



Brugge

College of Europe
Collège d'Europe



Natolin

A Monetary Union Requires a Banking Union

Hans GEEROMS and Pawel KARBOWNIK



DEPARTMENT OF
EUROPEAN ECONOMIC STUDIES

Bruges European Economic Policy Briefings

33 / 2014

About the authors:

Hans Geeroms

Research Associate at CES, visiting professor at the College of Europe and KULeuven, Campus Brussels; guest lecturer for the Polish Diplomatic Academy. Former adviser EU policy of Belgian Prime Ministers Leterme and Van Rompuy.

Pawel Karbownik

Deputy Director at the EU Economic Department of the Polish MFA, responsible for the European Councils in the field of economic policy; formerly worked at the European Parliament in Brussels, also gained experience in the corporate world and as an academic at the Lazarski University in Warsaw.

Address for correspondence:

Hans Geeroms: hans.geeroms@nbb.be

Acknowledgements:

This paper is based on research which has been undertaken on behalf of the Centre for European Studies. The authors are thankful to Jef Boeckx, Tomasz Chmielewski, Roland Freudenstein, Katarzyna Hanula-Bobbitt, Christian Kremer, Benoît Lallemand, Bart Lammens, Ivo Maes, Stefano Micossi, Siegfried Muresan, Hans Naudts, Vít Novotný, Peter Robberecht, Andrzej Sławiński, Izabella Szaniawska, Diego Valiente, Michael Van Dorpe, Nicolas Véron, Thomas Westphal and Pierre Wunsch for valuable comments on the draft paper. Only the authors are responsible for the contents. The paper reflects their personal viewpoints and not necessarily the position of the institutions to which they are affiliated. The authors also wish to thank David Rinaldi for his valuable assistance to prepare this paper for the College of Europe.

A monetary union requires a banking union

BEEP n° 33

Hans Geeroms and Pawel Karbownik

Abstract

This paper argues that a monetary union requires a banking union. While the USA developed both during a time span of two centuries, the EMU was created in the course of two decades and remains unfinished as the economic pillar is largely missing. The financial crisis and the Eurocrisis have shown that a genuine banking union is even more needed for the Eurozone than a budget or a fiscal union to let the euro survive.

Keywords: banking union, ECB, EMU, monetary policy, eurozone

JEL codes: E10, E42, E44, E52, E58, E61, E63

1 A Eurozone without a Banking Union

The economies of a well-functioning Monetary Union benefit from a single interest rate, reflecting the monetary policy stance of their common central bank. During the first phase of the EMU, this was also the case in the Eurozone, leading to booming economies in the whole Eurozone but even more in the periphery (the VEAPs or "Vulnerable Euro-Area Peripheral Countries" including the so-called GIPSI-countries, Greece, Ireland, Portugal, Spain and Italy, plus Cyprus and Slovenia).

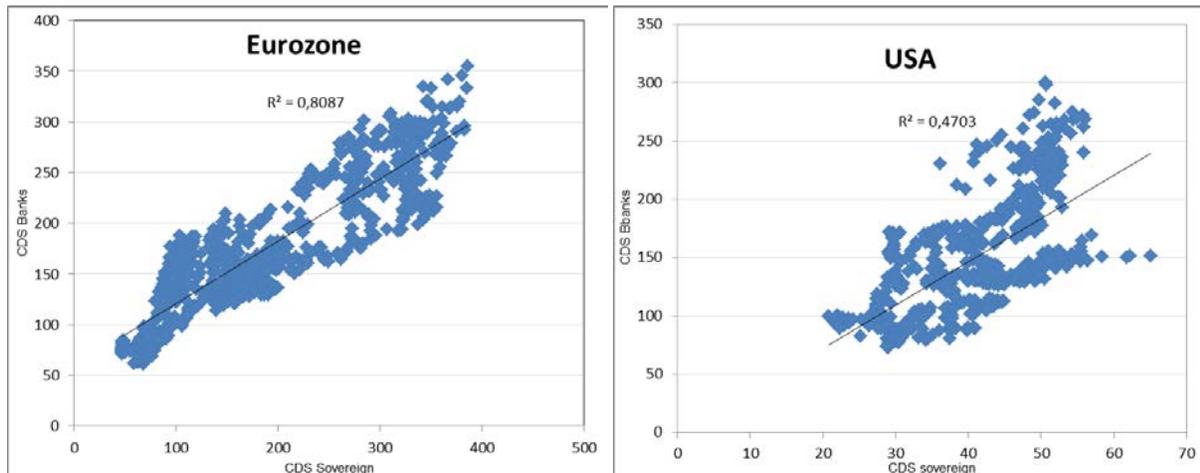
Shortly after the financial crisis, in 2009-2010, investors started adopting a different view on the fiscal and competitiveness position of each member of the currency union. They realised that the VEAPs suffered from weaker economic fundamentals than most of the Northern member states, problems that could not be compensated anymore by currency depreciations and higher inflation rates. An important variable was also the solvency situation of the governments, itself related to the solvency of domestic banks.

The dangerous embrace of banks and sovereigns in the Eurozone is the result of the fact that banks hold a large amount of domestic government debt on their books. Total sovereign bond holdings at the books of banks amounted to around 1200 billion euro at the end of 2007 and increased to 1720 billion euro of government securities mid 2013 (around 18% of the Eurozone GDP). This was even more the case in the Southern members. Their exposure on debt of their own sovereigns increased from 16 to 22% in Italy, from 26 to 33% in Spain, from 10 to 25% in Ireland and from 14 to 18% in Greece (even taking into account the debt restructuring of Greek sovereign debt in 2011). Banks in Spain, Italy, Portugal and Ireland now hold more than 700 billion of domestic sovereign debt on their books while in 2007 it was around half that amount. The reasons for "home bias" (the fact that banks hold a disproportionate share of debt of their own sovereign) are several. First is the "moral suasion" by national regulators; it is in the self-interest of banks to make domestic government financing more dependent on domestic banks, so as to have another argument to force the government to rescue domestic banks in case of banking problems. Another argument is "carry trades", where banks are betting long on high-risk sovereign debt, a phenomenon seemingly more prevalent in the Southern member states.

Funding such exposures was also made possible by the ample liquidity provided by the ECB via the three years Long Term Refinancing Operations, which started at the end of 2012. Additional factors that could have amplified the home bias approach were recommendations from core country supervisors to domestic banks, demanding risk reduction of their sovereign portfolios. And finally there is the systemic risk of an extreme scenario of a Eurozone break-up, when liabilities of banks would be re-denominated into local currency and so would the domestic sovereign debt, hence domestic banks would be better prepared for redenomination of domestic sovereign debt than foreign banks. Battistini, Pagano and Simonelli (2013) confirm that “moral suasion” and “carry trade” trade hypothesis are particularly valid for peripheral countries’ banks, whereas systemic risk scenario of the euro break-up forces all banks to “turn back home” and even more those in core countries.

