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A Banking Union for an Unfinished EMU[1]

Hans Geeroms and Pawel Karbownik

Policy Brief

Abstract

This paper argues that a fully-fledged banking union is needed to stabilise the euro and to prevent a decade of high unemployment and low growth in the Vulnerable Euro Area Periphery Countries (VEAPs). What has been agreed by the European Council and the European Parliament in March 2014 is a step forward but remains insufficient. A further transfer of responsibilities to European institutions and more risk sharing are essential to sever the doomed loop of banks and sovereigns because individual EU countries are too weak to address this challenge alone. Ideally, we need a treaty change, but we also need to develop a second best solution that is based on the current treaty, while using its institutional and legal capacity to the full. However, a banking union is not enough, given that banks' assets exceed the EU's gross domestic product (GDP) threefold. The banking industry needs restructuring so as to prevent systemic risks and the legislator needs to have the power to intervene efficiently when needed. Finally we stress that any banking union should be open to future eurozone member states.

Keywords Banking union – EU – Treaty change – Banking crisis

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The economic consequences of a eurozone without a banking union

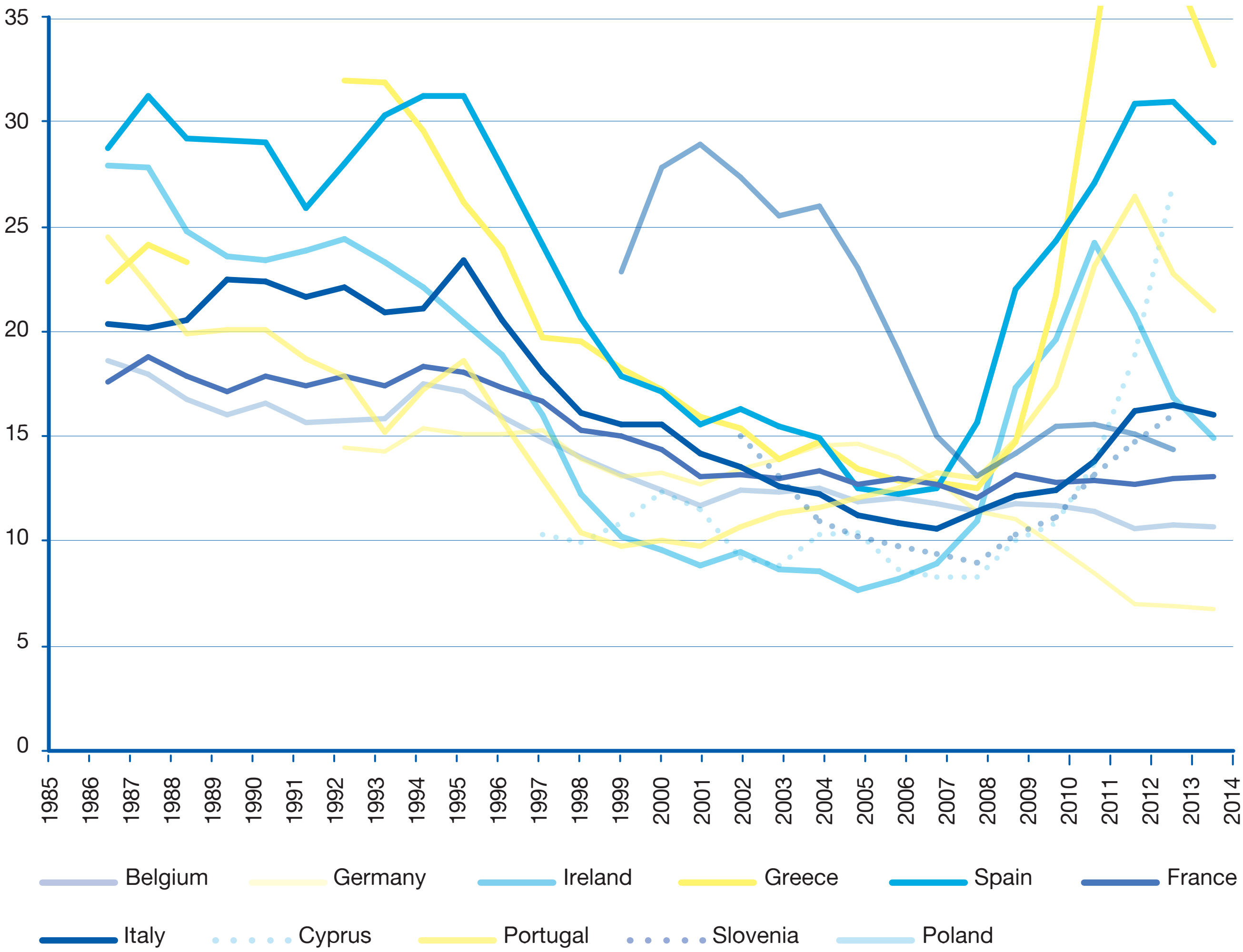
The euro crisis resulted in an increased exposure of banks to the debt of their own sovereign. All banks are interrelated and the bankruptcy of one bank can bring down other banks, the problem of being 'too big to fail'. In the absence of a European fund to save failing banks (i.e. a fiscal backstop) only national governments were able to rescue their banks. This set in motion the 'doomed loop' between banks and governments: weak banks are more likely to worsen the public debt problems of their sovereign, while countries with an unsustainable public debt are considered too weak to support their banks. This leads to weak banks that lose access to the inter-bank market.

