



## **Banking Union and Beyond**

### **Discussion Papers**

**for Session 2 of the BTTD 2014**

**jointly organised by Bruegel, Confrontations Europe, Egmont Institute,  
and Madariaga – College of Europe Foundation**

Three years have passed since the euro crisis broke out in 2010, revealing the shortcomings of the EMU architecture as it was foreseen in Maastricht. A number of reforms have been undertaken since 2010 in order to strengthen the Monetary Union, make it more adept to face the challenges of the financial integration that the euro itself created and ensure a stronger resilience to financial crises in the future. To this end, the EMU framework has been strengthened on the side of financial supervision, fiscal discipline and macroeconomic surveillance. Among the various reforms, the agreement to create a Banking Union is certainly a major one and represents probably the most important step towards integration to date. But is it enough? The economic session of the BTTD 2014 will review the progress on banking union so far and ask what else is missing in the EMU architecture to complement and enhance the reforms on the financial side.

2014 will be a year of important changes for the European financial system, and the shape of the European Banking Union is due to become clearer. The Banking Union, in the sense that the term is being used in Brussels, indicates a system of four major elements:

- a) Single rulebook for the European financial market;
- b) Single Supervisory Mechanism (SSM);
- c) Single Resolution Mechanism (SRM), ideally supported by a Single Resolution Fund (SRF) and a fiscal backstop;
- d) Harmonisation of the Deposit Guarantee Schemes (DGS).

The stated rationale behind a European Banking Union is to preserve the singleness of the European financial market, to ensure consistent high-quality supervision and to break the vicious circle between banks and sovereigns. Discussion has been on-going for a long while at the academic, as well as the political, level and agreement (or preliminary agreement) has been reached on these elements.

Borrowing conditions for sovereigns have improved markedly after the European Central Bank (ECB) introduced the new Outright Monetary transactions in September 2012, but the fragmentation of the European financial market induced by the crisis is far from being reversed. Starting in 2009 (and accelerating since 2010) Eurozone banks have been massively retrenching within domestic borders. This has led, especially in countries perceived to be weaker, to an impressive re-domestication of banks' assets in general and of debt portfolios in particular. Doubts about the quality of banks' balance sheets remain, still weighing on borrowing conditions for the private sector.

Credit volume has contracted by 6% in the Eurozone since early 2010, and the worsening of financing conditions seems unevenly distributed across the EMU, with borrowing costs showing diverging dynamics along the peripheral-core divide. Due to their strong reliance on the banking sector, small and medium businesses seem to pay a disproportionately high price in terms of lending conditions not only because of the economic slowdown, but also because of deleveraging undertaken by the banks.

The phase in of the SSM that will start in 2014 can help reduce uncertainty about the quality of banks' assets and about the thoroughness of financial supervision, thus helping to address also the divergence in the private sector borrowing conditions. However, several questions remain open, which is the reason why the issue of banking union is due to remain topical in early 2014.

First, some of the central elements of the ECB's balance sheet-assessment exercise have not yet been decided (or they have not yet been communicated). These include, in particular, the treatment of sovereign debt, the magnitude of the stress test, and the treatment of systemic risk. The choices that will be made on these issues will potentially significantly affect the results. Uncertainty should also be dispelled about the rules that will apply to bank recapitalisation, bank restructuring and bank resolution in 2014 and thereafter, including how remaining recapitalisation costs should be distributed between national taxpayers and taxpayers of other European countries.

Second, the recent deal on SRM leaves open the question of how far the present arrangements go towards achieving the stated aim of the banking union i.e. breaking the link between banks and sovereigns. The decision-making process envisioned in the proposed SRM Regulation is very complex and at least for the immediate future, no credible backstop is envisioned for resolution. The recent deal includes a commitment to establish a common backstop of 55bn by 2025 at the latest but during the transition the EU's fund will be split into national compartments that will be merged over time. In the immediate future, the construction will not differ much from the status quo, meaning that the link between banks and their sovereigns would not be weakened and that different member states' positions could still lead to potentially very large heterogeneity in the approach to financial sector problems.

# Banking Union: Progresses and Problems

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## European Banking Union: the progress so far

2014 will be a year of important changes for the European financial system, and the shape of the European Banking Union is due to become clearer. The Banking Union, in the sense the term is being used in the Brussels, indicates a system of four major elements:

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Discussion has been on-going for a long while at the academic as well as the political level, and agreement (or preliminary agreement) has been reached on these elements. But the issue remains topical. The Single Resolution Mechanism (SRM), on which a preliminary agreement has been reached before Christmas, will still be discussed in early 2014. Moreover, it's debatable whether a real Banking Union should also not include a federal deposit insurance system (see Véron 2013). The latter has been considered not a priority, but the simple harmonisation of national deposit insurance regimes may not be enough, especially in light of the outcome of recent discussion on the backstop for resolution.

The stated rationale behind a European Banking Union is to preserve the singleness of the European financial market, to ensure consistent high-quality supervision and to break the vicious circle between banks and sovereigns. Borrowing conditions for sovereigns have improved markedly after the European Central Bank (ECB) introduced the new Outright Monetary transactions in September 2012, but the fragmentation of the European financial market induced by the crisis is far from being reversed. Starting in 2009 (and accelerating since 2010) Eurozone banks have been massively retrenching within domestic borders. This has led, especially in countries perceived to be weaker, to an impressive re-domestication of banks' assets in general and of debt portfolios in particular<sup>1</sup>. Doubts about the quality of banks' balance sheets remain, still weighing on borrowing conditions for the private sector. The phase in of the SSM that will start in 2014 can help reduce uncertainty about the quality of banks' assets and about the thoroughness of financial supervision. But the recent deal on SRM leaves open the question of how far the present arrangement go in achieving the stated aim of the banking union i.e. breaking the link between banks and sovereigns.

## Single Supervision and bank recapitalisation: some clarifications are needed

Starting in 2014 the ECB will become the single supervisor<sup>2</sup> of "significant" credit institutions<sup>3</sup>), and will have exclusive competence for those "specific supervisory tasks which are crucial to ensure a coherent and effective implementation of the Union's policy relating to the prudential supervision of

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<sup>1</sup> <http://www.bruegel.org/nc/blog/detail/article/1194-home-sweet-home-bias-and-other-stories/>

<sup>2</sup> The legal basis is provided by Article 127(6) of the TFEU: "The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings".

<sup>3</sup> As defined by the regulation; see Darvas and Wolff, 2013.

*credit institutions*”. The supervisory tasks delegated to the ECB are wide-ranging<sup>4</sup>, and will be complemented with a potentially synergic direct role in macro-prudential supervision (see Darvas and Merler 2013). Preliminary to taking on its new role of single supervisor, the ECB will perform “*a comprehensive assessment, including a balance-sheet assessment, of the credit institutions*” (Article 27(4) of the SSM draft regulation).

Some of the central elements of the ECB’s balance sheet-assessment exercise have not yet been decided (or they have not yet been communicated). These include in particular the treatment of sovereign debt, the magnitude of the stress test and the treatment of systemic risk. The choices that will be made on these issues will potentially significantly affect the results. In fact, the lack of information about the balance sheets of banks, together with the uncertainty about these central parameters of the exercise, can probably explain the significant variance in market estimates of the recapitalisation needs that might be identified by the stress tests for the euro-area banking system (see Merler and Wolff, 2013).

