagion and unwanted results. What would be a better, i.e. "just" backstop then? Ironically, from the point of view of individual member states a better backstop would be the sovereign in A. The government of A would assume the losses in the first place; afterwards, it would be an issue between the bank and the authorities in A to decide on the cost sharing after the bankruptcy has occurred. No other member state would be affected, at least not significantly. The national supervisory authorities can require the banking industry to cover the public expenses on the rescue plan. This is in line with the US law which requires banks to pay "ex-post" adjustable fees in order to keep the taxpayer off the hook. The EU has the opposite view: to have the banks paying in the SRF "ex-ante", i.e. contributing to the fund in the form of insurance policy. The drawback is that there would not be sufficient money to meet the expenses. However, the US approach is problematic too, because it is the healthy, i.e. properly managed, institutions that must bear the consequences of other bank's failure.[5]

Graph 2: Stylized pass-on of losses onto stakeholders, banks included, as established by the SRM

Bank in country A →		Bank in country B →		Bank in country … →		Bank in country N →	
Bonds 10%	*Loss passed on*	Bonds 10%	*Loss passed on*	…	…	Bonds 10%	*Loss passed on*
Liability to First Bank in country B, 35%	***Loss passed on to First Bank in country B***	**Liability to First Bank in country…, 35%**	***Loss passed on to First Bank in country …***	…	…	**Liability to e.g. First Bank in country A, 35%**	***Loss passed on to First Bank in country A***
Liability to small depositors 50 %	*Deposits lost (possible reimburse-ment up to 100K €)*	Liability to small depositors 50 %	*Deposits lost (possible reimburse-ment up to 100K €)*	…	…	Liability to small depositors 50 %	*Deposits lost (possible reimbursement up to 100K €)*
Equity 5%	*Wiped out*	Equity 5%	*Wiped out*	…	…	Equity 5%	*Wiped out*

Notes: A bank is considered failed when its equity is wiped out. The cost of closure is burdened on all creditors. In the example cross-border business is between stand-alone banks only (no branches and subsidiaries).

[5] On the ex-ante versus ex-post discussion see for example Ch. Goodhard, Funding arrangements and burden sharing in banking resolution, in Thorsten Beck (Editor): Banking Union for Europe. Risks and Challenges, CEPR, London, 2012, pp. 103-112, http://www.frsn.de/fileadmin/research/studien/2012/VoxEU-CEPR_Banking_Union_10-2012_kl.pdf

But isn't that exactly what the BU is attempting to avoid – not to overburden national authorities with the costs of a bank resolution? By doing so the responsibility for bad supervision (if the supervision was good the bank wouldn't fail) would be shifted to the upper level of the supranational BU and away from the national authorities which failed to regulate properly. The outcome would be a redistribution of money in favor of poor oversight and detriment of well-regulated banks and countries. The protagonists of the BU call right away for this. A popular example is Ireland, which the banking sector overleveraged and made the Irish government insolvent as it decided to bail out the failing banks with money it did not have. The explanation was put forward that little Ireland was overwhelmed by the effort to deal with the mess of a banking sector tenfold the Irish GDP. If a European level BU was in place, then that would not have happened, because the agent in charge would have been the euro area, i.e. someone big enough not to collapse under the burden. Also, a comparison is made between the EU and the USA, where a fully-fledged central banking supervision operates. For example, US-EU comparisons point out that in the US a housing bubble occurred in the federal state of Nevada, which is similar in economic size to Ireland but Nevada's banks survived thanks to the American BU.[6] This comparison is misleading though. Since the federal state of Nevada does not have its own banking union a comparison with a county in Ireland would be the correct comparison. It would be better to compare the federal state of Nevada and the county of, say, Galway in Ireland or to compare the nation of Ireland with the nation of the US, and so on. The bottom line is that elevating the problem to a higher level is not the ultimate solution. After all, in the US with its seasoned banking supervision, the financial system collapsed in 2008 and some MFI of systemic relevance (AIG; also two government sponsored mortgage enterprises which had written off a large portion of their five trillion dollars ABS portfolio) were rescued with public money. Others, however, especially small banks, were closed by the Federal Deposit Insurance Corporation, which granted the authorities to resolve failed insured depository institutions, and since 2010, to orderly liquidate systemically important financial institutions (e.g. investment banks like Lehman Bros.). Taxpayers' money was not used in the process.

