



How to Form a More Perfect European Banking Union

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The euro area has made significant strides in the last six months in designing a banking union. The goal has been to centralize supervisory decision making and improve the management of failing banks while protecting European taxpayers and imposing costs on creditors through so-called bail-ins to reduce moral hazard. Euro area leaders have reached some political agreements, and legislation is being prepared for eventual adoption by the European Parliament and then the various member states.¹ This progress has been hailed as a step in the right direction, with particular praise for the euro area leaders' plan to endow the European Central Bank (ECB) with supervisory powers and create new rules for managing troubled banks.

European leaders first proposed the banking union in mid-2012 as a reaction to the sovereign debt crisis. Its purpose was to convince markets that European leaders would break the

link between troubled banks and debt-burdened sovereigns at the national level. The objective was to end the vicious circle whereby a crisis in a nation's bank or banks immediately spread to doubts about the solvency of the governments that tried to stand behind the banks. The best solution for that problem would have been to issue eurobonds backed by taxpayers across the region, which would have credibly shored up the stability of the system and helped sovereigns and banks through such systemic crises. But eurobonds were too sensitive a political issue and euro area leaders sought to avoid a debate on them. Activating the ECB's supervisory power was an attractive alternative step at the time because it does not require any change in the EU treaties. The current blueprint of the banking union exists because it was the easiest alternative at a time of stress, not because it was carefully designed to be the best one.

Now that the crisis has abated, it is time to take a step back and think carefully about why a banking union is needed and what it is supposed to accomplish. As I argued in Ubide (2013), it is clear that the banking union project has not been a crisis management mechanism: The vicious circle was broken by the

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launching of ECB's bond buying facility—known as outright monetary transactions (OMT)—not by progress on the banking union project. With the crisis ebbing, the urgency to rush into a banking union has receded. However, it is important to avoid the inertia of a project that started as a reaction to a deep crisis and has progressed heavily conditioned by the politics of crisis management and resolution. A banking union deals with two very sensitive issues—taxpayers' money and the allocation of losses, and property rights—and it should not be taken lightly.

This Policy Brief argues that some aspects of the current banking union project will improve the soundness of the euro area banking system, especially if supervisory practices are

1. My colleagues Nicolas Véron (2013) and Jacob Kirkegaard (2013a, 2013b, 2013c) have recently commented on the details of the legislation and its political context. The IMF (2013a) has argued for a strong banking union, supporting the view that the absence of a common resolution mechanism with a strong fiscal backstop will dent the credibility and effectiveness of common supervision.

upgraded. But it also argues that potential unintended consequences may flow from the project, which many analyses have overlooked.

Beyond centralizing supervision, the plan as envisioned by euro area leaders has three pillars: (1) minimizing the near-term need for taxpayer contributions to rescue troubled banks; (2) preventing moral hazard at the euro area country level by minimizing the euro area backstop for troubled banks; and (3) preventing moral hazard at the financial institution level by designing rules to force shareholders, creditors, and depositors to share in the cost of a future rescue. Together these proposals amount to a policy of “national bail-ins” (as most investors in the banks are locals) to avoid “euro area bailouts.”

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This framework may be satisfying to those who want to see some governments and lenders punished for the economic cost of the recent crisis. But it is backward looking (designed to avoid a repetition of recent events, such as the Greek rescue or the Cyprus bail-in fiasco), rather than forward looking (designed to achieve the best possible banking union). If implemented as is, the framework will dampen lending in the near term and reduce the potential growth of the euro area. It will likely increase the probability of self-fulfilling crises as a result of the bail-in rules and create a less efficient and fragmented banking system, ill-suited to deal with systemic crises. The current banking union framework is inefficient due to two elements: the minimal euro area backstop, to be invoked only as a very last resort, and the “forced” national bail-ins of creditors. This combination raises the danger of perpetuating the fragmentation of the euro area financial sector, as individual states worried about the cost of bank rescues rein in their banks and prevent them from expanding cross-border and taking other steps that would make the European system more efficient and prosperous. The euro area backstop, as called for by the current proposal, needs to be larger, more effective, and more credible. Otherwise there will be European supervision but only national banking sectors.² That is not a banking union.