Uncertainty should also be dispelled about the rules that will apply to bank recapitalisation, bank restructuring and bank resolution in 2014 and after. Currently, the main guiding framework is national decision-making authority, with some degree of harmonisation introduced through the amended state-aid framework. This regime, however, could lead to potentially significant differences between countries and deepen financial fragmentation. In this context, the discussion on bail-in is likely to remain topical during 2014. To credibly break the link between banks and sovereigns, creditors need to be more involved in the sharing of the burden than during most of the last five years. But at the same time, the rules applicable to bail-in should be the same in different countries in order to avoid competitive distortions. Discretion should be exercised by at the European (rather than national) level and the Eurogroup should agree that the same rules be applied to bank recapitalisation and creditor involvement in different countries, also during the transition. It is important to keep in mind that the Single Resolution Mechanism will not be in place by the time the ECB will conduct its supervisory exercise.

Last but not least, it needs to be clarified how remaining recapitalisation costs should be distributed between national taxpayers and taxpayers of other European countries. Governments should support the ECB in its effort to restore confidence in the banking system and bring it back to good health, even when that might require restructuring of banks; they should accept and support cross-border bank mergers where sensible (Sapir and Wolff, 2013) and they should also be ready to recapitalise banks where necessary. In the immediate aftermath of the AQR, national taxpayers will inevitably have to shoulder most of the burden. But in the longer term, after the consequences of the AQR have been dealt with, more pooling at the European level is needed to credibly break the link between banks and sovereigns. To this extent, a clear commitment to a single resolution mechanism with an appropriate common backstop is important to reverse banking re-nationalisation, keeping in mind that a resolution fund, even when fully built-up, would need to have a common fiscal backstop to be credible.

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<sup>4</sup> Including in particular authorizing (and withdrawing authorization) of credit institutions, ensuring compliance with the EU rules on own funds requirements, securitization, large exposure limits, liquidity, leverage, and reporting and public disclosure of information on those matters; ensuring compliance with governance rules, risk management processes, internal control mechanisms, remuneration policies and practices and effective internal capital adequacy assessment processes; carrying out supervisory reviews, including stress tests, on the basis of which to impose on credit institutions specific requirements; carrying out supervisory tasks in relation to recovery plans, and early intervention where a supervised entity does not meet or is likely to breach the applicable prudential requirements.

## Resolution complexity and credibility

The EU finance ministers on the 19<sup>th</sup> December reached an agreement on the proposed Single Resolution Mechanism (SRM)<sup>5</sup>, which will now have to pass the scrutiny of the European Parliament. The President of the European Parliament Martin Schulz has been very outspoken and in a speech delivered on the 19<sup>th</sup> December, he has criticised strongly the complexity of the process as well as the absence of a role for the ESM as an insurer of last resort during the transition phase. *“If we were to implement the ECOFIN decisions on a banking union in this way”* Schulz said *“it would not only be a lost opportunity. It would be the biggest mistake yet in the resolution of the crisis. If the resolution mechanism for banks does not work properly, it could jeopardise financial stability. A Banking Union is something which must either be done right or not done at all. The European Parliament will therefore not support the ECOFIN decisions in this form.”*

The deal has been welcomed with generalised discontent, because of the complex resolution process that it envisages and unsatisfactory provisions on the resolution fund. A step-by-step review shows in fact that a very large number of actors will be involved, who would need to take very quick agreements (given that speed is essence, in bank resolution) on matters that are, however, politically very sensitive.

According to the Regulation, three conditions need to be satisfied (all of them) for a bank to be put into resolution:

- a) The bank is failing or likely to fail, and;
- b) Given that the bank is failing or likely to fail, there are basically no alternatives to resolution<sup>6</sup>, and;
- c) Resolving that bank is also in the public interest.

To establish whether a bank is failing or likely to fail the text lists a number of criteria<sup>7</sup>, relatively vague, consistently with the fact that the matter is not clear-cut in practice and there is no mechanistic formula that could tell exactly whether a bank needs to be resolved.

In the end, it will be a decision based on a supervisory assessment. This is the reason why it is fundamental to envision a decision process that can deliver quick agreement, and this is precisely where the Regulation has been criticised. The assessment of the criteria is conducted by the Board of the Single Resolution Mechanism, which can start on its own or after receiving a communication by the ECB that the bank is failing or likely to fail and that there are basically no alternatives to resolution. Assuming that the ECB will conduct its job of supervisor properly, it seems reasonable to expect that the process will normally be triggered by the ECB.

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<sup>5</sup> Proposed Regulation 18070/13, available at <http://register.consilium.europa.eu/doc/srv?l=EN&t=PDF&gc=true&sc=false&f=ST%2018070%202013%20INT&r=http%3A%2F%2Fregister.consilium.europa.eu%2Fpd%2Fen%2F13%2Fst18%2Fst18070.en13.pdf>.

<sup>6</sup> “Having regard to timing and other relevant circumstances, there is no reasonable prospect that any alternative private sector or supervisory action [...], taken in respect of the entity, would prevent its failure within a reasonable timeframe”;

<sup>7</sup> (1) “The entity is in breach or there are objective elements to support a determination that the institution will be in breach, in the near future, of the requirements for continuing authorisation in a way that would justify the withdrawal of the authorisation by the ECB or national competent authority, including but not limited to because the institution has incurred or is likely to incur losses that will deplete all or a significant amount of its own funds; (2) “The assets of the entity are or there are objective elements to support a determination that the assets of the entity will be, in the near future, less than its liabilities; (3) “The assets of the entity are or there are objective elements to support a determination that the assets of the entity will be, in the near future, less than its liabilities.” (4) “The entity is or there are objective elements to support a determination that the entity will be in the near future unable to pay its debts as they fall due.” (4) “Extraordinary public financial support is required except when, in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability” the above-mentioned extraordinary public financial support takes some specific forms further specified.

When a bank is placed in resolution, the Board adopts a resolution scheme, which shall: (i) determine the details of the resolution tools to be applied to the institution<sup>8</sup> and (ii) determine the specific amount and purposes for which the Resolution Fund will be used to support the resolution action. This resolution scheme is adopted by the Board of the SRM, but this is just the beginning. Within 24 hours after the Board has adopted the resolution scheme the Council can, on proposal by the Commission, object or request amendments. In case of disagreement, a back and forth interaction would start between the Council and the Board<sup>9</sup>. The Council, can object or request amendment only on a set of specific matters, but these matters are fundamental ones, such as for example “*the assessment made by the Board on whether the criteria [triggering resolution] are met*” or “*the adequacy of the resolution tools chosen by the Board including [...] any use of the exemptions*” and “*the extent to which the use of the Fund respects its purposes*”. It should be self-evident that these are politically sensitive issues that could trigger discussion, disagreement and dangerous delay<sup>10</sup>.

The decision-making process envisioned in the SRM Regulation is therefore potentially quite problematic. Assuming that the process will be triggered by the ECB, then the decision to place a bank in resolution would involve the SSM Board (24 members), the ECB Governing Council (24 members), possibly the SSM Mediation Panel (minimum 3 members) and Executive Boards (up to 10 members) and the Board of the SRM (23 members). Even if these two steps were to go smoothly – which seems hard to believe, given the high political sensitivity of the elements to be included in the resolution scheme – the next level could be a back-and-forth-arguing between the Board and the Council (28 members), on a proposal by the Commission (28 members)<sup>11</sup>.

What is worse, all this would be unfolding before the eyes of reasonably nervous investors and depositors, in the absence of a credible backstop. The deal of 19<sup>th</sup> December, in fact, includes a commitment to establish a common backstop of 55bn by 2025 at the latest. Besides the fact that the final form of the backstop has been left open, the most important problem is that the pot will take time to build up and no common backstop will effectively be available in the coming years, when it may be needed the most because of the possible consequences of the ECB exercise. During the transition, in fact, the EU’s fund will be split into national compartments that will be merged over time. Countries in need of extra funding for resolution can inject money into the domestic compartment (recovered via ex-post contributions) or ask other nation’s resolutions funds to willingly lend money to the national compartment. Otherwise, the alternative is a traditional ESM loan like it was done in the Spanish case (ESM direct recap is in fact still unavailable). In the immediate future, this construction will not differ much from the status quo. This means that link between banks and their sovereign would not be weakened and that different member states position could still lead to potentially very large heterogeneity in the approach to financial sector problems.