Ideally, a bank should be able to go bankrupt, as any private company. However, if a bank faces difficulties, it is hard for a government to let that private institution fail. This is even more valid for large banks (and 85% of all assets in the Eurozone are held by some 130 banking groups). If one of these large banks goes bankrupt, a significant share of families lose their savings; this is something politically hard to accept and disastrous for the economy as the loss in wealth would shock demand in the country and bring down growth. All banks are interrelated and one bank going broke brings down other banks, which have them lend money via the interbank market or other channels. This is the problem of “too big to fail”. In the absence of a European fiscal backstop (something we argue for in this paper) only national governments can rescue their banks. It sets therefore in motion a "vicious circle" or "doomed loop" between banks and sovereigns: weak banks are more likely to add to the public debt problems and countries with a high or even unsustainable public debt are considered too weak to back their banks, leading to weak banks that are distrusted by other banks and loose access to cheap funding via the interbank market. The result is that markets start to link the fate of governments to the solvency of the banking system and the other way round. At least, that is the case in the Eurozone; in the USA there exists no such relationship. This is illustrated in Figure 1 where the credit default swap (CDS) premia on sovereign and bank debt is correlated.

Figure 1 - Relationship between solvency of banks and sovereigns in the EZ and the US



Source: Datastream

Note: Daily observations since end 2010.

This is due to the fact that: i) banks hold a smaller part of total US sovereign debt, which is mostly in the hands of foreigners and non-bank financial institutions ii) the USD, as the first international reserve currency, enjoys a special investment status and iii) to the fact that Eurozone banks rely more on volatile wholesale funding while US banks are more funded via equity and customers deposits (IMF, October 2013). However, the main reason is probably the existence of a fiscal backstop in the USA that helps the Federal Deposit Insurance Corporation (FDIC) to resolve smaller banks in a credible way via its 100 bn USD credit line to the Treasury. TARP (or Troubled Asset Relief Program of original 700 bn USD, later reduced to 431 bn USD) can be considered as an *ad hoc* fiscal backstop to rescue or resolve systemic banks.

The doomed loop between banks and sovereigns increases the costs of credits for business and households in the Southern member states leading to less investment. The fact that the economies of the eurozone are financed for around three quarters via banks (less than one fifth in the USA) increases the impact of this problem for investment and demand.

Table 1 illustrates that Vulnerable Euro Area Periphery Countries (VEAPs) grew faster than the Euro-area and even significantly faster than the North/core, prior to the outburst of the eurocrisis. During the period 2010-2014, the sudden capital withdrawal and the austerity measures needed

to readjust their economies led to a negative growth rate (except for Ireland) and a skyrocketing unemployment rate.

Table 1 - Fragmentation of Economic Performance in the Eurozone

	Annual GDP change		Unemployment rate	
	1999-2009	2010-14	1999-2009	2010-14
Euro area	1,5%	0,7%	8,7%	11,1%
North ¹	1,4%	1,4%	6.7%	6.9%
VEAPs ²	1,7%	-0,6%	7.5%	15.0%

Source: European Commission, AMECO

Note: Data for years 2013 and 2014 are estimates.

¹ *Belgium, Germany, Estonia, Luxembourg, Netherlands, Austria and Finland.*

² *VEAPs=Vulnerable Euro Area Peripheral Countries: Cyprus, Greece, Ireland, Italy, Portugal, Slovenia and Spain.*

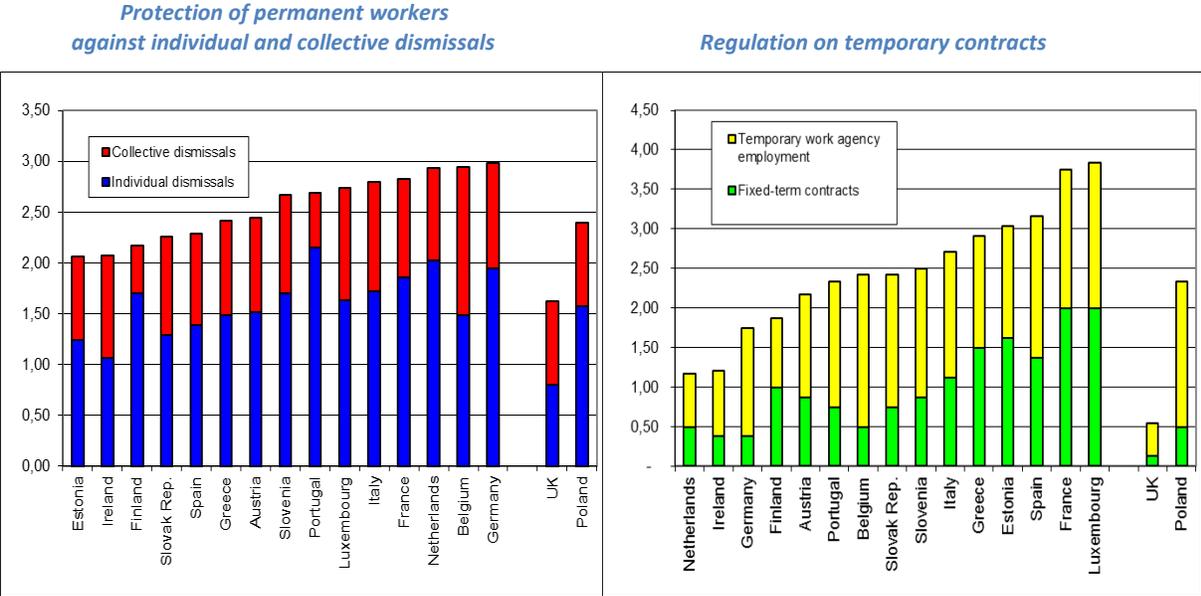
The Eurocrisis revealed the fundamental problem of the “vicious circle” or “doomed loop” between sovereigns and banks. It was reflected in the report “Towards a genuine Economic and Monetary Union”, prepared in 2012 by the Four Presidents (of the Council, the Commission, the Eurogroup and the ECB), who proposed the creation of an “integrated financial framework” or “banking union” as one of the four building blocks of a complete EMU. The report stresses the need to "break the link between banks and sovereigns".

2 Theoretical foundations of a Banking Union

The Theory of Optimal Currency Areas (OCA) states that a monetary union will only survive if the benefits of more economic integration due to adopting a common currency exceed the disadvantages caused by the loss of the exchange rate instrument. If this condition is not met and an economy is hit by an asymmetric shock, sufficient flexibility in factor markets can solve the problem. Flexibility should pertain to two aspects: across the board mobility and flexible prices.

Labour mobility is close to nil between North and South and very low between West and East of the EU. Cross border mobility within EU15 in 2010 stood at just 0.35 %, which compares to interstate/province mobility in the US, Australia and Canada of 2.4, 1.5 and 1 %, respectively (OECD, 2012). Labour markets in the EU are much more regulated and wages display downward rigidity, while cultural/language differences also inhibit migration.