[6] Daniel Gros, Banking Union: Ireland vs. Nevada, an illustration of the importance of an integrated banking system. In: Economic Policy, CEPS Commentaries, March 24, 2014, http://www.ceps.eu/book/europe%E2%80%99s-ungainly-banking-revolution-0; see also Daniel Gros, Dirk Schoenmaker: European Deposit Insurance in the Banking Union, Duisenberg School of Finance Policy Paper 30, September 2013, p. 6 ff, http://www2.deloitte.com/content/dam/Deloitte/nl/Documents/financial-services/deloitte-nl-DSF-policy-paper-38-European-Deposit-Insurance-in-the-Banking-Union.pdf

An efficient BU presupposes sound participating banks across the EMU

The banking system of the euro area is meanwhile large and complex. Currently, total assets exceed 320 percent of the area's GDP (USA: 90 percent) and some 7.5 thousand banks and other deposit taking institutions operate here. Of them, a few dozen assume the lion's share of all assets and cross border banking is the usual practice. Also, most large banks are universal institutes, i.e. large financial firms with many pieces such as a large commercial bank, an insurance company, and a broker-dealer structure. The proponents and pundits of a BU in Europe stress the necessity to deal with such players in the market at the highest European-level of supervision and regulation, instead at the national level.

The proponents and pundits of a BU in Europe also stress the vulnerability of weak national banking systems and governments, particularly in peripheral Europe. The two are mutually dependent on each other – the banks would hold large amounts of government debt; whereas, governments would rely on the banks in their jurisdiction to purchase their bonds. To a large extent, this is true: as of 2012 only Greek banks have been investing in Greek public debt, and Greek bonds do not appear in the portfolios of non-Greek banks. In other crisis-ridden countries like Cyprus, Ireland, or Italy, the share of foreign banks' claims on their governments dropped to very low levels as well.[7] Local banks would be in grave danger in case the government wanted a haircut or repudiated its liabilities. They would fail and wreak even bigger havoc without an option to receive financial support by their authorities (who are starving for revenues).

Therefore, the hope is that by introducing a BU this detrimental link would be severed. However, a BU is not meant to make a government stripped of cash financially healthy. The purpose of the severance is to shift the costs of a bank closure or bank recapitalization away from its host country authorities onto other shoulders. Wiping out owners and investors might not help though. Involving a Single Resolution Fund financed by all banks under the jurisdiction of the BU is a decent approach, and yet it might not prove sufficient enough either.

To their credit, the authors of the European BU did not have in mind public money and redistribution of funds between member states in the case of bank failures in the first place. They strived to make sure the losses a distressed bank causes would be the responsibility of the bank's owners and investors. As sketched above, the bank industry is called on to provide financial backup by contributing to the Bank Resolution Fund. It is financed by all banks under the jurisdiction of the BU. Unfortunately the planned size of the Fund is not sufficient, especially if an EU wide financial meltdown occurred. The ultimate backstop would likely be taxpayer's

[7] Banking Union: Who Should Take Charge?, The EEAG Report on the European Economy, CESifo, Munich 2014, p. 92, www.cesifo-group.de/de/ifoHome/policy/EEAG-Report/Archive/EEAG_Report_2014/eeag_2014_report.html

money.

Regarding the bail-in approach, it is touted as a brilliant innovation. This claim is mostly unjustified, because Bankruptcy Code in every Western country requires the owners of a failing company to be the first to assume the ensuing losses. Neither in the euro area nor in the USA did a bail-in take place in late 2008 - early 2009, probably because there was no time. The financial market froze suddenly, and in a desperate move governments on both sides of the Atlantic acted hastily to reinvigorate the financial system. Sadly, the European BU foresees a ponderous bail-in mechanism, which is likely to create a credit crunch in the case of a major bank crisis. As Lehman Bros. demonstrated, the money market comes to a halt within a couple of hours.

