EUROPEAN BANKING UNION (published in the *New Palgrave Dictionary of Economics*)

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Abstract

The sovereign crisis that has characterized the Eurozone since 2010 highlighted the potentially vicious circle between banks and sovereigns, adding an extra dimension to the 2007/08 financial crisis. This is why the EU Heads of State and Government committed to a European banking union in June 2012; a vision that was further developed in the European Commission's blueprint. The aim of the banking union is to ensure that financial institutions of the – for now – 19 Member States will be subject to a single supervision, a single resolution, and a common deposit insurance system. This article explains the background to these initiatives and weighs the progress towards their completion.

Keywords: economic and monetary union; European Union; financial integration; bank supervision; bank resolution; European deposit guarantee; banking crisis; financial crisis;

JEL Codes (relevant fields within Economics): G01; G18; G28; O52; E61

European Banking Union

The European Banking Union (henceforth, Banking Union or BU) introduces for the first time an integrated approach in supervision and resolution of European banks, representing an important step towards enhancing the Economic and Monetary Union. The aim of the Banking Union is to deliver absolute consistency of implementation of new regulatory rules across the euro area (at the moment of writing 129 banking groups, representing more than 80 percent of the euro area banking sector's assets),[1] ensuring that financial institutions of all member states will be subject to a single supervision, a single resolution, and a common deposit insurance system. The need for a banking union emerged in response to the 2007/08 global financial crisis and the ensuing sovereign debt crisis in the Eurozone. Particularly, the sequencing of the events highlighted the costs of the vicious link between public and private sector debt, and how these can easily overflow national borders and cause systemic risk and failures.

The Banking Union's proposal dates back to June 2012; it covers a preventive stage, (i) regulation and supervision, and a crisis management stage, (ii) resolution and (iii) safety nets (see European Commission, 2012; IMF, 2013b).

The first two components of the Banking Union, a single European supervisor (i.e. the Single Supervisory Mechanism) and a single resolution authority (i.e. the Single Resolution Mechanism) have been agreed. The third element of the BU, however – a European deposit insurance scheme covering eligible individual deposits in all participating countries – has been stalling, largely because of political opposition from some creditor member states; Germany in particular.

The Single Supervisory Mechanism (SSM) has been in place since 4 November 2014; this is the date from which the European Central Bank assumed responsibility for banks' supervision. The SSM is a key ingredient of the BU, but it is not the only one. Particularly, a European approach for the resolution of banks – with a Single Resolution Mechanism (SRM), centered on the idea of a Single Resolution Board (SRB) and a Single Resolution Fund (SRF) – needed to follow. The EU adopted a Bank Recovery and Resolution Directive (BRRD) together with an agreement on the Single Resolution Mechanism from December 2013. Such an agreement – following on from the SSM already agreed – was significant because it meant that two of the three components of banking union have been operational since 2015. Nonetheless, both elements of the BU have been somewhat watered down from their original conception. The SSM will *de jure* not be supervising the whole European banking system, with national authorities continuing to supervise smaller financial institutions. Furthermore, unlike the SSM, the SRM will be "single in name only" (Posner and Véron, 2014) as

[1] See ECB (2015).

the framework that sets up the resolution mechanism foresees a significant degree of continuing autonomy for national authorities (see Section on "Progress on achieving a banking union") – particularly on the issue of funding – at least for the next eight years. Progress has been very uneven on the third element of the Banking Union as well, with a common approach to deposit insurance having been sidelined during the first stages of the negotiations. Despite a first legislative proposal for a euro-area wide protection for bank deposits, that came as late as 24 November 2015, negotiations are currently stalling. The lack of this third element is critical because it means there would ultimately be no European backstop for depositors in the event of a new banking crisis.

If implemented properly, the original vision for the Banking Union may be the most far-reaching reform since the inception of the euro (Constâncio, 2013). The fact that the Banking Union vision was further developed in the European Commission's blueprint for economic and monetary union (see Genuine Economic and Monetary Union; Juncker et al., 2015) reveals the Eurozone's willingness to continue to deepen integration and to put in place a framework making member states' participation in the Eurozone "sustainable" (see also Pisani-Ferri, 2013). However, with an established supervisory authority, a resolution mechanism on the way, and a delaying agreement on a common deposit insurance scheme, it remains to be asked whether the European banking project can be credible without a fully-fledged fiscal backstop.

Background to financial supervision in Europe

The financial market regulation under the Basel Accords, as well as the system of EU financial supervision before 2010, were generally characterized by the lack of mutual recognition. The existing Lamfalussy Process envisaged a largely delegated legislation and enforcement system with an explicit legislation in co-decision procedures (see also ECB, 2010). The implementation and transposition of detailed rules on supervision and resolution were delegated to three Committees – the so-called 3 Level Lamfalussy (3L3) Committees: the CESR (Committee of European Securities Regulators), the CEBS (Committee of European Banking Supervisors), and the CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors). Day-to-day supervision was left to national supervisory agencies, with a strict separation of supervision from central banking, both geographically and functionally (see also Masciandaro *et al.*, 2011).