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<sup>8</sup> The resolution tools available are: (a) sale of business; (b) bridge institution tool; (c) asset separation tool and (d) bail-in tool.

<sup>9</sup> “In case the Board does not agree with one or more of the directives formulated by the Council it may, during the deadline fixed by the Council, address a notice to the Commission and to the Council requesting their amendment and explaining the reasons for disagreement, in which case the referred deadline shall be suspended. The Council may, in a deadline of 24 hours after reception of the Board's notice, on proposal by the Commission, amend its directives in line with the views expressed by the Board. If, during the deadline referred to in this subparagraph, the Council has not acted or if the Council expressly rejects the request for amendment by the Board, the latter shall incorporate the Council’s directives in the resolution scheme. Where the Council objects to the placing of an institution under resolution on the ground that the public interest criteria referred to in paragraph 2(c) is not fulfilled, the relevant entity shall be orderly wound up under normal insolvency proceedings within the meaning of Article 2 point 40 [BRRD]”.

<sup>10</sup> Moreover, if the resolution action involves the granting of State aid or of Single Resolution Fund aid, the adoption of the resolution scheme shall not take place until the Commission adopts a positive or conditional decision concerning the compatibility of the use of public aid with the internal market. But this can be a conditional decision, so it could be rapid.

<sup>11</sup> The FT Brussels Blog recently produced a striking visual representation of the agents involved at <http://blogs.ft.com/brusselsblog/2013/12/how-to-shutter-a-bank-in-europe/>.

## Conclusion

In 2014 the European financial system will start being supervised by a Single Supervisory Mechanism (SSM) and the European Banking Union is due to assume its final shape. The deal on the Single Resolution Mechanism is however problematic. When speaking of resolution, time is money. And not only in a figurative way: rapidity is really the essence to prevent massive withdrawals of funds. At the same time, confidence is likely to drop the faster in the absence of a credible backstop (and with no federal deposit insurance). Such credible backstop does not exist at present in the European deal and on top of that it's really hard to see how the resolution of a bank in Europe could be carried out over a weekend. As stressed in the previous section the arrangement currently envisioned for resolution funding is also very problematic. There will be no common resolution fund available in the immediate aftermath of the ECB review, when it could be more needed, and different member states position could still lead to potentially very large heterogeneity in the approach to financial sector problems. This not only fails short by far of the objective to break the link between banks and sovereign, but it could also hinder the credibility of the resolution process.

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# What Does the Banking Union Mean for the Real Economy?

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*This contribution intends to evaluate the extent to which a Banking Union might be beneficial to the real economy, in particular small and medium enterprises (SMEs), considering how the banking/sovereign distress has contributed to the divergence of lending rates along the core-periphery divide. The Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) can do a lot to repair balance sheets and ensure macroeconomic stabilisation. However, it might not be enough to reduce the banks' preference for sovereign debt. Cross-border lending for SMEs could be further revived by adopting additional measures which aim at integrating capital markets.*

## Introduction

Small and medium enterprises are the backbone of the European economy. They represent 68% of the EU employment, and almost 60% of the EU's GDP. Due to their strong reliance on the banking sector for external financing, they are paying a disproportionately high price, compared to large businesses, for the banking distress which followed the global financial crisis of 2008 and the sovereign debt crisis of the Eurozone which started in 2010. In addition this price appears to be unevenly distributed across the EMU, with lending rates rising sharply in the peripheral countries and further hindering their prospects for recovery.

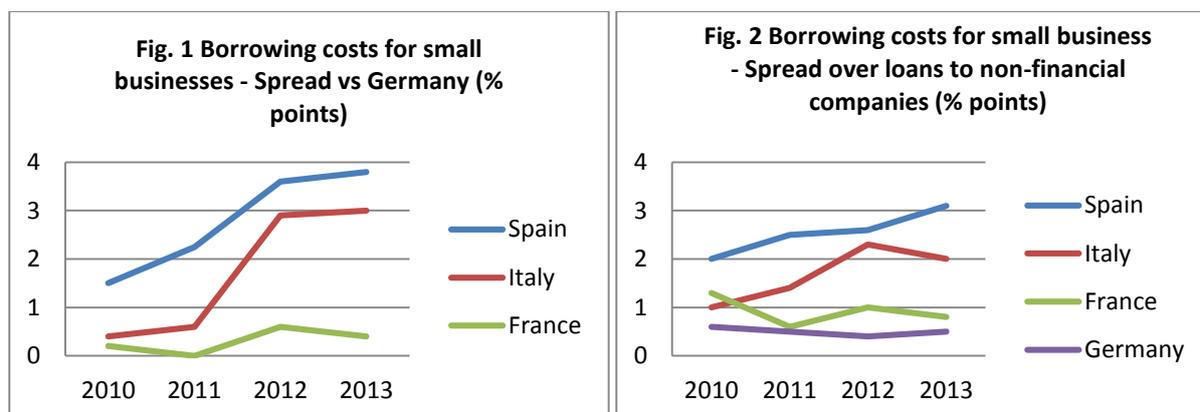
This paper attempts to explore whether the envisaged banking union is likely to contribute to the reduction of the lending rates spread and to a rebound of credit to the real economy. The first section will give a brief overview of the current lending conditions to Eurozone SMEs, and try to figure out whether negative externalities arising from diverging dynamics provide enough of a rationale for policy action and at which level. The second section will list some of the main reasons which may help to explain this dynamic. The final section will then attempt to understand what a banking union can and cannot do to reduce the divergence in lending rates to the SMEs, and also provide recommendations to approach the non-banking-related aspects of the small businesses' credit constraints.

## SME access to finance in the eurozone: an asymmetrical decline

Credit volume has contracted by 6% in the eurozone since early 2010, while it rose by the same proportion in the US. The worsening of financing conditions seems unevenly distributed across the EMU, with borrowing costs showing diverging dynamics along the peripheral-core divide. According to the latest ECB Survey on the SMEs' access to finance, 32% of SMEs in Greece, 23% in Spain, and 20% in Italy and Ireland mentioned access to finance as the most pressing problem, compared to only 8% in Germany and Austria. The need for bank loans grew by 15% in Greece and by 12% in Italy between 2010 and 2012, compared to a reduction in Finland and Austria (-6% and -7%) and no variation in Germany. The availability of bank loans changed in a diverging way over the same period, with Italy accounting for the largest part of the deterioration, almost equalling the improvement recorded by German SMEs. Finally, and perhaps more tellingly, euro area SMEs reported a deterioration in the terms and conditions of bank loans, again displaying diverging dynamics: Spain and Italy contributed most to the reported net increase of interest rates, which are declining in Germany and France (see figures 1 and 2). As for the costs of financing other than interest rates, the general increase at the euro area level between 2010 and 2012 was mainly driven by Italy, Ireland and Spain. Collateral requirements have steadily reduced their impact on German SMEs (only 8% of SMEs reported an increase), whilst they increased markedly in Greece and Spain.

To some extent, this trend should not be deemed as surprising. First, the share of SMEs in terms of employment and value added in peripheral Europe is well above the EMU average. Second, the bleak economic outlook there imposes more conservative decisions when it comes to loans. In this situation, a process of creative destruction might lead to the survival of SMEs which are best equipped for facing

the crisis. However, the strong asymmetries between core and periphery SMEs' access to finance do imply a number of externalities which are independent from idiosyncratic risk, and therefore imply the need for policy action.



