

Framing Banking Union in the Euro Area

Some empirical evidence

Diego Valiante

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Abstract

Evidence shows that financial integration in the euro area is retrenching at a quicker pace than outside the union. Home bias persists: Governments compete on funding costs by supporting 'their' banks with massive state aids, which distorts the playing field and feeds the risk-aversion loop. This situation intensifies friction in credit markets, thus hampering the transmission of monetary policies and, potentially, economic growth. This paper discusses the theoretical foundations of a banking union in a common currency area and the legal and economic aspects of EU responses. As a result, two remedies are proposed to deal with moral hazard in a common currency area: a common (unlimited) financial backstop to a privately funded recapitalisation/resolution fund and a blanket prohibition on state aids.

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1. Introduction

If bank resolution is never an easy task, the additional layers of interaction within the financial system in Europe, its legal rules and the relevant governing bodies make this matter even more complicated. The nexus of interests, as well as the legal and economic barriers that affect management and operations, has been slowing down the restructuring of the banking sector and has hindered proper management of troubled assets that are a legacy of the financial crisis. This complicates discussions on how best to devise a mechanism for orderly bank resolution and burden sharing. As European institutions strive to strike the proper balance on burden sharing between countries in developing a fully fledged European resolution framework, the breadth and depth of the new mechanism for bank resolution is affected by several factors, such as the impact of the currency union that is discussed in this paper. A main point of conflict is the extent to which national governments ought to be allowed to bail out national banks and concurrently how much creditors and depositors of the bank ought to be subject to compulsory 'bail-in' procedures in the recapitalisation process. Complexity in the negotiations has been growing, as European institutions try to make this reform match other pieces of the banking union puzzle, such as the creation of a common supervisory mechanism, which would centralise supervision of systemically important banks under the European Central Bank, and the creation of a common deposit guarantee scheme to replace those that today in countries like Italy and Spain rely solely on unfunded government guarantees. All these proposals aim to shield the financial system from the adverse effects of another systemic crisis and potential runs on banks by providing an appropriate supervisory mechanism and safeguards to ensure that the banking system functions on an equal footing for all banks involved in the process, minimising the involvement of taxpayers' money. Such a common system would also revive the cross-border market for banks' mergers and acquisitions.

2. The banking system and financial fragmentation

Although the financial crisis badly hit European banks, the banking system has barely embarked on the restructuring process, particularly in the euro area. Reasons for the delay are manifold, but a fundamental cause is the key role of banks in the funding of European economies, both at the periphery and within the core. Their mammoth size and their interconnections, not just among themselves but also with national political establishments and local constituencies, tie their fate closely to their domestic governments. This 'fatal hug' between governments and banks has materialised most prominently in two ways:

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- Banks' use of central banks' 'cheap' liquidity for massive purchases of domestic government bonds, in spite of attempts by the European Central Bank (ECB) to transfer the impulse of monetary policy to the economy via bank lending (Merler and Pisani-Ferry, 2012; Valiante, 2012b; EBA, 2013).
- The fast retrenching of banks' international diversification when the financial crisis hit, despite deep financial integration in the European Monetary Union (EMU) (so-called 'home bias'; see Manna, 2011; Valiante, 2012b; Liikanen Report, 2012).

The former development was spurred by incentives to increase concentration of domestic government bonds holding, so indirectly calling for massive government intervention (through guarantees and liquidity injections) to limit the repercussions of banks' difficulties on each other's financial situations. The carry trade between the ECB liquidity injection and the higher 'safe' return on government bonds has helped national governments sustain public finances in a time of deep liquidity crises. The latter outcome is a more general trend caused by frictions in the financial system and in particular cross-border transactions in the common currency area (see the next section). Specifically, cross-border asset holdings have been decreasing since the beginning of the financial crisis, and that tendency accelerated when the sovereign crisis spread (see Figure 1). Cross-border securities holdings, most notably, have diminished by more than 30% after reaching a historical peak in 2008.

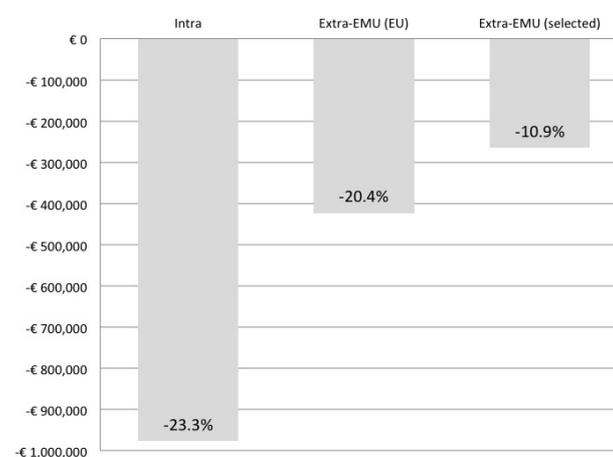
Figure 1. Intra-EMU monetary financial institutions' euro-area holdings, 2006–13 (€ mn)



Note: Up to November 2013.

Source: ECB.

Figure 2. Intra versus Extra-EMU (EU) and other extra EMU (selected) outstanding loans and securities other than shares or foreign claims (€ mn), Δ Q2-2010/Q3-2013



Note: loans and securities holdings of EMU MFIs versus MFIs and non-MFIs counterparties. 'Selected' extra EMU countries are foreign claims of domestic banks in France, Germany, Italy and Spain versus Australia, Brazil, Canada, China, Hong Kong SAR, Japan, New Zealand, Singapore, United Kingdom, United States.¹

Sources: ECB and BIS.

As the sovereign crisis expanded, the retrogression of financial integration in the euro area accelerated compared with claims against other major areas of the world. Claims of EMU banks versus those of other EMU countries dropped by almost €1 trillion (or 23%), while

¹ Bank for International Settlements data converted to euros with a simple average of yearly exchange rates from 2010 to 2013 calculated by www.oanda.com/currency/average. For a definition of 'foreign claims', see the BIS Glossary (www.bis.org/statistics/bankstatsguide_glossary.pdf).

claims of EMU banks vis-à-vis other European counterparties dropped by a lesser amount. Moreover, foreign claims of banks in the four biggest EMU economies (France, Spain, Germany and Italy) versus counterparties in selected non-EMU economies only dropped by 10% since the second quarter of 2010, while intra-EMU claims for these countries dropped by more than 15% during the same period (see Figure 2 and Figure A1 in the annex). While financial integration and freedom of capital movement should protect the financial system from extreme bias in favour of domestic institutions, idiosyncrasies specific to the monetary union have instead accelerated financial fragmentation compared with other areas of the world (see the following section). As a result, home bias persists despite early signs of recovery. The UK, US and Japan have seen a much lower drop in the foreign claims of domestic banks since the inception of the sovereign crisis. For the US and Japan, foreign claims of domestic banks versus the rest of the world have significantly increased since 2005 and have only marginally dropped versus euro-area counterparties since the beginning of the sovereign crisis in the second quarter of 2010 (see Figures A2 and A3 in the annex).

Furthermore, the cross-border interbank market for banks in some euro-area countries remains frozen, and distrust among euro-area financial institutions continues. Cross-border loans to other EMU monetary financial institutions (MFIs)² and MFIs' deposits have been experiencing a steady drop since the beginning of the financial crisis, which then accelerated with the sovereign crisis later on (see Figure 3).

Figure 3. Intra-EMU MFIs' loans to other MFIs and MFIs' deposits (€ mn), 2006–13



Note: Up to November 2013.

