THE FISCAL IMPLICATIONS OF A BANKING UNION

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THE ISSUE
Systemic banking crises are a threat to all countries whatever their development level. They can entail major fiscal costs that can undermine the sustainability of public finances. More than anywhere else, however, a number of euro-area countries have been affected by a lethal negative feedback loop between banking and sovereign risk, followed by disintegration of the financial system, real economic fragmentation and the exposure of the European Central Bank. Recognising the systemic dimension of the problem, the Euro-Area Summit of June 2012 called for the creation of a banking union with common supervision and the possibility for the European Stability Mechanism to recapitalise banks directly.

POLICY CHALLENGE
To be consistent, a banking union needs a common supervisor and common resolution arrangements with the aim of reducing fiscal costs. At the same time, arrangements for a common fiscal backstop need to be made. A robust institutional set up, which also addresses incentive problems, is required for credibility of banking union in case of a major crisis. Legacy problems should be addressed head-on to reduce overall costs. Four options for a common fiscal backstop could be considered: a European Resolution Fund, an ex-ante burden-sharing agreement, the European Stability Mechanism (ESM) as a fiscal backstop, or contingent European taxation. Because the ESM is operational, it would be the preferable short-term option.
THE FIRST SENTENCE of the Euro Area Summit Statement of 29 June 2012, “We affirm that it is imperative to break the vicious circle between banks and sovereigns”, unambiguously specifies the motivation for creating a banking union in Europe. The overriding objective is to remedy an acute fragility in the euro area that was not fully perceived before the 2010-12 crisis. The potentially devastating consequences of this fragility have been illustrated by the parallel increase in sovereign and bank default risks, and the ongoing fragmentation of the euro-area financial market along national lines.

But there is another possible motivation for forming a banking union, with significantly different fiscal consequences. It is rooted in the logic of completing the single market, facilitating the resolution of cross-border banking failures and ensuring a level playing field in competition among EU banks. This logic underpinned the European Commission’s June 2012 proposals on the strengthening and reform of the common EU banking framework. While there are good reasons for this approach, the priority should be to repair the deficiencies of Economic and Monetary Union, and ensure the stability of the European currency. A banking union should also take account of the EU member states that are intending to join the single currency, by making it possible for them to participate where appropriate and to prepare for eventual full membership.

The fiscal dimension is of second order if one prioritises the single market, but it is of paramount importance for EMU. The notion of a perverse feedback loop between banks and sovereigns highlights both the financial risk involved in leaving banks under the responsibility of fiscally weak sovereigns, and the fiscal risk involved in letting national governments alone bear the responsibility for rescuing the banks headquartered on their territories.

The rationale for forming a banking union is to minimise these twin risks through a common insurance system that breaks the feedback loop, thereby reducing both the frequency and incidence of systemic banking crises. The design of the new regime, its credibility and its consistency will determine if there will actually be fewer, less severe banking crises. This will also depend on all actors being given the right incentives to behave prudently.

THE FISCAL DIMENSIONS OF BANKING CRISSES

Systemic banking crises entail potentially huge fiscal costs. Implicit or explicit state guarantees to banking systems represent major contingent liabilities, the materialisation of which could jeopardise sovereign solvency. To the extent that markets expect this

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2. June 2012 Commission proposal on the creation of an EU framework for bank recovery and resolution.
4. The literature identifies three main channels through which to assess the fiscal costs of financial instability: (i) direct bailout costs, (ii) losses of tax revenues from lower capital gains, asset turnover and consumption, and (iii) effects of asset price changes on the real economy and the cyclical component of the budget balance (see Eschenbach, F. and L. Schuknecht (2002) ‘The fiscal costs of financial instability revisited’, Working Paper 191, European

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**BOX 1: FISCAL CONSEQUENCES OF BANKING CRISIS**

Banking crises tend to occur more frequently in developing economies, but are longer-lasting and deeper in developed economies. According to the IMF, the average duration, output loss relative to trend and direct fiscal costs of all banking crises between 1970-2011 were three years, 33 percent (cumulated output loss) and 3.8 percent (direct fiscal cost) of GDP for advanced economies. Other studies find similar results. For the current crisis, the IMF data shows that at end-2011 the cumulated output loss in the euro area amounted to 23 percent while the direct fiscal cost was estimated to be 3.9 percent of GDP.