Figure 2 - Labour market protection in the eurozone and other EU member states

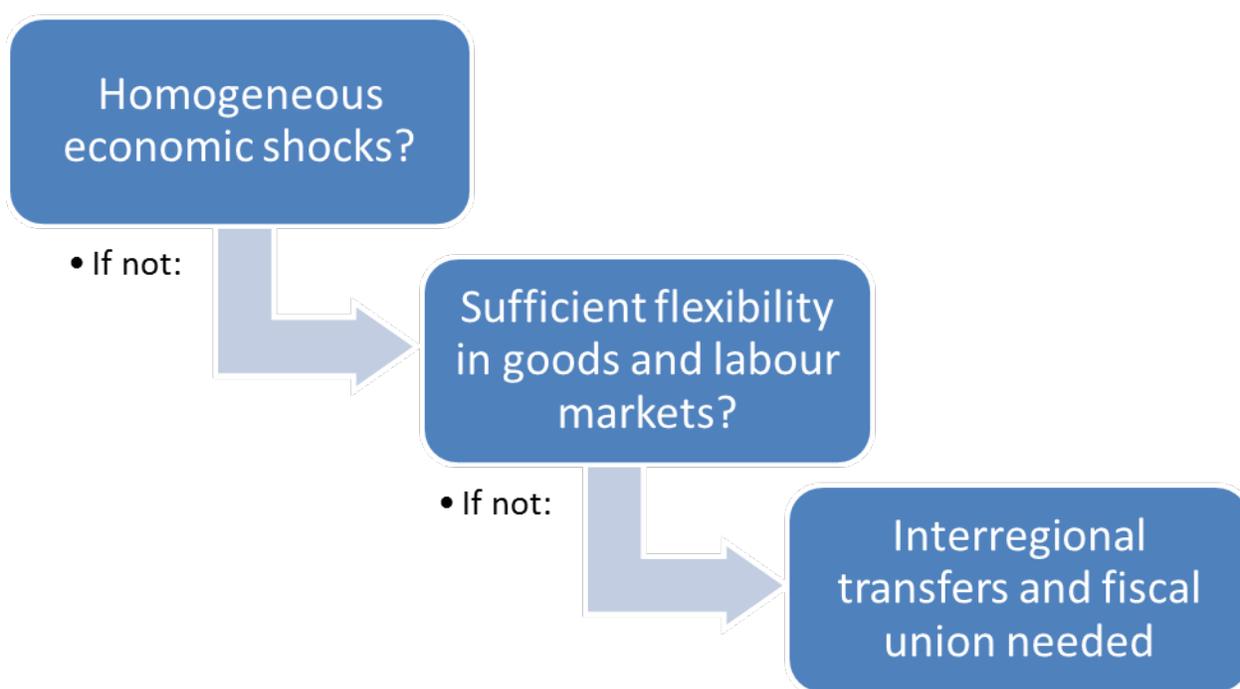


Source: OECD

Note: The indicators of Employment Protection are compiled by the OECD, for more information on the methodology refer to www.oecd.org/employment/protection.

Concerning the factor capital, before the eurocrisis, cross border capital mobility was high, as a result of the single financial market after the introduction of the euro. However, due to the eurocrisis, banks withdrew behind national borders and this condition for a successful monetary union (cross-border free flows of capital) is now much weaker than before. This is in itself a strong reason for a Banking Union.

Figure 3 – Conditions for an Optimal Currency Area



If an economy is adversely hit by a shock and the labour markets cannot absorb that shock, a monetary union is still viable, the OCA concludes, if there is sufficient solidarity and shock absorbing capacity at the federal level. The EU budget amounts to 1% of the total GDP generated by the EU countries, only about half of which can be considered as fiscal transfers from richer to poorer Member States. The larger share of these transfers are of a structural nature and do not serve as shock absorbers. Moreover, the EU Treaty includes two "no bailout" clauses, meaning that fiscal transfers are limited to the EU budget or separate intergovernmental arrangements, the European rescue funds: the temporary European Financial Stability

Mechanism (EFSM) - based on the EU budget and amounting to 60 bn euro borrowing and lending capacity, the European Financial Stability Facility (EFSF), *ad hoc* institution with a borrowing and lending capacity of 440 bn euro and the permanent European Stability mechanism (ESM). Currently, these instruments consist of additional funds which, amounting to more than 5% of EU-27 GDP, that can be used to help mitigate imbalances within the EMU and support structural change. These funds can be deployed only in programme countries and have to be repaid, so they cannot serve as automatic stabilizers and shock absorbers for the whole EMU but are rather financial assistance instruments, which are used in times of real hardship. They include an element of solidarity because all Eurozone sovereigns that back the rescue funds accept risks rejected by private financial markets. Proposals of a Eurozone budget that would play a stabilizing function (cf. Trésor, 2013 and Wolff, 2012, National Bank of Belgium, 2014, Geeroms, Ide and Naert, 2014) meet fierce rejection by important member states such as Germany and other Nordic member states, mainly net-payers to the EU budget. The condition for accepting these proposals is the establishment of a political union, something that is also rejected by most countries. The chances to move closer to a political union are even more remote after the May 2014 elections for the European Parliament, whereby Europe critical parties represent a larger number of MEPs.

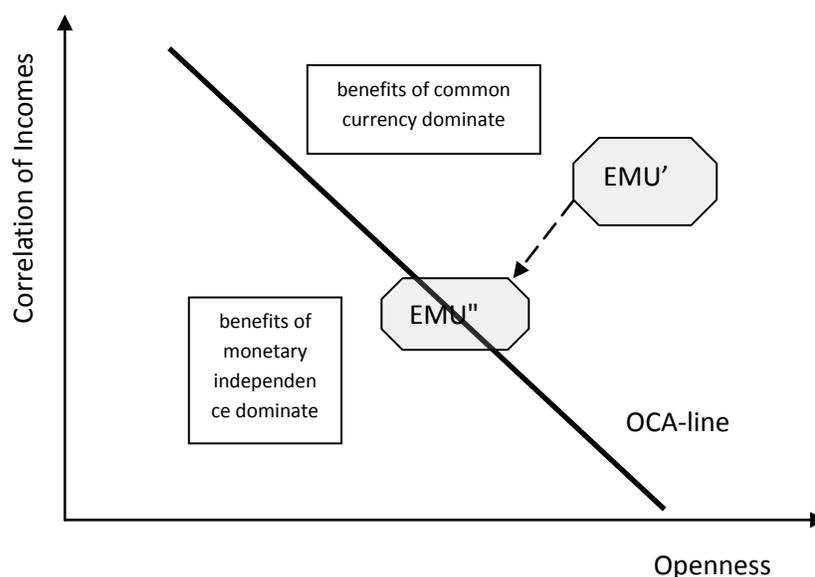
It is interesting to note that the traditional 1960s OCA theory does not provide any theoretical foundation for a banking union. This could probably be explained by the capital restrictions prevailing in those years; the dramatic surge in international capital flows was only triggered by the oil shock in 1973-1974, the growth of the Eurodollar market and the remarkable increase in bank lending during 1979-1981 (Kaminsky, 2005). The OCA theory was developed well before that period and could not draw lessons from sudden reversals of capital flows that caused a Latin American debt crisis (early 1980's), a Scandinavian debt crisis (early 1990's), a South-east Asian debt crisis (1997-1998) and a Russian debt crisis (1998). The theory was also developed by international economists who may have been less focused on financial theory (Maes, 2002).