Source: Author's elaboration on Thomson Reuters DataStream data

First, the growing fragmentation of credit to SMEs along national lines distorts competition in the single market in several ways. Darvas (2013) notices that banks' growing risk-aversion increases their scepticism about credit-worthiness of small business, leading to an allocation of credit which reflects the availability of collateral rather than expectation of returns. This does not benefit the most innovative SMEs, which rely more on human capital rather than physical capital, distorting credit flows towards businesses potentially less viable but richest in property. Such a suboptimal allocation calls for government action to correct the market failure and protect viable businesses that are short on collateral. However, governments across the eurozone have different fiscal capacity for manoeuvre, and those suffering the toughest budget constraints are also those hosting the SMEs which operate within the most deteriorated lending conditions. Also, growing differentials in borrowing costs reduce the profitability of peripheral eurozone's SMEs no matter how viable and innovative these businesses are, precipitating them into a loop where declining profitability and rising lending rates mutually reinforce. Finally, these asymmetries might potentially provide incentives for a cross-border shift of tax base in search of better lending conditions, reducing tax revenues in distressed countries. Although it is probably too soon to identify a trend, there are growing reports of peripheral countries' SMEs moving their invoicing, procurement and other internal processes to newly created core eurozone-based subsidiaries in order to benefit from easier financing conditions.

These market failures and the differentiated ability of governments to cope with them seem to provide enough of a rationale for policy action at the European level. Understanding the causal reasons why asymmetries in borrowing costs are overshooting the fundamentals is critical to elaborating policy responses, and this will be the subject of the next section.

### Why are lending rates diverging?

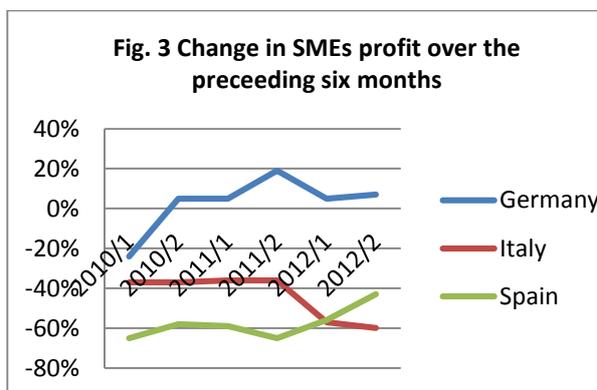
Scholars and commentators have identified several explanations for the current divergence of lending rates to the real economy.

According to Al-Eyd and Pelin Berkman (2013), fragmentation reflects a mix of elevated counterparty risk and uncertainties about new regulatory framework, especially as far as the Basel III capital requirements are concerned. These rules require banks to hold higher levels of risk-free assets, reducing the portion of balance sheets available for lending, and allow for a 0% risk weight to be assigned to sovereign bonds issued in domestic currency. Also individual regulatory ring-fencing in specific Member States has led to declining cross-border flows. The subsequent reduction of the core bank's

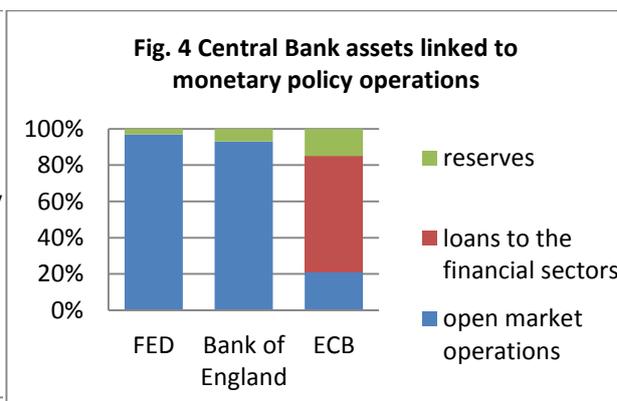
foreign exposure has reduced the availability of credit in the periphery and increased its relative abundance in the core's domestic market. As a result, lending rates have diverged.

Darvas (2013) identifies two intertwined reasons for the credit crunch in the peripheral eurozone: impaired banks' balance sheets and a negative economic outlook in these countries. In a situation of recession, banks facing weak balance sheets tend to deleverage by reducing exposure to firms which are most likely to run into bankruptcy due to a compression of demand. Stress tests have not proved satisfactory enough to reveal where capital shortfalls actually occur, but evidence from elsewhere shows a potential correlation between capital shortfall in specific banks and a reduction of their lending activities.

A further explanation of the divergence of lending rates to SMEs can also be found in recent policy measures aimed at restoring access to markets for distressed countries. Instead of focusing on open-market operations in order to reduce governments borrowing costs, the ECB opted for loans to the banking sector that were granted by sovereign bonds as collateral. Open market operations account for more than 90% of FED and BoE operations, whilst they account for slightly more than 20% when it comes to the ECB (Fig. 4). More than 60% of the ECB loans are for the banking sector (Siciliano, 2013). This might sound apparently reasonable also in light of the disproportionate reliance of the continental European real economy on banks rather than on securitisation (Bank loans account for 50% of firms external financing in Europe, whilst in the US 80% of firms' financing comes from capital markets), but this type of liquidity issuance does not necessarily push banks to issue credit to the corporate sector. The Long-Term Refinancing Operations (LTROs) of the ECB translated into a precautionary use of the provided liquidity. In Southern Europe, giving cyclical uncertainties, LTROs have translated into a massive purchase of sovereign bonds (after all, borrowing at 1% resources to lend at 4%-6% to their own government is a perfectly reasonable business decision in a time of recession-induced non-performing loans).



Source: Author's elaboration on ECB data



Source: Author's elaboration on La Voce.info data

### What a banking union can and cannot do

The abovementioned reasons for the fragmentation of lending rates in the eurozone expose the complexity of the matter, and implicitly confirm that there are no silver bullets. However, the lesson seems to be that SMEs are extremely reliant on the banking sector, so that impaired balance sheets and the policy-induced home-bias in sovereign debt holding in peripheral Europe adds to the detriment of lending conditions in those countries. As such, what can a banking union achieve? It is necessary to distinguish between the short term and the long term. The eurozone is a bank-based system, and, in the short term, credit access for SMEs will remain bank-based. Here, there is a lot a banking union can do.

First, the Asset Quality Review (AQR), which is a comprehensive assessment paving the way for the establishment of the Single Supervisory Mechanism (SSM), has the potential to shed some light on European banks' balance sheets. Uncertainty has fostered risk aversion, and the growing number of

non-performing loans in the periphery has deepened the intra-eurozone fragmentation. Once in place, the SSM is likely to reduce the differentials in the perception of quality supervision between eurozone countries, a perception which has contributed to prevent the liquidity surpluses of some countries from funding needs in others. However, some questions remain: about 85% of the euro area banking assets will be reviewed, so that the smaller banks which are left outside of the exercise – for which lending to SMEs is the core business – are only expected to be involved, notably in the form of member states being “encouraged” to do the rest of the job and apply the same standards. Also, undertaking the AQR, without a mechanism for restructuring already in place, risks either undermining the credibility of the effort, or ends up being paradoxically counterproductive for loans to SMEs in the short term.

Second, a Single Resolution Mechanism (SRM) would absorb shocks, allowing for a revival and stabilisation of cross-border activities, with converging interest rates which would reduce borrowing costs for peripheral eurozone’s SMEs. However, there is no particular evidence that an SRM would be enough to break the national bias in sovereign debt holding, especially in its current formulation. Banks in distressed countries will continue to pay higher risk premiums, reducing the appetite for lending to the real economy. To this extent, additional measures such as exposure limits to national sovereign bonds (Sapir and Wolff 2013) could also be considered. This should be compensated by adopting measures that avoid excessive divergence in government borrowing costs – going beyond the exceptionality and the conditionality attached to the Outright Monetary Transactions (OMT) - such as an (even partial) central bank switch from loans to the banking sector to open market operations. By doing that, the safest assets (notably sovereign bonds) would reduce their returns to the point of disincentivising banks to hold a disproportionate amount of them in their portfolios. In contrast to the LTROs, the targeted Funding and Lending Scheme (FLS) in the UK helped private sector loans to rebound, in part because of the use of open market operations instead of cheap bank refinancing. To make such a switch possible in the eurozone, it would be up to other bodies to prevent direct assets purchase by the ECB from incentivising governments to slow down budget consolidation; however, the engineering of these measures goes beyond the purpose of this paper.