Banks remain a major obstacle to growth in the eurozone. Eurozone banks rely more on volatile wholesale funding than US banks and the latter seem to be better capitalised as a result of binding stress tests. However, the main reason why the banking crisis seems to be over in the US is the existence of a real banking union, including a credible fiscal backstop and an effective supervisor and resolution system. The US regulatory regime and its well-developed capital markets limit the role of banks: total bank assets are around 80% of GDP in the US, compared to around 350% of GDP in the EU.

The doomed loop between banks and governments increases the cost of credit for businesses and households in the VEAPs. This leads to suppressed investment due to the fact that about three-quarters of the financing of the economies of the eurozone comes from banks (whereas less than one-fifth is financed in this way in the US). While the VEAPs performed better than the northern core prior to the start of the euro crisis, this was based on an unsustainable credit boom. The sudden withdrawal of capital in 2010 and the fiscal consolidation needed to readjust their economies has led to a negative growth rate since then (except in Ireland) and a significantly increased unemployment rate.

A more illustrative way to summarise the consequences of the euro crisis for the VEAPs is the 'misery index', developed by Arthur Okun in the 1970s to monitor the consequences of the economic policy of the Carter administration. We have used a modified version, including the unemployment rate and the long-term interest rate (reflecting both the inflation rate and the real long-term interest rate), and deducting real GDP growth. The idea is that high levels of unemployment, inflation and real interest rates all contribute to the economic misery of a country, while stronger GDP growth alleviates the 'misery' and therefore is deducted. We observe that misery levels fell in all countries prior to the introduction of the euro and continued to do so until around 2008. The financial crisis of 2008–9 and especially the sovereign debt crisis have reversed that trend in all VEAPs.

Okun's Misery Index applied to the EU



Sources: Eurostat, Directorate-General for Economic and Financial Affairs, Reuters (long-term interest rates for 2014 are those of 24 March 2014) and the authors' own calculations.

Europe needs a banking union in the short to medium term for the survival of the euro itself. If it is not properly constructed and financial market fragmentation remains, there will only be limited restoration of economic activity in the peripheral countries, while youth unemployment and fiscal consolidation will further undermine political support for the EU. The political backlash due to the financial crisis and its poor handling will further undermine the European integration needed to stabilise the euro.

A common currency requires a banking union

The Theory on Optimal Currency Areas[2] states that a monetary union will only survive if the benefits of a common currency outweigh the disadvantages caused by the loss of the exchange rate instrument. The very low labour mobility between both northern and southern and eastern and western member states makes the eurozone susceptible to negative economic shocks. However, even better functioning labour and goods markets cannot compensate for shocks of the magnitude caused by the vast reversal of capital flows that began in 2010, which amplified the existing fiscal imbalances and private debt problems in the eurozone.

The essential role of a banking union for the survival of the euro can be explained in two ways: 1) the absence of a banking union can be a cause of important asymmetric shocks due to sudden capital flow reversals; while 2) a well-functioning banking union is an important instrument in accommodating such shocks through portfolio diversification and the creation of European banks regulated by the EU institutions. Capital market integration in the US accounts for the absorption of two-thirds of shocks, hence a banking union is more important as a shock absorber than a fiscal union.

[2] McKinnon, R., ‘Optimum Currency Areas’, American Economic Review 52 (1963), pp. 717-25.