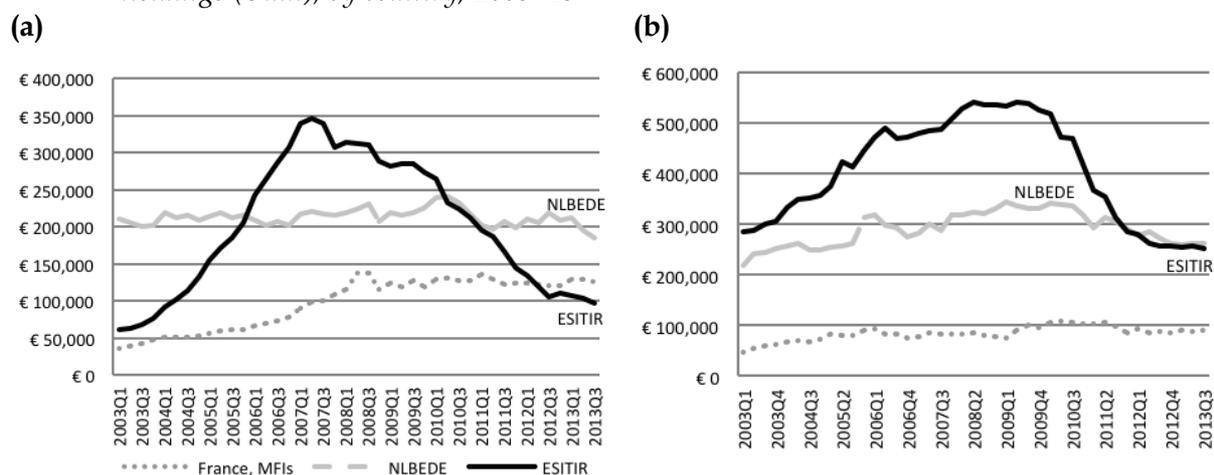
Source: ECB.

Since 2008, with an acceleration in 2010, differences among the euro-area regions emerged also in relation to MFIs' cross-border securities holdings, as ring-fencing at national level

² According to the ECB Glossary, 'Monetary Financial Institutions' are "resident credit institutions (as defined in EU law) and all other resident financial institutions whose business 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 credit and/or invest in securities. The latter group consists predominantly of money market funds." The full definition is available at <https://www.ecb.europa.eu/home/glossary/html/glossm.en.html#447>.

(home bias) for the sake of liquidity led to a significant drop of holdings of MFI and non-MFI in securities of counterparties located in peripheral countries such as Spain, Ireland and Italy. In countries such as Belgium, Germany and Netherlands, considered to be at the core of the eurozone, cross-border MFIs' holdings of local counterparties' securities remained at a stable level (see Figure 4).

Figure 4. Intra-EMU monetary financial institutions' (a) and non-MFIs' (b) cross-border securities holdings (€ mn), by country, 2003–13



Note: Securities holdings by nationality of the counterpart. 'NLBEDE' stands for the Netherlands, Belgium and Germany; 'ESITIR', for Spain, Italy and Ireland.

Source: ECB.

Since the inception of the sovereign crisis, therefore, liquidity ring-fencing has been fragmenting the financial system of the euro area along country lines. Most notably, on top of precarious market conditions, which also affect non-euro-area countries, the following policies and practices have boosted risk aversion (home bias), particularly in the eurozone:

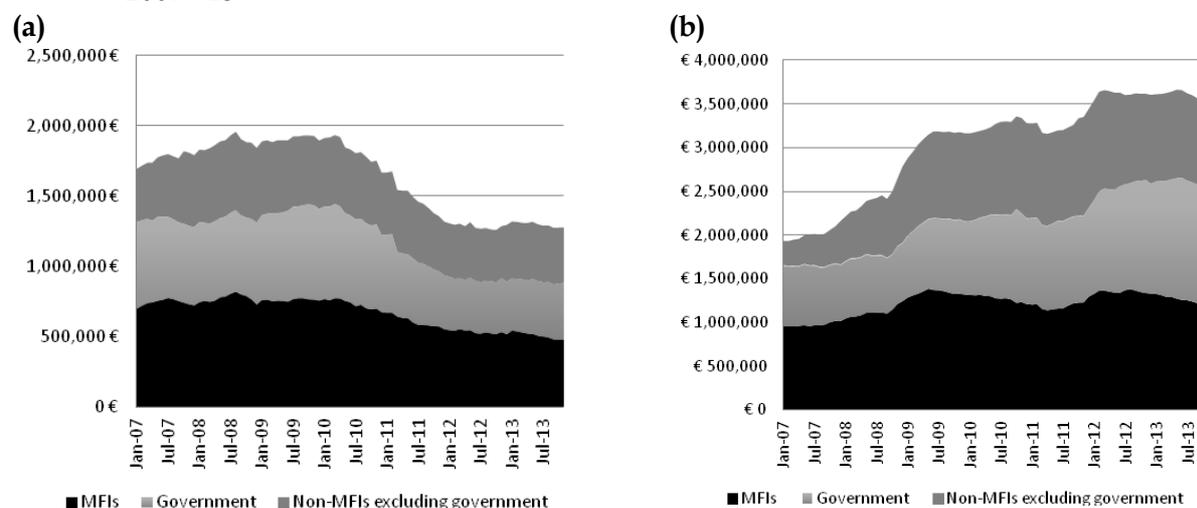
1. Regulatory capital requirements;
2. National resolution mechanisms;
3. Governance and political interference; and
4. Common currency and payment system (infrastructure).

First, the purchase of domestic government bonds in the eurozone by local banks is strongly encouraged by the opportunity to count government bonds as 'risk-free assets' under the risk-weighting provisions of current capital requirements, even for those bond issuers that are not backed by a currency printer anymore (such as countries in the euro area). These rules come on top of a carry trade created by the ECB's cheap liquidity injections (so-called 'Long-Term Refinancing Operations'), in particular from early 2012 onward.

Second, the absence of 'bail-in' procedures and homogeneous national resolution mechanisms for banks, equipped with a credible (i.e., sizeable and funded) resolution fund, has fuelled banks' risk aversion (Manna, 2011). Uncertainty regarding who would bear the costs of the resolution of financial institutions that have in the meantime built strong cross-border interests thanks to the high financial integration of the euro area has played an important role in fuelling liquidity ring-fencing at the national level. Moreover, the sharp increase in banks' domestic holdings could increase pressure for a pre-emptive government intervention to avoid a disorderly liquidation that would ultimately have repercussions on governments' own funding resources (De Grauwe and Ji, 2013). Since 2010, as suggested by Figure 5, a more than €200 billion drop in financial institutions' holdings of securities issued by foreign governments has been offset by an increase of roughly €500 billion in holdings of

domestic government securities, on top of the increase in other domestic assets precipitated by home bias.

Figure 5. Securities other than shares, non-domestic (a) versus domestic (b) holdings (€ mn), 2007–13



Note: Up to November 2013.

Source: ECB.

In the aftermath of the financial crisis, this bad mix of incentives has prompted the G-20 to issue a statement about the need to have more effective crisis management rules for banks.³ The discussion of common rules in the EU is still under way, after a first draft proposal was released in June 2012, but it will rely on how fast and accurately governments will transpose the current EU Directive into national law.⁴

Third, banks' management in many EU countries has over the years cultivated a tight relationship with the political establishment and local constituencies, mainly through non-profit legal entities such as foundations (for instance, the Cajas in Spain or the Landesbanken in Germany; see, among others, Garicano, 2012). These relationships with the political establishment contribute to delaying reforms that can sensibly reduce systemic risk yet also hurt profitability for banks' shareholders in the short term.

Finally, and perhaps most important, in some European countries, the existence of a single currency and payment infrastructure has removed barriers to the circulation of capital and introduced an exogenous constraint on governments' ability to borrow funds and affected the links with domestic banks that are main buyers or intermediaries for buyers of government bonds. The following section will discuss the implications of the common currency on the nature of a banking union.

3. The common currency dimension

With the introduction of the common currency, capital (savings) across euro-area countries can move freely, and investors can quickly exchange cross-border investments in the same

³ See G-20 Conclusions in Washington 2008 (www.g20.utoronto.ca/2008/2008declaration1115.html#risk) and London 2009 (www.g20.utoronto.ca/2009/2009ifi.html).

⁴ See more on the Commission's website (http://ec.europa.eu/internal_market/bank/crisis_management/).

asset class, for instance, from Spanish government bonds to German ones when risk aversion increases (Kopf, 2011). Because fiscal policies and backstops are national, governments behave strategically to avoid instability in the banking system that would result in capital shifting toward safer banking systems within the same currency area, causing a sharp increase in their own borrowing costs. Fear of capital flight and of a quick polarisation of the eurozone banking system (via savings transfers) toward countries endowed with greater fiscal capacity motivates these interventions. In addition, imposing the losses of domestic banks on creditors, including international investors and local government debt holders, might provoke a sell-off that could involve domestic government bonds, thus leading to a jump in refinancing costs. As a result, the use of fiscal power to prop up domestic banking systems in the Eurozone has served the purpose of ring-fencing liquidity at national level, ultimately delaying a much-needed restructuring of the sector.