**Figure 1: Fiscal cost of banking crises, 1970-2011, advanced economies**

One of the main determinants of the fiscal cost of crises is the resolution policies that are applied. Empirical evidence suggests that resolution policies that included open-ended liquidity support, regulatory forbearance and an unlimited deposit guarantee added a significant fiscal cost. For example, Japanese forbearance in the 1990s and the early 2000s resulted in magnifying fiscal costs and prolonging economic stagnation, whereas swift Swedish resolution in 1991-92 had the opposite effects.

Source: Bruegel using the Laeven and Valencia (2012) database (see footnote 3).
threat to materialise, the fiscal risk may lead them to price a sovereign default. Actual public finance costs result from assistance provided to financial institutions through recapitalisation and the liability guarantees (the direct fiscal cost) and from foregone tax revenues or additional expenditures implied by the adverse economic impact of banking crises (the indirect fiscal cost). International Monetary Fund data indicates that economies of very unequal development level can be subject to such shocks (Box 1).

Box 1 notes that the resolution regime is of central importance to minimise the economic and fiscal costs of banking crises. In particular, the extent to which costs can be distributed to private creditors matters considerably. It would be an illusion, however, to believe that together with adequate micro- and macro-prudential supervision, a properly designed resolution regime can eliminate the fiscal risk. There are circumstances when the commitment of significant amounts of public money is the best or even the only economically efficient way to contain the consequences of a banking crisis. Access to budgetary resources in case of need is therefore an essential part of financial stability. Resources must be sufficient to cover direct re-capitalisations and bail-outs, and also guarantees that help prevent bank runs. Even if the guarantees are not called on, they can affect market perceptions of sovereign solvency. A credible fiscal backstop is therefore an indispensable element of any crisis management and resolution regime.

WHY BANKING UNION SHOULD CONTRIBUTE TO REDUCING FISCAL VULNERABILITIES

The crisis has revealed that under conditions of financial stress, participation in monetary union magnified existing fragilities and the corresponding threats to fiscal and financial stability. In turn, increased worries about public finance sustainability and the health of national banking systems contribute to financial fragmentation, to the emergence of large disparities in funding conditions for banks and non-financial agents such as households and SMEs, and ultimately to the reinforcement of the very vulnerabilities at the root of market concerns. This vicious circle is a potentially lethal threat to the common currency.

Figure 2: 5-year credit default swap risk premia on sovereigns and banks in selected countries

Source: Datastream.
and sovereign risk in the United States and the United Kingdom – despite, in the US case at least, a strong deterioration of bank default risks at the time of the global financial crisis.

In all countries, a potential feedback loop exists. Banks are exposed to sovereigns because of their domestic government bonds portfolios and their exposure to the domestic economy, and because the value of the implicit government guarantee they benefit from diminishes when the sovereign’s solvency is put into question. Sovereigns are exposed to banks precisely because of this guarantee and the indirect fiscal cost of a financial crisis. In addition, there are several reasons why bank stress and sovereign stress are more correlated in the weaker euro-area countries:

- Correlation only sets in if markets assess sovereign default risk as significant. It does not show up if the fiscal position is strong, or if banking sector troubles have limited fiscal consequences.
- The credit risk borne by banks is more diversified in the US than in European economies where exposure is strongly geared towards domestic loans and assets. This renders European banks vulnerable to strong national cycles, including in the mortgage market.
- Banks in the US and the UK hold fewer securities issued by their own governments than most euro-area banks. In 2011, 2 percent of US Treasury securities were held by domestic banks, compared to about 10 percent in the UK and the Netherlands, 15 percent in France, Italy and Ireland, and 20 percent or more in Greece, Portugal, Germany and Spain.

‘A banking union would help repair monetary policy transmission and reduce disparities.’