We can explain the role of a Banking Union in the framework of the OCA-theory in two ways:
1) the absence of a Banking Union can be a reason for important asymmetric shocks due to

sudden capital flow reversals, or alternatively, 2) a well-functioning Banking Union can be an important instrument to accommodate such shocks.

In line with the (graphical) framework elaborated by Mongelli (2013) we can illustrate the impact of the Eurocrisis and of creating a banking union as follows.

Figure 4 - The OCA equilibrium: impact of the euro crisis



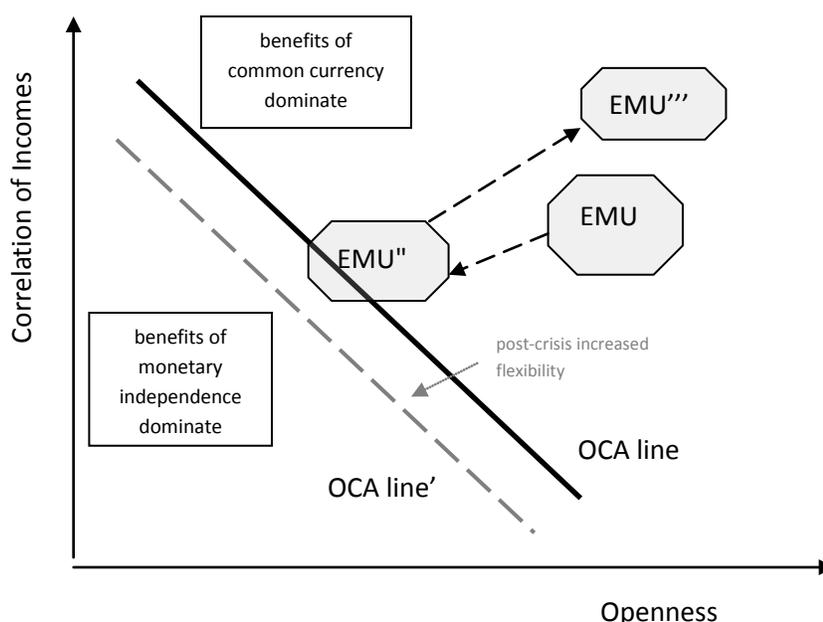
Source: Geeroms, Ide and Naert (2014)

Figure 4 illustrates how the Eurocrisis has led to increased heterogeneity in the euro area, including a diverging business cycle and unilateral adjustment in the indebted member states, causing a drop in the correlation of incomes. The degree of openness, in particular in terms of financial integration, has decreased (see above). All in all, the euro area shifted from EMU' (pre-crisis) to EMU'' (after-crisis), whereby some argued that for instance Greece would better leave the Eurozone as it felt below the OCA-line.

On the other hand, the banking union has the unique feature of increasing private and public risk-sharing. A full banking union will first of all increase financial integration by harmonising regulation (single rulebook, single supervisory mechanism, resolution plans, etc.) stimulating private financial flows and private risk sharing (depending on the nature of the financial flows)

and increasing the correlation of income and/or the degree of openness. This causes a shift from EMU'' to EMU'''. (see Figure 5). At the same time, a Banking Union includes an element of public risk sharing via the Single Resolution Fund of the SRM and the direct bank recap (see below). This shifts the OCA line downwards to OCA line'. In other words, the banking union improves the functioning of the EMU according to the OCA theory in two ways.

Figure 5 - The post-crisis OCA equilibrium



Source: Geeroms, Ide and Naert (2014)

2.1 Destabilising capital flows in the absence of a Banking union as the main reason for the Eurocrisis.

The volume of capital flows grew steadily from the mid 1990s to 2000 but then took a dip during the 2001-2002 recession, before a near tripling in flows between 2002 and 2007. At the peak, gross capital flows exceeded 40 percent of the Eurozone GDP, far in excess of other advanced economies.

The common shock absorbers, i.e. flexible labour and goods markets, can never be sufficient to compensate for shocks of the magnitude caused by the vast volumes of capital flows that have amplified the existing imbalances. The Euro area countries exchange goods and services equivalent to around 20% of euro area GDP per year, compared with 15% in 1999 (ECB, 2013). The pre-crisis volume of capital flows within the Euro area was twice as much as the volume of intra Eurozone trade.

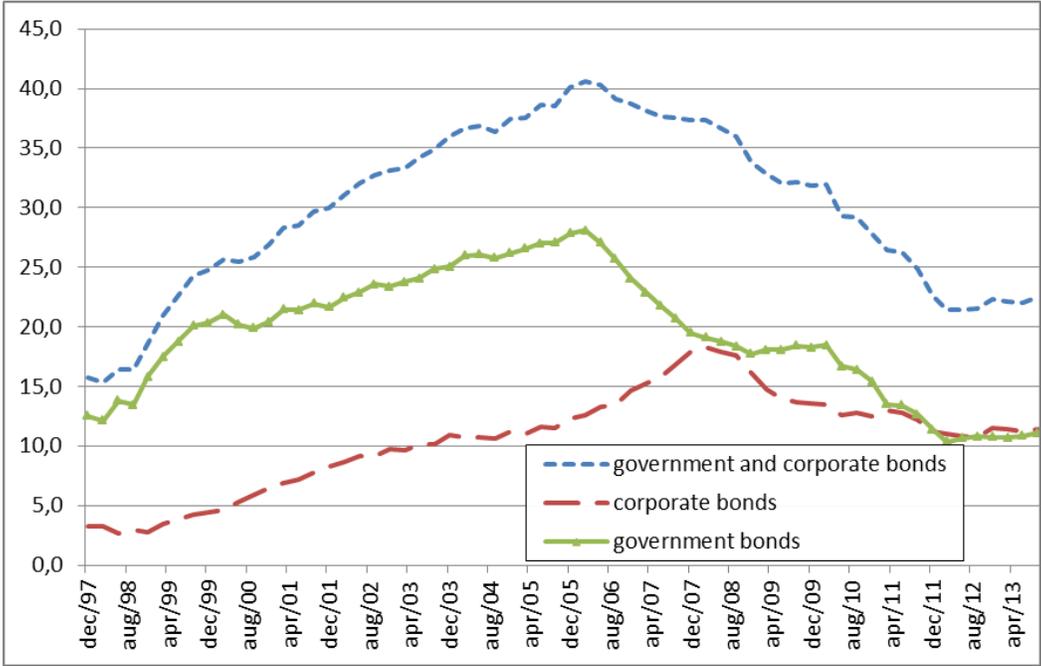
Paul De Grauwe (2011) outlined why the capital flow reversal provoked such an important asymmetric shock in the Eurozone. He proves that a member state, for the very fact of joining the EZ and giving up the control of its own currency and monetary policy, becomes more vulnerable to capital flow reversals and speculation against its sovereign debt compared to countries that keep their currency. A country that maintains control over its monetary policy can still monetise its sovereign debt or its central bank can allow higher inflation to erode the domestic debt. Even more important is the fact that capital outflows in such a country lead to a currency depreciation which, if not followed by an increase in exports, can only be reinvested in the same economy. In this sense, De Grauwe explains why American and British sovereign debt was not attacked by the markets - although these countries have weaker economic fundamentals than the Eurozone. The sovereign debt of several VEAPs was suddenly dumped in early 2010, but in their case, the capital outflow was in euro, a currency shared with other countries that benefitted from capital inflows, the mirror of the outflow from the VEAPs. Greece, Portugal and Ireland did not benefit from a drop in their currency nor had they the possibility to allow a higher inflation rate. The results are well-known and have already been outlined above: they became disconnected from the financial markets and needed support from the other eurozone members.