This fear, however, is typical of a currency union while less significant for countries that do not share a common currency for at least two reasons: the intrinsic legal and economic barriers raised by a different currency, and the financial backstop that the domestic central bank can offer in case the government runs out of money. Eurozone governments' creditworthiness is therefore priced by financial markets according to their actual fiscal capacity, taking into account the lack of a central bank backstop, which by statute cannot come from the ECB. The delay in the restructuring of domestic banking systems has also put off proper management of losses from 'legacy' assets (banks' troubled or impaired loans). Frictions in the banking system have further slowed down the creation of a single market for banks' control, despite the low market capitalisation that several banks have today.⁵ Despite greater financial integration, cross-border equity ownership of banks is still limited and has only somewhat increased since the introduction of the common currency. Additional underlying legal and fiscal barriers still hamper equity market integration.

The moral hazard governments incur in putting off to their successors the restructuring of the banking system to avoid repercussions on their borrowing costs resembles what happened in Japan after the incredible growth of its banking sector during the 1970s, when the national economy was still fairly closed. After the country gradually opened up, the delay in restructuring banks and corporations in the country, driven by the interference of public policies, substantially contributed to its stagnation over the years. These tensions depressed the economy by distorting the proper channelling of credit into the economy or diverting it toward underperforming sectors (Hoshi and Kashyap, 2004; 2011). The Japanese experience offers lessons about the importance of a flexible financial system in an open economy, through, for instance, solid resolution procedures that allow restructuring (and liquidation) of banks when they suffer losses caused by a prolonged downturn in the business cycle.

Furthermore, fragmentation in the banking system can generate negative spillover for credit markets, with significant welfare losses in particular for the economies in a currency union. As Bignon, Breton and Rojas Breu (2013) suggest, a currency union without smoothly functioning credit markets aggravates issues of adverse selection because of the difficulty banks encounter getting cross-border information on borrowers or discounting the costs of different bankruptcy laws. Most notably, this situation can ultimately magnify welfare losses for EMU citizens compared to non-EMU ones thanks to fear of savings flight. The lack of enforcement mechanisms for cross-border debt repayment is one of the frictions in the working of the credit system. Conflicting bankruptcy laws or government interventions to

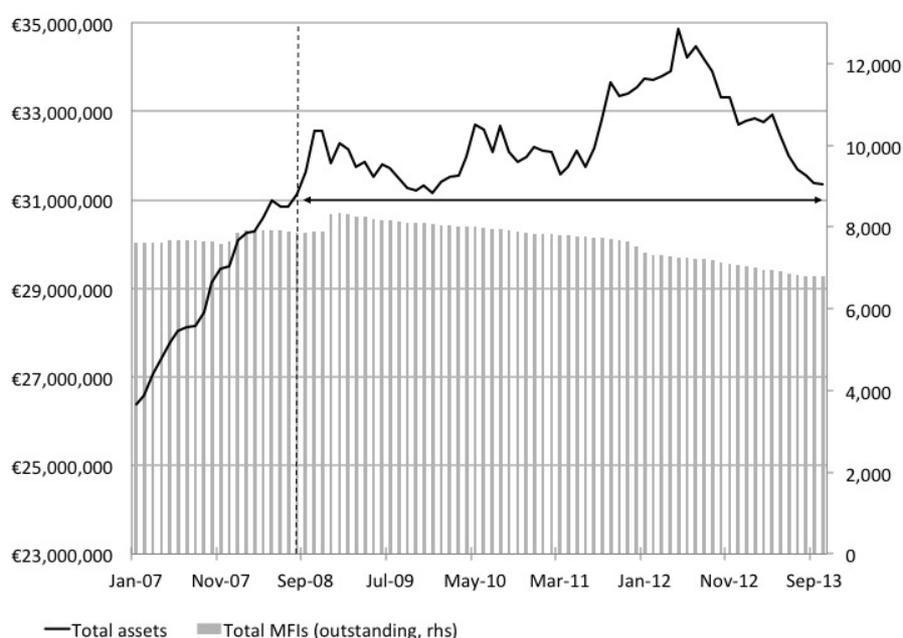
⁵ The three top Italian banks (by assets) had a total market capitalisation of €58.8 bn on 16 December 2013.

protect local banks lead good borrowers to borrow domestically because of the implicit guarantees that offset potential lower costs of cross-border services (home bias). As a result, a fragmented banking system can impose higher welfare losses in a common currency area because capital can easily move in good times but might not be easily disinvested when a crisis looms. Prolonged inability to resolve these problems in the credit market may thus have unpredictable effects on the stability of the euro area.

3.1 The banking system in the eurozone

The banking system in the eurozone has shown flexibility during the growth phase of business cycle but, as with Japan, it remains sticky in the negative adjustment phase, when losses need to be absorbed by the system. As discussed above, assets that are the legacy of a financial crisis can hamper governments' ability to raise money and so postpone the absorption of losses by the financial system. Evidence in the euro area corroborates these findings. While monetary financial institutions shrink in number partially because of the historical up-scaling trend of the European banking system to a single-market dimension and the shutdown of several money market funds, the size of total assets is still above pre-crisis levels (see Figure 6). By considering only credit institutions, findings do not change. However, the reduction of the asset side may not necessarily be a measure of the on-going restructuring of the sector and the write-offs; it can also reflect an attempt to prop up banks' balance sheets by reducing size and thus limiting equity dilution.

Figure 6. EMU banks' total assets (€ mn) and number of monetary financial institutions (outstanding), 1999–2013



Note: From January 1999 until October 2013. The progressive entry of new countries in 2008 and 2009 (Cyprus, Malta and Slovakia) has caused jumps in the MFI series over time, as new entities were added to the sample. However, due to the limited size of these banking systems, the impact on the series and the analysis is negligible.

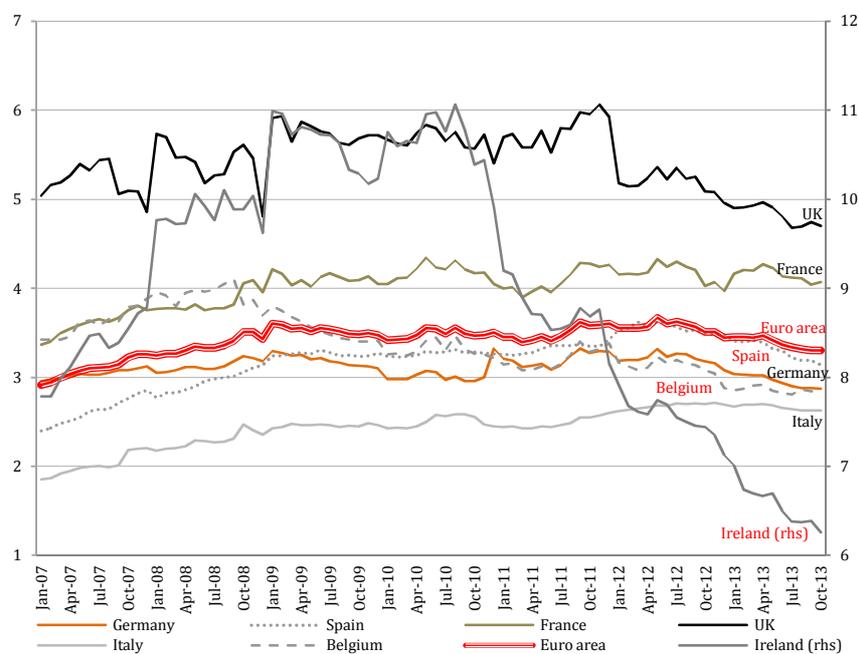
Source: ECB.