Fixing the banking sector is the way to solve only the banking crisis-related problems of lending to the real economy. Although the expansion of cross-border lending was spectacular in the period between the introduction of the single currency and the eruption of the crisis, SMEs have not been the main beneficiary. This expansion was mostly driven by speculative opportunities in the periphery, as suggested by the fact that in Italy (which did not experience real estate bubbles) the debt holding of banks was never really internationalised (the share of domestic securities remained constantly above 80%), whilst in the case of Spain and Ireland – the countries that are most affected by property speculation – their domestic debt was spread all across Europe before 2008. In the UK, the FLS helped to lift the economy out of the recession, but the banks’ preference for using it to rebound real estate induced the government to prevent the scheme from funding mortgage lending.

For the future, two aspects are therefore of critical importance: giving the right incentives to orienting credit flows towards financing productive and long-term investment, in order to prevent a rebounding of cross-border activities from repeating the mistakes of the past; and a reduction of the SMEs reliance on the banking sector. A more integrated capital market is likely to encourage funding to SMEs through equity, but this requires decisive structural measures: first, a harmonisation of bankruptcy legislation. Different legal systems hinder the ability of lenders to enforce contracts, especially in those countries affected by opaque norms or slow justice. Other areas where harmonisation would be of critical importance for restoring normal lending conditions are corporate governance, and corporate taxation, whose differentials have played a role in hindering cross-border capital-raising for firms. Although a reversal from a bank-centred system for SME-funding towards a market-based system is unlikely, a rebalancing might also help to reduce the reliance of national governments on large domestic banks for conducting distorted industrial policy, often fuelling politically-motivated plans with insufficient returns and helping large businesses much more than the small ones.

## Conclusions

SMEs are particularly hit by the European banking distress. Lending rates grew unevenly, threatening the recovery of the peripheral eurozone further still. Although this reflects a risk assessment largely based on a weak economic outlook and the significant growth of non-performing loans, it is creating severe externalities such as adverse selection in favour of businesses with available collateral rather than viable and innovative human capital-based firms, and a not yet properly detected phenomenon of “borrowing arbitrage” potentially shifting corporate tax base from the periphery towards the core. Considering that the fiscal room for manoeuvre in peripheral countries is tight, there is rationale for a centralised intervention.

Divergence in lending rates to the real economy depends on a number of reasons: regulatory hurdles assigning zero risk to sovereign debt reinforce bank preference for these low-risk assets. This phenomenon is accentuated in the periphery, where capital shortfalls (due to austerity-induced non-performing loans) and the refinancing schemes engineered by the ECB have translated into a massive repatriation of sovereign debt in countries affected by cyclical uncertainties.

Repairing bank balance sheets is the right response in the short term. The SSM can reverse risk aversion by shedding light on balance sheets, although many uncertainties still remain concerning the exemption of small banks and the absence of a mechanism for restructuring already in place. The SRM might help to revive cross-border lending and ensure stability, but still not enough incentives are provided to revert preferences for domestic sovereign debt holding. Additional measure might include limitations of this holding, and open market operation by the ECB rather than loans to banks to stabilise government borrowing costs. On the structural side, a reduction of SMEs’ reliance on bank financing is also desirable. To achieve this, interventions should tackle the fragmentation of capital markets by harmonising bankruptcy norms, corporate governance, and corporate taxation.

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# Banking Union and Fiscal Capacity: the Case for the ESM as a Fiscal Backstop

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Confrontations Europe

A fiscal backstop associated to the single resolution mechanism (SRM) agreed on during the last December 18<sup>th</sup> ECOFIN meeting is needed to strengthen the credibility of the banking union. Such backstop should be active as soon as 2015 in order to provide bridge financing to banks with restructuring needs. This is because “bail in” rules would only apply by 2016 and the single resolution fund (SRF) will be next to empty in 2015. Other financing arrangements envisaged during this period (bad banks, bridge banks, intra SRF compartments’ lending) remain unclear, lengthy or insufficient. 2015 is a particularly important period, as many banks will have 6 to 8 months to comply with SSM recommendations from the fall of 2014 onwards.

## 1. Rationale for a fiscal backstop<sup>13</sup>

The single resolution mechanism (SRM) covering all banks regardless of their nationality provides a powerful tool to sever the adverse feedback loop between sovereigns and domestic banks at play in times of stress. It also provides a mechanism to reduce home-host concerns and reach an agreement on cross-border resolution and burden sharing. As such, it naturally complements the single SSM to avoid protracted and costly banking resolutions. Resolution is to be of the essence for Euro area members, and possible for non-Euro area members.

Resolution involves sensitive choices over the distribution of losses, hence clear *ex ante* burden sharing mechanisms – as agreed between European Ministers of Finance in the context of the BRRD – are foremost necessary. They also provide the right incentives for investors and foster market discipline. But when systemic risks prevail, exceptional treatment may require recourse to a common fund, which would be refinanced by a fiscal backstop from the centre. Federations always have the responsibility for resolving or providing deposit insurance for troubled banks.

The ECOFIN agreed on the creation of a fiscal backstop by 2025. Such backstop would complement the bail in scheme (up until 8% of liabilities) as well as use of the single resolution fund (up until 13% of liabilities). Rather than providing a credit line to the SRF, the fiscal backstop would facilitate borrowing on markets by the Fund. The fiscal backstop would eventually be reimbursed by greater *ex post* contributions by banks to the Fund. The resolution fiscal backstop could be refinanced by the ECB or another common fiscal resource.

## 2. The “institutional” case for the ESM to act as a common fiscal backstop<sup>14</sup>

As was highlighted by Bruegel in September 2012, four options were initially considered to act as a fiscal backstop to the SRM:

- a) a “European Resolution Fund”
- b) an “*ex-ante*” burden sharing agreement

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<sup>12</sup> This paper was last updated on January 2nd, 2014.

<sup>13</sup> Argument developed in an IMF Staff paper – « Towards a fiscal Union for the Euro Area » (Allard, Brooks, Bluedorn) – September 2013

<sup>14</sup> Argument developed in a Bruegel Policy Brief – “The fiscal implications of a banking union” (Pisani-Ferry, Wolff) – September 2012.

- c) the ESM
- d) a contingent European taxation scheme

For each of these four potential backstops for the banking sector, Bruegel considered the following *pros* and *cons*:

A European resolution fund: has been recently agreed. However, Bruegel argued that the pertinence of accumulating resources in a fund instead of reducing public debt (i.e. allowing debt restructuring losses among the banking sector) could be questioned, a stance that Confrontations could also support. Nonetheless, a fund might have difficulties in finding safe and liquid assets to invest in. Also, a fund of such size would be too small and have limited capacity to borrow in the first years without enough capital or sovereign guarantee.

Contingent European taxation: the collection of European resources could enable a credible guarantee scheme in case of a banking crisis. Options have been in the public debate for some time (sharing of VAT, common corporate taxation scheme, financial sector tax, etc) but they imply a level of political willingness and of democratic legitimacy that is not yet reached. Rather, other elements of fiscal integration (further oversight of national fiscal policies, moves towards greater fiscal harmonisation) are considered and are likely to be in the foreseeable future.