One can add that a currency zone like the EMU offers more protection against such sudden capital reversals compared to a system of fixed exchange rates. Indeed, the Target2 system compensates the domestic banking sector from the weaker countries at least partially from deposit and funding withdrawal via the possibility to build up debts Target2 balances. It helps to smoothen the financial system but this is not a structural solution that helps economies re-gain their strength.

2.2 A Banking Union is needed in a monetary union

Mundell himself (1973) added a new OCA property after developing his original approach of the early sixties. He showed that a common currency could better mitigate adverse shocks by reserve pooling and portfolio diversification. He argued that countries suffering from asymmetric shocks could still share a common currency while missing labour flexibility and a solidarity mechanism, if they can “insure” each other through financial markets. Financial integration permits to cushion asymmetric shocks through capital flows: deficit countries can borrow from surplus countries or can sell foreign assets if needed to finance their current account deficit. Under a common currency, a country suffering an adverse shock can better share the loss with a trading partner because both countries hold claims on each other’s output and “insure” one another through private financial markets.

Figure 6 - Share of MFI cross-border holdings of debt securities issued by euro area and EU corporates and sovereigns (percentages)

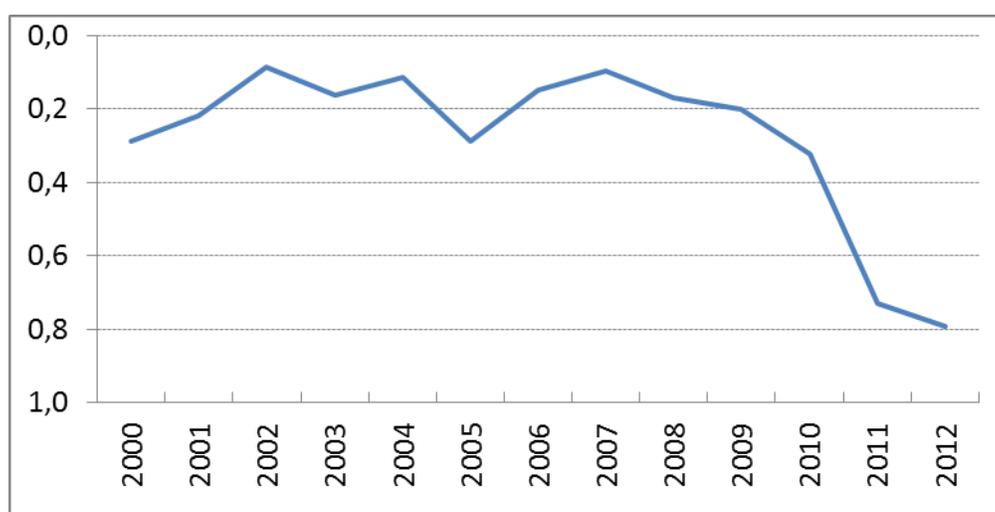


Source: ECB

Figure 6 illustrates that until around 2005, financial integration in the Eurozone increased (for corporate bonds even until 2008) but this tendency was reversed since then and banking sectors started to withdraw behind national borders (see also Valiante, 2014), thereby making the EMU more vulnerable to shocks. The same tendency is observed for investment funds' holdings of debt securities and equity (ECB, financial integration indicators). The collapse in capital flows in 2008-2009 was truly remarkable, falling to about 5 percent of GDP; global capital flows are now one third of the pre-crisis level (Lane, 2013).

In a well-functioning single market capital flows should lead to equalisation of the marginal product of capital across member states and that would be the only determinant of capital flows; thus domestic saving rates would be uncorrelated with domestic investment rates. Feldstein and Horioka (1980) observed that this is not the case in the world, due to differences in taxation and regulations, besides other reasons. We observe that since the eurocrisis, the fragmentation of the EU's single market and the eurozone became very prevalent.

Figure 7 - Collapse of financial integration since financial crisis (Correlation between savings and investment in the member states of the Eurozone)

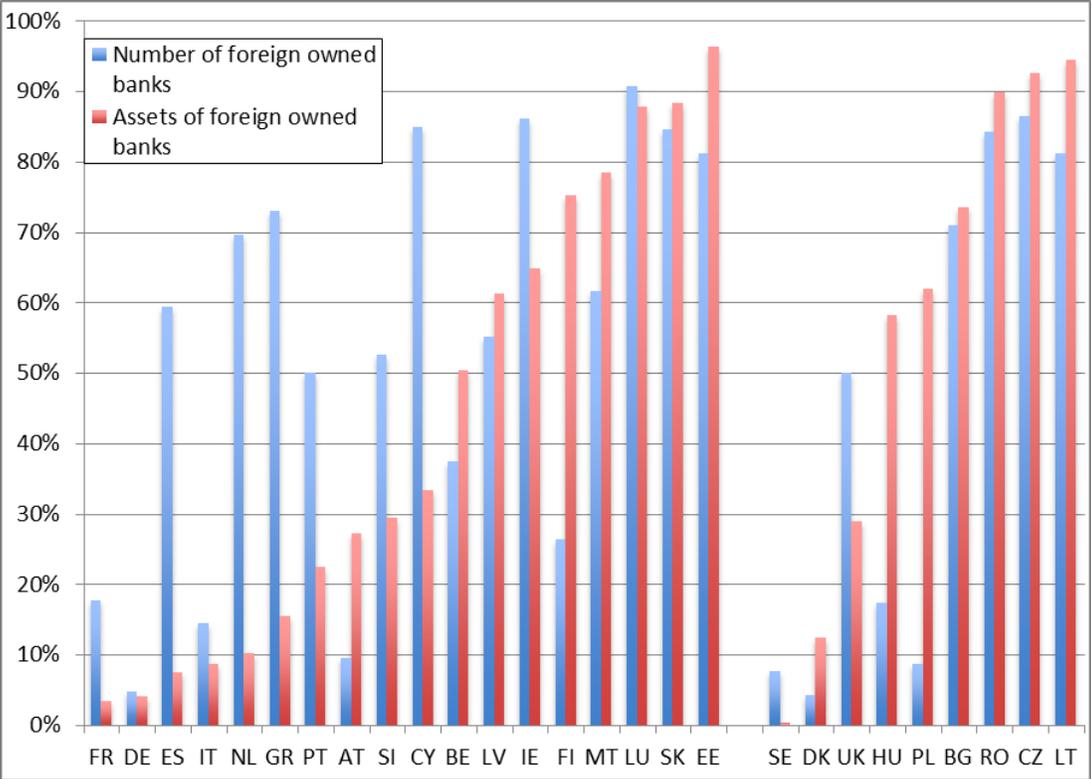


Source: European Commission, AMECO

Note: The higher the correlation, the lower the financial integration and risk sharing between member states.