The initial drop in the total number of MFIs and the stabilisation of total assets growth is slowly reversing the pre-crisis trend. However, the adjustment process still requires dealing with legacy losses, so necessitating a widespread restructuring of banks' balance sheets (Acharya and Steffen, 2014). Although the regulatory reserve capital of EMU banks has been

constantly increasing since 2008, the rise in non-performing loans and their systemic risk may compel banks to continue efforts to dilute their equity (EBA, 2013; Acharya and Steffen, 2014).⁶

Significantly, the adjustment process appears uneven across euro-area countries, calling into question what really drives financial integration in the banking system. As Figure 7 suggests, banks' total assets over gross domestic product (GDP) have greatly diminished in countries where restructuring was imposed by external intervention such as through the European Stability Mechanism, as in the case of Ireland (around 600% of GDP) and most recently Spain (around 300%), or by financial firm bankruptcies, as for Belgium's Dexia and Fortis. In either case, interventions were forced by the inability of both public and private sectors to raise money directly. The size of the banking sector has remained stable or is relatively bigger in euro-area countries where banks or governments have been able so far to source capital, such as France and Germany, on top of the credit relief provided by the ECB Long Term Refinancing Operations. This also occurred for countries with well-known problems with non-performing loans, such as Italy.

Figure 7. Banks' total assets over GDP in selected countries (xtimes), 2007–13



Source: ECB and IMF (annual GDP data).

Negative GDP growth in some countries, such as Spain, has contributed to keep this ratio stable. In Italy, for instance, the private sector has been able so far to avoid hard restructuring decisions, raising capital from the country's abundant private savings and to less extent than other countries from public support. The German (in absolute terms) and French banking systems are also a bigger part of the economy than their pre-crisis levels, despite significant issues with legacy losses during the 2007–2008 financial crisis. Massive government interventions to subsidise the banking system in these two countries have been

⁶ For a deeper analysis of the systemic risk of EMU financial institutions, see the New York University Volatility Institute at <http://vlab.stern.nyu.edu>. Standard & Poor's has recently estimated a capital shortfall of €110 billion for Western European banks; see www.scribd.com/doc/191086580/Untitled. For a recap of recent estimates, see also S. Merler and G.B. Wolff, "Ending uncertainty: Recapitalisation under European Central Bank supervision", Bruegel Policy Contribution, Issue 2013/18, Bruegel, December 2013.

critical in delaying restructuring. The United Kingdom's banks have undergone some measure of restructuring as a result of the financial crisis since limited interventions to recapitalise banks with limited conditions were pursued, rather nationalisations and hard restructuring. Although bank assets size overall is close to pre-crisis levels, the volatility displayed by the country's total bank assets in recent years is perhaps the effect of on-going restructuring.

3.2 Governments and moral hazard

Direct government intervention to offer guarantees or asset relief or to recapitalise banks in the European Union, especially in the euro area, has been approved under state assistance rules for significant amounts, as shown in Table 1. State aids were approved under the exceptional circumstances of Article 107.3.b of the Treaty on the Functioning of the European Union (TFEU),⁷ which allows aid to be used "to remedy a serious disturbance in the economy of a Member State", with conditions that have been gradually tightened as the crisis eased. In some countries, such as Ireland and Spain, external public funding sources, for instance, the new European Stability Mechanism, have provided support to governments tied to additional conditions beyond that of the state aids framework of Article 107 that apply to the government (generally called, 'structural reforms'). More than 75% of all state assistance (around €4 trillion) from 2008 to 2012 in the European Union has been used by euro-area countries, which have on average provided more state aids to local banks than the rest of the European Union and perhaps the rest of the world.

Table 1. State assistance in selected countries (by total state aids; € bn), total 2008–12

	State aid	Recapitalisation	Total state aid as a percentage of banks' assets	Recapitalisation as a percentage of banks' assets	Type
Ireland	920.92	62.78	62.43%	4.26%	Government/ ESM/EFSF/Troika
UK	693.77	82.39	7.52%	0.89%	Government
Germany	483.37	64.17	6.00%	0.80%	Government
Spain	371.36	59.74	10.59%	1.70%	Government/ESM
France	344.28	25.05	4.34%	0.32%	Government
Netherlands	211.07	18.86	9.08%	0.81%	Government
Belgium	201.16	23.32	17.18%	1.99%	Government
Italy	102.63	6.05	2.63%	0.15%	Government
Total EMU	2,999.23	318.49	9.29%	0.99%	-
Total extra- EMU	968.12	94.71	7.79%	0.76%	-
Total EU-27	3,967.35	413.2	8.87%	0.71%	-

Note: State aids include recapitalisation, asset relief, guarantees and other liquidity-boosting measures. The value of guarantees is the cumulative sum of yearly amounts renewed on a six-month basis.

Source: European Commission Directorate-General for Competition and ECB.

⁷ Treaty on the Functioning of the European Union, Part 3: Union policies and internal actions, Title 7: Common rules on competition, taxation and approximation of laws, Chapter 1: Rules on competition, Section 2: Aids granted by states – Article 107 (ex Article 87 TEC).

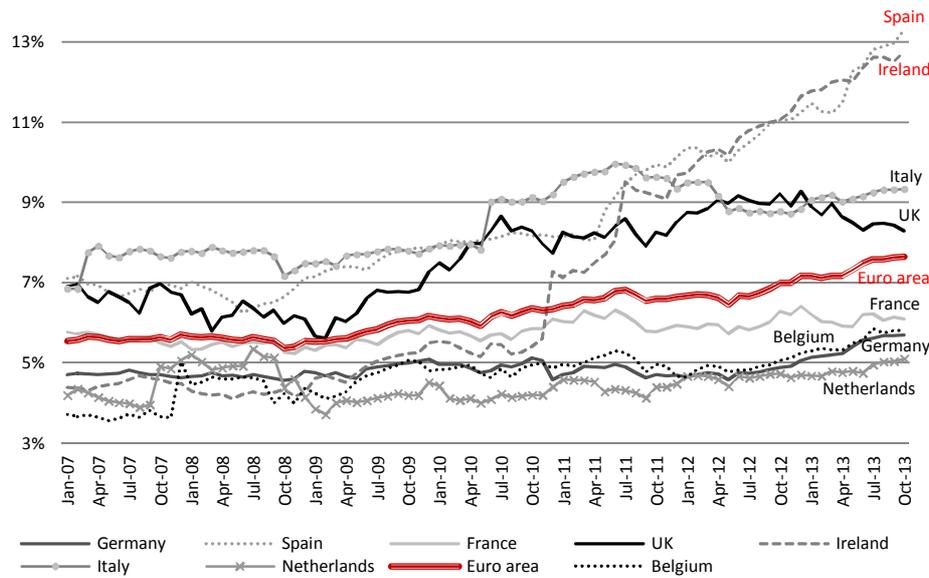
EMU countries thus have been using their fiscal capacity to support the domestic banking system, in particular before the European Commission's rules on state aids were further tightened in July 2013 with the forced 'bail-in' of bank owners and junior creditors.⁸ State assistance rules have been mostly used for guarantees, which required fewer conditions, such as no restructuring plan, than those requested for the recapitalisation of banks with public money. Guarantees have allowed and still allow governments to subsidise national banks' issuance of credit or borrowing in the interbank market with limited conditions (a fee, under the formula set by the Commission's 2011 Prolongation Communication, and a viability review of the bank's business model, if total outstanding guarantees are higher than 5% of total liabilities). From July 2013 only, a restructuring plan must be also submitted if guarantees exceed either the specified ratio of 5% or €500 million. As a result, trillions of euros in guarantees have been used to support the borrowing activities of domestic banks, ultimately distorting the pricing of their credit risk and increasing liquidity fragmentation along national lines and so frictions to the smooth functioning of the common credit market.

Notwithstanding the importance of a robust state aids framework in the European Union to protect the single market, with strict conditionality to limit banks' risk-taking behaviours, the above-mentioned rules can only partly deal with moral hazard of banks and are certainly unable to deal with moral hazard of governments that use their fiscal power to support artificial credit market dynamics to avoid repercussions on borrowing costs. Notably, in countries where the banking system has been subsidised through government intervention, the reinforcement of local banks via capital increases (equity dilution) has made fairly modest progress, beyond the 'natural' gap caused by different national definitions of capital and loan provisions (see Figure 8; see also De Grauwe and Ji, 2013).