Box 1: The Cypriot bail-in exercise

The EU tested its resolve to apply a bail-in on a small member state of the euro area, Cyprus, in 2013.[8] Specifically, the bail-in came in exchange for emergency liquidity assistance (ELA) to two major domestic banks and a 10 billion EU/IMF program that was supposed to ensure the solvency of the Cypriot banks. It was the first case in the short history of the common currency that the EU insisted that debt holders and uninsured depositors should absorb bank losses. Deposits exceeding 100,000 euros were converted into equity, thus making the depositors co-owners of one bank (the other one was wound down). The EU intention was to avoid a bail-out when considering the size of the banking sector (the aggregate assets of the banking system were up to 900 percent of GDP). However, given the requirement that a bank resolution must be executed within hours and without disruption of the payment flows, the Cypriot exercise was dismal. The authorities imposed bank holiday, and banks were closed for almost two weeks. ATM withdrawals were limited to 100 euros per day; moreover, for the first time the euro area imposed capital controls. Controls on cross-border transfers of money are still – one and a half years later - in place. Yet in spite of the effort, three out of four Cypriot banks subject to the SSM failed the stress test under the baseline and adverse scenario, and one is still undercapitalized (its common equity Tier 1 capital ratio was by the cut-off date of the Comprehensive Assessment negative).[9]

In terms of a bank resolution fund financed by all participating banks, it is doubtful that it would deliver if a fully-fledged crisis erupted. The BRF is required to provide funds of up to 5 percent of the balance sheet of banks, but otherwise it is limited to just 55 billion euros. However, when a major crisis is to be contained, money is spent on

[8] For details see Central Bank of Cyprus, Annual Report 2013, Chapter 3 and 4.1, http://www.centralbank.gov.cy/media//pdf/ANNUALREPORT2013_EN.pdf
[9] ECB, Comprehensive Assessment, Bank-by-Bank Results, Cyprus, https://www.ecb.europa.eu/ssm/assessment/html/index.de.html .

1. Guarantees on liabilities;
2. Recapitalization;
3. Asset relief measures.

Guarantees are most costly, but they serve as a sedative to calm the markets in the first place. Often, they are not called to the fullest. At the peak of the crisis, in 2012, Member States pledged over 835 billion euros in guarantees.[10]

During the same period, 2008-2012, Member States have granted an overall amount of € 413.2 billion (3.2 % of EU 2012 GDP) in recapitalization measures. According to the EU Commission, four countries were the most supportive with capital measures during these years: UK (€ 82 billion), Germany (€ 64 billion), Ireland (€ 63 billion), and Spain (€ 60 billion). The top receiving banks were RBS (46 billion), Anglo Irish Bank (32 billion), and Bankia (22 billion).

Also, between 2008 and 2012, Member States provided asset relief measures for a total of € 178.7 billion (1.4 % of EU 2012 GDP).[11]

In short, the financial crisis forced Western European governments to have at hand very large amounts of money in order to reassure the markets and mitigate the effects of the financial crisis. Across the EU more than one and a half trillion euros on guarantees, on troubled assets clean up, and on banks recapitalization were mobilized. The US government spent on its TARP program alone 700 billion dollars. This gives a perspective that the 55 billion euros in the BRF would not suffice. Admittedly, the fund can borrow further amounts if required and repay ex-post by ex-post contributions of the banks. However, ailing banks would likely try to postpone or even to avoid such charges, which would be significant, given that the liabilities of big European banks are huge. Here again, the understanding is that in the case of a major meltdown public money would be needed (e.g. by the ESM). The conclusion is that the BU should not set out towards SRM and SRF before a level playing field is created. The participating banks should restore their balance sheets first; otherwise, the BU is doomed to become a redistribution scheme between healthy and weak banks in the euro area and beyond.

The Irish case again

Again, the events in Ireland provide a good case study. Recall that Ireland did not suffer from a detrimental loop between government and banks before the crisis, yet the country is seen as an unfortunate case given the misbehavior of its financial sector and the smallness of the economy,

[10] EU Commission, State Aid Scoreboard 2013, Aid in the context of the financial and economic crisis, at: http://ec.europa.eu/competition/state_aid/scoreboard/financial_economic_crisis_aid_en.html

[11] Ibid.

which collapsed under the weight of the required funds to fix the ailing Irish banks.[12] Had there been a European Banking Union in operation, so the argument, Ireland would not have been forced into insolvency (by bailing-out the owners and creditors of its banks). Although true at a first glance, the point is still problematic.