- Bank refinancing by the European Central Bank through the three-year long-term refinancing operation has alleviated concerns over bank funding but has increased banks’ exposure to their own sovereign. Liquidity provisioning is not a structural response to the fragility and debt overhang exhibited in the crisis;
- Resolution policies that impose the greatest part of the cost on private bank creditors reduce the fiscal risk. In the US, there have been on average 90 bank closures per year since 2008, but reported fiscal costs since the onset of the crisis have been limited.
- Participation in a monetary union increases the sovereign default risk on the face value of debt because monetary policy does not react to country-specific solvency fears and debt is not monetised. Threats to public finance sustainability, including those arising from bank bailout risks, therefore translate into sovereign solvency risk instead of giving rise to expectations of exchange-rate depreciation and inflation.

Some of these vulnerability factors are independent from participation in a currency union and can therefore be addressed separately. But some are inherent to it. Hence, there is an overwhelming case for complementing EMU in a way that will strengthen its resilience. A banking union should help reduce the negative feedback loop in three ways:

- By protecting individual sovereigns from the adverse feedback loop.
- By pooling risk. Increasing the number of insured banks with different, partially uncorrelated credit risks will make it less likely that banking risk becomes so large that sovereign risk increases, reducing the potential for major crises to develop.
- By facilitating bail-ins. Resolution authorities currently have to consider the risk that bailing-in private creditors will accelerate capital flight. A banking union should reduce country-specific risk so that the European authority can more easily impose losses on private creditors of banks without undermining financial stability. A well designed banking union could therefore also reduce the global fiscal cost by increasing creditor involvement.

In addition, a banking union would help equalise funding conditions for banks and therefore for ultimate borrowers of same creditworthiness. This would help repair the transmission of monetary policy and reduce disparities across countries.

It should be kept in mind, however, that a well-designed banking union would not address the asset side of the problem. Vulnerabilities arising from the banks’ high exposure to country-specific credit risk and sovereign default should be addressed through different means – banking market integration, regulatory limits to single-
borrower exposure, or the creation of Eurobonds – which are beyond the scope of this paper.

THE STRUCTURE OF A BANKING UNION

Banking union relies on a single rulebook for the whole of the EU and involves four pillars:

- Supervision of financial institutions;
- Deposit insurance;
- Resolution of failing banks or systemic banking crises;
- A (common) fiscal backstop.

These pillars are closely linked. A consistent approach therefore suggests allocating them to the same level of governance. For example, if bank supervision is organised at European level, central resolution functions should be allocated to the same level. Otherwise, the national resolution authority may argue that it has to act because of supervisory failures at European level and that it lacks appropriate information. Similarly, national taxpayers would not agree to a system that would make them pay for the faults of a European institution over which they have no control. It is also easy to imagine cases in which the European supervisor would withdraw a given institution’s banking licence, forcing national resolution and the commitment of public money, whereas national authorities would have preferred forbearance. Making national taxpayers pay for the consequences of a decision their government opposes would be a recipe for trouble.

At the same time there are obstacles to complete centralisation, in addition to practical obstacles:

- Even though deposit guarantee systems have the same aims, their organisation differs significantly across and even within countries.
- Resolution involves the closing or absorption of financial institutions, which is organised differently in a heterogeneous legal system, for example in relation to bankruptcy and labour laws.
- The complete pooling of the potential fiscal costs of banking crises would create incentives for countries to support the development of oversized banking sectors, because potential losses would be socialised, while benefits in terms of jobs, profits and credit would remain mostly national.

Supervision is of vital importance. Distribution of supervisory responsibilities largely drives the degree of centralisation in other fields. It is also where the Euro Summit took the clearest stance. One issue that is still heavily debated concerns the number of banks to be covered by common supervision, with suggestions ranging from 20 and 6000 banks. Clearly, staff located at the staff located at the ECB cannot supervise all European banks directly. At the same time, limiting the scope of banking union to the very small number of banks that are systemic at European scale would be insufficient to break the sovereign-banking feedback loop. However the real choice is not between 20 and 6000. The largest 200 banks represent more than 95 percent of bank assets in the euro area (Figure 3). This suggests a regime in which legal responsibility for supervising all banks is given to the ECB, but supervision of the smallest is delegated to national authorities. The implementation of monetary policy decisions within the Eurosystem and antitrust enforcement within the European Competition Network are two examples of decentralised decision-making powers combined with a degree of centralisation in implementation.