This divergence becomes more evident in looking at the annual marginal increase in capital and reserves as a proportion of total capital and reserves vis-à-vis the euro-area average, a calculation that partially neutralises the differences in the definition of capital among countries. Spain and Ireland, driven by the strict conditions imposed by EU intervention, have been the only two countries that had an increase of equity above the euro-area average in five out of the past seven years. While the UK has experienced a marginal increase higher than the euro-area average in our out of seven years, as illustrated by Figure 9, countries where direct or indirect government intervention took place have performed worse in the recapitalisation of banks, in particular, Germany, France and Italy (just slightly above average for three years out of seven) or Belgium and the Netherlands (only two years above the euro-area average, with high volatility in the flow of funds toward recapitalisation). This might be a sign that only limited restructuring of the domestic banking system has taken place in recent years, despite banks strengthening their regulatory capital reserves across Europe. Only Ireland and more recently Spain have implemented or are implementing plans to restructure the domestic banking system to a degree that is unprecedented elsewhere.

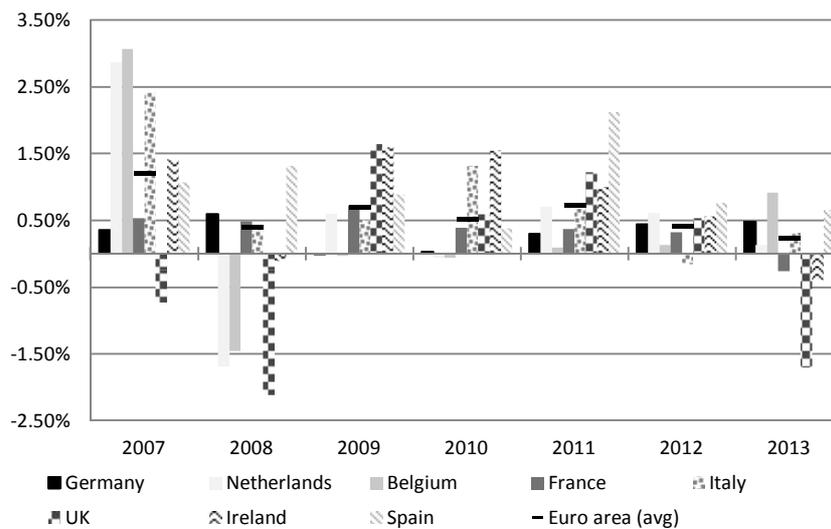
⁸ See European Commission, Communication COM (2013) 216/01, entered into force on 1 August. This communication embodies the six communications of the Commission on state aids to the financial system (so-called Crisis Communications). These six communications are: the Banking Communication COM (2008) 270; Recapitalisation Communication COM (2009) 10; Impaired Asset Communication COM (2009) 72; Restructuring Communication COM (2009) 195; 2010 Prolongation Communication COM (2010) 329; 2011 Prolongation Communication COM (2011) 356.

Figure 8. Capital and reserves (% of total assets), 2007–13



Source: ECB and IMF (GDP data).

Figure 9. Capital plus reserves, marginal increase as a percentage of total vs euro-area average, 2007–13



Source: ECB.

Note: Annual average of monthly marginal increases. 2013 data are up through October.

Banks in the euro area that have been able to benefit from the credit status of the local government have experienced a slowdown in equity dilution, a delay in restructuring and recapitalisation and hence additional losses incurred on legacy assets. Countries where restructuring/recapitalisation was imposed by external funding conditions (European Stability Mechanism or other financing arrangements) or prompted by the fear of being forced to conduct a hard restructuring under external funding arrangements have seen a sharper increase in capital held by domestic banks. This divergence is relevant for euro-area countries, as non-euro-area countries like the UK and the US have been more active in restructuring their financial sectors. Finally, as banks in some countries choose continued reliance on the national fiscal backstop over restructuring/recapitalisation, the European continental banking system is gradually polarising, with those countries boasting greater fiscal capacity serving as the primary destination of capital flight from peripheral countries.

As the health of the domestic banking system may affect governments' borrowing costs, public interference in the banking sector thus promote liquidity ring-fencing at national level as a way for governments to protect themselves from an acceleration in capital flights toward the countries with greater fiscal capacity. This situation increases the likelihood that citizens' welfare in the currency union will be undermined, driving the union into uncertain circumstances.

4. Banking union revisited

Banking union reforms in the EU in recent years are perhaps the most important achievements stemming from the introduction of the common currency, but these reforms still lack a solid theoretical framework. The coordination problem among member states, which can be framed under the prisoner's dilemma (Valiante, 2012a), has led so far to sub-optimal responses to the problem of banks' legacy assets. In this respect, a theoretical framework for the banking union needs to take into account the role of the single currency in shaping these incentives, on top of the standard market failures that are inherent in banking. As a consequence, banking union in the single currency area faces three potential market failures: risk-taking behaviour; depositors' runs on banks and financial disintegration (see Table 2).

Table 2. Banking union revisited

Failures	Causes	Effects	Behaviour	EU remedies	EU dimension
Risk-taking behaviour	Public guarantees	Asset bubbles	Banks' moral hazard	SRM and SSM	Single market
Run on banks	Lack of confidence	Liquidity dry-up/insolvency	Avoiding losses on deposits	SRM and DGS	Single market
Postponing absorption of legacy losses	Capital flights	Financial disintegration	Governments' moral hazard	SRM (common unlimited backstop to SRF and no state aids clause)	Common currency

Note: SRM (Single Resolution Mechanism) also includes 'bail-in' procedures. "DGS" and "SSM" stand for "Deposit Guarantee Scheme" and "Single Supervisory Mechanism".

Source: Author.

While risk-taking behaviours and runs on banks are universal market failures when dealing with the economics of banking and money (Diamond and Dybvig, 1983; Akerlof and Romer, 1993; Stiglitz, 1993), financial disintegration driven by the moral hazard of governments that compete on their own funding is a market failure caused by the common currency framework. In a common financial system, a public (supranational) intervention is needed to ensure that the location of the bank (and not its assets)⁹ does not affect its borrowing costs and the funding costs of the government where it is legally headquartered.

In this respect, a *tout court* prohibition of state aids, which produce distortions and destabilise the common financial system, would protect the system from governments' moral hazard. However, such a prohibition would not be credible without a common financial backstop, which would assess the need for recapitalisation/resolution of a bank, taking into account financial stability concerns in the common currency area, i.e. the actual perimeter of

⁹ The quality of the assets will always be affected by the economic conditions of the economy in which they are located. For instance, real estate assets in Spain shall be affected by the asset bubble in the country to the same extent whether the owner is a Spanish or a foreign bank.

the financial system. The common financial backstop to a fund privately financed by banks with *ex ante* and *ex post* levies, plus 'bail-in' procedures and the concomitant partial mutualisation of losses (to deal with banks' moral hazard), would not be sound if a national government were to retain the option of providing its own funding in an extreme situation where the resources of the banks' collective fund and other levies on banks were exhausted, before or after the recapitalisation/resolution mechanism kicks in. If that situation were possible, even with a formal *ex ante* state aids prohibition, markets would be still pricing in the status of the domestic banking system in a government's funding costs and thus distorting borrowing costs for domestic versus non-domestic banks.

As a consequence, the common backstop to a privately sourced bank fund is credible if the only resources available after the exhaustion of the fund in extreme situations come from a common intervention that does not discriminate based on the nationality of the bank. In order to counter the risk of a bank run by depositors, the size of the backstop in other countries like the US is formally limited, but *de facto* unlimited, as national treasuries can actually request central bank money when all the bail-in, restructuring and liquidation procedures have been put in place but have been insufficient to stop the panic. A careful institutional design of the common backstop leaves EU institutions with multiple options, such as access to the European Stability Mechanism (ESM) or any other common institution that can ultimately resort to unrestricted funding, if private or public resources raised from open markets are insufficient. Whether through supranational debt issuance or ECB credit lines, the potentially unlimited funding of a European resolution mechanism renders irrelevant the nationality of taxpayers vis-à-vis the credit risk of their country's banks.