One of the reasons is probably that banks are still very much "national banks" in the EU (see Figure 8), supervised by national prudential regulators that impose rules on their banks resulting in restrictions on international capital flows.

Figure 8 - Foreign ownership of banks (number of foreign owned banks as percentage of total banks and assets of foreign owned banks as percentage of the total assets of the banking system)



Source: ECB

Banks in the EU remain to a large extent national, if we look at the relevant parameters "number of foreign owned banks" and "assets owned by foreign banks". The “nationalisation” of banks is more outspoken for the bigger member states, France, Germany, Spain and Italy (and the Netherlands) than for the smaller member states. The smaller member states have much more foreign banking activities and this is even more outspoken for the central European countries. It is therefore no surprise that France, Germany and Italy are among the most reluctant in transferring the responsibility for banking resolution to the EU level.

The policy reforms should aim at a new financial environment with less destabilising capital flows (such as excessive debt flows intermediated by non-diversified local banks) and increased stabilising capital flows (such as equity flows and debt flows inter-mediated through diversified banks that are embedded in an area-wide banking union). (Lane 2013)

A monetary union therefore needs a single financial market and a Banking Union. Schoemaker (2013) reformulates this conclusion in the form of an “impossible trinity” of simultaneously having integrated banking markets, national supervision and financial stability. This impossible trinity can logically only be overcome in one of two ways: either, one returns to a world of segmented national banking markets and forgoes the benefits of integration, or one moves towards supra-national structures for financial supervision and resolution. It is estimated that capital markets integration in the USA explains the absorption of two-thirds of shocks in the USA (Sørensen and Yosha, 1996). Gros (2012) illustrates, comparing the US State of Nevada with Ireland, that a banking union is more important as shock absorber than a fiscal union.

3 The EU and the Eurozone's Banking Union

The Report of the Four Presidents “Towards a genuine Economic and Monetary Union” (EU, 2012) rightly suggests that the EMU requires an integrated financial framework or a Banking Union built on three pillars: a single supervisory mechanism, a single resolution mechanism and a single deposit guarantee scheme. President Van Rompuy also adds that there is a crucial need for a Single Rule Book and for an harmonised application of EU rules.

This paper will not elaborate further on the key features of a fully-fledged banking union. The authors have argued elsewhere (Geeroms and Karbownik, 2014) what are the desired characteristics for a well-functioning banking union. At this moment (June 2014) a true Banking Union is not yet in place, even though it is addressed as such.

3.1 The Single Supervisory Mechanism and the Comprehensive Assessment

The first pillar, the Single Supervisory Mechanism (SSM), started functioning at the beginning of 2014, when the Supervisory Board met for the first time.

The ECB/SSM cannot afford to become responsible for banks that can fail because they have hidden losses on their books; this could destroy the credibility of the ECB and of its monetary policy. For this reason, the SSM regulation includes the provision that the ECB must conduct a comprehensive assessment (CA); this CA is crucial and includes:

- 1) a Risk Assessment exercise: an examination of all types of risk related to funding and liquidity, management, business models and so on (this less known aspect of the CA started third quarter of 2013);
- 2) a Balance Sheet Assessment (BSA) which includes an assessment of the balance sheets and of a risk based selection of credit and market portfolios; it includes an Asset Quality Review (AQR) that is scheduled for the first half of 2014, based on the annual financial statements for the year 2013;
- 3) a stress test using the output of the BSA to be jointly conducted by the EBA and the ECB/SSM. This test will make a dynamic diagnosis for three years ahead.

The AQR and the stress test will lead to one single figure on the capital needs of each bank. Banks will need to have at least 8% CET1 (7% of CRDIV plus 1% because it concerns systemic institutions). Under the severe scenario of the stress test, the threshold to force an increase of CET1 will be 5.5%. It would be useful if the ECB would also consider a minimum ratio of risk bearing capital over total assets ratio of more than 3% (Basel rule), preferably in the range of 4.5 to 6%.

The ECB has no other choice than to produce credible results and to withstand the pressure by national supervisors (who want to keep their own credibility intact), by banks (who want to continue their existing business models without raising extra capital) and by national fiscal authorities (which are anxious to avoid that capital shortfalls are detected as they would have to, at least partially, fund them). Hiding problems once more, as was the case for the unfortunate previous EBA stress tests, is not an option any more as the credibility of the ECB and thereby the credibility of the euro is at stake. Likewise, we expect the ECB to insist on a credible and more severe one for certain eurozone member states than the one organised by the EBA for the 28 member states. A credible stress test has proven to be important to return to solvent banks in the USA (IMF, 2013); the current stress tests by the FED will even put more pressure on the ECB and the EBA to come up with credible scenario's. One can even assume that at least a few banks in the VEAPs will have to be found lacking capital to prove the credibility of the exercise while also the weakness of the business model of the German Landesbanken should be revealed. The CA can restore confidence in the banking industry, resulting in a proper functioning of the interbank market, restoring the monetary transmission mechanism and reducing the interest rate differentials which jeopardise investment and economic growth in the Southern member states. The Comprehensive Assessment has the potential of becoming a "game changer" in the Eurocrisis. Its main force is already visible: banks are anticipating the outcome of the CA and started increasing their capital buffers, while governments and national supervisors also took action (e.g. in Italy).

3.2 The Single Resolution mechanism and bail-in

The second pillar of the Banking Union is the Single Resolution Mechanism (SRM). It is important to understand that the SRM builds further upon the Bank Recovery and Resolution Directive (BRRD), adopted by the Council end of June 2013 and planned to come into force at the beginning of 2015.

The importance of the BRRD is frequently disregarded as the focus is on the problem of the missing fiscal backstop for the SRM. The main resolution measure is however, the automatic bail-in which is inscribed into the BRRD. This controversial measure was first applied at the time of the Cyprus banking crisis while it was fiercely rejected by the ECB shortly before in the context of the Irish banking crisis. The bail-in instrument enables resolution authorities to write down or convert into equity the claims of the shareholders and creditors of institutions, which are failing or likely to fail (so-called "going concern" as compared to "gone concern" or failed bank). The ranking order of bail-in is crucial: first of all ordinary unsecured, non-preferred creditors are bailed in, like shareholders, bondholders and deposits from large corporations. Only if that is insufficient, the resolution authority can bail-in deposits from natural persons and SME's; these have preference over the claims of the previous creditors. Deposits up to 100,000 euro are protected by the Deposit Guarantee Scheme (see below) and are not bailed in; these are called "covered deposits". Certain types of other liabilities are also permanently excluded, such as covered bonds, liabilities to employees, liabilities arising from a participation in payment systems and certain interbank liabilities. The BRRD states that bail-in should at least absorb losses amounting to 8% of the liabilities of a bank. That amounts to some 2500 bn euro, which is more than the capital and reserves of the eurozone MFI's balance sheet (2400 bn euro). This is much more than the 55 bn euro the Single Resolution Fund will dispose of in eight years time (see below).