2. Bruegel (2013) provides a very extensive discussion of the fragmentation of the euro area banking system, which is evident across many aspects of the business.

Another problem is that the current proposals call for an unbalanced mix of centralized supervision: mostly centralized decision making on resolution but with budgetary repercussions at the national level. Seen this way, the proposals are politically untenable—it is taxation without representation. Moreover, if the current banking union project becomes the permanent alternative to eurobonds, its creation could undercut the solidity of the euro area. Eurobonds would better safeguard the euro area economy and, more importantly, create a risk-free asset that can facilitate the ECB’s monetary policy operations and the banking system maturity transformation and improve the channeling of euro area savings to the best investment opportunities.

How to move forward? At a minimum, a European banking union should achieve coherence: Banks supervised by the ECB should be covered by a European resolution authority and a European resolution fund, and the governance structure of supervision has to match the governance structure of resolution.³ The credibility of the ECB as a supervisor is at stake: If a robust resolution system is missing, the ECB may be tempted to keep insolvent banks afloat with liquidity injections. At the same time, one has to acknowledge that resolution decisions are political decisions that involve the allocation of losses and can’t be taken on purely technical grounds. A realistic alternative would be to place the resolution authority at the ESM, with a governance structure that does not allow for veto power by any country (thus eliminating the unanimity rule) and facilitates quick decisions, better capital structure, and a much expanded budgetary allocation (or, at a minimum, a line of credit from the ECB) to increase the size of the direct recapitalization instrument.

In addition, the contribution to the resolution funds of the banks supervised by the ECB should be consolidated with the direct recapitalization instrument at the ESM to create a European resolution fund.⁴ This consolidation would bolster the framework and break the national nature of banking sectors—creating a well-defined two-tiered system of large European banks and small national banks—and add to the borrowing ability of the ESM in case of need. This framework would allow the ESM to become a credible euro area backstop for troubled banks. Expanding the issuance of ESM bonds would be a natural path toward eurobonds. Combined with an easing of costs to be imposed on creditors and depositors—clarifying that precautionary recapitalizations will only require the contribution, at

3. Belaisch et al. (2001), in the early discussions about the euro area banking system, already alerted us about the need for European supervision and resolution for the largest euro area banks.

4. During the transition period until this European resolution fund is fully funded by private sector contributions, it should be funded temporarily with a loan from the ESM.

most, of junior and hybrid debt instruments—this framework would enhance the stability of the euro area financial system.

The crisis has shown the dangers of living with a half-built system with no provision to deal with systemic shocks. Just as the concept of balanced budgets was hampered by a lack of a

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euro area fiscal authority, the current plans threaten to leave the euro area again half way with a banking system that cannot handle systemic crises. If the “solution” to the crisis falls short in this fashion, the opportunity presented by a very deep crisis would have unfortunately been wasted.

THE BACKGROUND

The creators of the euro area’s economic infrastructure assumed that balanced budgets at the national level would be enough to cushion recessions. Unfortunately, the crisis has shown that this hypothesis was not correct or complete. Systemic banking crises can produce recessions that inflict a heavy fiscal cost and lead to potentially unsustainable situations. To deal with the crisis, the euro area created a small fiscal backstop in 2010—the European Financial Stability Facility (EFSF), which was then replaced by the European Stability Mechanism—to lend to countries in trouble. In mid-2012 euro area leaders also started a project to establish a banking union as a way to break the vicious circle developing between sovereign debt and banking systems, in which worry about the stability of the banking system led to worry about the debt outlook, rising funding costs, worsening growth, and further weakening of the banks.