The relevance of deposit insurance seems to have been somewhat overemphasised in recent

Figure 3: Distribution by assets and deposit size of the euro-area banking sector

Source: The Banker Database and ECB. Note: 2010 year-end data. Reading: the assets of the 20 largest banks represent 68.6 percent of total bank assets in the euro area.

11. This approach would also raise potential competitive distortions, and would imply different benefits across countries, for a detailed description, see ibid.
The organisation of a backstop nevertheless raises important questions.

- Would common insurance lead to a distributional bias of tax resources from some countries to others? The empirical evidence does not suggest it would. As pointed out by Reinhart and Rogoff (2008), banking crises are "an equal opportunity menace" that can affect all countries rich and poor.

- What incentives would a common fiscal backstop create? The introduction of insurance creates moral hazard. The pooling of risk at a European level would give countries a greater incentive to run irresponsible banking policies because potential losses can be socialised while the benefits in terms of jobs and credit would mostly be national. A robust system needs to deal with this incentive problem.

- How would contributions to the common insurance be shared? In principle, contributions should be commensurate to risk.

These questions suggest that a common fiscal backstop requires...
centralised supervision and resolution to mitigate the moral hazard problem. Moreover, *ex-ante* contributions to resolution and contributions to the fiscal backstop should be linked to the size of the banking sector in the country. Finally, even with a fully centralised supervision and resolution framework, other still-national policies matter for banking-sector risk. Therefore, national taxpayers should always be partly liable for fiscal casualties. The exact distribution between the national and the supranational fiscal backstop should be based on clear *ex-ante* rules.

Against this background, there are several options:

**A European Resolution Fund**

A common resolution fund calibrated to cover a large proportion of potential banking crises costs could be created. Contributions to the fund would be paid in over 10-20 years to build up a fund of, say, 5 percent of euro-area GDP. The contributions could come from a levy based on the assets of financial institutions.

This option would have a number of advantages. To start with, potential resources from the financial sector are available to this end. Second, a pre-funded scheme would be very credible and the immediate availability of resources would mitigate banking panics.

However, there are potential shortcomings. First, under current circumstances one may question the wisdom of accumulating in a fund instead of reducing public debt. Second, a fund of such size would have difficulties finding safe assets that can be liquidated in crisis times. Third, a fund of even significant size cannot provide a full guarantee. Overall, the idea of a fund deserves consideration but it seems unlikely that the EU will agree on establishing in the short to medium run a fund of sufficient size. Until it is established, other fiscal resources will be needed.

**An *ex-ante* burden-sharing agreement**

*Ex-ante* agreement on distributing the fiscal costs of banking crises would consist of a clear rule spelling out how much of the cost would be borne by taxpayers of the country in which the bank is located and how much by the taxpayers of the European partners. The rule could be based on the ECB capital key or a variant of it taking into account the size of each country’s banking sector. A clear governance structure would be needed to call in the national resources.

This solution, however, would make the intervention capacity dependent on *ex-post* approval by the participating states. Experience with assistance to countries in distress has shown the limits of such schemes. Burden-sharing therefore entails the risk that states, which retain the ultimate decision, will backtrack from commitments. An *ex-ante* agreement therefore requires strong institutions in order to be time consistent and credible *ex-post*.

**The European Stability Mechanism as a fiscal backstop**

Also the EFSF/ESM could serve as a fiscal backstop. If all of the resources available in the ESM were to be allocated to that purpose, the European Financial Stability Facility/ESM would sufficiently large to cover the median direct fiscal cost of a banking crisis of about 4 percent of GDP [see Box 1]. However, the option has disadvantages. First, many banking crises cost significantly more. Second, in current conditions the EFSF/ESM cannot provide the *ex-ante* guarantees (or blanket guarantees) that may need to be given to prevent a generalised panic. The big advantage of the EFSF/ESM option, however, would be that the institution is already being established, that it has resources and that burden-sharing agreements are in place. Moreover, it has strong governance mechanisms that make it able to take swift decisions in emergencies.

Under current arrangements the EFSF/ESM option would fall short of providing the guarantee that may become necessary in exceptionally adverse cases. It has, however, the big advantage of being operational and is therefore our preferred short-term option.