To solve cases when the bail-in is insufficient, member states have to set up ex-ante resolution funds, which need to reach within 10 years at least 1% of covered deposits of all credit institutions in the country. Financial institutions have to pay into these funds via contributions based on their liabilities, excluding own funds and covered deposits, and adjusted for risk.

The EC's new State aid rules applicable to support measures for banks in the context of the financial crisis (August 2013) mirror the provisions in the BRRD. They stipulate that equity and sub-ordinated bondholders must definitively be wiped out before any state assistance can be considered. EU state aid control thus effectively constitutes the basis for bank resolution well before the BRRD and the SRM take effect (Deutsche Bank, 2013). There is a heated debate about the bail-in with arguments for and against. However looking at the case of Cyprus, where it resulted in capital controls, one needs to treat this instrument cautiously.

The Single Resolution Mechanisms includes two institutions: a Single Resolution Board and a Single Resolution Fund. The European Commission presented its proposal on 10 July 2013 and the Council adopted a general approach in December 2013.

(1) **The Single Resolution Authority (SRA)** is based on article 114 TFEU. The decision making process is complex and involves several institutions. The Board consists of an executive director, four full-time appointed members and the representatives of the national resolution authorities of all the participating countries. It can meet in executive session, including only the director, the four full-time members and the representatives of member states concerned by a particular resolution decision. The ECB/SSM starts the resolution process via a notification to the Board that a bank is failing or likely to fail or the Board can decide itself placing a bank into resolution. It then decides the application of resolution tools and the use of the single resolution fund. Decisions by the Board would enter into force within 24 hours of their adoption, unless the Council objects. Most draft resolution decisions are prepared in the executive session. The plenary session is responsible for decisions that involve liquidity support exceeding 20% of the capital paid into the fund, or other forms of support, such as bank recapitalisations. If the European Commission disagrees with the Board, it has to go to the Council. Under pressure from the European Parliament, the too cumbersome decision-making process (see Lorenzo Bin Smaghi, 2013) proposed by the Council has been streamlined and the role of the EC has been strengthened.

(2) **A Single Resolution Fund (SRF)** is set up under the control of the SRA to ensure the availability of medium-term funding support while the bank is restructured. It needed to be based

on an Intergovernmental Agreement, because Nordic countries were afraid that such fund could impact their budgetary sovereignty, which would breach the Treaty ‘no-bail-out’ clause. During the first eight years, a network of national resolution funds will operate including the possibility to lend from each other on a voluntary basis; there will be no real common fund from the start, but rather a mechanism whereby the national resolution funds are gradually merged. All bail-in tools of the BRRD first need to be exhausted before the SRF can be tapped; it is the last line of defence before the ESM is used as a fiscal backstop but in a currently agreed manner, namely via national budgets. After eight years, a common SRF will be in place, which presumably will have a credit line to the ESM or the capital markets.

The SRF is based on an Intergovernmental Agreement (IGA), although three legal services (of the EC, the Council and the ECB) argued that article 114 TFEU was sufficient legal basis, but Germany vetoed this legal approach. An IGA runs counter to the Community method, it adds to the complexity of the EU decision making and it sidelines the European Parliament.

A ten years period to mutualise a (rather small) resolution fund as proposed by the Council has been shortened to 8 years and the mutualisation is regressive over time, which is an important victory of the EP. The same applies to the possibility of the SRF to borrow. However, the latter possibility can backfire, because it can work procyclical. Indeed, when banks run into problems and need to be rescued by the SRF, they are most in need to raise extra capital, but the SRF will compete at the capital markets and burden the already weakened banks by an extra implicit liability, namely the duty to pay the loans back to the SRF (albeit within a certain limit).

This complex system of decision making, based on a future network of national resolution funds cannot be called the key stone of the Banking Union. It misses the effective SRA as proposed by the EC and requires a true fiscal backstop. Such system exists in the USA, where the FDIC decides with a board of five independent experts and has a credit line of 100 bn USD to the Treasury, a credit line which is extended in times of crisis. For the eurozone, the available lending margin of the ESM (440bn euro) can be used to support governments in case they have to recapitalise banks and are not able to do so. However, this approach does not cut the “doomed loop” between banks and sovereigns, because the ESM provides for loans and these are added to the sovereign debt. It is irrelevant in this respect whether Eurostat excludes these from the

Maastricht debt or not as the financial markets will always consider it as government debt in an economic sense. It is recommended to give the SRF a credit line to the ESM. In this case, we would defend to stop the, much debated, direct recap, whereby the ESM can invest directly in problem banks for a maximum of 60 bn euro, but very conditional and in the very last instance, when all other channels of support for a bank have been exhausted. This direct bank recap runs indeed counter to the principle that the taxpayer should not pay for losses of banks.

3.3 The Single Deposit Guarantee Scheme

The political energy invested in the Banking Union and the short memory of politicians, helped by the fact that the ECB has temporarily calmed down the financial markets with its OMTs, explains that the lessons of the financial crisis are already forgotten and the required actions to finish the Banking Union are timid. The third pillar of the Banking Union, a Single Deposit Guarantee Scheme is not anymore on the agenda of the EU. Only an agreement on a coordinated Deposit Guarantee Scheme has been reached end 2013, repeating the existing national guarantee of at least 100,000 euro and adding the requirement of setting up a prefinanced fund of at least 0.8% of the covered deposits. The missing link is the common guarantee fund. If an important bank would collapse, the national prefunded deposit guarantee fund will quickly prove insufficient, thereby forcing the national government to rescue the failing bank and risking setting in motion the "doomed loop". What is needed is a gradual risk sharing by mutualising national deposit guarantee funds, merging them with the SRF and giving the SRF a credit line to the ESM, as argued above.

4 Conclusions

It is clear that the establishment of the Euro is not an end in itself and that the EMU needs to be expanded in order to function well. Given that fiscal and economic pillars are currently not further developed, the Banking Union seems the only available instrument at our disposal. A true Banking Union is not only a quick fix but a genuine game changer. In a situation where labour is not mobile and trade of goods is relatively small, capital flows play a major role in

stabilizing or destabilizing the EMU. Therefore a true Banking Union could not only solve the doomed loop between intertwined banks and sovereigns, it could also strengthen the EMU by facilitating effective shock stabilisers via the financial system, which normally absorbs 2/3 of all shocks in a well-functioning currency union. Building a genuine Banking Union will not be easy as there are banks and sovereigns that prefer to continue business as usual. However, as the US example shows, without a real public backstop or efficient resolution authorities, there cannot be a real Banking Union. Therefore, one should learn the lesson of the eurocrisis and come up with a truly centralized and efficient Single Resolution Authority that acts in a real European way and is able to resolve banks quickly. Additionally, we need a public backstop to assure markets that Europeans are serious about honouring their commitments and that the euro is based on solid foundations. Once all this is in place, there will be less need for a Eurozone budget or any other type of fiscal mutualism that is politically so difficult to achieve in Europe today. Given that there is no will for a political union, one has to take into account that beyond the Banking Union there are no other options to stabilise the EMU. We therefore reinforce the vision that a monetary union needs a banking union.