An “ex-ante” burden sharing agreement: such scheme would distribute the costs of banking crises among taxpayers of the country in which the bank is located and that of European partners, depending on a previously agreed key (like that of the ECB). This option has been ruled out and replaced by the ECOFIN June agreement on creditors’ bail in and national resolution funds, as well as the initial contribution scheme to the SRF, which provide for an incremental pooling of national contributions, eventually leading to a pooling of banking resources.

The ESM: it could lack resources to provide full fiscal capacity for banks’ losses, and could not give guarantees before a potential intervention. But the ESM has the merit to be already in place and to benefit from a substantial capital cushion. It already has an oversight of the banking sector following the June 2013 bank recapitalisation agreement. It is also trusted by Member states and the ECB. It is recognised by markets, as illustrated by its recent successful bond issuance and AAA rating (Fitch). It is accountable to the EP, which expressed concern on the Parliament’s involvement in resolution schemes.

In line with the ECOFIN, Confrontations sees the ESM as the most credible fiscal backstop to the European resolution fund, and favours the option of a guarantee scheme that would help the SRF to borrow on markets (as the SRF will be undercapitalised and will not benefit from sovereign guarantees). Whether or not the ECB could refinance the ESM acting as the backstop is an open question. It seems unlikely in the near future.

### **3. Where do we stand now?**

The main parameters of the forthcoming SRM have been agreed by the ECOFIN on December 18<sup>th</sup>, 2013. These will be negotiated with the EP with the aim of agreeing the regulation on the SRM at first reading before the end of the legislature.

Two sets of issues remain problematic, however:

- the governance of the SRM remains complex and leaves a lot of power to Member states : although the sequencing of the resolution decision-making process is unlikely to be altered<sup>15</sup>, the respective powers of the plenary and the executive bodies of the Single Resolution Board (SRB) may lead to disagreements between the two instances, notably on the use of the SRF<sup>16</sup>
- some form of bridge financing from 2015 onwards is necessary to enhance the credibility of the banking union: as the BRRD “bail in” rules will only come into force as of January 2016, and as the SRF will be next to empty by 2015 (5.5 bn EUR), and as state programs (financed by ESM?) and intra-SRF lending are either unclear or insufficient, this is where the fiscal backstop has to fit in.

The latter point is of particular importance as Euro area banks will have 6 to 8 months from October 2014 onwards to comply with recommendations and corrective measures of the SSM as a result of the AQR and “stress tests” time sequence. The SRM is likely to intervene for banks that would remain problematic after this period.

Meanwhile, the loss absorption capacity of the many banks that are likely to be resolved during 2015 is limited. Bail in of shareholders and subordinated debt will be limited by the characteristics of State aid arrangements or the structure of bank liabilities, as was illustrated during the Slovenian and Cypriot bail out episodes.

Bad banks and bridge banks could be mobilised during 2015, but their financing arrangements are unknown. For its part, the ESM is projected to recapitalise banks up to 60 bn EUR but only once the SSM enters into force (Fall 2014). The ESM can provide finance to states in need as of today, but only after a lengthy process.

This situation does not guarantee enough confidence in the coming months, notably up until the fall of 2014 and thereafter.

#### **4. Confrontations Europe’s stance**

Therefore, in view of the forthcoming negotiation with the EP, Confrontations Europe argues that:

- ⋮ The governance arrangements of the SRB are fine-tuned in order to reduce disagreements between the executive and plenary bodies, notably on deciding recourse to the SRF
- ⋮ The ESM is identified as the main fiscal backstop to the SRF as soon as possible. This implies a Treaty change to include the SRF as a beneficiary of ESM financing<sup>17</sup>. The ESM is unlikely to benefit from credit lines from the ECB

Ultimately, a credit line from pooled fiscal resources would provide the best insurance against financial risks.

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<sup>15</sup> For instance, the SRB resolution plan would ultimately have to be approved by the Council, which is already likely to be an issue in case of large resolution operations.

<sup>16</sup> According to the draft ECOFIN regulation, the plenary session is likely to be granted two responsibilities, which appear problematic: a) the power to oppose decisions by the executive session to authorise the fund to borrow; b) to organise the mutualisation of financing arrangements in the event of the resolution of institutions that are both in and outside of the SRM scope. It is outside the scope of this position paper to develop this governance point, however.

<sup>17</sup> Such Treaty change could be achieved in less than a year as there would be no further sovereignty transfer involved, nor mobilisation of further budgetary resources.

# Is the EMU ready for future shocks? An overview of available ‘backstops’

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*This contribution explores how the EMU can cope with present and future economic ‘shocks’ given its present architecture. A background framework to think about the different ‘backstops’, or ‘safety nets’ gradually put in place since the beginning of the crisis will first be dressed. This will be followed by some general - but certainly far from exhaustive - comments on their adequacy. In particular, the governance, rationale and possible shortcomings of the available instruments will be broached.*

## Backstops overview

The following table provides an overview of the backstops that were put in place to deal with the different – but interconnected – dimensions of the crisis affecting the eurozone: (i) banking crises that are often tied to prolonged periods of excessive credit growth and/or asset bubbles (ii) fiscal or sovereign-debt crises originating with fiscal imbalances, and (iii) balance-of-payment crises linked to current account imbalances or sudden stops but that are usually associated with banking or sovereign debt crises<sup>18</sup>. This break-down of crises is far blurrier in reality but this allow for a simple overview.

A distinction is also drawn between liquidity and solvency crises. Caution is here warranted because it is extremely difficult to distinguish in practice between liquidity and solvency issues. Both are related, as liquidity crisis typically relate to some solvency concern. Moreover, mismanaged liquidity issues easily morph into solvency problems. This categorization is mostly useful because the ‘backstops’ themselves are in principle designed to address one or the other issue separately.

**Table 1 : Available backstops in the eurozone**

<i>Shocks or crisis</i>	<i>Liquidity</i>	<i>Solvency</i>
Banking	- ECB : Emergency Liquidity Assistance (ELA), Long Term Refinancing Operations (LTRO) - National Government guarantees -? <i>Supranational deposit guarantee</i>	- Resolution including bail-in principles - Single Resolution Fund (SRF) - ? <i>common backstop to SRF</i> - National fund and ESM Direct bank recapitalization
Sovereign	- European Stability Mechanism (ESM) precautionary financial assistance + ECB (Outright Monetary Transactions) EFSF/ESM/IMF programme	- Debt restructuring (private sector involvement/ ? <i>official sector involvement</i> )
Balance of payment	- Emergency Liquidity Assistance - ECB liquidity (increased net Target 2 liability) - Official assistance flows (EFSF/ESM/IMF)	? <i>elements of a ‘fiscal union’ (eurozone shock absorption mechanism /contractual arrangements)</i>

Legend: items in italic following a ‘?’ represent unavailable instruments for which there is an ongoing debate.

<sup>18</sup> The definition is from - and the (updated) associated table is inspired on Bijlsma, M., Vallée, S., (2012), “[The creation of euro area financial safety nets](#)”, Bruegel working paper, 2012/09, July 2012.

## Banking crisis backstops

How the eurozone will deal with a shock affecting its banking sector is not a mere theoretical question. The ECB comprehensive assessment to be performed in 2014 will notably include a stress-test – in essence a ‘simulated’ shock. The exercise is not only preventive but also corrective in nature. It should promote the transformation of the European banking sector by fostering recapitalization and resolution of banks failing to meet capital requirements. One key question revolves around the actual recapitalization needs of the banking sector and the available absorption capacity of resolution tools - financial markets, the banks themselves (via bail-ins), the Single Resolution Fund and available public backstops.

For many observers, at this stage of negotiations, the design for the Single Resolution Mechanism (SRM) is unsatisfactory because its decision making process is too complex and because the resolution fund lacks a common fiscal backstop. As a result, many fear this setup will not allow the ECB to be sufficiently bold in its upcoming assessment.