**Contingent European taxation**

The euro area could be granted a limited and contingent taxation capacity. This would create the capacity to raise resources to pay for bank resolution, and would also imply the creation of an institution that could issue a credible guarantee in case of a major systemic banking confidence crisis. It is, therefore, a desirable long-term

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13. There have even been discussions on the value of taxing the financial sector on purely Pigouvian grounds, ie to limit excessive financial development rather than to raise revenues. See International Monetary Fund (2010) ‘A fair and substantial contribution by the financial sector’, in Financial Sector Taxation: The IMF’s Report to the G20 and Background Material, edited by Stijn Claessens, Michael Keen and Ceyla Pazarbasioglu.

14. Government bonds cannot be used for such a purpose precisely because in times of banking crisis one wants to prevent government firesales. Assets in countries outside the euro area suffer from being subject to exchange rate risk. Only gold appears to have the right properties for times of financial crisis.
option. In the short run, however, this solution is unlikely to command broad enough support within the EU, and would require significant advancement in terms of EU governance and democratic legitimacy.

DEALING WITH THE LEGACY

Introducing a common fiscal backstop in the current situation is made difficult by legacy conditions: some banking systems are in worse shape than others; some sovereigns are more at risk than others; some countries have already drawn on euro-area assistance while others have contributed. In this context a few points deserve short discussion.

First, delaying resolution increases the size of the problem. Forbearance is very costly, as Japan found out in the 1990s and 2000s\(^1\). The sooner European decision makers agree to act and distribute the burden of the current crisis, the lower the overall cost will be. Unfortunately, Europe is already experiencing a Japanese-style scenario in which bank losses are not recognised and overall credit provisioning to the real economy is subdued for a prolonged period.

Second, fairness requires that legacy costs should be borne by creditors and governments that failed to exercise appropriate surveillance. The creation of a fiscal backstop should therefore ideally not apply to existing problems but rather to future ones. The mutualisation of legacy costs may nevertheless be warranted. Banking problems in some countries express to some extent a common failure. For example, the absence of a common supervisor has allowed for regulatory arbitrage which has effectively put limits on the scope of national supervisors in some countries to prevent excess risks. Also, unresolved banking problems in some parts of the monetary union have negative repercussions on the union as a whole. When banking problems cause a sovereign debt crisis, a much more significant financial stability risk emerges which also affects strong countries. Finally, legacy costs that prove too high may eventually be mutualised one way or another. Concerted support is probably preferable to sovereign debt restructuring or inflation.

Applying a common fiscal backstop to legacy problems requires careful design. Robust screening must be done, with a neutral institution assessing the overall cost of the problems accumulated in individual banks and national banking systems. Once this is established, the legacy cost will need to be distributed so that incentives for good policy are preserved. There are different options: allocate the first loss always to the national taxpayer (the fiscal backstop would step in only if costs exceed the threshold beyond which national sovereign solvency is endangered); burden-sharing starting with the first euro of loss; provide backstop to governments that would still be held uniquely responsible for bailing out banks (this option, however, would be insufficient to break the sovereign banking feedback loop)\(^16\).

CONCLUSIONS

The creation of a European banking union is a major endeavour. The euro area is characterised by the particular weakness that banking and sovereign risk is mutually reinforcing. A viable banking union requires common supervision, a strong common resolution framework and a common fiscal backstop because, while good bank resolution policies with creditor bail-in are central to reducing fiscal costs, they cannot fully eliminate them. A mechanism for a common fiscal backstop is therefore needed and its design should minimise perverse incentives. Beyond the actual fiscal costs of banking crises, arrangements need to be found under which implicit or explicit government guarantees can be provided to backstop the financial system.

As the creation of a meaningful banking union has far-reaching consequences for resolution policies and fiscal policy, a strong and robust governance system needs to be put in place. In particular, clear decision-making power needs to be allocated so that decisions about bank resolution and about distribution of costs are taken quickly and effectively. Moreover, the democratic legitimacy of those decisions needs to be strengthened significantly.

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16. Pisani-Ferry et al (2012), cited in footnote 10, includes a more developed discussion, especially of the screening process.