To see why, think of a small country called Paradise experiencing asset price bubbles, usually in the form of significant hikes in property and housing prices. Across a country, housing bubbles are in most cases unevenly distributed since they tend to be more pronounced in urban centers. Assuming assets price bubbles in the capital city of Paradise, on the southern coast, and in its major industrial center on the northern coast, but no property price changes in the rest of the country, the Paradise banking system would be confronted with diametrically different challenges. Provided the bubbles in the capital city and in the industrial center burst, the local banks would face - other things equal – bankruptcy, whereas the banks (or the local branches of big banks) in the rest of the country would be in balance. In the wake of the bubble, the books of many, yet not all banks will be fraught with non-performing loans. Would it help that in Paradise, like in any European country, there is an established Banking Union? Of course, county authorities do not deal with bank bankruptcies in Paradise. Rather, the handling of the banking crisis is executed at the highest (government) level. The answer is "probably not": a countrywide collapse of the financial system is likely if the capital shortages of the weakened banks are sufficiently large (larger than the aggregate capital of the rest[13]). That would cause the national banking system of Paradise to fail. Worse, the counties of Paradise that were greedy and reckless (because they would not curb their banks) in effect managed to export their problems to the healthy (probably because less overheated) counties, but this was not sufficient to avoid a nation-wide financial collapse.

To a large extent, Paradise is thus a copy of Ireland. Ireland, a sovereign country, does have a banking system with a nationwide supervision, resolution laws, and (introduced in 2008) deposit insurance mechanism. Just like the EU Banking Union, the major components were in place long before the crisis erupted. To be sure: no local authority was trying to protect a local bank from the central Irish authorities; vicious financial loops between a bank in a given county and the county finances did not exist in the sense that a local bank's collapse would cause the host county finances to collapse and vice versa; a cross-county resolution regime is in place. Yet Ireland failed, because the leverage of its banking system became

[12] For an overview and analysis see for example and Patrick Honohan: Recapitalisation of failed banks – some lessons from the Irish experience, Address by Patrick Honohan, Governor of the Central Bank of Ireland, at the 44th Annual Money, Macro and Finance Conference, Trinity College, Dublin, 7 September 2012, Bank for International Settlement, Review, http://www.bis.org/review/r120907j.pdf

[13] In that case the losses cannot be covered by the capital of the healthy banks.

unsustainable and not because the country is too small. Little Luxembourg didn't fail, yet big US did, and so on. The lesson is that the credit institutions of any EMU member state - whether large or small - should be regulated and supervised properly; a mere pass-on of the responsibility to clean up the mess of failing banks to the EMU is not a solution at all.

The Spanish case

Spain is another instructive hint that the promise the European BU makes might not materialize. During the 2000s, Spain's public finances were in good shape with insignificant budget deficits and moderate public debt ratios. As in Ireland, no detrimental loop between banks and public debt existed. The banking sector was thought to behave responsibly – a paper by the ECB[14] from 2009 indicated one of the lowest loan-to-value ratios for new mortgages - 72 percent compared to the estimated average of 79 percent for the euro area. Also, in 2007, Spain was the country with the highest non-financial assets-to-GDP ratio in the EU – way ahead of rich countries like Germany or the Netherlands.[15] Spanish banks were not involved in the American subprime mortgages business.

Against this backdrop, no bank supervision authority would have initiated steps to prevent a bank collapse in Spain; there was simply no reason for that. But as we know, the Spanish banking system plummeted in the wake of the financial and debt crisis in Europe. The crisis in Spain followed and was exacerbated by the crisis of Spain's real sector, which is not subject to supervision and regulation by the bank supervision authorities. In short, even if a European Banking Union was there before 2009, little would have happened, for that institution would have monitored the banks the same way the Spanish national bank supervision did. The notion that national authorities tend to downplay the problems of their banks does not hold, because the reason for the banking system crisis in Spain was outside that system in the first place.

Therefore, one may wonder what a BU would have done better if it had been set up earlier. Can the effect of shifting monitoring, resolution regime, and – someday – deposit insurance to the European level be seen as the ultimate stabilization of Europe's banking system? Ireland banks would not have failed if they had not over-leverage. The Irish government bailed them out instead to bail-in the owners by executing the Irish bankruptcy code. It applied for EU rescue package instead. (Yes, its government would have survived if a European BU was in place, because the costs of bank resolutions would have been put onto the shoulders of Ireland's euro area partners. As an outcome, the partners would have been forced to assume foreign liabilities). Spain would not face a banking crisis

[14] ECB, Housing Finance in the euro area, Structural Issues Report, March 2009, (see especially Table 1), http://www.ecb.europa.eu/pub/pdf/other/housingfinanceeuroarea0309en.pdf

[15] Ibid, Part 3.2.3, p. 29 ff., and Table 2.

without having undergone an asset price bubble. Both, Ireland and Spain, have oversight authorities and resolution laws, but in the end, they proved of little help. Against that backdrop, the question why an EMU-wide BU would do better is yet to be answered.