5 Bibliography

Asmussen, Jörg (2013), The Single Resolution Mechanism and the Limits of Bank-Regulation, Speech at the Humboldt Universität, 8 November.

Battistini, Niccolò, Pagano, Marco and Simonelli, Saverio (2013), Systemic Risk and Home Bias in the Euro Area, *European Economy, Economic Papers* No. 494.

Beck, Thorsten (ed.) (2012), Banking Union for Europe, Risks and Challenges, CEPR.

Bini Smaghi, Lorenzo (2013), The European banking union is a disappointment, *Financial Times*, 19 December.

Cœuré, Benoît (2013), The way back to financial integration, public speech, Madrid, 12 March.

De Grauwe, Paul (2011), The governance of a fragile eurozone, *CEPS working Documents*, No. 346..

Deutsche Bank (2013), EU Banking Union, right idea, poor execution.

European Commission (2013), On the Application, from 1 August 2013, of State Aid Rules to support measures in favour of banks in the context of the financial crisis ("Banking Communication").

European Commission (2013), Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ('Banking Communication'), 2013/C 216/01.

European Commission (2012), Impact Assessment Accompanying the proposal on the Directive establishing a framework for the recovery and resolution of credit institutions and investment firms, SWD(2012) 166 final, Brussels, 6 June.

ECB (2013), Opinion on a proposal for a Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council.

Enria, Andrea (2013), The Single Market after the Banking Union, AFME and EBF Banking Union in Europe Conference, Brussels, 18 November.

European Union (2013), Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 - General approach, June.

European Union (2013), Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 published in the *Official Journal of the European Union*, L 176, vol. 56, 27 June.

European Union (2013), Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, published in the *Official Journal of the European Union*, L 176, vol. 56, 27 June.

European Union (2012), Towards a Genuine Economic and Monetary Union, Report by President of the European Council Herman Van Rompuy Brussels, 26 June.

Feldstein, Martin and Horioka, Charles (1980), Domestic Saving and International Capital Flows, *Economic Journal*, vol. 90, No. 358, pp. 314–329.

Geeroms, Hans, Naert, Frank and Ide, Stefaan (2014), The European Union and the Euro: How to deal with a currency built on dreams?, Intersentia Cambridge.

Geeroms, Hans and Karbownik, Pawel (2014), A Banking Union for an unfinished EMU, *Center for European Studies, Policy Paper*.

German Council of Economic Experts (2013), Financial Markets in Europe: From the Single Market to a Banking Union, 9 January.

German Council of Economic Experts (2012), After the Euro Area Summit: Time to Implement Long-Term Solutions, 30 July.

Goodhart, Charles and Schoenmaker, Dirk (2009), Fiscal Burden Sharing in Cross-Border Banking Crises, *International Journal of Central Banking*, vol. 5, No. 1, pp. 141-165.

Gros, Daniel (2012), Banking Union: Ireland vs. Nevada, an illustration of the importance of an integrated banking system, *CEPS Commentaries*, 18 October.

IMF (2013), A Banking Union for the Euro Area.

IMF (2013), European Union: Publication of Financial Sector Assessment Program Documentation—Technical Note on Macroprudential Oversight and the Role of the ESRB, IMF Country Report, No. 13/70.

IMF (2013), Credibility and Crisis Stress Testing, by Li Lian Ong and Ceyla Pazarbasioglu.

IMF (2010), A Fair and Substantial Contribution by the Financial Sector, Final report for the G-20.

Kaminsky, Graciela (2005), International Capital Flows, Financial Stability and Growth,' *DESA Working paper*, No. 10.

Kenen, Peter (1969), The Optimum Currency Area: An Eclectic View, in R.A. Mundell and A.K. Swoboda, *Monetary Problems of the International Economy*, Chicago, University of Chicago Press, 1969.

Lane, Philip (2013), Capital flows in the Euro area, *the European Commission Economic Papers*, No. 497.

Maes, Ivo (2002), Economic Thought and the Making of European Monetary Union, Selected Essays, Edward Elgar.

Mac Kinnon, Ronald (1963), Optimum Currency Areas, *American Economic Review*, Vol. 53, pp. 717-725.

Mersch, Yves (2013), On the road to a Banking Union: the way forwards from the ECB's perspective, Frankfurt am Main, 18 November.

Micossi, Stefano, Bruzzone, Ginevra and Carmassi, Jacopo (2013), The New European Framework for managing Bank Crises, *CEPS Policy Briefs*, No. 304.

Mongelli, Francesco Paolo (2013), The mutating euro area crisis: is the balance between "sceptics" and "advocates" shifting?, *European Central Bank, Occasional Paper Series*, No. 144.

Mundell, Robert (1973), A Plan for a European Currency, in H.G. Johnson and A.K. Swoboda, *The Economics of Common Currencies*, Allen and Unwin, pp. 143-72.

National Bank of Belgium (2013), Structural Banking Reforms in Belgium: final report, July.

National Bank of Belgium (2014), Annual Report 2013.

OECD (2012), OECD Economic Surveys: European Union 2012, OECD Publishing.

O'Rourke Kevin H. and Taylor Alan M., Cross of Euros, *Journal of Economic Perspectives*, vol. 27, No. 3, pp. 167–192.

Sapir, André and Wolff, Guntram (2013), The neglected side of the banking union: reshaping Europe's financial system, Bruegel, note presented at the informal ECOFIN 14 September 2013.

Schoenmaker, Dirk and Gros, Daniel (2012), A European Deposit Insurance and Resolution Fund, *CEPS Working Documents*, No. 364.

Schoenmaker, Dirk (2013), Governance of International Banking – the Financial Trilemma, Oxford.

Sorensen, Bent and Yosha, Oved (1998), International Risk Sharing and European Monetary Unification, *Journal of International Economics*, vol. 45, No. 2, pp. 211-238.

Direction générale du Trésor (2013), Un budget pour la zone euro, *Trésor-éco*, No. 120.

Valiante, Diego (2014), Framing Banking Union in the Euro Area: Some empirical evidence, *CEPS Working Documents*, No. 388.

Verhelst, Stijn (2013), What if the Next Financial Crisis hits the Banking Union? A Call for an "If all else fails" clause, *Egmont European Policy Brief*, No. 16.

Véron, Nicolas (2013), A Realistic Bridge towards a European Banking Union, *Bruegel Policy Paper*, No. 9.

Webel, Baird (2013), Troubled Asset Relief Program (TARP): Implementation and Status, Congressional Research Service, 27 June.

Wolff, Guntram (2012), Why the Eurozone needs a separate budget, Bruegel, 30 November, available at www.bruegel.org/videos/detail/video/65-why-the-eurozone-needs-a-separate-budget/.