The Single Supervisory Mechanism (SSM): a possible game changer

Due to the financial crisis, several member states entrusted their central banks with prudential supervision based on their credibility. This increased the synergies between monetary policy and prudential supervision. It also increased the credibility of the supervisory process; credibility which in many cases had been lost by national supervisors. The SSM charges the European Central Bank (ECB) with the supervision of the 6,000 banks in the eurozone, based on its credibility and legal constraints. Article 127(6) was the only solid legal basis possible within the current Treaty on the Functioning of the European Union (TFEU), but it excludes supervision of insurance companies by the ECB, and, more importantly, it subordinates supervision to the ECB's decision-making bodies. This creates a potential conflict of interest when the ECB's Governing Council is ultimately responsible for both monetary policy and prudential supervision. An imperfect solution was found via the creation of the Supervisory Board. The final separation of monetary policy from supervision and the coverage of insurance companies requires a treaty change.

The interinstitutional agreement between the European Parliament and the ECB provides for strong parliamentary oversight of the ECB's supervisory tasks. This is important, as one of the weaknesses of several national supervisors was the lack of transparency and accountability.

The ECB cannot afford to become responsible for banks that later fail because they had hidden losses on their books (i.e. legacy assets): this could destroy the credibility of the ECB and of its monetary policy. For that reason the forthcoming Comprehensive Assessment is of key importance.[3] The asset quality review and the stress test will produce one single figure regarding the capital needs of each bank in November 2014. The ECB cannot afford to hide banking problems in member states, as national authorities have done too frequently. Therefore the Comprehensive Assessment has the potential to become a game changer in the euro crisis. Its impact is already becoming visible as banks anticipate the publication of possible capital shortfalls by raising their capital basis, and some national authorities are also reacting in advance by increasing their statutory capital requirements.

[3] The Comprehensive Assessment to be conducted by the ECB consists of three closely interlinked components: 1) a supervisory risk assessment, 2) an asset quality review (AQR) and 3) a stress test.

The SSM also awards certain responsibilities concerning macro-prudential supervision to the ECB. In a monetary union and a single market the instruments used for financial stability are even more important because the exchange rate instrument and the instruments of capital control can no longer be used. Macro-prudential policy is also important for steering the economy after a financial shock, while in normal times monetary policy seems to be sufficient. The TFEU predates the financial crisis, and therefore it subordinates financial stability to price stability. The TFEU should be reviewed so as to integrate the new policy area of financial stability into the objectives of the ECB, alongside price stability. The European Systemic Risk Board, whose actions have so far been disappointing, should be strengthened.

The Single Resolution Mechanism (SRM): we cannot escape our responsibility

A real pan-European banking union that is directly responsible for all banks in the eurozone would be ideal, but political realism forces us to look to the principle of subsidiarity for a pragmatic yet effective SRM. The banking union should cover the systemically important banks, or the ‘European banks’, while making member states fully responsible for the fate of their own smaller banks.

The Single Resolution Board should be able to act in a timely and efficient way, if necessary over the weekend, and keep its distance from national banking interests. Within the current Treaty, the best solution is to award the European Commission with this task: it is an existing body, with experience of banking resolution via the Directorate General (DG) for Competition; it is supposed to act in the interests of the Community; and it is accountable to the European Parliament. We propose splitting the current DG Internal Market and Services into a DG for financial markets and banking resolution and a DG for other aspects of the Single Market. A ‘Commissioner for the Single Financial Market’ should be appointed. The nature of the decisions will be similar to those already taken by the European Commission in the case of mergers and acquisitions and state aid.

A treaty change would allow the creation of the ideal of a small board of independent experts as a resolution authority; members would be appointed for a fixed time period by the European Council and would have the ability to make quick, independent decisions, after consulting national and European stakeholders.

The bail-in instrument enables resolution authorities to write down or convert into equity the claims of the shareholders and creditors of institutions. The European Commission's new state aid rules mirror the provisions of the Banking Recovery and Resolution Directive (BRRD) and constitute the basis for bank resolution well before the BRRD or the SRM come into force. The European Commission should stop the abuse of loopholes by member states so as to prevent taxpayers' money again being required to recapitalise banks. The Single Market acquis should be enforced and national authorities should avoid imposing a strong home bias and hindering cross-border mergers when it comes to rescuing banks. The bail-in instrument has the potential to become a very powerful tool, seriously limiting the need for a backstop as 8% of the capital that is able to be 'bailed-in' corresponds to around 25% of the risk-weighted assets, if it can be made operational in times of stress caused by a systemic bank failure.

To resolve cases when the bail-in is insufficient, member states must set up ex ante resolution funds, which need to reach at least 1% of the covered deposits as soon as possible. It makes good economic and political sense that only the financial sector should contribute to bank resolution and deposit protection. The levies best take into account the systemic risk of the institutions, thus internalising the external effects of socially unwanted risk behaviour. Objections by certain member states that their banks would then pay a disproportionate share to the fund should be disregarded, as this concerns European banks generating European risks.

