European Banking Union

A Banking Union for Europe: Part of an Encompassing Long-term Governance Structure, No Short-term Fix

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Principles for an encompassing solution concept

For the last three years, the German Council of Economic Experts (GCEE) has analysed the crisis in the euro area, and proposed possible solutions. In its annual report for the year 2010 (see GCEE 2010), it suggested a concept of 'three pillars for stability' as a viable framework for the long-term governance of the euro area. A year later it proposed the idea of a 'European Redemption Pact' as a fiscal bridge into the future (see GCEE 2011), and it worked out this concept in more detail in a special report published in the summer of 2012 (see GCEE 2012a). Resting on these foundations, in its most recent annual report (see GCEE 2012b) the GCEE completed the detailed elaboration of its comprehensive solution concept with an extensive discussion of a European banking union in its possible role as a vital element of a sustainable governance structure for the euro area, but also outlined a workable transition path towards this long-term structure.

In all these contributions, three principles have guided the considerations of the GCEE:

- *Systemic problems require integrated solutions.* The crisis of the euro area is an amalgamation of three problem areas, which are entangled with one another in a vicious circle – a sovereign debt crisis, a banking crisis and a macroeconomic crisis. Together, they have led to a serious crisis of confidence in the integrity of the euro area. Consequently, a solution concept must be comprehensive, integrating all relevant aspects of this crisis in an internally consistent package. Trying to alleviate such a systemic crisis with isolated measures, which merely address one of the problem areas at a time is not only insufficient, it might even lead to an exacerbation of the situation.
- *Liability and control must be closely aligned with one another.* Unlike the original framework of the euro area, its future governance must adhere to one ironclad principle, the proper alignment of liability and control. Any form of joint liability requires joint control and, if this is not feasible, sovereign liability is the only option. Considerations regarding the choice between joint and sovereign liability pertain to both the fiscal realm and the governance of financial markets; and the ideal choice of liability-control-alignment might well be different in these two areas.
- *A comprehensive solution concept needs to include a viable transition path.* All considerations regarding this long-term structure pertain to a distant future, perhaps to some decades hence; but the principal problem is currently implementation. Firstly, crisis measures might provide relief in the short run at the expense of long-term stability, and might even make desirable aspects of the long-term structure unattainable; secondly, some measures which would provide stability in the long run might not be implemented, since they would tend to exacerbate the crisis in the short run; and thirdly, implementation of any sensible measure might be precluded by an impasse between different visions for a stable long-term structure.

This contribution sketches the GCEE's encompassing solution concept for the crisis of the euro area, which was derived on the basis of these three principles.

The multi-faceted nature of the crisis

The European Economic and Monetary Union (EMU) is suffering from a multi-faceted crisis. Most

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prominently discussed is the sovereign debt crisis, which is holding many members of the euro area firmly in its grip. Starting from elevated levels of public debt (relative to GDP), some countries in the euro area periphery have seen their debt ratios rise during the crisis to values questioning their ability to serve this debt in full. The most visible symptom of doubts in the solvency of peripheral member states are the interest rate spreads on government bonds and CDS premia, which both indicate that investors charge a risk premium *vis-à-vis* the euro area's safe haven, German debt. Clearly, the two avenues out of this problem are, in principle, the consolidation of public households and the stimulation of economic growth.

Somewhat less in the spotlight of the current policy debate, but nevertheless highly relevant, is the fragile banking sector in several member countries. In fact, it is still unclear to what extent individual banks are holding bad assets on their balance sheets, and whether their equity is sufficient to withstand serious shocks to their asset base. Not only have we seen a tendency towards a renationalization of credit relations, banks in the periphery of the euro area have increasingly needed to refinance themselves through their national central banks and, thus, in effect through the euro system. Clearly, the two avenues out of this problem are, in principle, raising additional equity capital from private sources, recapitalization and, in some instances, even the resolution of individual banks by the public authorities.

Both the sovereign debt crisis and the banking crisis would not be as serious if countries suffering from these problems were on a solid growth path. Yet, it is precisely these euro area members whose enterprises have been lacking competitiveness on the international markets for a protracted period. Even worse, some member states have slid into recession as a consequence of the austerity measures implemented to address their excessive sovereign debt, leading to the seemingly paradoxical phenomenon of fiscal consolidation being coupled with rising debt ratios. Clearly, the two avenues out of this problem are, in principle, to design the return to solid public finances as a 'qualitative consolidation', favoring public investment over public consumption, and to conduct structural reforms by enhancing the flexibility of factor and product markets and by privatization of key industries.

