BANKING UNION AND FISCAL BACKSTOPS

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The banking union is an epochal institutional change, comparable in many respects to the introduction of the euro in 1999. Besides the Single Supervisory Mechanism (SSM), the banking union comprises a Single Resolution Mechanism (SRM) with its Single Resolution Fund (SRF), and a harmonized system of deposit insurance schemes.

The new institutional architecture is certainly an important step forward in the construction of the eurozone and constitutes an important boost for further economic and financial integration in the euro area. Yet, something seems to be missing. Despite the numerous – political as well as economic – efforts in this direction, the banking union does not entail at the moment proper fiscal backstops, that is contingent public credit lines at the euro area level that can be used in case of extreme needs of refinancing or recapitalization of the banking system. This is a crucial shortcoming of the design of the banking union which risks undermining its fundamental principles and objectives.

To understand this, it is important to start from the rationale underlying the creation of the banking union and its main objectives, and then discuss the current institutional design in light of its ability to contrast and deal with systemic risk and systemic shocks in the euro area.

An incomplete financial architecture

As it is now well-known, the creation of the monetary union was incomplete in many respects. The starting idea was to create a single market through the introduction of a single currency. However, the monetary union was not accompanied by a fiscal or a political union. And even more important for our purpose, it still entailed nation-bound supervision, resolution mechanism and safety nets. As often argued, the idea behind the different jurisdictions of monetary policy and banking supervision was that the single market, and in particular the single passport and the cooperation between national authorities, would have provided a sufficiently integrated system, able to deal with an integrated banking market and to provide unified policy responses whenever needed.

These predictions turned out to be true for a while. Despite its incompleteness, the monetary union worked very well in strengthening the single market. It was a boost for economic and financial integration in the euro area, and in Europe more generally. In particular, it was an important determinant for the integration of wholesale banking markets, including the interbank market, up to nearly the end of the 2000s.

The situation, however, changed dramatically when the financial crisis hit Europe. Starting in early 2009, the eurozone experienced impaired monetary policy transmission mechanism, vicious spirals between sovereigns, their banks and non-financial institutions, problems with the resolution of cross-border banks, and re-fragmentation

of credit markets. In other words, the euro area revealed itself unable to deal with a systemic crisis hitting its integrated market.
One of the main reasons for this inability was the sudden recognition that banks were "international in life but national in death", as Charles Goodhart posed it. Since the introduction of the single currency, banks were heavily encouraged to expand in the whole EU as if this was their reference market. However, when the crisis emerged, bank bailouts became exclusive responsibility of national governments. This was due to the political sensitivity of involving foreigner taxpayers' money to support domestic banks, also given that the domestic jurisdiction of bank supervision.
The domestic sovereigns turned out to be unable to cope with the massive fiscal needs bank bailouts entailed because of their already elevated level of indebtedness and/or because in the meantime banks had expanded well beyond the national borders and had grown well beyond the fiscal capacity of national taxpayers.
The consequences of the eurozone crisis with its political uncertainty and stream of controversial political decisions on sovereign spreads, financial stability and credit supply are well known. What matters here is the push that this situation had for the creation of the banking union.

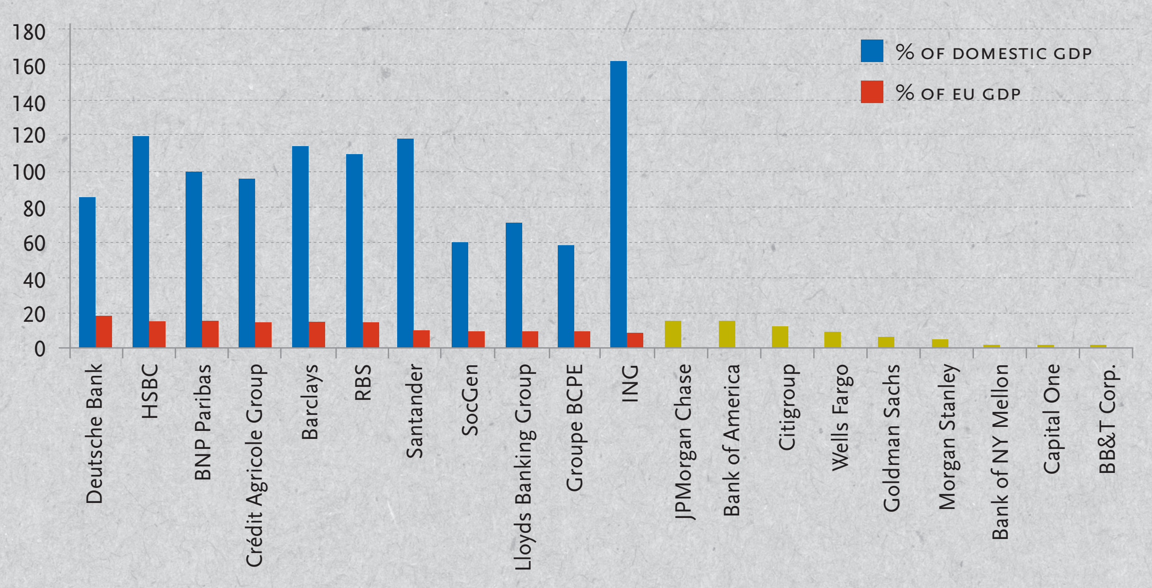
Rationale and structure of the banking union

As the crisis evolved and turned into the eurozone debt crisis, the need for a deeper integration among the countries sharing the same currency and their banking system became evident. To this end, the EU institutions agreed in 2012 to establish a banking union among the countries in the euro area. Non-euro countries may join as well, but it is not mandatory for them to do so.
The creation of the banking union responds to the three main objectives:

1. break the vicious spirals between sovereigns, domestic banks and real sector;
2. prevent forbearance and regulatory capture;
3. improve homogeneity and effectiveness of supervision.