As for the European BU, in a certain sense size matters. A European BU is a national - Irish, Greek, Belgian, German, and so on - banking union on steroids. The financial sector collapse of Ireland would have been manageable at the euro area level, only because of the apparent smallness of Ireland. Redistribution would not be of any help though if things happened the other way around: if Germany's, Frances, Italy's, Spain's, and some day Poland's, and so on, banking systems were shaky. It wouldn't matter then that, say, Malta's, Estonia's, Greece's, and Luxembourg's financial system was in excellent shape. A burden shift - away from the ailing banking systems of the big member states onto the back of the small ones – would not be a way out at all. In this sense, a European BU cannot be a cure-all. The belief that the European level can deal better with bank problems may well be misleading since often it refers to the presumption that Germany and other northern member states of the euro area will be forever in the position to absorb redistribution shocks.

When considering the intention of the fathers of the European BU, one is tempted to believe that the BU is another step towards deepening the EU-wide mutualization already under way. Is it not merely further reinforcing the trend towards redistribution among the euro area member states? It is not unlikely that the establishment of a European BU will turn out to be a mutualization of bank liabilities, and a call on the taxpayers in financially sound parts of the Union to serve as the ultimate backstop. In short, a BU might be a redistribution system in order to relieve member states in financial trouble and to make others shoulder their burden. The Banking Union would allow recapitalizing weak banks not by governments short of cash, but by all partners across the euro area, although this is denied. The danger that this may happen is obvious though. Under the new Non Performing Loan and Forbearance Loan definition[16] more – up to 20 percent - problematic loans may appear on the banks' balance compared to the current narrow definition of impaired loans.[17] There is no satisfactory idea where the money for recapitalization should come from. To avoid what Germany and other member states of the euro area fear – mutualization - the recommendation is to first clean up the balance sheets of all banks, not just the ones covered by the SSM. Only then would the BU live up to the promise that it is not a redistribution system between sound

[16] EBA FINAL draft Implementing Technical Standards. On Supervisory reporting on forbearance and non-performing exposures under article 99(4) of Regulation (EU) No 575/2013, https://www.eba.europa.eu/documents/10180/449824/EBA-ITS-2013-03+Final+draft+ITS+on+Forbearance+and+Non-performing+exposures.pdf

[17] Stress Testing, in: Moody's Analytics Asset Quality Review and Stress Testing Solutions, http://www.moodysanalytics.com/~/media/brochures/solutions/moodys-analytics-asset-quality-review-and-stress-testing-solutions.ashx

and weak banks. However, when looking at the tight timetable – the SRM is scheduled to start operating very soon - this appears doubtful.

The effect of BU on implicit guarantees for banks

The trend towards redistribution might be involuntarily and unintentionally reinforced by particular side effects of a – credible – Banking Union. Here is why: the declared goal of the BU to sever the link between sovereign and banks implies that national governments are supposed to cancel any implicit guarantees for banks under their legislation. Implicit guarantees (sometimes called implicit warranties) are assessments by credit agencies of how far the support for banks by the state might go. The credit agencies assign according to those assessments credit ratings to various classes of debt issued by banks. Experience points out that there is a negative correlation between the lender of last resort function of the state and the cost of debt. Similarly, costs of debt may change reflecting the changes in bank resolution legislation. Basically, a drop in implicit guarantees would follow new regulations on bank capital and improved resolution legislation aiming at incurring losses on owners and unsecured creditors.

One may expect that the certainty arising from credible European Banking Union and the lender of last resort role by the state are substitutes. Once the state as a guarantor is replaced by the BU, the ratings should stay unchanged. In reality though, ratings are closer correlated with the implicit guarantees by the state. That is why authorities have often proven reluctant to deny banks implicit guarantees, at least not to a full extent. There are various reasons for why authorities have been cautious in withdrawing such guarantees in the past. Among the many, two reasons stand out; they shall be explained in turn:

i. **Contagion**

ii. **Funding.**

One reason is the apparent fear of contagion. Because the creditors of a distressed bank are most likely many other banks, the prospect to trigger a cascade of bank failures tends to discourage regulators and courts from deciding on bank liquidation or on sell-off of its assets. A simple model gives an idea why: the SSM is applied to banks with assets in excess of either 30 billion euros or of 20 percent of the host country's GDP.[18] Let's assume that in a small member state of the euro area with a GDP of 2 percent of the euro area total GDP a bank with assets of some 100 percent of that's country GDP (commonplace in small economies[19]) has to be