These three problem areas have combined into a serious crisis of confidence in the integrity of the euro area, giving this combination the character of a systemic crisis questioning the whole institutional arrangement. Firstly, while devising individual solutions might seem straightforward theoretically, they will be difficult to implement politically, and they will take considerable time to show measurable effects. This is most obvious for the structural reforms designed to enhance economic growth. Secondly, these problem areas are deeply entangled, and as the recession in some countries demonstrates, measures taken to alleviate the situation in one area might exacerbate the situation in another area. And thirdly, European policy makers appear deeply divided about the future governance structure of the euro area.

In consequence, the European Central Bank (ECB) has been the single European institution able (for now) to stabilize financial markets (LTRO) and to guarantee the euro area's integrity (OMT). However, this achievement comes at a serious cost: the division between the fiscal and the monetary realm has been blurred; and one might even be inclined to conclude that the ECB has currently given some European governments more than a little taste of the forbidden fruit of state financing.

Proponents of these ECB actions might forcefully argue that, at the time being, buying more time is all that is needed in order to let improvements in the three problem areas sink in, and that the ECB will easily be able to exit from the fiscal realm after sufficient time has been won. Indeed, major steps have been taken towards a more stringent governance framework for the euro area in recent months and some structural reforms are clearly bearing their first fruits. However, there is a serious risk that the strategy of buying some time will eventually transmute into a persistent approach, as withdrawing the drug of cheap credit is itself proving to be highly difficult in the political process. This should definitely be avoided.

Fiscal discipline requires national responsibility

Perhaps the most serious obstacle to breaking the crisis' vicious circle is the current impasse between European policy makers regarding the long-term governance structure of the euro area. Notably, these considerations pertain to the distant future, perhaps some periods hence. Nevertheless, in this context one arguably needs to know where the tour is going before embarking on the journey. The overarching criterion for choosing between candidate governance structures is their sustainability. Governance structures that

promise to be stable in the long-term need to align two core aspects, liability for the consequences of fiscal policy and control over the planning and the execution of public budgets.

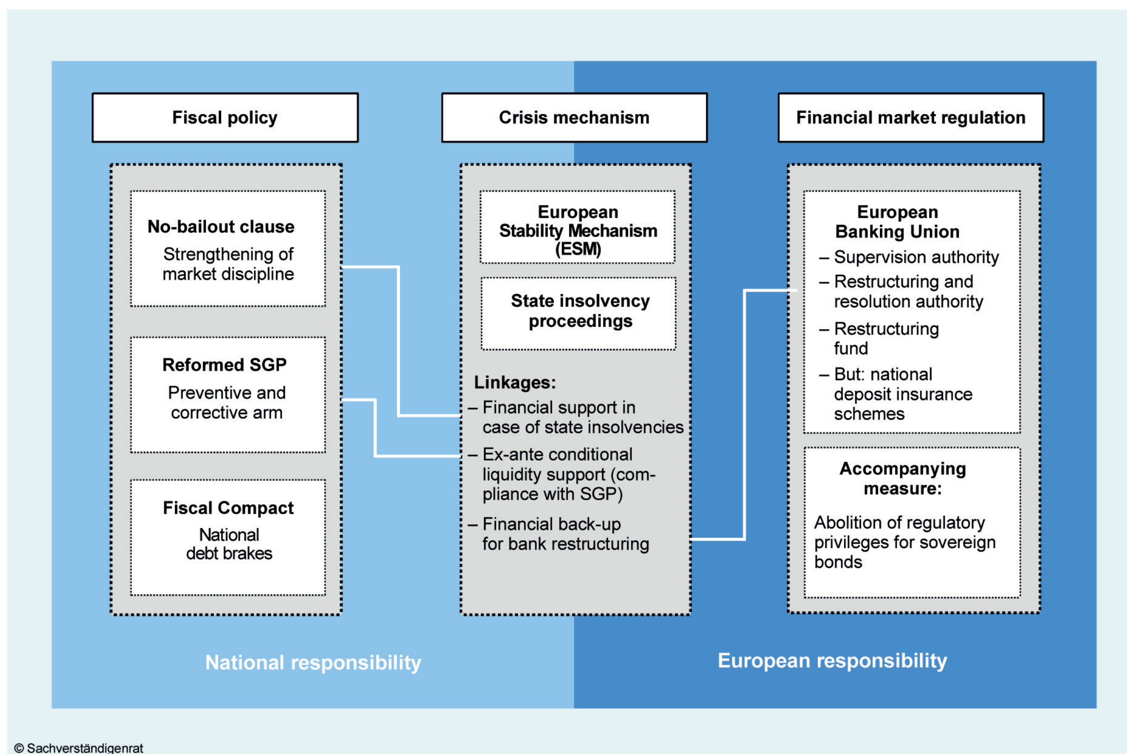
The current situation does certainly fail to satisfy this sustainability criterion. While public budgets are, despite all attempts at their coordination at the European level, ultimately a national affair, the consequences of fiscal policy have been mutualized, most importantly *via* the ECB interventions. This cannot be a recipe for ascertaining fiscal discipline in the future. A more serious candidate structure is that of a fiscal union, which tries to balance joint liability by joint control of public budgets, executed by a European finance minister, for example. The GCEE clearly rejects this candidate structure as illusionary, however, since the desired joint control would require national authorities to transfer sovereignty to the European level regarding two similarly important aspects, namely both with respect to the planning and to the execution of public budgets. All available evidence from historical and contemporaneous experience suggests that this simply will not happen in reality.