Following are the recent banking union agreements and proposals on supervision and resolution, along with a discussion of the problems they pose:

1. **The transfer of supervisory powers over European banks with balance sheets over €30 billion to the ECB, to become effective sometime in late 2014 at the earliest.** The ECB estimates that it will conduct direct supervision over about 130 banks, representing about 85 percent of the

European banking sector. This supervision is to be preceded by a comprehensive assessment of the soundness of the European banking system, with three elements: a risk assessment of banks’ portfolios to determine the areas that deserve a deeper analysis; a balance sheet assessment and Asset Quality Review (AQR) intended to determine the correct valuation of the assets; and a stress test to be undertaken in coordination with the European Banking Authority. While such tests must be a part of any European banking overhaul, they pose a short-term danger of revealing weaknesses and capital needs that may have to be addressed before a credible backstop is in place. If badly managed, the comprehensive assessment—intended to stabilize the system—could actually introduce further financial instability in the near term.⁵

2. **The establishment of a direct recapitalization instrument at the ESM,⁶ which would inject equity directly into banks but only as a last resort and only if providing a loan to the sovereign pushes its debt ratio to unsustainable levels.** Established in 2012, the ESM is a €500 billion euro area fiscal backstop that can be used to lend to countries in trouble and also may soon be able to recapitalize the banking system. The size allocated for bank recapitalization is limited to €60 billion,⁷ and the member state would have to first recapitalize the bank so that its core Tier 1 capital (the highest quality capital, mostly composed of common stock and retained earnings) reaches 4.5 percent of total bank assets. The ESM’s direct recapitalization of a troubled bank would also require a 20 percent co-financing by the member state. Strict conditionality would be required, on institutions and, possibly, general economic policies. The plan is give the ESM powers to change the management and business model of the recapitalized bank.

5. Especially if there is a requirement that any public capital injection must be accompanied by some degree of bail-in, per the recent State Aid guidelines.

6. Council of the European Union, “ESM direct bank recapitalisation instrument,” Luxembourg, June 20, 2013, www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/137569.pdf.

7. The capital structure of the ESM is quite inadequate to be the permanent direct recapitalization instrument. The ESM’s capital is composed of €80 billion paid in and €420 billion callable capital. Thus the bulk of the ESM financing is supposed to come through capital markets, which are expected to rely on the callable capital as the guarantee for repayment if the ESM’s loans and investments fail. The ESM lacks capital markets track record and would need to borrow long term to match the duration of the equity investments, having to raise funds at times of market stress. In addition, issuing bonds over and above the paid in capital amount would amount to effectively exercising the call, which would then need to be recognized on the sovereign balance sheet of the ESM contributor countries, threatening the AAA rating of the ESM. Obviously, improving the ESM’s capital structure so that it can become the embryo of a euro area debt agency and materially increasing its size would be an important move toward a more efficient euro area banking structure.

3. A draft EU directive on bank recovery and resolution⁸ with explicit rules on costs imposed on banks' private investors during bank rescues.

The process of so-called bail-ins would involve three steps: First, losses up to 8 percent of a bank's liabilities must be imposed on private investors. Second, another tranche of up to 5 percent of bank's liabilities can be injected via further bail-in or public capital. Third, after 13 percent in losses have been covered, the country could resort to ESM direct recapitalization but only after having bailed in all unsecured senior bonds. The EU directive would also establish a commitment to create, within 10 years, national bank resolution funds for insolvent banks worth 0.8 percent of each country's covered deposits, financed collectively by each country's banks. This would add to previously agreed national deposit guarantee schemes covering 0.5 percent of deposits. Note these funds would only serve to deal with isolated banking issues. Systemic crises require much larger financial resources and are always dealt with by the fiscal authority.

4. A European Council agreement on a Single Resolution Mechanism (SRM)—but, importantly, not on a Single Resolution Authority—which would comprise a network of national resolution authorities.

It is unclear what the final shape of this process will be. There are alternative options to dealing with banks that have to be dissolved or taken over, with different degrees of complexity and treaty changes. A logical option would be for the resolution authority to reside in the ECB, the European Commission, the ESM, or a new independent agency. Adding this task to the ECB would likely overburden it; empowering the ESM or creating a new agency could require a treaty change; and entrusting the Commission with the resolution authority, which does not require a treaty change, is not politically palatable in some countries. The current proposal is to create a network of national resolution funds and of national resolution authorities, possibly coordinated via resolution boards, which would include the national resolution authorities affected by the bank, the ECB, and the Commission. This resolution board, upon indication by the supervisor (the ECB), would recommend to the national resolution authority the winding down of a failing bank.