On paper, all these objectives seem reachable. Concerning the first objective in particular, as argued above, in the last two decades banks have grown substantially well

FIGURE 1 TOTAL ASSETS OF THE LARGEST EU AND US BANKING GROUPS IN % OF GDP



SOURCE: LIIKANEN REPORT

beyond national borders and fiscal capacities but their size remain adequate relative to the European market as a whole. As Figure 1 shows, the size of the largest EU banks, as measured by total assets as percentage of GDP, is comparable to that of the largest US banks if we take the EU GDP as being the relevant benchmark.

This means that it would be possible to break the loop between banks and sovereigns by creating an adequate integrated safety net. However, the design of the banking union does not entail a truly integrated support mechanism for banks and thus there is the risk that banks' support will remain, at least partly, under the responsibility of national sovereigns should a new financial crisis occur in the future. This in turn means that despite the creation of the banking union, the euro area may still not be sufficiently equipped with the necessary tools to deal with systemic risk and with the occurrence of a similar crisis to the last one we experienced.

Let me elaborate on this point. At this stage, the banking union consists of three main elements:

1. Single Supervisory Mechanism (SSM)
2. Single Resolution Mechanism (SRM)
3. Single Rulebook.

The SSM places the European Central Bank as the main supervisor of financial institutions in the euro area. The SSM is directly responsible for the largest banks (approx. 130) and indirectly for the other smaller banks that remain under direct monitoring of their national supervisors. This structure forms *de facto* an integrated system of banking supervision in the euro area. Its main objective is to control that banks comply with the EU banking rules and to prevent – or at least reduce – the risk of forbearance and capture.

The SRM ensures a single resolution procedure for failing banks covered by the SSM jurisdiction. The purpose is to make it possible for banks to be orderly resolved, and at minimal costs for taxpayers and the real economy. The SRM comprises a Single Resolution Board and a Single Resolution Fund, and it is accompanied by the BRRD directive establishing the harmonisation of powers, procedures and instruments of EU member states (asset sale, asset separation, bridge bank, bail-in, and so on).

The Single Rule book consists of a set of legislative rules that all financial institutions in the EU must comply with. In this sense, it represents the basis for common regulation and supervision in the EU.

Shortcomings in the design of the banking union

Despite being a tremendous achievement, the design of the banking union presents important shortcomings. In particular, given our focus, the Resolution Fund seems highly inadequate.

The total target size of the fund will be equal to approximately € 55 billion, i.e., approximately 1% of the covered deposits of all banks in the banking union. The fund will be built over 8 years (or possible 12) and will consist of contributions of individual banks. The fund will thus be entirely *ex ante* financed, and it does not have the possibility to extend its size further through the use of public credit lines should this become necessary. No other forms of contingent lending are envisaged at the moment.

> *One shortcoming of the reform is the inadequacy of the Resolution Fund, which will be equal to approximately 1% of the covered deposits of all banks*

The limited (and fixed) size of the fund implies that this is not designed for systemic crises, but only for individual ones. Together with the lack of fiscal backstops, this implies that the banking union is inadequate to deal with systemic crises and with an integrated banking system.

Is this a problem? The views are split. Some argue that the fund is rightly constructed to deal with individual crises, which are the majority. Systemic crises are rare events, and even more so now that banks have been recapitalized, stricter capital regulation has been enforced and bail in instruments are in place. Moreover, it is important to curb bank managers' moral hazard. Thus, bailouts should be excluded and losses and penalties should be imposed on shareholders and creditors rather than on taxpayers. As a consequence, the fund has to be limited so to make it credible that bailouts are no longer on the table. Finally, there is no need to specify *ex ante* burden sharing agreements or any other contingent mechanism given that, as the recent crisis has shown, common funds and proper mechanisms to guarantee financial stability can always be constructed *ex post* should the need emerge.

Whereas there is certainly something warranted in these views, they overlook the distortions that the lack of proper fiscal backstops may entail. Firstly, without clear fiscal backstops at the European level, the vicious circles between sovereigns and their domestic banks may appear again if investors realize that bailing out banks is still – at least partly – a responsibility of national governments. Secondly, the lack of the "end game", that is the uncertainty as to what would happen should the *ex ante* built resources of the various European funds be exhausted in the event of a new financial crisis, risks to distort the whole decision process governing bank supervision.

It is in fact well known that providing full guarantees to banks and their creditors may induce bank managers to take excessive risk and exacerbate the so-called moral hazard problem. However, it is equally well known that any form of guarantee has to be clear and credible to avoid panic crises among investors and contagion among financial institutions.

Without this, the agents in charge of bank supervision may take inefficient decisions – either too strict or too lax – in order to avoid the occurrence of panic crises and contagion. Either type of decisions lead to inefficient decision making process and inefficient outcomes. Excessive rigor may impede the normal credit function of financial intermediaries, while excessive laxity, the so-called forbearance, may induce bank managers to take excessive risks.

> ***The banking union has to be credible to function properly and its incomplete architecture may be tested at some point***

To conclude, one of the main rationales behind the creation of the banking union was the need to create common and integrated safety nets to break the loop between sovereigns and banks. As it stands, the current design seems inadequate in this respect and thus inappropriate to achieve this objective. One wonders what will be the consequences of this on the functioning of the banking union. What is certain is that the recent comprehensive assessment exercise has not found important shortfalls in banks' capital structures and has *de facto* promoted the banking system as a whole. One wonders whether this positive result is the "genuine" outcome of a fair evaluation process of banks' resiliency or whether it is related to the lack of fiscal backstops. Whatever the truth is, the banking union has to be credible to function properly and its incomplete architecture may be tested at some point. ■