The GCEE instead advocates a return to the spirit of the original Maastricht treaty, which envisaged the alignment of liability and control for fiscal policy at the national level, albeit with sufficient modifications to make this adamant exclusion of a bail-out of one member state by other members truly credible (see Figure 1). It certainly would not be enough to simply invoke adherence to the no bail-out-principle to achieve this credibility. The current sovereign debt crisis provides more than convincing evidence that such promises need to be enforced by appropriate institutional arrangements instead. Specifically, the original Maastricht treaty did neither offer any possibility of an exit from the EMU, nor did it stipulate any viable provisions for sovereign insolvency. As these two release valves were excluded altogether, as the Stability and Growth Pact (SGP) did not ascertain fiscal discipline throughout the euro area and push came to shove in the still ongoing financial and economic crisis, the only sensible possibility was to tweak the no bail-out-promise.

Thus, the GCEE is perfectly aware that the alignment of liability for and control of fiscal policy at the national level needs to be ensured by corresponding institutional arrangements. In its assessment, the tightening of the rules in revised SGP, such as a closer monitoring of debt levels and the quasi-automatic nature of possible sanctions for non-compliance, will be insufficient. Neither will deeper coordination of

Figure 1

THE CGEE'S LONG-TERM FRAMEWORK FOR THE EURO AREA



Source: German Council of Economic Experts.

European fiscal policy and the implementation of national debt brakes be enough, as much as they mark steps in the right direction. Instead, an insolvency regime for ailing sovereigns that is backed by a crisis mechanism like the already implemented ESM is an indispensable element of the long-term institutional framework for fiscal policy in the euro area.

To this end, the GCEE proposes that a country's access to the ESM should primarily depend on its debt. More specifically, a country with a debt ratio exceeding 60 percent (90 percent) should receive ESM assistance only if both its debt is restructured and a macroeconomic adjustment program is accepted. While such an insolvency regime would from the cornerstone of the long-term institutional framework, if it were introduced today, this may even exacerbate the crisis. Naturally, investors would fear that those countries with debt ratios of around 90 percent and beyond would be potential candidates for a debt restructuring. Therefore, debt ratios need to be reduced well below 60 percent before such an insolvency regime could be implemented.