8. Council of the European Union, "Council agrees position on bank resolution," press release, June 27, 2013, Brussels, www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/137627.pdf.

DRAWBACKS OF THE EURO AREA PROPOSALS

The transferring of banking supervision to the ECB, if properly implemented, should bring some benefits to the euro area financial sector. It would harmonize supervisory practices and some important definitions, such as nonperforming loans, leveling the playing field across euro area countries. It would also reduce the potential for supervisors to become overly influenced or "captured" by the banks they are overseeing. Hopefully, it will also make future stress test exercises more credible and allow for robust horizontal assessments of euro area banks' balance sheets. However, there are several reasons why these agreements do little to alleviate the current problems and may even move the euro area banking sector in the wrong direction in the long run.

First, the proposals barely address the current problems of the weak countries. Many banks are still unable to fund themselves in the market and have to turn to the ECB for liquidity. Target 2 balances—the accounts of the national central banks in the European system of central banks—have come down a bit but remain high, showing the extent of the ECB's funding of the banking sector. Yes, the vicious circle has been broken and sovereign bond yields have come down, but that is due to the existence of the ECB's OMT program of bond purchases, not to the banking union progress. The ECB will not have supervisory powers for at least another year, and this long delay precludes forceful action to fix the disruptions to the transmission mechanism of monetary policy. Without adequate information about the state of the banks' balance sheets and the quality of the loans, the ECB is reluctant to put in place measures to alleviate the funding crunch of small and medium enterprises (SMEs), such as buying bundles of loans to these enterprises from the banks.⁹ This lack of information is behind the statements by some European officials and ECB members arguing that much higher loan rates in the periphery are "rational" because such rates reflect higher perceived risk for banks and borrowers. This situation is very worrisome. As long as private lending rates in each country are allowed to reflect location, rather than the ECB's policy stance, monetary policy in euro area countries with troubled banking systems will remain too tight, discouraging demand and keeping banks' balance sheets fragile.¹⁰

9. In a manner similar to the Term Asset-Backed Securities Loan Facility (TALF) in the United States, the ECB could buy bundles of SME loans to incentivize banks to lend to SMEs, as banks would know that the ECB would stand ready to take those loans from the banks' balance sheets, thus reducing the capital cost of those loans for the banks.

10. In fact, one could argue that an important part of the reason why euro area bank balance sheets are still in such a weak state is the double dip recession. A more aggressive monetary policy stance could have avoided the recession and banks' balance sheets would look healthier, as it was the case in the United States.

Second, the proposals do little to improve current risk sharing. Direct recapitalization by the ESM remains a very distant prospect. The AQR and ECB's taking over of supervision should allow for a "fresh start"—from the moment the ECB becomes the supervisor, new losses and capital needs should be taken care of at the European level, as the ECB would have signed off on the AQR and therefore valuations should be considered appropriate. But the German position seems to insist that all the nonperforming loans and capital needs resulting from the crisis should continue to be dealt with at the national level (the "legacy assets" doctrine based on the argument that unless banking legislation is completely centralized, countries will continue to be able to play with legal tricks that "send the bill" to the euro area), even after the ECB takes over. If the legacy assets doctrine prevails, it will perpetuate the current fragmentation. It would instead make sense to do a retroactive direct recapitalization in the countries under programs as a way to lower their debt ratios to more sustainable levels.

Third, there is not much in the proposals to promote a single market in financial services and to facilitate future risk sharing via cross-border banking integration. A banking union would in theory encourage the expansion of efficient pan-European banks, even if they are too big to save at the national level. However, the current arrangements seem designed to create banking sectors in each euro area country that are small and domestically manageable. The agreement on bail-in rules is a perfect example of these perverse incentives toward conditioning the size of banks to the size of the home country's GDP: It contains a set of rules for bailing in the private sector but also a set of rules for a country to avoid complying with the bail-in rules, provided the country can fund the recapitalization itself.