A prefinanced resolution fund can never insure against tail risks (i.e. a risk that is very rare and that cannot be dealt with via normal insurance principles). The only solution to that problem is to reduce the probability of tail risks via a credible public backstop (i.e. the availability of resources sufficient to cover the potential costs of recapitalisations, bail-outs and guarantees). While this backstop is an extra argument for a real budget for the eurozone, in the absence of one, a credit line to the European Stability Mechanism (ESM) is the closest substitute. Consequently the ESM should have a credit line to the ECB for the purpose of bank recapitalisation. This would assure the financial markets of the credibility of the backstop arrangement. The moral hazard should be avoided by preventing higher expectations and making sure that it is an ultima ratio instrument, or an instrument only to be applied in the very last instance. Direct bank recapitalisation by the ESM runs counter to the principle that taxpayers' money should not be used to rescue banks, but in the likely event that the fiscal backstop remains unacceptable, direct bank recapitalisation remains a second-best solution and should also remain accessible after the Single Resolution Fund is established.

Unfortunately the agreement reached by the Council and the Parliament in March 2014, although an improvement compared to the weak general approach of the Council in December 2013, can hardly be called an SRM. The role of the European Commission is still constrained by a Board including national resolution authorities, the decision-making process requires the Council's involvement in certain cases and, most important, it lacks a credible backstop. The new system may not withstand the reality-check of failing banks. We must hope that it will not take the occurrence of a new systemic banking crisis before member states will accept the need for an effective, real resolution mechanism, based on fair contributions and related to the systemic risk of the banks covered.

The role of future eurozone member states

The banking union is conceived for the eurozone to break the vicious circle between banks and sovereigns. The non-eurozone countries have fewer reasons to join the banking union because their own currencies protect them better against the consequences of sudden capital reversals. On the other hand, by joining the banking union they could benefit from strong and credible supervision (provided it is achieved) and from a common backstop (provided it is created) to strengthen their own banks, which are, to a large extent, separate from the eurozone. Experience also shows that it is harder to exert influence and shape institutions when involved in their creation than when they are already in existence. For that reason the ESM Treaty would have to be reviewed so that non-eurozone countries willing to join could contribute to and benefit from the ESM. Using the Balance of Payments Facility[4] as a backstop for non-eurozone countries would cause those countries to be treated differently, but could be considered as a second-best, interim solution.

[4] The Balance of Payments Facility provides loans from the EU (mostly joined by the IMF) to support member states facing balance of payments problems or a lack of foreign exchange.

The unavoidable treaty change

Ultimately, the further development of the banking union requires a treaty change for several reasons:

- Article 127(6) of the TFEU is insufficient to fully separate the monetary policy function of the ECB from its role in the SSM;
- an intergovernmental treaty as the legal basis for the Single Resolution Fund (SRF) is no substitute for a treaty change, as it risks further fragmentation of the EU, sidelines the European Parliament, increases the complexity of the institutions and makes it very difficult to involve the European Commission;
- the objectives of the ECB need to be updated in order to allow more flexibility to achieve the goal of financial stability; and
- banking resolution requires a new legal basis as insolvency procedures currently belong to national competences and need to be harmonised at the EU level.

Because this implies a transfer of sovereignty to the European level, only an ordinary treaty change, based on Article 48(2–5) of the Treaty on European Union, can solve all the existing legal problems. This procedure requires a Convention. The EU has to convince the financial markets of a credible timescale for such a treaty change, as well as for the creation of a fully-fledged resolution mechanism. We think that a technical treaty change[5] 'only' to empower the EU to fully manage the SRF and integrate the Intergovernmental Agreement on the Fund into the EU's legal framework will not escape the same fate as an ordinary treaty change. A referendum would probably be needed in France, the Netherlands and Ireland.

Unfinished business: the fourth pillar of the banking union or how to solve the problem of 'too big to fail' in the EU

The political energy invested in the banking union and the short memory of politicians mean that the lessons of the financial crisis and the actions required to stabilise the EMU and save the euro have already been forgotten. This is supported both by the fact that the ECB has temporarily calmed the financial markets with Outright Monetary Transactions and other non-conventional monetary policy actions, and the fact that the

[5] Some have considered an amendment of Article 136 of the TFEU or to Protocol 14 of the TFEU. Both refer to provisions that only apply to the member states of the eurozone, which is a serious handicap given that the Banking Union is open to all member states.

economy is recovering. This situation will probably remain for the rest of 2014, unless a new crisis erupts.