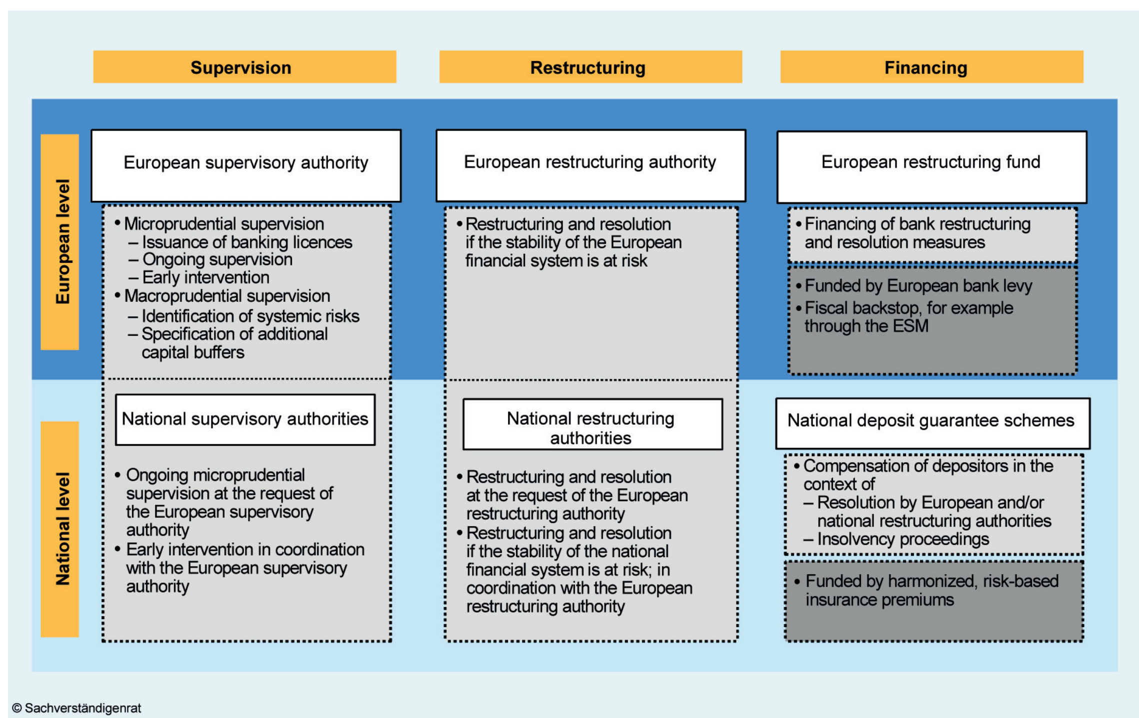
Requirements for a European banking union

While both the political discourse and the public discussion have focused on the European sovereign debt crisis, this is only part of the problem. Up to the outbreak of the crisis not only public, but also private borrowers had incentives to borrow excessively, created by deficits in the regulatory structure of financial markets. Capital requirements for banks were too low, and were even designed to exert pro-cyclical effects. National supervisors did not prevent the build-up of risks in banks' balance sheets; and highly disconcertingly, the risks of banks and states have become dangerously intertwined. Regulatory reforms in this area need to address these weaknesses. In particular, stricter capital requirements that go beyond the Basel III framework and are destined to become fully operational in 2019 should enhance the resilience of individual banks. The GCEE suggests that government bonds should be risk-weighted as well, and that banks should satisfy a leverage ratio of at least 5 percent.

While remarkable progress has already been made with respect to the individual resilience of banks and, thus, incentives for taking excessive risks have declined, the focus of the current reforms has been on the national level. Yet, many financial institutes operate at an international level. Correspondingly, monetary policy in the euro area is following a common approach. However, the authority to supervise and restructure banks has not yet been transferred to the European level. This has created undesirable incen-

Figure 2

STRUCTURE OF THE EUROPEAN BANKING UNION



Source: German Council of Economic Experts.

tives to take excessive risks, since banking distress in one country impairs the stability of financial systems in other countries. In principle, a well-designed banking union might be a framework for successfully addressing these negative spill-overs.

A properly designed European banking union would consist of three elements: banking supervision at the European level, a European authority for bank restructuring and resolution, and a bank resolution fund to finance restructuring and resolution (see Figure 2). Contrary to what the current political debate might suggest, a European deposit insurance fund is not necessarily an element of such a banking union. Thus, a banking union is a long-term project. Just as the insolvency regime for sovereigns cannot be an answer to the current overhang of public debt, a banking union cannot provide a solution to the acute problems in Europe's banking sectors (see Buch and Weigert 2012; GCEE 2012a). However, concrete proposals concerning the formation of a European banking union are currently disregarding this insight (see President of the European Council 2012). More specifically, both a European restructuring authority and fiscal burden sharing rules have not yet been specified, but only proposals for joint supervision. Such a half-hearted setup cannot constitute a solid long-term framework for financial markets.

As far as European supervision is concerned, all banks in the euro area should be in its perimeter, while the option to participate should be kept open for other European banks. This principle of comprehensiveness reduces the risk of regulatory arbitrage and binds all banks to the same supervisory standards. Yet it does not preclude the delegation of supervisory tasks to the national authorities where this turns out to be sensible in practice.

