



# *What if the Next Financial Crisis Hits the Banking Union?*

## *A Call for an “If All Else Fails” Clause*

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**This Policy Brief argues that the envisaged design of the Banking Union risks not being sufficient to deal with the next large-scale financial crisis. Therefore, an “if all else fails” clause should be approved, stating that the Banking Union members can provide joint last resort financing to deal with a future crisis. An agreement on the clause should be feasible because it is beneficial to all Member States.**

Since 2007, the world has been suffering from one of the biggest financial crises in modern history. Astonishingly large amounts of public money were required to keep the financial sector afloat. Since the outbreak of the crisis, the eurozone countries alone have had to provide more than €1.1 trillion in public support to the financial sector (or 12% of the eurozone’s GDP). As Europe is still dealing with troubles in its financial sector, the costs are likely to increase even further.<sup>1</sup>

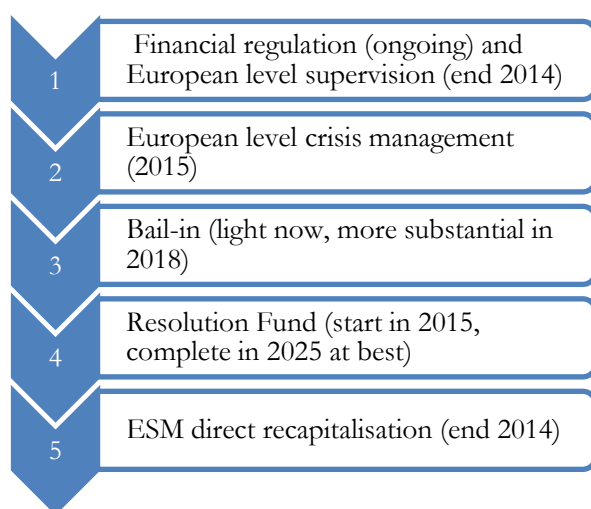
Given the devastating effects of the financial crisis, regulators worldwide have been taking far-reaching steps to prevent similar crises from reoccurring. In the EU, policymakers face an even more pronounced reform challenge, due to the weaknesses of its monetary union. The crisis painfully highlighted the great interdependency of eurozone countries and their banking sectors. Because of the “vicious link” that exists between the two during crises, European leaders agreed to put in place a Banking Union for the eurozone and other, voluntarily participating, Member States. The Banking Union’s key goal is to lift the control of the banking sector to the European level and –as a result– to undo the tenacious link between banks and sovereigns. Completing the Banking Union is a vast endeavour that will take several years.<sup>2</sup>

The reforms are likely to facilitate a better response to a future financial crisis. However, will the measures be sufficient for when a large-scale crisis hits? After providing an overview of the firewalls that are to deal with financial upheavals, this Policy Brief argues

that the Banking Union might indeed not be sufficiently equipped to deal with big crises. It therefore calls for a last resort instrument in the form of an “if all else fails” clause.

## THE FIREWALLS TO PREVENT CRISES AND BAILOUTS – AND THEIR LIMITS

If completed, the post-crisis reform measures are to result in five successive firewalls in the Banking Union to prevent and/or limit financial crises. The figure below provides an overview of each of these firewalls.



**Figure 1: Banking Union firewalls to prevent and deal with crises**

### 1) Regulation and supervision

The first financial crisis firewall aims to make the occurrence of financial crises less likely. This is to be achieved by reforms in financial sector regulation and supervision that attempt to fill in the numerous gaps that have been laid bare by the financial crisis. In terms of supervision, three European Supervisory Authorities have been created to improve coordination across Member States. The European Systemic Risk Board, in turn, is to monitor overall risks in the financial sector.

For the countries that will participate in the Banking Union, supervisory reforms are to go a lot further than better coordination. In

the second half of 2014, these countries will see the responsibility for bank supervision lifted to the European Central Bank through the creation of the Single Supervisory Mechanism (SSM).

While these reforms address a number of manifest problems in the financial sector, it is not realistic to expect that better regulation and supervision will prevent all future crises. As regulators and supervisors have difficulties keeping up with new developments in the financial sector, the regulatory framework tends to become gradually less effective. Even with periodic readjustments, it is not feasible to prevent financial bubbles and the resulting crises from occurring altogether.<sup>3</sup> Or, as John Kenneth Galbraith summed it up: “[r]egulation outlawing financial incredulity or mass euphoria is not a practical possibility.”<sup>4</sup>

### 2) Crisis management

To deal with these future financial upheavals, common crisis management rules are being developed in the EU. The Council and the Parliament are discussing a Directive on Bank Recovery and Resolution (BRRD in the EU jargon), with the aim of approving the text by the end of 2013.<sup>5</sup> Early intervention will be a main element of these new rules, in order to address difficulties as soon as they arise.