Furthermore, the direct recapitalization fund at the ESM is very small and is defined as a very last resort, and the conditions associated with it are so politically tough (because of the cofinancing requirements and the conditionality attached to it) that it looks designed to discourage its use. The establishment of national resolution funds will perpetuate the national nature of euro area banking and imply that there is no intention to create a credible euro area fiscal backstop. With many euro area countries still likely to have debt ratios near 100 percent by the end of the decade, the incentive to reduce the size of the banks will be very strong.

In fact, this combination of bail-ins, small euro area backstop, and large debt ratios will help perpetuate the current fragmentation, because each country—knowing how politically costly it will be to request European help if a large bank were to get in trouble—will want to avoid the cost by discouraging their banks from expanding cross-border.

In addition, the politics of making the current project work are difficult. On the one hand the current proposals suggest that the system would depend mostly on national funds. On the other, there is to be centralized decision making on the resolution of failed banks. To some extent, this is akin to taxation without representation, at least for the small countries, given the governance structure of the euro area (and the precedent of the Stability and Growth Pact, where the European Commission decision to fine Germany was overruled by the eurogroup). This is aggravated by the fact that a very large portion of the German banking sector, the *Sparkassen*, has been excluded from the system (under the argument that the *Sparkassen* are individually "small"—which is true, but this doesn't mean that as a sector they couldn't create systemic problems, as the savings banks in Spain show), giving Germany a strong say in other countries'

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banking sectors but allowing it to retain control over its own banks. This asymmetry between decision making and budgetary cost cannot possibly be stable. If supervision is going to be at the euro area level, then the budgetary impact of those supervisory actions must be at the euro area level as well.

The undertone of these proposals is that "you are mostly on your own." In effect, countries with troubled banking systems are being told that if private lending rates are too high, no help is forthcoming. The ECB does not feel it has the supervisory information to intervene, and thus the stance of monetary policy remains too tight. If banks are allowed to become "pan-European"—too big for the size of a national economy—countries must be prepared for harsh treatment if they get in trouble, even if moving toward a pan-European system may have brought efficiency gains to the euro area economy as a whole. Countries that oppose bail-ins (forcing creditors to fund the bulk of the cost of banking crises) are being told to fund rescues with their own national funds.¹¹ As a result, euro area risk sharing is being thinned or at least delayed, significantly increasing the future risks to financial stability. The euro area seems to be moving in a direction opposite to a global trend toward adopting macroprudential policies to safeguard financial stability.

Before 2007, across the board euro area solidarity implicitly allowed the development of a wholesale euro area financial market. Now, however, this implicit solidarity has vanished. It has been replaced by an explicit minimalist plan to transfer costs

11. Sweden has openly criticized the bail-in rules and suggested it will avoid them to the extent possible.

to the private sector rather than widening the euro area safety net. The essence of a monetary union, which is risk sharing, is being short-changed. To a large extent, this is analogous to what happened post 1997 in emerging markets. The very large cost of the crisis and the tough medicine to avoid moral hazard that was prescribed by the International Monetary Fund and other international financial institutions created a feeling of “never again” among emerging markets. Feeling they were on their own, many countries ran current account surpluses and accumulated reserves as self-insurance to defend themselves in a crisis so that they would never again have to resort to international aid. Their actions led to the development of global imbalances—a hazard for the world economy but rational from an individual country standpoint.

The banking union proposals similarly are likely to generate a “never again” reaction by euro area national governments. In order to minimize the risk of having to resort to European help, they will create small, nationally focused banking systems until the sector has achieved a “safe” size as a proportion of national GDP, with little incentive to create cross-border banking groups that foster risk sharing,¹² thus reducing the potential benefits of economies of scale and scope in the euro area.¹³ These countries may also try to run current account surpluses, as the crisis has shown that markets attacked mostly countries with external funding constraints—which is why Belgium, with very high public debt, was left untouched.

Lacking eurobonds as a risk-free asset, banks will likely also load up on national government bonds, increasing the risk of sudden stops because of the home bias inherent in the system.¹⁴ And it will perpetuate the higher funding costs in weak countries, as the odds of bail-ins will remain higher in weaker countries for a long time, given the persistence of debt levels.