If we want to continue with the euro, we face the need for a trade-off between a functioning banking union and a fiscal union. At the moment we only have embryos of both: the SSM combined with an insufficient SRM, and the ESM. As the fiscal union is a political non-starter for the time being and because more work is needed to create a banking union, the euro area remains vulnerable to shocks created by an overreliance on weak banks to finance economic growth. We therefore have to solve the 'doomed loop' between sovereigns and banks, create truly European banks, and finance the economy via alternative and more diversified channels. Ideally, the financial industry should be organised in such a way that systemic crises cannot happen and banks can insure themselves against normal risks; only in that way will taxpayers' money never again be used to compensate bank failures. This requires three actions.

Preventing banks from becoming too exposed to the debt of their own sovereign

The default of Greece and the need to bail out other peripheral member states proved that attaching a zero-risk weighting to sovereign bonds, as was done in Capital Requirements Directive IV,[6] does not correspond to reality. Only a common eurozone debt can be considered safe, as it would be based on a monetary zone with its own currency; national debt has proven to be unsafe and related to the solvency of the sovereign itself. Banks should gradually be forced to include the risk of insolvency of individual member states in their prices, which in itself would be a brake on the development of unsustainable sovereign debt. The application of the large exposure rule on sovereign debt holdings is also needed, meaning that banks would be prohibited from investing more than a certain percentage of their balance in one specific asset, for instance the debt of their own sovereign.

[6] Capital Requirements Directive IV translates Basel III rules into EU law. It strengthens, among others, capital requirements, but continues the old practice of allowing banks to not have to keep any capital buffer to compensate for possible losses on holdings of sovereign debt.

Development of the equity and corporate bond markets

The dominant role of banks in financing the economy of the eurozone can be explained by the importance of small to medium-sized enterprises and by the limited role of private pension funds. The financial and the euro crises provided new arguments to promote alternatives to traditional bank financing. A higher share of long-term cross-border holdings of assets would make member states less vulnerable to capital reversals. Equally, encouraging insurance companies and occupational pension funds to diversify their 16 trillion euros of assets, and developing a pan-European capital market by removing legal and tax obstacles would also make the economies of the eurozone more stable.

Bank restructuring

Splitting investment banking from retail banking, or ring-fencing, has taken place in the US and the UK, but some major EU member states have refused to do this due to pressure from their large banks, or have adopted a weak version of bank restructuring. We do not underestimate the practical difficulties of implementing this idea to make traditional retail banking safer. It is, however, remarkable that the eurozone, which is so dependent on bank financing, is hesitant about restructuring its banking industry to make it safer. It is important that the EU pursues its agenda on bank restructuring. The proposal of the European Commission of 29 January 2014 leaves too much discretion to the national supervisors; only the Supervisory Board of the ECB should be allowed to rule on exceptions for risky trading activities, and existing national bank restructuring schemes should be improved to comply with the agreed European model. This applies even more for banks in the eurozone, where the risk of a doomed loop with the sovereign is a matter of common concern.

Conclusions

The euro is an unfinished project, the new economic governance structure remains ineffective and the fiscal union is a distant dream. We therefore need a true banking union to strengthen the unfinished EMU and provide effective stabilisers for shocks via the financial system, which should normally absorb two-thirds of all shocks in a well-functioning currency union. This union is much needed in the euro area, which has been hit by financial shocks resulting from bank renationalisation and by too much reliance on bank funding. The euro area is also characterised by rigid labour, product and factor markets, and the absence of a eurozone budget. In other words, banking union is the last resort when it comes to preventing unsustainable new debt evolutions and imbalances. The structure and the role of banks in financing the economy should be adjusted, so that they support business activity and economic growth. This is not only a problem in the EU but is a global dilemma that needs to be addressed in the post-crisis reality. Banks should raise capital to meet minimal solvency and leverage thresholds, and investments in national sovereign bonds should not receive special treatment. This could be realised based on the current TFEU, but a treaty change is needed in the longer run. Creating this truly European banking union would be the biggest move towards integration and the most important shift of power from the national to the European level since the establishment of the euro.

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About the authors

Hans Geeroms is a Research Associate at the Centre for European Studies; Professor of European Economic Policy at the College of Europe and KULeuven, Brussels Campus; and a guest lecturer at the Polish Diplomatic Academy. He is a former adviser on EU economic policy to Belgian Prime Ministers Leterme and Van Rompuy.

Pawel Karbownik is Deputy Director of the EU Economic Department of the Polish Ministry of Foreign Affairs, responsible for the European Council in the field of economic policy. He previously worked at the European Parliament in Brussels, and has also gained experience in the corporate world and as an academic.

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Wilfried Martens Centre for European Studies
Rue du Commerce 20
Brussels, BE - 1000

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