Moreover, the institutional arrangement of European supervision should ascertain the separation between monetary policy on the one hand, and both banking supervision and the competence for restructuring and resolution on the other. Otherwise, there will always be some risk that virtually insolvent banks might be refinanced instead of being restructured or resolved; since drastic curative steps always tend to throw a critical light on previous supervision. Unfortunately, current European plans do not adhere to this principle of separation, as supervision is envisaged to be organized within the ECB, and restructuring is not discussed at all.

The second necessary element of a banking union, the European resolution authority, should be funded through a bank levy as well as through the ESM. However, financial resources accruing to the resolution fund over the next years will not suffice to cope with large distressed banks. Therefore, a fiscal backstop is provided by the ESM that already entails the option of providing funds for bank recapitalization. In the design of the banking union, however, it will be necessary to determine *ex ante,* how any future fiscal burden arising from bank restructuring and resolution should be shared. Otherwise the availability of centralized fiscal resources at the European level will provide serious incentives to shift risks to the ECB again, and harm the necessary independence of the restructuring authority. Consequently, a functioning banking union could only be established with a corresponding amendment to the European Treaty.

Similar considerations pertain to the currently intensely discussed introduction of European-wide deposit insurance. Again, a necessary pre-condition for European deposit insurance would be the prior establishment of an effective and powerful European resolution authority. By contrast, introducing a European deposit insurance now would seriously undermine incentives to prevent excessive borrowing. Instead, individual countries should introduce and harmonize national deposit insurance systems based on risk-adjusted insurance premia.

A fiscal bridge to the future: the European Redemption Pact

Fiscal policies are still a national affair, and yet their consequences have been mutualized by the stabilization efforts of the ECB. Restoring national responsibility by implementing an insolvency regime for sovereign debt is now impossible, as this would intensify the crisis. Finally, the ESM, as an element of the long-term framework, is not designed to tackle the current crisis. Thus, the ECB is on the verge of becoming a permanent crisis mechanism. While this might seem a preferable option from the perspective of myopic European policymakers, it would harm long-term stability, and cement the deplorable confusion between fiscal and monetary policy.

With its concept of a European Redemption Pact (ERP), the GCEE proposed a crisis resolution mechanism that forms a viable fiscal bridge leading into the long-run institutional framework, securing a breath-

ing space that governments could use fruitfully to restore the international competitiveness of their economies. Relying on the forces of strict conditionality and market discipline, it would help to restore the separation of fiscal and monetary policy, and it would make the true scale of risks involved transparent, unlike *de facto* debt mutualisation by the ECB. The ERP consists of two vital elements: (i) a tightened Fiscal Compact together with its prescribed fiscal consolidation paths, and (ii) a European Redemption Fund (ERF) for sovereign debt in excess of 60 percent of GDP, providing limited and temporary joint and several liability. Participation in the ERP is open to all member countries, while participation in the fund is restricted to countries that are not already under an adjustment program of the EFSF/ESM.

As a prerequisite for joining the ERP, countries need to ratify the Fiscal Compact and to introduce national debt brakes. Additionally, an independent European institution should monitor and certify each country's compliance with national debt brakes. Countries that qualified would be allowed to roll over that part of their sovereign debt that exceeds the debt-to-GDP threshold of 60 percent at a pre-specified date. The process of rolling over sovereign debt is stretched out over a multi-year time horizon until the predefined volume of debt is reached. During this roll-in phase, the ERF will buy a country's long-term bonds (with maturity over two years) on the primary market while any short-term debt is still issued on the financial market. The interest rates for any debt transferred to the ERF are expected to be significantly lower than the rated demanded by the markets from countries like Italy or Spain, but are most likely to be higher than Germany's current rates. Countries participating in the ERP would have to pay an annual amount to the ERF that would be calibrated to precisely redeem its transferred debt within 25 years. After this period, the ERF would dissolve itself.

As an expression of its spirit of conditionality, the proposal comprises a series of safety valves and a sanctioning mechanism to ensure a successful transition to sound public finances: participating countries need to comply with consolidation plans that are agreed upon at the time of joining the ERP. Sanctions in case of non-compliance range from interest rate mark-ups for debt already transferred to the fund to complete suspension of the roll-in phase. To limit moral hazard and to limit the amount of the joint and several liability borne by participating countries, each country has to pledge collateral – currency or gold reserves or covered bonds – amounting to 20 percent of its liabilities against the ERF. The collateral would automatically accrue to the fund if a country were not to meet its payment obligations.