What I have just described is very different from what a strong banking union would look like: In addition to European supervision and a European resolution authority, it would

feature a strong euro area fiscal backstop in the form of eurobonds and bail-ins only as a last resort to promote the creation of a genuine European banking system where excess savings can be channeled optimally across countries, cross-border banking groups can develop, and economic risk sharing is effective.

BAIL-INS AND THE NEED FOR EURO AREA RISK-FREE ASSETS

The focus on bail-ins is perhaps the best example of the tension between reaction to past events and forward-looking decisions. The demand for strict rules on bail-ins has been driven less by economic analysis than by politics to satisfy the popular demand for sacrifice imposed on creditors. Nor has the insistence on bail-ins been honored in the recent crisis. The bailout of Irish banks during the crisis was a prime example, but most recent examples, such as the bailout of SNS Reaal in the Netherlands, would not have met the new rules, because the extent of the bail-in before public capital was injected was quite small. The rescue of Bankia in Spain, which included one the sharpest bail-ins to date of bondholders, would have also failed to meet the new rules setting targets for the amount of liabilities bailed in. A deeper bail-in of Bankia’s debt holders would have done little to improve Spain’s debt profile but could have triggered a run on the whole Spanish banking sector.¹⁵ One could conclude that there is perhaps a reason why bail-ins have not been pervasive in the past, let alone prescribed ex ante—they are risky and not cost efficient.

In fact, the overarching principle of banking crisis management is “least cost resolution,” and that depends on the context at the time, which cannot always be foreseen. For example, only after Lehman was allowed to fail was it clear that money market funds in the United States would be hit, with unforeseen global consequences. This experience demonstrates that strict rules are not the answer to banking crises. Some argue that banks should be governed by bankruptcy rules that apply to all corporations, but this argument misses the point. There are almost no systemic nonfinancial corporations, so bankruptcy rules provide clarity in such cases. But this reasoning cannot be extended to the financial sector.

The “least cost resolution” principle should also not be measured by the extent of fiscal support given to financial institutions at the time of the crisis, which is understandably of great concern to voters and taxpayers. Rather the alternative scenarios should be weighed in light of their total GDP cost. Many bail-

12. The lack of cross equity shareholdings, driven by the desire to create national champions and protect the national market, has been a key element of the lack of risk sharing in the euro area (see Olivier Garnier, remarks to Euro 50 Group, Rome, June 27, 2013). Had German savers been owners of Spanish banks, rather than just owners of *cedulas* (mortgage-backed securities issued by Spanish banks), the link between Spanish banks and Spanish sovereign bonds would have been much lighter.

13. This will not necessarily solve the “too big to fail problem” either, as concentration at the national level will remain high.

14. In fact, in the last several months periphery banks have increased their holdings of national debt, to the point that supervisors are starting to worry about concentration of exposures. Of course, this is the worst of all possible worlds: Banks are trying to retrench and hold “safe” assets, but these safe assets are not considered too safe by the supervisors because of the deficiencies of the euro area economic infrastructure. This problem would not have existed if eurobonds were available as the euro area risk-free asset.

15. For the same reason, again, that Germany bailed out a few financial institutions during the crisis, with little cost to creditors. In fact, the first use of the ECB’s Emergency Liquidity Assistance was to support a failing German institution.

outs, as dubious as they were to the voters and taxpayers, avoided calamitous blows to GDP. The Nordic banking crises in the 1990s or the US, UK, or euro area bailouts in the recent crisis are examples of the benefits of bailouts. In hindsight, the global GDP cost of letting Lehman fail was enormous, with repercussions that could not be foreseen.¹⁶ If properly executed, bailouts create value where there is none, as they typically correct a panic-triggered market failure. For example, the US government has made a profit on its holdings of AIG, Citi, and Bank of America, and the Federal Reserve is also showing a profit on its exposure to Bear Stearns and AIG. Was it risky and did it create moral hazard for the US government to bail out those institutions? Yes, certainly. But the alternative was much worse.¹⁷