Although rather complex and ultimately in the hands of finance ministers, the decision-making process on the resolution of banks should nonetheless be workable. The governance balances technocracy (the Single Resolution Board and the Commission) with politics (ECOFIN). If the SRM indeed falls short of being a truly ‘single’ authority, functioning as an agency, this setup should nonetheless make it possible to take prompt decision when required. Given that national fiscal resources would be on the line in the short term, it seems unrealistic to grant exclusive authority to the Commission and the Board for now. The governance of the ESM, which may as well be required to take urgent decisions, actually present stronger ‘intergovernmentalist’ limits.

The second major concern is that the Banking Union would lack a proper common fiscal backstop. Instead of breaking the vicious circle between banks and sovereigns, the absence of common risk-sharing mechanisms would instead reinforce that link. However, the main focus of the ECB exercise should be the restructuring of unviable banks presenting structural profitability problems. And solvency problems should not be dealt with bail-outs (requiring fiscal backstops). If capital shortfalls are detected, then banks will be required to raise capital. But failure to raise capital above the current regulatory minimum<sup>19</sup> would in principle imply that the bank fundamentals are wrong, primarily pointing out to insolvency. In this case, before any public support can be granted, a restructuring plan would first have to be notified to the Commission, specifying how bail-in measures should limit the aid to its minimum<sup>20</sup>. The bail-in pecking order will be equity then subordinated debt, possibly followed by senior debt, except if the Commission estimates the short-fall too big not to cause a disruption of financial stability.

There are much uncertainty regarding the precise recapitalization needs of the banking system in Europe, owing to the many questions left open regarding the exact parameters the ECB will use when it conducts its assessment<sup>21</sup>. It is thus difficult to judge how much public funds may ultimately be necessary. In the short term and before the Single Resolution Fund reaches a considerable size, the available private resources may be insufficient. If so, the ultimate backstop will remain national taxpayers. This does however not preclude that if the burden becomes too important for the sovereign, the ESM can step in as a common backstop to share a part of this burden, by making use of its direct bank recapitalization instrument<sup>22</sup>.

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<sup>19</sup> Common Equity Tier 1 should represent 4.5 percent of the bank’s risk-weighted assets as of January 2014 according to the Capital Requirement Directive (CRD IV) and Capital Requirement Regulation.

<sup>20</sup> According to the State Aid guidelines (see the “Banking Communication” 2013/C 216/01) that will apply before the harmonized framework of the Bank Recovery and Resolution Directive enters into force in 2016.

<sup>21</sup> See Merler, S. and Wolff, G. (2013) ‘Ending uncertainty: recapitalization under European central bank supervision’, Bruegel Policy contribution, Issue 2013/18, December 2013.

<sup>22</sup> The new instrument must not exceed €60 billion but this amount is revisable. See ESM (2013), ‘ESM direct bank recapitalisation instrument - Main features of the operational framework and way forward’, 20 June 2013.

While falling short of an ideal design, this transitory resolution set-up may be workable. The EMU will have to rely on the executive boldness of the ECB which will hopefully act as a strong supervisor. In the longer-term, especially when the banking system is hopefully brought back to health, the governance and fiscal backstops of the banking union could be improved to better deal with future crises.

### **Sovereign-debt crisis backstop**

*For (pure) liquidity crisis – the ECB’s Outright Monetary Transactions*

Liquidity issues have attracted much attention at the height of the sovereign debt crisis, when several countries experienced the rapid rise of their borrowing costs in a seemingly contagious way. Some economists argued that a self-fulfilling liquidity crisis was underway as the market speculated about the possible break-up of the eurozone.

Initially, Eurobonds were discussed as possible solution to halt contagion. In essence, a country would be able to borrow via ‘Eurobonds’, debt issuances benefiting from the shared guarantees of all other Eurozone members. Numerous proposals were voiced, none actually making it to the negotiation table<sup>23</sup>. Technically, Eurobonds proposals were probably ill-suited to address strict liquidity issues<sup>24</sup>. Their introduction may not have halted the self-fulfilling liquidity crisis dynamic. The limit set on the amount of debt that could be issued via Eurobonds may have offer a clear target to speculation. Moreover once introduced, Eurobonds would have at best allowed a country to borrow under its market rate thereby raising severe moral hazard concerns, or at worst be inefficient, if the overall sovereign risk was transferred to its remaining national issuances.

Because Eurobonds were technically and politically questionable, the solution had to come from the Central Bank which – despite political tension about its statute – was a more obvious eurozone lender-of-last-resort candidate. As it turned out, the mere announcement by the ECB over the summer 2012 that it would ‘do whatever it takes to save the euro’, concretized via the creation of the ‘Outright Monetary Transactions’ (OMT) programme, has for now effectively managed to halt speculation about an imminent euro break-up. Since the ECB has endorsed this lender-of-last-resort role refinancing conditions of countries under the most severe stress have considerably eased.

However, the governance of this backstop for sovereigns still present some flaws<sup>25</sup>. In principle, a lender of last resort should best be able to act on an *unlimited* and *unconditional* basis. While essentially unlimited, the ECB intervention is not unconditional. The country facing refinancing difficulties should first request precautionary assistance under the form of a credit line from the ESM.

A Memorandum of Understanding and a Financial Assistance Agreement would set the ‘conditionality’ of potential ECB interventions. These conditions would have to be negotiated among Eurozone finance ministers who ultimately hold the key to the door leading to potential purchases by the ECB. This may not be a smooth process to undertake in the midst of a crisis, when distinguishing liquidity from solvency issues would be extremely difficult. Germany which holds a veto right in the ESM Governing Council would in particular need to further take a stance from the Bundesbank which opposes the very concept of the OMT. The uncertainty may moreover represent an important stigma for the ailing eurozone country to make a request in the first place.

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<sup>23</sup> Most notably: the Blue bond proposal (Delpla, J., von Weizsäcker, J., (2010), “[The Blue Bond proposal](#)”, Bruegel policy brief, Issue 2010/03), the European Redemption fund proposal (German Council of Economic Expert, (2011) “[Euro area in crisis, Annual report 2011/12](#)”, annual report of GCEE, chapter 3), the Eurobills proposal (Hellwig, C., Philippon, T., (2011), “Eurobills, not Eurobonds”, available at: <http://www.voxeu.org/article/eurobills-not-euro-bonds>). For a broad overview and comparisons see Claessens, S., Mody, A., Vallee, S., (2012), “[Paths to Eurobonds](#)”, Bruegel Working Paper, 2012/10.

<sup>24</sup> We are not discussing here the merits of other forms of ‘Eurobonds’ conceived as debt instrument backed by a genuine eurozone ‘fiscal capacity’. Preventing contagion and self-fulfilling liquidity crises was the core rationale for ‘Eurobonds’ based on shared guarantees.

<sup>25</sup> What follows is a summary of the argumentation made in Vanden Bosch, X. (2012), “[Preventing the rise of sovereign borrowing costs in the eurozone: what can the ESM and ECB achieve?](#)”, Egmont paper 56, November.

A similar judgment than for the public backstop for the banking union may apply here. The decision-making is certainly not ideal and involves some risks but remains workable as long as stakeholders cooperate. In a longer time perspective, this improvised patchwork should be turned into a more robust solution.

#### *From liquidity to solvency crisis – ESM programme and debt restructuring*

Ensuring countries solvency - i.e. the sustainability of public finances - will remain a key challenges for many years to come in the EMU. With aggregate public debt levels of the Eurozone currently above 95% of GDP, public deleveraging will require continuous effort. Therefore, considerable attention was devoted during the last years to strengthen fiscal discipline in the EMU.