Additionally, countries would have to politically earmark certain (new) taxes that are used to meet the payment obligations. Remarkably, the ERF does not completely substitute the markets' disciplining effects: during the roll-in phase, governments would still refinance their short-term debt on the financial market. After the roll-in phase had ended, a country would be fully exposed to the financial markets, as it would have to refinance the remaining debt of up to 60 percent of GDP.

A transition path into the banking union

As in the fiscal realm, the major obstacle to the introduction of a banking union is the legacy that insufficient arrangements of the past have created. Currently, many banks hold substantial amounts of bad assets on their balance sheets. Most importantly, shifting to a greatly reduced variant of a European banking union now, comprising only of a European-wide supervision, but without clear rules for burden-sharing in the case of restructuring or resolution, would not resolve the current problem of the fragile banking system.

While dealing with these non-performing assets is arguably the responsibility of national governments, as the decisions leading to their accumulation were made under the existing national-control regime, the incentives to use national fiscal resources to restructure and, if necessary, resolve banks, would be quite limited. Specifically, if it were possible to mutualize the burden, applying for funding through the ESM would be comparatively unattractive for national governments under the current arrangement, since the associated debt would be the responsibility of the respective government, and it would probably entail serious elements of conditionality.

This has led some European governments to push for direct access to the ESM under the heading of a 'banking union', using quite feeble and certainly insufficient steps towards its implementation as a pretext. And yet, while this is understandable politically, European governments could overcome the impasse between the proponents of such an ill-designed mutualisation and its opponents, most prominently the

German government, by agreeing on the ERP. After all, The ERP would be designed to provide the fiscal bridge into the future, and one of the conditions associated with participation could well be the responsibility to use the breathing space offered to clean up national banking systems.

The implementation of a banking union designed to ascertain long-term stability will also take some time. Instead of ill-conceived attempts to misuse elements of the banking union for crisis management, European policymakers should take this time and use it wisely. To this end, the GCEE has developed a three-phase plan for the transition to a European banking union. Most importantly, in each phase of this transition, close alignment of liability and control is warranted. The first year of implementation should be utilized to alter the relevant European treaties in order to construct the institutional and legal framework: a European supervision authority, a European restructuring authority and a restructuring fund. Concomitantly, the new capital adequacy regulation, a common legal framework for the restructuring and resolution of banks, and for deposit insurance, should be completed.

In the second phase, banks successively qualify for a European banking license. Qualification involves a complete re-assessment of banks' assets through external experts, and the requirement that the bank meets the full regulatory stipulations of Basel III, as well as a Leverage Ratio of at least 5 percent of total on- and off-balance sheet activities. Until banks have obtained a European banking license, liability and control would remain at the national level. Deposit insurance would remain at the national level throughout the entire process. Banks that have not qualified for a European banking license should enter a mandatory restructuring process. If the respective country lacks the necessary fiscal resources, ESM funding could be used on conditions comparable to those applied to Spain (see Council of the European Union 2012), to ensure that existing shareholders bear losses. However, liability for any ESM loan would remain with the respective sovereign.

In the banking union, supervision and restructuring and resolution of all banks would rest with the European authorities. The restructuring authority will have recourse to the restructuring fund, the ESM and pre-specified fiscal burden sharing rules: both, control and liability would be at the European level. Given that the legal framework would be established within a year's time, the banking union could potentially resume in 2019, at which point banks will also have to meet the new Basel III regulatory requirements.

Concluding remarks

The recovery of the euro area from its current systemic crisis will only be achieved if the proposed solution satisfies three principles. Firstly, it needs to provide a package deal tailored to the multi-faceted nature of the crisis, not a smorgasbord of isolated measures. Specifically, it needs to address the fiscal realm and financial markets alike. Secondly, in addition to getting the details right, in each problem field the solution needs to align liability and control at the same level of action to be sustainable. Specifically, while national responsibility and national control does seem to constitute a promising approach for fiscal policy, aligning responsibility and control in a European-wide banking union appears to be the best recipe for constructing a stable long-term framework for financial markets.

Thirdly, problems of private and public debt overhang accumulated in the past will not dissolve upon the implementation of a sustainable governance framework. Instead, the European Redemption Pact could be a powerful vehicle for breaking the spell exerted by the combination of high interest rates and low growth rates, freeing up the fiscal means to overcome – if properly monitored and enforced – the legacies of the past.

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