[18] See EU Commission, SSM, at http://europa.eu/rapid/press-release_MEMO-13-780_en.htm?locale=en

[19] A number of large banks in small euro area member states report similar and even much greater shares: Fortis Bank (Belgium) some 200 percent of Belgian GDP in 2008,

wound down. That bank's balance sheet states that, on the liability side, some 30 percent are amounts owed to other monetary financial institutions, e.g. mostly banks, of which one half, i.e. 15 percent of the bank's liabilities, are nonperforming loans. The EU Banking Union ruling is that bank's shareholders are to be wiped-out first. Next, we assume that the common equity Tier 1 capital is 5 percent, while the risk-weighted assets are 50 percent of the balance sheet. Therefore, the loss absorption would be at least 2.5 percent of the balance sheet, meaning the shareholders would absorb 2.5 percent of the liabilities; whereas, the creditors' burden would be 12.5 percent. We assume further that the creditors in question are two other banks sharing the loss evenly, i.e. each absorbing over 6 percent of the amount lost. Either bank is linked to two other banks the same way, which now face forbearance loans of some 3 percent[20] each of the initial amount. In the banking industry, this pattern of mutual dependence typically continues down the chain of interlinks. In the model, each further bank's losses are divided by a factor of two reflecting business connections to two other banks. (In reality, those links are much more complex though; here a mutual dependence of the simplest form is assumed).

In the end, substantial losses would be accumulated. Obviously, the more banks involved, the greater the amount of the loss as a share of that country's GDP. In spite of the 2.5 percentage points to be absorbed by the main stakeholders, still 12.5 percentage points will remain to be covered by the creditors. So the remaining losses will constitute 12.5 percent of the nation's GDP at the onset of the bank distress. Because of the interlinks within the banking sector, the loss would be multiplied and would sum up to almost 25 percent of the nation's GDP if that bank has business with 10 other banks.[21] However, it is more realistic to assume that the bank in question is linked not to only ten other, but to more banks, which are in turn linked to many other banks. The total loss will then of course increase, because the multiplier effect will be more profound. If the country's GDP were big compared to the EMU aggregate GDP, then the losses would be surely felt across the whole common currency area. However, the good news is that a deep integration within the banking sector provides better hedging against potential losses resulting from a collapse of individual banks. A greater number of partner banks means that the initial loss is split among many partners. Per bank the loss may be

Bank of Ireland and Anglo-Irish (Ireland) some 100 percent each, and so on. See Sebastian Schich and Byoung-Hwan Kim, Developments in the Value of Implicit Guarantees for Bank Debt: The Role of Resolution Regimes and Practices, Appendix 3, in OECD JOURNAL: FINANCIAL MARKET TRENDS – VOLUME 2012/2 © OECD 2012, http://www.oecd.org/finance/Value_Implicit_Guarantees_Bank_Debt.pdf ; ECB, Bankin Structures Report, November 2013, Chart 2, page 8, at http://www.ecb.europa.eu/pub/pdf/other/bankingstructuresreport201311en.pdf

[20] Effectively a bit less, because here the owners must incur losses first. For simplicity this is omitted in the calculation which skews the overall result only marginally though.

[21] Calculated as the sum of infinite geometric series the total would be 124.95 percent

within the capital adequacy ratio of 8 percent as required by the EU CRD IV, i.e. manageable. (Technically, if a creditor bank is dependent on just a few big debtor banks, then the exposure to large counterparty risk is higher and vice versa).

The recent history of bank crises in the EU sheds light on the reluctance of the authorities to resort to resolution or break-up of banks, in spite of national bankruptcy codes in every country. Rather, the commonplace approach was to exempt various classes of stakeholders from assuming losses and to apply government money instead. Between 2008 and 2012, only shareholders were subjected to loss bearing when banks failed. In a few member states of the EU subordinated bondholders were included; whereas, senior unsecured bondholders were almost everywhere exempt from loss bearing.[22] Since the BU gives national supervisory authorities a say in bank resolution decisions, pressure on them by affected stakeholders may mount and lead to even more reliance on such money.