In principle, as long a eurozone member complies with the European fiscal governance framework, it could benefit from the ESM support should it face an adverse shock destabilizing its public finances. This could in particular be the case following a banking crisis. However, contrary to the earliest phase of the crisis, the common backstop will probably not be first in line anymore. Some form of debt restructuring would be in order when mostly solvency rather than liquidity issues are involved. The ESM Treaty explicitly foresees the possibility of private-sector restructuring should a future debt sustainability analysis show that the country cannot service its debt in full. Collective action clauses in sovereign bonds contracts were made mandatory to facilitate such restructuring. Moreover, for large eurozone countries, a full bail-out would anyway not be conceivable due to the limited size of the ESM. Finally, the European banking sector is for the time being much fragmented, with a strong ‘home bias’ for sovereign debt. For all the downside of this fragmentation, it would however greatly facilitate the parallel restructuring of both a national banking sector and of sovereign debt because it limits contagion effects.

However, in a prolonged low-growth and low-inflation context, reducing debt levels relies on the long term commitment to fiscal consolidation. This will involve important redistribution issues at the national level. In extreme instances, the high level of debt and the burden imposed on young and future generations may be judged excessive and illegitimate. If national social and political forces intend to take more radical measures to reduce the national stock of debt, instead of relying on fiscal consolidation, the eurozone would enter into an uncharted territory.

#### **Balance-of-payment crisis backstops – towards a fiscal union?**

The extent to which the euro crisis qualifies as a balance-of-payment crisis is debatable. It may in particular be argued that the imbalances affecting the eurozone merely reflect the other dimensions of the crisis – in particular the banking crisis. Accordingly, the backstops for balance-of-payment crisis overlap the ones that exist for banks and sovereigns (see table 1). Indeed, the major backstop that mitigated sudden capital outflows were public inflows, especially eurosystem refinancing i.e. central bank liquidity<sup>26</sup>. This rightly points out that solving banking sector issues is the priority to unwind exceptional liquidity provisions, foster financial (re)integration, and ultimately allow private flow back to the eurozone countries most negatively affected by the imbalances.

However, next to banking issues, addressing competitiveness imbalances also represent a challenge. The macroeconomic imbalance procedure introduced in 2011 as part of the strengthened European economic governance framework reflects this concern. Excessive wage and price inflation that followed the introduction of the euro certainly significantly explains the deterioration of the competitiveness of crisis-hit economies. This would call for a significant ‘competitive devaluation’ or ‘relative disinflation’ backed by the necessary product and market reforms.

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<sup>26</sup> Which explains Target 2 imbalances. See Merler, S., Pisani-Ferry, J.,(2012), “[Sudden stops in the euro area](#)”, Bruegel policy contribution, Issue 2012/06, March 2012.

Yet such adjustment bears potential social costs for which no ‘backstop’ exists other than the strictly national ones. A currency devaluation (or a eurozone exit) could have played this absorption function but within the eurozone no such flexibility exists. As a result, no common instrument is currently available to mitigate the cost of the necessary adjustment following the shock that sudden stops implied. Addressing this void would imply developing instruments that would be part of a ‘fiscal union’. Yet, proposals for a fiscal union, conceived as ‘building block’ towards a ‘complete’, ‘genuine’ EMU, were so far largely sidelined.

In particular, a mutual insurance mechanism could help absorb shocks and smooth out business cycles. However, any scheme involving automatic insurance against adverse shock will be extremely difficult to implement at this stage. The insurance mechanism would create moral hazard issues and its automaticity would make the conditionality of the transfers difficult to establish. Many fear that supposedly temporary automatic transfers may actually become permanent. An insurance mechanism is also best put in place under a ‘veil of ignorance’, when risks are perceived as nearly equal, whose realization is a distant, uncertain prospect. In the current situation – with the ongoing crisis not yet resolved - risks have already materialized as shocks for several countries. Unwinding the accumulated competitiveness imbalances therefore seems a prerequisite.

In order to promote long-term convergence, the Eurozone may still need a financial instrument that would both facilitate the *correction* of the imbalances - rather than be only focused on their *prevention* – and mitigate the shock experienced by countries most hit by the crisis. The ongoing discussion on ‘contractual arrangements’ offers such opportunity<sup>27</sup>. Contracting countries committing to structural reforms advocated by the EU would benefit from a limited, timely, targeted and temporary transfer scheme. There would be by design no moral hazard issue since contractual arrangements would be designed to *speed up* not *slow down* the adjustment process (these are contracts not insurance policies which would involve close monitoring). Selected recipient countries would thereby be contractually bound to implement the labour market and product market reforms that aim to facilitate the adjustment, necessary for their own sake but also for the EMU as a whole. The financial support to the necessary adjustment phase required in some countries could mitigate some of the social and political costs necessarily involved in their competitive adjustment process.

Quite obviously, this financial support attached to contractual arrangement will not match the benefit of restoring normal lending conditions and reversing financial fragmentation in the eurozone. Therefore a functioning banking union remains the top priority. Yet these targeted and timely public transfers could be a useful complement in the short term – say 5 years – by the time the most pressing competitiveness and banking issues are addressed. The experience with this mechanism could then possibly serve as a basis towards more ambitious shock absorption schemes part of a fiscal union.

## Conclusion

In the recent years, much has been accomplished to make the EMU more resilient to crises. Several backstops were progressively put in place to ‘absorb’ the shocks that could have otherwise ‘broken’ the EMU as a system.

In the banking sector, the ECB ensured sufficient liquidity were made available to financial institutions. To deal with more severe solvency issues, the incoming setting-up of a Single Resolution Mechanism along with new bail-in principles should allow the ECB to effectively endorse its role of single supervisor to bring the banking sector back to health. A Single Resolution Fund will be gradually built-up. In the short-term, the fiscal backstop will remain national but the ESM could as well be used to directly recapitalize banks if necessary. Regarding sovereign debt risks, the ECB’s OMT in combination with the ESM fends off most severe self-fulfilling liquidity risks. The ESM may be used in case of a sovereign debt crisis, but contrary to earlier bailouts, future ESM programmes would likely involve debt restructuring with a Private Sector Involvement.

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<sup>27</sup> This possibility is explored in Vanden Bosch, X. (2013), ‘[Contractual arrangements: the overlooked step towards a fiscal union](#)’, European Policy Brief 18, Egmont, December.

These substantial advances followed a gradual ‘trial-and-error’ approach rather the logic of a grand design that would have completely overhauled the EMU architecture. While flexibility and realism have advantages, the clear downside risk is complacency. With no roadmap to follow, efforts to complete the architecture of the EMU may fade out with time. Maintaining a sense of direction is crucial because possible vulnerabilities remain in the current EMU design.

Some of these vulnerabilities are associated with the governance of the backstops. It is understandable that Member states are not willing to concede strong executive powers at the EU level. Yet these are necessary for most of the backstops. The fact that the ECB, which disposes of strong executive powers, is managing several of the backstops in the EMU is no coincidence. Involving high-politics to decide on the resolution of banks, or to authorize the ECB to purchase sovereign bonds represents a risk. Moreover, a comprehensive backstop to the common resolution fund for the banking union is desirable. The greatest question mark remain on the desirable degree of a ‘fiscal union’ in the EMU. While the crisis triggered the creation of backstops for banks and sovereigns, no European mechanism directly mitigate the social cost implied by the adjustment process in eurozone countries most hit by the crisis. ‘Contractual arrangements’, presented as a building block towards such a fiscal union, are the only remaining elements still on the European Council agenda – the debate should integrate this dimension.

Overall, the current EMU ‘backstop’ framework is not ideal but is workable. Different backstop exists and many instruments can be quickly expanded if necessary. However, this ‘risk management’ exercise must be pursued by considering all risks and available options and by learning from past mistakes. The overarching objective should be to increase the EMU resilience in all possible dimensions.