In addition to the common rules, the Commission has proposed lifting crisis management to the European level for the countries that belong to the Banking Union. This would involve a Single Resolution Mechanism (SRM) that is to become operational in 2015.<sup>6</sup> Under the Commission’s proposal, decision-making in the SRM would be centralised at the

European level – which makes sense as supervision would be centralised as well.

European level crisis management will allow for a more coherent, and hence less costly, cross-border approach to financial turmoil. Nonetheless, larger crises would still require substantial financial resources. This is illustrated by the United States' response to the financial crisis: despite the centralised supervision and crisis management, the US still had to spend approximately € 395 bn (\$ 520 bn) to save its financial sector.<sup>7</sup>

### 3) *Bail-in tools*

The financial resources for crisis management would, in the first instance, be claimed from a troubled bank itself through a “bail-in”. This implies that the costs of the restructuring or resolution of a bank are paid for by the bank's shareholders and bondholders (and, ultimately, deposits above € 100,000) as far as possible. Full-scale bail-in rules are expected to enter into force in 2018. In the meantime, revised state aid rules have been put in place in August 2013. These are already a partial move in the direction of bail-ins. If successfully applied, bail-ins will represent a fundamental shift in the modern approach to crises in the financial sector, which has relied heavily on public bail-outs.<sup>8</sup>

The bail-in tools will likely allow covering part of the costs attached to a large financial crisis. However, they might not always be sufficient. Moreover, in case of major crises the bail-in tools will probably not be used to their full extent. If investors in one bank see the value of their shares and claims evaporate during a crisis due to a bail-in, investors in other banks will likely be willing to sell their shares and claims at huge losses before they risk losing even more. This can easily aggravate panic in the financial markets,

running against a core goal of crisis management.

### 4) *Resolution Fund*

If the bail-in tools, in turn, prove insufficient or too risky to be applied, the EU foresees a Resolution Fund to step in. Under the Commission's SRM proposal, the Resolution Fund is to cover all countries participating in the Banking Union. The Fund is to be built up over a period of 10 years by contributions from the financial sector itself.<sup>9</sup> The Fund will hence only be fully funded by 2025 at best. These ex-ante resources of the Resolution Fund are to be equal to 1% of the deposits protected by deposit insurance, which amounts to approximately € 55 bn. Such limited resources could be quickly exhausted if a large-scale crisis occurs.

If the ex-ante resources indeed prove insufficient, the Fund could compel the financial system to provide ad-hoc funding to finance the resolution of a troubled bank. If such funding would not be available in time, the Fund would be able to borrow the necessary resources on the financial market, or from other parties. Yet, during significant crises, it might not be realistic to expect the Fund to be able to collect or borrow large sums of money from the private sector. The financial system risks being too fragile for such operations.

In that case, the Commission hopes that the Resolution Fund can turn to the European Stability Mechanism (ESM). Yet, nowhere in the legislative proposal is this mentioned explicitly.<sup>10</sup> The lack of clear rules on whether the Resolution Fund can borrow from the ESM might hamper a swift response to a large-scale financial misadventure. Furthermore, it is quite possible that the ESM would have already responded to the

crisis by lending substantial amounts to Member States or directly to banks (see *infra*), leaving it short of resources to lend to the Resolution Fund.

### *5) ESM direct recapitalisation*

If the firewalls above have proven unsuccessful in financing the costs associated with a financial crisis, the Banking Union is to rely on the final instrument that is foreseen by the EU, i.e. direct recapitalisation by the ESM. This is a rather traditional bail-out instrument that is lifted to the European level. Member States foresee a total of € 60 bn at most for this purpose.

The relatively small amount constitutes the weak element of this supposedly ultimate firewall. In light of the huge costs linked to a big crisis, the funding could possibly be depleted rather swiftly. In addition, only eurozone countries participate in the ESM. It should not be taken for granted that they will provide money to recapitalise a bank that operates in a non-eurozone member of the Banking Union.

## **THE POSSIBLE NEED FOR PUBLIC RESOURCES AND THE UNCERTAINTIES ATTACHED**

The implementation of the firewalls discussed above is likely to provide the necessary resources to deal with moderate financial turmoil. Yet, it is doubtful whether the instruments will be sufficient when a large-scale financial crisis hits. As mentioned, the financial crisis that started in 2007 has required more than €1 trillion of public money in the eurozone alone. Even if the costs of a large-scale financial crisis would be cut in half by improved regulation, supervision and crisis management, a tremendous amount of money would still be

needed. There is hence a genuine possibility that the instruments that have been foreseen by the Commission will not be able to generate sufficient resources in time.