4.1 Brief chronicle of the European action plan

Although the ECB will soon take over supervision of most of European banks, not much can practically be done today at the European or euro-area level to recapitalise (with strict conditionality in place) or to resolve euro-area banks without the intermediation of national governments and political establishments, which are often deeply involved in the governance of their own banks. The chronicle of European collective actions is fairly short, and only recently has awareness increased about the importance of a banking union for the financial system of the euro area. Since the inception of the financial crisis in 2008, the European Commission has been active in putting forward new proposals to reform the banking system, as a follow-up to G-20 common resolutions and as necessary revisions of outdated legislative texts. However, a first set of guidelines on how to create a banking union was issued only at the end of June 2012, with the first 'Four Presidents' Report¹⁰ (EU Council, 2012a), followed by a more detailed communication of the Commission in September (European Commission, 2012b). The communication was followed by a proposal for a single supervisor for European banks (via two regulations) and the idea to have a Single Resolution Mechanism (SRM) to complement common resolution procedures proposed earlier via directive (6 June 2012), as a follow up to a G-20 commitment on crisis management (European Commission, 2012a). A single resolution authority at the European level, however, was suggested only in December 2012, by the second 'Four Presidents' report, to be implemented "once the directive on resolution is approved" (European Council, 2012b). While waiting for the directive on resolution to be approved, a severe banking crisis broke out in Cyprus in March 2013, triggering a disorderly EU intervention that ultimately involved the bail-in of depositors. After staggering discretionary decisions caused by the

¹⁰ The 'four presidents' are those of the ECB, the European Council, the European Commission and the Eurogroup.

unprecedented situation, which fuelled uncertainty about the stability of the financial system and its institutions in the euro area, the fear that Cyprus could wreak havoc on financial markets and on the borrowing costs of banks and governments accelerated negotiations for the creation of an SRM. On 10 July 2013, the European Commission finally presented a proposal for the institution of Single Resolution Board (SRB), to govern the resolution of banks in EU member states that will take part in the Single Supervisory Mechanism (SSM).

Table 3. Key European policy actions for a banking union

EU Action	Date of the proposal	Objectives	Tools	Legal basis	Mandate	Status
State aids framework	Since 2008	Competition in the single market	Communications (supervision) ¹¹	Art. 107.3(b) TFEU	EU Treaties (independent)	Ongoing
Deposit Guarantee Scheme (DGS)	15 October 2008	Harmonised threshold	Directive	Art. 40.2 TEU	European Council ¹²	Approved (March 2009)
	12 July 2010	Harmonised procedures	Directive	Art. 114 TFEU	European Council ¹³	Under approval
Capital Requirements (CRD IV)	20 July 2011	Greater resilience of banks to shocks	Regulation and Directive	Art. 114 TFEU	G-20 ¹⁴ European Council ¹⁵	Approved (July 2013)
Banks Recovery and Resolution Directive (BRRD)	6 June 2012	Common crisis management	Directive	Art. 114 TFEU	G-20 ¹⁶	Under approval
Under Banking Union mandate						
Single Supervisory Mechanism (SSM)	12 September 2012	Common supervision	Two Regulations	Art. 127.6 TFEU	European Council ¹⁷	Approved (October 2013)
Single Resolution Mechanism (SRM)	10 July 2013	Common resolution authority/fund	Regulation	Art. 114 TFEU	European Council ¹⁸	Under approval

¹¹ European Commission, Communication COM (2013) 216/01, op cit.

¹² EU Finance Ministers meeting on 7 October 2008; see http://ec.europa.eu/economy_finance/articles/eu_economic_situation/article13219_en.htm.

¹³ Ibid.

¹⁴ G-20 Conclusions in Washington, 2008, <http://www.g20.utoronto.ca/2008/2008declaration1115.html#risk>, and London, 2009, <http://www.g20.utoronto.ca/2009/2009ifi.html>.

¹⁵ See the conclusions of the European Council on the establishment of a “Single Rulebook” on 18/19 June 2009, www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/108622.pdf.

¹⁶ G-20 Conclusions in Washington, 2008, and London, 2009, op. cit.

¹⁷ After the informal EU Council of 23 May 2012, Council President Herman Van Rompuy issued a press release talking about a “more integrated supervision and resolution” and directing the ‘Four Presidents’ to produce a report to flesh out more details; see the press release, www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/130376.pdf.

¹⁸ See European Council (2012b).

As indicated by Table 3, the two major pieces of the banking union (SRM and SSM) were proposed only in the past year and a half, as a result of a growing understanding that lack of unity in dealing with issues in the banking system could cause much pain to European economies. Because of the sharply delineated boundaries of current treaties and political pressures by the European Parliament to limit inter-governmental agreements, due to a lack of democratic legitimacy, the inability to frame banking union primarily as a euro-area issue has affected the ability of EU policy-makers to address financial stability concerns in the banking system.¹⁹ Despite the bold actions taken by the European Central Bank to avoid market disruptions and two official reports by the presidents of the ECB, European Council, European Commission and Eurogroup (EU Council, 2012a) to lay out reforms for the euro area, European Union institutions' initiatives in the service of creating a banking union have been mostly characterised as actions to ensure the cohesion of the single market, under the tools offered by the European Union Treaties. Those actions have thus lacked focus on the market failure caused by the single currency (see the introductory part of this section). The current banking union framework lacks a common euro-area backstop and requires national bailouts as the last-resort intervention. Interest rates will thus reflect even more a bank's location rather than the ECB's monetary policy stance (Ubidé, 2013). A resolution fund without a credible common backstop thus more closely resembles a deposit guarantee scheme to be used when bank resolution is likely to affect protected deposits (those of €100,000 or less).

Under the single market mandate, critical steps toward a banking union, such as a credible common resolution/recapitalisation bank-supplied fund with a common, unlimited backstop and prohibition on state aid, look like an unnecessary corollary to current financial integration. In truth, it is harder to justify these actions under the single market umbrella because national banking systems outside the euro area are indeed marketing services at the EU-wide level, but they are acting in accordance with national monetary policy and a credible (sizeable and funded) backstop that is ultimately in the hands of the domestic government, backed by their own central bank. Keeping the backstop national in this case avoids indirect cession of monetary and fiscal policy sovereignty to EU institutions. An EU undertaking to override this defence of sovereignty via a more comprehensive backstop and supervisory framework at EU level might not be interpreted as a complementary act to national prudential supervision for the smooth functioning of the single market, thus violating the subsidiarity principle enshrined in the Treaty on European Union (TEU) (see the following section).

4.2 Some legal aspects of current EU proposals: A disorderly intervention?

Most of the EU's initiatives in this sphere (including the creation of new agencies) have been done using Article 114 of the Treaty on the Functioning of the European Union (TFEU) as legal basis (see Table 3), which allows, simply put, approximation of national laws by EU law if the latter does a better job in ensuring the smooth functioning of the single market. This legal basis has been working fine for the harmonisation of most of financial services legislation so far, despite earlier case law that contested its use for harmonisation in instances

¹⁹ See, for instance, the governance of the single resolution board within the agreement on the single resolution mechanism agreed by the European Council, which pushes back control on the trigger for the liquidation of a bank to the vote of the member states and a complex procedure (European Council 2013).

where it does not necessarily remove barriers to smooth functioning of the single market, in line with the subsidiarity principle enshrined in Article 5 of the TEU.²⁰

Doubts about this legal basis arise, however, with respect to the powers that the proposed Single Resolution Board will have under the 'EU agency' framework set by Art. 114 of the TFEU. In particular, problems crop up with both the breadth and depth of the powers granted to this new agency. Regarding the latitude of these powers, the Meroni case is still the precedent for the creation of new agencies through secondary EU legislation.²¹ This case law limits the discretionary powers of the agency to those specifically prescribed by the delegator (the European Commission), prohibiting the delegation of powers that are not in the Commission's remit. Decisions of these authorities thus need to follow detailed guidelines and requirements set by the legislation. According to the Legal Service of the Council of the European Union, the current legislative proposal on the creation of the Single Resolution Board (SRB) would grant powers that are too ambiguous and discretionary to the SRB in at least nine instances (Council of the European Union, 2013). More specifically, the Board would exercise discretionary powers in violation of the Meroni case (and so the 'principle of conferral' of Art. 5 of the TEU) in defining certain aspects of the resolution plan and scheme (also in relation to the use of resolution tools); the individual contributions to the Single Resolution Fund (SRF) and the Fund's use; and the sanctioning powers.