The second reason why countries don't want a bank to fail is funding, especially with regard to subordinated, i.e. uncovered, or just partly covered, classes of bonds. Not wishing that banks go bankrupt is equivalent to issuing implicit warranty for banks even though they are not written in law. But like explicit guarantees (e. g. deposit insurance), the result is that implicit warranty makes it easier for banks to over-lend and over-borrow. They simply trust in their government that it will not let them fail. Implicit and explicit government bail-out guarantees are identified as one of the main causes for various bank crises. Governments issue implicit warranty to make sure roll-over of bank debt is unobstructed. The latter is sensitive particularly in terms of cross-border banking – the standard case in the euro area. In 2010, the perception in Ireland was that the ECB was applying pressure on Dublin to accept a bail-out as the preferred solution of the Irish financial crisis.[23] At the time, the Irish government was debating to make unsecured senior bondholders junior to uninsured depositors. The fear arouse that this would have led potential bond-holders in other euro area countries to expect similar bail-in. The consequence would have been mark-ups and price hikes in the market for such bonds in the middle of the financial crisis when banks were struggling to keep open funding channels. Against that backdrop, the ECB is believed to have practically blackmailed Ireland not to bail-in unsecured creditors.[24]

In an uncertain environment, the issuance of covered bonds tends to

[22] Sebastian Schich and Byoung-Hwan Kim, Developments in the Value of Implicit Guarantees for Bank Debt: The Role of Resolution Regimes and Practices, op. cit., Appendix 3.
[23] Dublin warned over ECB liquidity, Financial Times, November 15, 2010, http://www.ft.com/cms/s/0/d1841b72-f0ef-11df-bf4b-00144feab49a.html#axzz3C9cw0ABo
[24] Charles A.E. Goodhart, Funding arrangements and burden sharing in banking resolution, VOX Research-based policy analysis and commentary from leading economists, October 16, 2012, http://www.voxeu.org/article/funding-arrangements-and-burden-sharing-banking-resolution

largely replace the issuance of unsecured bonds. The cancellation of implicit warranty by the government tends to shift the market towards collateralized debt instruments; though, the problem is that the supply of acceptable collateral is limited. After all, collateralized debt instruments represent a call on bank assets to an extent which is not well-known.[25]

The result could be that when the EU Banking Union is in full operation (earliest in 2018-19; if we look at the planned deposit insurance mechanism even later – around 2026 or past) funding cost will stay high. That could make public guarantees, and thus public money necessary again; a reestablishment of the vicious cycle between state and banks may materialize.

Conclusion: Don't resort to the SRM prematurely

Unexpected effects of BU

The bail-in rule may drive a bank into default, because major creditors of banks are other banks. The BU bans bailouts of banks by the authorities of the country where the institution is located, but the pass-thru mechanism, as described above, may cause unexpected consequences for sound banks. A well-managed bank may suddenly face write-offs in its claims on partner banks; while the trigger may be a remote bank, the affected bank has little to do with it. In spite of national regulations on resolution of companies, banks included, during the financial crisis that erupted in 2008 authorities preferred bailouts to bail-ins. One reason was the fear that bail-ins would raise the cost of funding for banks, which would weaken them further. The other reason might have been the fear of contagion spiraling out of control across the industry. Credit institutions are by the nature of the credit industry illiquid (though not insolvent). When a financial institution runs into payment difficulties, its counterparties would trigger a run on it in order to be first to recover their assets. As the simple model above points out, the complex interaction between dozens and even hundreds of banks may well translate into huge collective losses when a financial institution is pulled into default. A panic in the market, frozen credit lines, calling-in of loans, and fading confidence among the players as it occurred in 2008, literally pushes the authorities towards a bailout decision. Under the conditions of the EMU, this is almost certain as the ECB nominally still does not have a clear cut lender of last resort authority in the government bond market. (The ECB is being encouraged to assume a lender of last resort role in order to fight sluggish growth and deflation in the euro area.[26] Basically, such role would help to isolate institutions in distress from their sound counterparties and assuring all stakeholders that

[25] Sebastian Schich and Byoung-Hwan Kim, Developments in the Value of Implicit Guarantees for Bank Debt, op. cit, p. 16