Of course, private sector losses are necessary in certain instances. Equity holders of banks are almost always bailed in. But defining the allocation of losses across taxpayers and investors is a political decision that should not be taken ahead of a crisis. Indeed, strict ex ante rules for bail-ins can very easily trigger a systemic crisis. In 2008, the G-7 solemnly declared that no bank would fail and their statement avoided a systemic problem. But, had the bail-in rules been in place, the likely run on bank bonds could have had catastrophic consequences for the European banking sector. Similar to currency crises, the moment investors thought banks would fail, there would have been a run on all the debt vulnerable to being written down or restructured, with its likely negative contagion.¹⁸ And, in the future, given the Cyprus fiasco, in which insured deposits were initially threatened with being wiped out, why would anyone believe deposits would always be protected?

The Greek private sector involvement (PSI) experience provides a similar example. The moment PSI was introduced as a possibility, at the infamous Deauville declaration, markets started to apply PSI considerations to all periphery countries. A key reason why the euro area has been in recession in 2012 is the sharp tightening of financial conditions triggered by the PSI contagion from 2010. Tellingly, as Portugal is now approaching the end of its current program, investors are very aware of the prospect of a potential PSI on Greek terms, thus keeping the cost of funding for Portuguese firms excessively high.

16. The agreed-on view is that Lehman was let go because it had no value and therefore the Fed had no legal basis for the rescue.

17. The keywords here are “properly executed.” There are certainly cases where bailouts have been closed at a loss, for example, the capital injections in Spanish *cajas* in the last couple of years. To be effective, bailouts have to be aggressive, properly value the assets, include a clear restructuring plan that ensures a viable business model, and combine them with aggregate demand policies that improve the economic outlook.

18. Which is why the ECB correctly opposed any haircut for bank senior bondholders.

The bail-in debate in the euro area echoes in many ways the ongoing PSI debate at the IMF. The IMF¹⁹ seems to be moving to make PSI almost a prerequisite in any program where debt sustainability cannot be completely guaranteed. The problem is that debt sustainability is dependent on the context—and thus the IMF could be setting ex ante rules for a concept—debt sustainability—that cannot be defined ex ante (the 120 percent debt-to-GDP ratio threshold for Greece is completely arbitrary, for example). This is producing the sort of confusion and volatility that ex ante bail-in rules threaten to create for the euro area banking sector. The anchoring effect of PSI and bail-in rules can be powerful, as they quickly become baseline scenarios when they should be used only in exceptional cases.²⁰

The combination of preemptive PSI, no eurobonds, and bail-in rules could be quite toxic. As Landau (2013) discusses in a very lucid manner, adequate liquidity is essential for the efficient functioning of the financial system. Debt is the natural instrument to provide liquidity, as long as it remains information insensitive, and the ability of a country and of a financial system to provide liquidity rests ultimately on its capacity to issue information-insensitive financial assets—in other words, risk-free or safe assets. Not surprisingly, safe assets have historically amounted to a rather constant share of total financial assets held in an economy—when privately supplied safe assets decline, the government provides an offset by issuing a greater amount (see Gorton, Lewellen, and Metrick 2012).

The provisions in the euro area banking union, by ruling out eurobonds and focusing on bail-ins, reduce the share of risk-free, information-insensitive assets in both the public and private sectors. At the same time, regulatory reform is increasing the potential demand for safe assets from the private sector. Faced with this supply/demand imbalance of risk-free assets, euro area financial institutions will therefore have two choices: either accept lower-quality safe assets or reduce their leverage and thus lending growth. The likely outcome is a combination of both, which will preserve the heavy home bias on domestic public debt and depress growth.

The problem of a lack of a risk-free asset cannot be underestimated. Risk-free assets not only serve as credible stores of value but also are key as collateral in financial transactions and

19. See the post mortem of the Stand-By Arrangement with Greece (IMF 2013b), which argues that PSI was too little too late, and the IMF Policy Paper (2013c), which implicitly supports a new policy of demanding PSI as a prerequisite of any program where debt sustainability can't be guaranteed with high probability.