If the foreseen instruments prove insufficient indeed, the Banking Union would have the choice between either letting one or more banks fail in an uncontrolled manner, or resorting to public resources. The latter will at times be the least bad option; in the midst of a crisis, there may be little or no alternative but to resort to the taxpayer.<sup>11</sup>

This assessment gives rise to the question of how a public bailout would take place in the Banking Union. It is most probable that the Member State in which a troubled bank is located will pass the blame for the bank's failure on to the rules and supervision at the European level. Indeed, due to the responsibility for supervision at this European level, the countries in the Banking Union become jointly responsible for when such supervision fails. This joint responsibility for common policy failures leads to the belief that all the Member States that participate in the Banking Union would have to provide jointly the last resort financial means to deal with a crisis if needed.

Yet, despite the fact that collective public bailouts are a distinct possibility, there is no clarity whatsoever on how such bailouts would take place in the Banking Union. How would the common decision be made? Would (some) national parliaments have to approve it? Which formula would be used to divide the financial resources put up by each Member State? These questions all remain unanswered.

A degree of uncertainty about whether and how public resources would be used during a financial crisis is in itself not a bad thing. It

helps to counter the moral hazard that arises if bankers are confident that they will be bailed out in case their risky investments turn sour. In their seminal book *Manias, Panics, and Crashes*, Charles Kindleberger and Rober Aliber put it as follows: “[s]ome ambiguity as to location of ultimate responsibility may be helpful to the extent that it leaves some uncertainty so that bankers are more self-reliant—*provided there is not so much uncertainty as to disorient the market.*”<sup>12</sup>

The last part of this quote is of paramount importance for the Banking Union. As Kindleberger and Aliber add, ambiguity may be preferred in a “close-knit society.” Yet, a different situation arises when there is a lack of coherence among the decision-makers. The authors refer to the consequences of the 1907 financial crisis in Italy, where “[p]art of the difficulty may have lain in the lack of sufficient cohesion among Turin, Genoa, Milan, and Rome and the resulting uncertainty, buck-passing and indecision.”<sup>13</sup> Given the reluctance in the EU to foresee cross-border transfers, the Banking Union at present hardly seems the close-knit society envisaged by Kindleberger and Aliber. Therefore, if the cited cities are replaced by Berlin, Madrid, Paris and Rome, the response of Italian cities to the 1907 crisis could read as a prediction of the Banking Union’s response to the next big crisis.

### THE “IF ALL ELSE FAILS” CLAUSE

Precisely because solidarity in the Banking Union is not self-evident, a basic level of clarity should be provided on the way last resort public resources would be deployed during a financial crisis. The Commission’s proposals leave excessive uncertainty, which could prove most costly during the next crisis.

This weakness is a reason to agree on an “if all else fails” clause. This clause would provide the basic outline of the Banking Union’s last resort public backstop, without providing too much detail either. The key to success is affirming that public financial assistance is conceivable as a last resort, while letting bankers understand that it will most likely not take place.

From this point of view, the “if all else fails” clause should state two things. First of all, it should explicitly acknowledge that the ESM is able lend to the Resolution Fund under extraordinary circumstances. Implicit speculation is simply not enough. In addition, the clause should mention that, if all else fails, the Member States of the Banking Union can decide to lend on an ad-hoc basis to the Resolution Fund. The clause ought to indicate which basis would be used for the calculation of national contributions (e.g. the ESM capital key calculations) and how the decision would be made (qualified majority voting or based on ESM decision-making rules).

It is possible that this “if all else fails” clause cannot be included in the future SRM Regulation due to the fact that the Treaty basis of that Regulation does not extend to fiscal matters (Art. 114(2) TFEU). If this would indeed be the case, the clause can be adopted on the basis of unanimity under Article 192(2) TFEU. Alternatively, an intergovernmental agreement outside of the EU Treaties framework can be signed (possibly annexed to the ESM Treaty). If the EU Treaties would be revised in the future, Member States would then be able to include the “if all else fails” clause into the *acquis communautaire*.



## HOW TO MAKE THE CLAUSE ACCEPTABLE TO EVERY MEMBER STATE

It might at first sight seem difficult to get all Member States to agree to an “if all else fails” clause. Creditor countries –Germany is a case in point– are wary of having to pay for the policy mistakes of others. However, if properly designed, this would not hold true for the “if all else fails” clause.