[26] Paul DeGrauwe, The European Central Bank as Lender of Last Resort in the Government Bond Markets, CESifo Economic Studies, Volume 59, Issue 3 , pp. 520-535, http://cesifo.oxfordjournals.org/content/59/3/520.full.pdf+html

banks are sound and trustworthy). Besides, a Central Bank must know the institution it is lending money to. Since 2009 the ECB has expanded its balance sheet. In the current almost deflationary environment, monetary easing is not a problem; in the long run, the danger of getting the inflation expectations of the public out of control should be taken into account. That danger is obvious given that the ECB does not supervise the bulk of small banks, while the lender of last resort function may well be extended to such banks too. Therefore, problems evolve out of the new regulatory and business environment the BU creates. In the example above, the big bank in the small member state of the euro area would cause losses of just 0.5 percent of the overall GDP of the euro area (25 percent of 2 percent). Given that in spite of the associated contagion effect the loss is sufficiently small, banks which are not covered by the SSM can feel encouraged to moral hazard. Taxpayer’s money is likely to be called for. Apparently, monetary programs by the ECB aiming at the stabilization of the financial system (Securities Market Program, Long Term Refinancing Operations, Outright Monetary Transactions) which are decoupled from the supervisory role of the ECB, would be a “free lunch” for those institutions. Here, the design of the BUs looks incomplete.

Moreover, since a lot of banks are in a dire condition, a Bagehot approach[27] – while having great merits – can hardly be applied. Many banks simply cannot provide trustworthy collateral. That makes it even more important to properly implement the supervisory measures the Comprehensive Assessment will recommend. The stress test must be credible this time, and a cleanup of banks’ balance sheets must come before resorting to the SRM and the (not yet existent) SRF. Otherwise, the principle that banks contribute to the SRF, according to their risk profile, is pointless. The BU has to create a level playing field: only sound banks should draw on the SRM and SRF; undercapitalized ones must be banned from BU – e.g. by closure.

“United we can”?

The move towards a European BU is widely justified by the assumption that “united we can”. The arguments go as follows:

Individual member states are overwhelmed when dealing with large, but ailing banking sectors. Pooling the resources of many member states provides the required strength to overcome such crises.

The Single Rule Book approach of the EU Commission sidesteps national interests and delivers a level playing field for all. Banks cannot expect blanket guarantees anymore; whereas, a blind eye on the side of national regulators and their forbearance are ruled out. This being for the good of all since those practices only make the macroeconomic losses associated

[27] Walter Bagehot in a book entitled Lombard Street (published 1873) gave a classic prescription: a Central Bank must lend freely, at a high rate of interest and on good banking securities.

with bank recapitalization or liquidation to rise.

European BU eliminates the link between the credit rating of governments and the funding cost of banks under their legislation. (This is true only when in the euro area many large member states are economically in a good health; otherwise it is not).

The bail-in tool is supposed to involve various stakeholders: shareholders, subordinated bondholders, and senior unsecured creditors, so governments are safe. Depositors are basically safe, too, since deposits up to a certain threshold are exempt; only deposits beyond that limit would be bailed-in when a bank is wound down.

More arguments are put forward.

At the same time, the first basic question remains whether the BU will stabilize the financial system. The second question is whether it will be less costly for the taxpayer.

When assessing the potential benefit (real evidence is yet to be obtained), most promising appears the capacity of BU to overcome the coordination problem of dealing with cross-border major financial institutions in default.

As for pooling resources together, this is a two-edged sword. While banks' defaults in a small country can overwhelm that country's finances, they would not harm the euro area much as its GDP is big enough to withstand the shock. In this respect, "big is beautiful". At the same time, pooling should be a solution of last resort; the firsthand solution should be to recapitalize or shut down such banks.

Much of taxpayers' money would be required if a distressed large, or worse, very large, bank has to be closed or parts of it are sold. More troubling would be the case when big banks in large member states in crisis were to fail simultaneously. Applying the same assumptions and considering that the largest European banks' assets are close to 15-20 percent of the euro area GDP (BNP Paribas, Deutsche Bank, Santander and others), the conclusion would be that only generous support with taxpayers' money could prevent the worst. This might be true in spite of the SRF (even when it is fully operable), because of it limited backstop power of just a fraction of the percent of EMU's GDP.

Undoubtedly, the ECB is a crucial actor within the framework of the euro area BU. However, the ECB should be careful not to discount its responsibility for price stability in favor of fiscal stability. In short, the problems of the EMU are not curable with monetary measures. The lack of competitiveness in many member states of the common currency area and the issue of overburdened public finances and banks have to be addressed by means of structural adjustment at the macro level, by bank recapitalization, removal of troubled assets from the banks' balance sheets, and banks resolution. Only when this is accomplished, the BU may live up to its promise to keep European banks and public finances safe.