20. Risk management is always a function of imagination. After the last few years, no risk manager will ever agree to an analysis that has not incorporated the impact of a Lehman-size shock, a Greek PSI, or a Cyprus bail-in. This massively widens the range of risk scenarios with respect to the pre-2007 period and, ceteris paribus, raises the return threshold for any project and the cost of capital.

as pricing benchmarks (Gourinchas and Jeanne 2013). This concern is not a plea for fiscal transfers to solve the current problems of the periphery. It is about setting a solid basis for the future growth and financial stability of the euro area. Risk-free assets behave in a countercyclical fashion: During times of stress, they provide a cushion as a hedging instrument. Because of elevated levels of public debt as the starting point (and the PSI doctrine), government bonds in the weak euro area countries are unlikely to behave in a countercyclical manner for a long period of time. Therefore the combination of bail-ins and no eurobonds makes the euro area banking system fragile and vulnerable.

LOOKING AHEAD

In reaction to the past crisis, the euro area has adopted many decisions and moved forward with many initiatives intended to advance the euro project. The depth of actions is commendable, and the institutional framework of the euro area has changed in material ways. However, this reactive behavior is substantially different from past moves, such as the adoption of the Stability and Growth Pact designed to instill fiscal restraint or the creation

The coming elections to the European Parliament, which will also involve the election of a new European Commission president, provide a great opportunity to start this process of devolution of power to the European institutions....

of the ECB, where decisions and designs were mostly forward looking with the purpose of maximizing growth. Policymaking during a crisis is more focused on punishing past misbehavior and minimizing the cost for the individual countries rather than on maximizing future welfare for the euro area as a whole.

Now that the acute period of the crisis is over, the question euro area leaders need to face is this: Is the current banking union blueprint the best possible one? The answer is very unclear. Yes, the current banking union project could be a step toward the ideal one. But it could also become a serious impediment, especially if it becomes the political alternative to eurobonds. With its focus on national resolution authorities and funds, a minimal euro area backstop, and bail-ins, the banking union

blueprint does not move the euro area toward an “ever closer union.” Rather, it could be the beginning of a move toward an ever looser union of permanently fragmented banking systems and less financial solidity.

The world does not evolve in the deterministic fashion that seems to be implicit in the current minimalistic project. If the next recession or crisis does not occur until 2018, when the resolution funds are fully funded, national banking sectors have retrenched, and budget outlooks improve, perhaps the current framework could have a chance. But this is only one scenario, and the risk in the interim is very high. Business cycles last between three and eight years on average. That means a 20 percent probability of recession in any given year, with a very high level of debt as a starting point.

The euro was not an optimal currency area before 2007 because of imperfect risk sharing. It cannot grow stronger if institutional changes continue to be driven by the desire to minimize euro area risk sharing. This negativism must change. The euro area must move forward with a positive project than enhances, rather than curtails, financial stability. As stated many times, the euro area project cannot succeed without a euro area risk-free asset that can help manage systemic events.

One way to break the negativism would be to reverse the long-standing drive to reduce the power of European institutions. A key reason why the banking union is focusing on minimizing costs is that the process today is being driven mostly by the member states, not the European Commission. The decision more than a decade ago to weaken the Commission and transfer power to the member states (essentially by appointing politically weak Commission presidents and reinforcing the inter-governmental decision making structure at the expense of the Commission) has created an imbalance in which nobody really leads with the best interest of the euro area in mind. Instead they are primarily responding to domestic politics. The coming elections to the European Parliament, which will also involve the election of a new European Commission president, provide a great opportunity to start this process of devolution of power to the European institutions, by electing a strong president of the Commission who can have a strong mandate and lead the process of creating the euro area of the future.

In order to achieve a European banking system that blurs the national borders—which has to be the ultimate objective of a banking union—the institutions governing it and the funds supporting it must be European in nature. If the current project is to be a stepping stone toward a more united, solid, and stable euro area, it has to lower the national barriers. Otherwise, it will no longer be a step toward an “ever closer union.”

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