Crucially, the clause should relate only to problems that occur after the ECB takes over bank supervision. Problems that arise earlier evidently have to be addressed as well.<sup>14</sup> Yet, as ill-fated national policies play a substantial role in the present difficulties, it is understandable that creditor countries expect individual national governments to pay the bulk of the costs associated with these problems. Potentially, an additional transition period could be foreseen during the first year(s) of the ECB’s supervisory operations, as problems that arise early on can still be partly due to previous ill-fated national policy choices.

After that point, the Banking Union members will inevitably face a new reality. Financial difficulties that will arise from that moment onwards can no longer be attributed to national policy mistakes. They will have become a common responsibility. The consequences of bank failures will then have to be dealt with jointly, i.e. financed jointly if ultimately required.

The “if all else fails” clause would allow the Banking Union to deal with future problems in a credible manner, without unjustly dragging individual countries into the vicious link between banks and sovereigns. As the clause deals only with future problems, it should be seen as an insurance mechanism,

not a hidden transfer device. Every Member State would benefit from the balanced burden-sharing rules, and the improved financial stability it entails.

## CONCLUSION

The EU has come a long way since the financial crisis hit the banking sector and the economy at large. The reform process that has been initiated needs to be continued. Depending on the completion of this process –notably the European Banking Union project– the probability of new financial crises ought to be reduced. Yet, crises will still occur. While the successive firewalls that are envisaged can be sufficient for a range of financial difficulties, there is a genuine risk that they will not be enough when the next big financial crisis hits the Banking Union. This risk needs to be addressed in order to prevent the indecisiveness and uncertainty that can prove so very costly during crises.

To this extent, an “if all else fails” clause, enabling the Banking Union to deal with a large-scale crisis, should be introduced at the European level. The clause should provide for two things: (i) an explicit acknowledgement that the ESM can lend to the Resolution Fund and (ii) a statement that the Banking Union Member States can decide to provide last resort financing in case all other instruments have proven insufficient. This “if all else fails” clause would be proof of the Banking Union’s resolve and capability to deal effectively with financial crises. Preparation for a next crisis should indeed start now.

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## ENDNOTES

- <sup>1</sup> The amount refers to public resources spent from October 2008 to the end of 2011. In that same period, all EU Member States combined have had to use more than € 1.6 trillion to help the financial sector (or 12.8% of EU-wide GDP). In a set of 40 prior crises, countries had to use on average about 13% of GDP to solve financial sector difficulties. See EUROPEAN COMMISSION (2012). *Facts and figures on State aid in the EU Member States - 2012 Update*. Commission Staff Working Document. p.32; and HONOHAN, P. & KLINGEBIEL, D. (2003). *The fiscal cost implications of an accommodating approach to banking crises*. In: *Journal of Banking and Finance*, 27 (8), pp. 1539—1560.
- <sup>2</sup> VERHELST, S. (2013). *Assessing the single supervisory mechanism: Passing the point of no return for Europe's banking union*. Egmont Paper, No. 58.
- <sup>3</sup> MINSKY, H. P. (1986). *Stabilizing an unstable economy*. New Haven, Yale University Press.
- <sup>4</sup> GALBRAITH, J. K. (1993). *A short history of financial euphoria*. New York, Whittle Books, p. 108.
- <sup>5</sup> In spite of the common rules, some national discretion would remain. See: COUNCIL (2013). *Proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms*. 28 June.
- <sup>6</sup> EUROPEAN COMMISSION (2013). *Proposal for a Regulation 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*. COM(2013) 520. 10 July.
- <sup>7</sup> KIEL, P. & NGUYEN, D. (2013). [Bailout Tracker](#). ProPublica, consulted on 3 September 2013. Government assistance to non-financial sectors (notably the automotive industry) has been excluded from the calculations.
- <sup>8</sup> LEMANGNEN, A. (2013). *From bail-out to bail-in: the paradigm shift is official*. Natixis. Special Report No. 121. July.
- <sup>9</sup> The period can be longer than 10 years under specific circumstances.
- <sup>10</sup> Borrowing from the ESM is mentioned in the [Memo](#) linked to the Commission proposal, but not in the SRM legal proposal itself.
- <sup>11</sup> GOODHART, C. Funding arrangements and burden sharing in banking resolution funding. In: BECK, T. (2012). *Banking union for Europe risks and challenges*. London, Centre for Economic Policy Research.
- <sup>12</sup> KINDLEBERGER, C. P. & ALIBER, R. Z. (2005). *Manias, panics, and crashes: a history of financial crises*. Hoboken, John Wiley & Sons, p. 235.
- <sup>13</sup> Ibid, pp. 235-236
- <sup>14</sup> VERON, N. (2013). *A realistic bridge towards European banking union*. Bruegel Policy Contribution 2013/09, June.