Finally, as recently confirmed by the conclusions of the European Court of Justice in a case on short-selling regulation,²² Article 114 of the TFEU also puts a limit on the depth of these powers, which cannot replace those of national authorities since it would be beyond the harmonisation mandate provided by this legal basis. That is, the agency cannot make legally binding decisions overruling national authorities' decisions. In few instances, the current SRM legislative proposal might run afoul of the legitimacy, whether an agency or the European Commission is responsible, when considering a triggering mechanism overriding the power of national authorities to decide when a bank should be considered "failing" and need to be broken up, sold or liquidated. However, it should be recognised that European measures are needed to promote the creation of a banking union and keep the single market intact. If done under a different legal basis, these measures might pass muster. Article 352 of the TFEU might be better placed to ensure that the Board is endowed with effective powers and speedier procedures to ensure that banks are swiftly wound up.

Relying on harmonisation of rules for the single market, Art. 114 of the TFEU may thus not be sufficient as a legal basis to introduce a common, unlimited backstop to the bank resolution/recapitalisation fund, and a blanket prohibition of national state aids to domestic banks, that is, the elimination of the exemption granted under Article 107.3(b). As explained above, these two elements would round out a policy action that is for the moment only dealing with the moral hazard of banks, not governments. Ideally, Art. 352 of the TFEU is the best legal instrument under current treaties, but the creation of an entity that can properly

²⁰ See the first tobacco advertising case of annulment of the Directive 98/43 for violation of the subsidiarity principle in Article 5 of the TEU; Case C-376/98, *Germany v. Parliament and Council* [2000] ECR I-8419.

²¹ Case 9/56 *Meroni & Co., Industrie Metallurgiche, SpA v. High Authority of the European Coal and Steel Community*, [1958] ECR 154.

²² See the legal opinion of Advocate General Niilo Jääskinen on *United Kingdom of Great Britain and Northern Ireland v. Council of the European Union and European Parliament*, Case C-270/12, delivered on 12 September 2013, on the validity of article 28 of Regulation No. 236/2012 (short selling) and the final judgment of the European Court of Justice on 22 January 2014 (<http://curia.europa.eu/juris/document/document.jsf?text=&docid=146621&pageIndex=0&doclang=en&mode=req&dir=&occ=first&part=1&cid=407914>).

function as a backstop to the Single Resolution Fund (SRF) may more realistically come out of an inter-governmental agreement, since there appears to be a lack of unanimous political support for making use of Art. 352 of the TFEU or drawing up a procedure for a treaty change. It might also turn out to be hard to compel governments to introduce a sweeping prohibition on state aids, as it could go against their short-term interests.

Despite the odds, following proper legal procedures will ensure that this mechanism has the powers needed to impose strict conditions on banks for recapitalisation/asset relief and to establish a potentially unlimited backstop to support the privately funded SRF (with mutualisation of losses) so that it does not run out of money during acute liquidity crises. The funding of the SRF remains a key pending issue since it would most likely need its own independent bond issuance with capital injections by participating member states or access to a credit line at the ECB if exhausted. Either way, the SRF may also benefit from access to the European Stability Mechanism, especially if SRM member states manage to come to an inter-governmental agreement, so obviating discussions on revision of the treaties. However, today, ESM intervention is only allowed via government intermediation and under additional fiscal policy conditions together with an increase in public debt. This may cause responsibility for the indirect backstop to revert to national governments once more.

Furthermore, claims that an inter-governmental agreement would not ensure a proper judicial review of the decisions at European level (see, in particular, Véron, 2013) might be not well grounded in fact. As is the case with the decisions taken by the ESM, the Court of Justice of the European Union (CJEU) can be responsible for judicial review of the newly constituted SRB (through inter-governmental agreement) under the joint application of Articles 267 and 273 of the TFEU.²³ “The Court of Justice shall have jurisdiction in any dispute between Member States which relates to the subject matter of the Treaties if the dispute is submitted to it under a *special agreement* between the parties”. (Art. 273 of the TFEU, emphasis added) The Treaty establishing the ESM can be classified as a ‘special agreement’ between parties that can be subject to judicial review by the CJEU for decisions that involve interpretation of the treaties. If EU institutions are unable to reach an agreement under Art. 352 of the TFEU or to change the Treaty to set up an effective resolution mechanism, the inter-governmental agreement is the most realistic option currently available that may fall under the category of ‘special agreements’, even if it would have limited democratic legitimacy.

Three open issues for the Single Supervisory Mechanism (SSM)

Together with the Single Resolution Mechanism, the Single Supervisory Mechanism (SSM) is the cornerstone of the banking union, not necessarily for the power that the regulations will confer on the European Central Bank, which power is already indirectly exercised by the Eurosystem through the moral suasion of the common monetary policy framework and implementation guidance. The SSM defines the boundaries of authority of the Single Resolution Mechanism and serves as the reference point for further harmonisation of definitions (e.g., capital and loan provisions).

Among other issues, such as the direct supervision that is limited to banks whose impact is significant enough to be deemed systemic, there are three open issues for the SSM that are intrinsically related to banking union and to the impact of the monetary union on its very nature:

²³ These articles apply on top of the general clause about judicial review of decisions taken by EU institutions under Article 263 of the TFEU.

- potential conflict with non-EMU countries' monetary policy approaches,
- the incentive system of the Asset Quality Review (AQR) and
- conflict of interest between the ECB's supervisory and monetary policy functions.

First, because the SSM will also cover some non-euro-area member states, it is of primary importance that the supervisory guidelines set by the ECB on the implementation of capital requirements do not clash with comparable monetary policy actions in non-euro-area countries. In particular, governments could exert political pressure on their central banks' monetary policy when a disagreement that cannot be solved in the current governing bodies of the SSM emerges. For instance, the ECB may have a stricter interpretation of the application of capital requirements, which may be in conflict with an expansionary monetary policy in those non-EMU countries or may even affect the domestic government's borrowing costs. This inconsistency could distort the implementation of ECB supervisory policies and become a potential barrier to the level playing field that a banking union requires. It also raises the question of whether a true banking union can be created with financial systems outside the boundaries of the monetary union.

Second, the design of the Asset Quality Review (AQR) may have significant flaws in the incentives offered to banks. It is essential that banking systems comply with the best safeguards set by prudential regulation and by supervisory guidelines. Constant monitoring is critical to ensure that the banking system is well capitalised. However, while the announcement that the ECB will have the power of investigation and will periodically review banks' balance sheets is salutary, disclosing specific information about and timelines for the review has triggered a rush among banks to engage in certain window-dressing exercises. In particular, with some regional differences linked to the general market conditions, many banks are cutting credit to firms (in particular to small and medium enterprises) and ending some riskier exposure to make their balance sheet look better, in line with regulatory capital requirements, so as to avoid public stigma that would ultimately increase funding costs for an undercapitalised bank. By shrinking in size, rather than increasing equity holdings, management also avoids the problems of equity dilution for current shareholders but in doing so imposes a credit crunch on bank-centric economies (those whose companies use loans primarily rather than equity to finance investments) like most countries in the European Union. Posting a public timeline for reviews, which should instead be done on a random basis, and ultimately publishing the full results of such reviews may only accentuate the perverse incentives to avoid equity dilution.

Finally, while performing these reviews, the ECB has to contend with an internal conflict of interest between supervisory and monetary policy functions. It will have to answer publicly as to whether the AQR will aim to spot 'zombie' banks and seek recovery or resolution or rather will collect evidence to justify another round of credit easing, perhaps via another long-term refinancing operation. If the review process intends to serve both goals, then that should be clarified *ex ante* followed by market guidelines. The multi-faceted nature of financial stability can readily lead to situations where monetary policy and supervisory duties work at cross-purposes.

5. Conclusions

This paper has provided ample evidence of the impact that the single currency has on a fully fledged banking union. While boosting further financial integration in the European Union may be a commendable objective, the harmonisation of rules for the smooth functioning of the single market neglects the breadth of the interventions required in the common currency area to deal with governments' moral hazard driven by competition on funding (borrowing) costs. Current EU actions to build a banking union and reverse financial fragmentation are de facto postponing proper management of banks' legacy losses, with the risk of being ineffective and harming the economy. While addressing or trying to address the potential moral hazard of banks, current solutions miss effective remedies for a similarly important market failure in the eurozone financial system: By putting off the legacy assets issue to the future, the moral hazard of governments could push the monetary union, followed by the EU as a whole, into a prolonged deflationary spiral, as experienced by Japan over the past two decades. Completing the banking union by taking into account the reforms needed for the single currency area is not just an empty treaty exercise, to be done whenever political support might emerge. Evidence shows that 'home bias' can lead an imperfect banking union to undermine citizens' welfare in a currency union, thus threatening the stability of and hence political support for the euro area. To bring banking union closer to its ideal design, two remedies for governments' moral hazard have been proposed in this paper: a credible resolution mechanism and a blanket prohibition of state aids to the financial system for euro-area countries.

A credible resolution mechanism requires a sizeable and privately funded recapitalisation/resolution fund (with a common, unlimited backstop) that will apply strict conditionality to its use. The criteria will be the same (or stricter) than those that the European Commission tries to impose today through the distorting and unnecessary intermediation of governments. Without a common backstop to the fund, the resolution fund will simply resemble a deposit guarantee scheme with limited firepower, so pushing back to national governments the role of lender of last resort. Resolution will take place when no other viable solutions (including guarantees, asset relief and recapitalisation) can be pursued. The European Commission, in the meantime, will have to look for a better legal basis (perhaps Article 352 of the Treaty on the Functioning of the European Union) or build consensus around a revision of the treaties, since the current framework might violate the Meroni jurisprudence on delegation of powers. Once in place, the Single Resolution Mechanism, designed and implemented properly, would help in the smooth functioning of credit markets and thereby avoid the harmful effects that would be caused by a self-inflicted credit crunch. Even if a credible (sizeable and well-funded) resolution mechanism with a common, unlimited backstop were to neutralise the distortions produced by individual member states' intervention, a blanket prohibition of state support through the elimination of Article 107.3(b) of the TFEU for euro-area countries might be required in any case. In effect, the possibility of intervening before the recapitalisation/resolution mechanism kicked in would still allow for competition on borrowing costs among member states, with the attendant risk of capital flight from countries whose banking sectors are perceived to be less stable).

Because winds of economic crisis still blow on eurozone economies, it is of the utmost urgency that European institutions work in a comprehensive and timely fashion to achieve a fully fledged banking union. The frightening prospect of a prolonged inability to deal with issues that exert drag on the financial system ought to serve as a goad to action, this time done the right way.

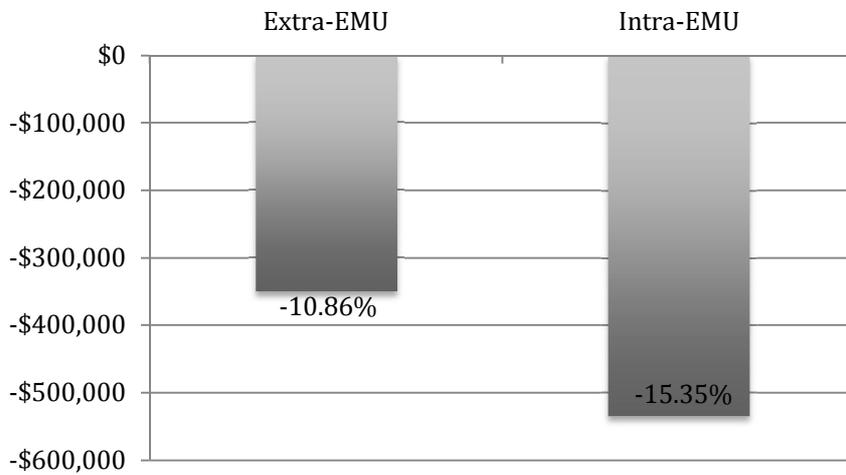
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Annex

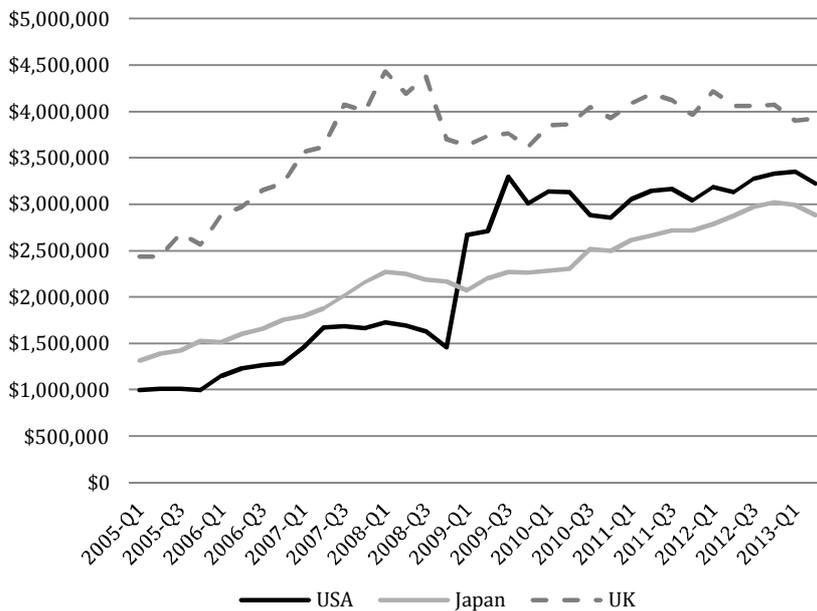
Figure A1. Intra-EMU vs Extra-EMU claims of Spanish, French, Italian and German banks, Q2-2010 Q2-2013 (\$ mn)



Note: 'Extra EMU' includes Australia, Brazil, Canada, China, Hong Kong SAR, Japan, New Zealand, Singapore, United Kingdom and the United States.

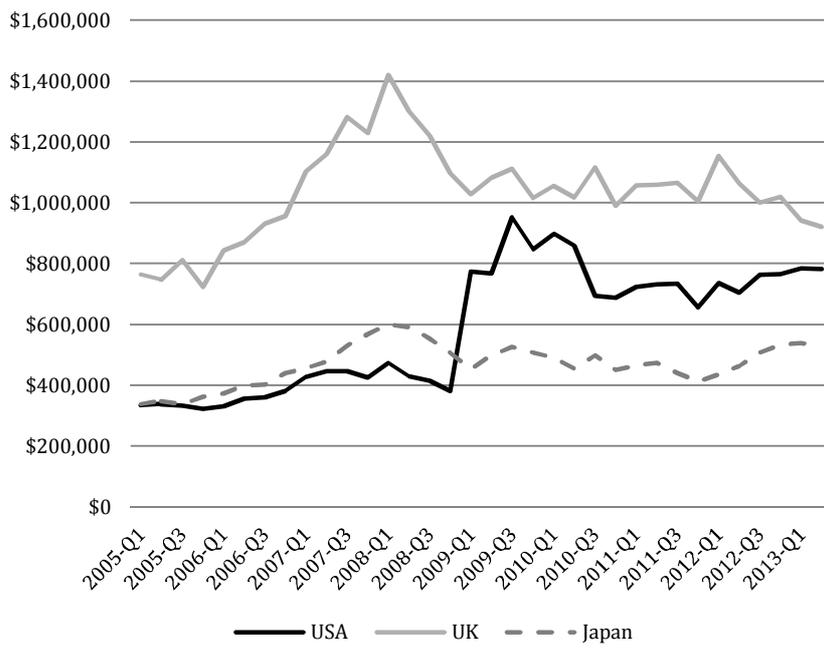
Source: BIS.

Figure A2. Foreign claims of domestic banks vs the rest of the world (\$ mn), 2005-(Q2)2013



Source: Bank for International Settlements.

Figure A3. Foreign claims of domestic banks vs EMU counterparties (\$ mn), 2005-13



Source: BIS.



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