After 2010, such an approach to financial supervision and regulation changed, under the pressure of the systemic nature of the crisis and the de Larosière report. On the legal side, there was a significant tightening of the regulation of banks with Basel III raising minimum capital ratios and redefining riskiness of assets. Furthermore, the de Larosière Report (see de Larosière Group, 2009) established a European Systemic Risk Board (ESRB), chaired by the ECB's President and Vice-President, with the aim of providing macroeconomic supervision of the financial system as a whole.[2] The ESRB was created at the end of 2010 as a part of a new two-pillar system of financial supervision, the European System of Financial Supervision (ESFS). The report also gave recognition to three European Supervisory Authorities (ESAs) to cover micro-prudential supervision; representing the ESFS second pillar. These three EU-level bodies, being effective as of 1 January 2011, were not created *ex novo* but they upgraded the existing 3L3 Committees. In particular,

- The CEBS was upgraded into the European Banking Authority (EBA);
- The CEIOPS was upgraded into the European Insurance and Occupational Pensions Authority (EIOPA);
- Finally, the CESR was upgraded into the European Securities and Markets Authority (ESMA).

This change in governance structure marked not only the beginning of a greater (than in the rest of the world) involvement of the central bank in Europe, but also the start of a two-pillar strategy ensuring – by means of institutional separation and coordination with national supervisors – a system of checks and balances between macro and micro prudential supervision (see also Goodhart and Schoenmaker, 1995; Masciandaro *et al.*, 2011; Eijffinger, 2013; Goodhart, 2014).

The first agreement on a banking union came in September 2012. The European Parliament's final "go-ahead" for the ECB to be fully entrusted with responsibility for the supervision of banks in the framework of

[2] For a discussion on the governance of the ESRB see Gerba and Macchiarelli (2015).

the SSM came after extensive negotiations between various stakeholders. This happened one year after the first agreement, on 12 September 2013. The 2012 EU Council agreement appropriately conferred broad investigatory and supervisory powers to the ECB, which – as of November 2014 – is responsible for the effective and consistent functioning of the SSM. National authorities remain responsible for the banks remaining under their direct supervision (i.e. the so-called "less significant financial institutions").

Guidance on the design of an effective supervisory mechanism for Europe was provided in the Basel Core Principles.[3] According to these principles, a number of preconditions and prerequisites were to be met at the euro area level, including (i) the implementation of coherent and sustainable macroeconomic policies; (ii) a clear framework for financial stability policy; (iii) an effective crisis management and resolution framework to deal with bank failures and minimize disruptions; (iv) an adequate safety net to deal with confidence crisis while minimizing distortions; (v) a well-developed public infrastructure; and (vi) effective market discipline. On the other hand, as underlined by IMF (2013b), prerequisites to establish a sound basis for the SSM included: (i) its operational independence; (ii) clear objectives and mandates; (iii) legal protection of supervisors; (iv) transparent processes, sound governance and adequate resources; and (v) accountability (see also IMF, 2013b; Gerba and Macchiarelli, 2015). As we shall discuss in the next sections, after the comprehensive assessment performed by the SSM at the end of 2013, with extensive granular balance-sheet facts being provided and a higher degree of transparency and availability of information to the public, the SSM seems to meet these criteria.

The European 'doom-loop'

The crisis highlighted the importance of having in place a framework for dealing efficiently and in a timely manner with the resolution of cross-border financial entities (Obstfeld, 2013), avoiding the long-term implications on fiscal sustainability of having national governments and banks dangerously tied together (see, *inter alia*, Reinhardt and Rogoff, 2013; Gennaioli *et al.*, 2014). These ties essentially intensified during the Eurozone's crisis because of: (i) banks engaging in *carry-trade* by using "cheap" central bank liquidity to purchase government bonds (see Acharya and Steffen, 2015).[4] Next, (ii) there was a fast rebalancing of banks' international portfolios towards "home" assets and bonds (see Battistini *et al*., 2014; Valiante, 2015). The latter was possibly the result of risk-shifting (Gennaioli *et al.*, 2014; Farhi and Tirole, 2016; Acharya *et al.*, 2015); discrimination (Broner *et al.*, 2013) and/or financial repression (Chari *et al.*, 2014; for a general discussion see also Reinhart *et al.*, 2011).

Government guarantees to banks at the expense of higher debt and the inability of regulators to stall the crisis, together with a "faulty" design of the currency union – centered on a single central bank and multiple Treasuries (see De Grauwe, 2016) – are known to be amongst the weighty factors at the root of the private-public European "doom-loop".

In the euro area, in particular, together with the impossibility of monetizing debt (an explicit provision contained in the Lisbon Treaty on the Functioning of the EU – the 'no bailout rule' – art. 125), as of 2010 countries had *de facto* to compete "internally" over capital flows (see Valiante, 2015). This was the reflection of an institutional set-up built on the idea of "tying one's hands" – i.e. guarding against government failure by simply agreeing on strict fiscal rules (e.g. the Stability and Growth Pact) and letting markets find their equilibria (Fuest and Peichl, 2012).[5] The sovereign debt crisis that followed confronted almost all non-AAA-rated euro area countries (Greece and Ireland first, followed by others as of 2012) with a liquidity dry out, as the result of a flight-to-quality of capital – facilitated indeed by the single currency – towards their 'safer'

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[3] The so-called "Core Principles for Effective Banking Supervision" http://www.bis.org/publ/bcbs30a.htm.

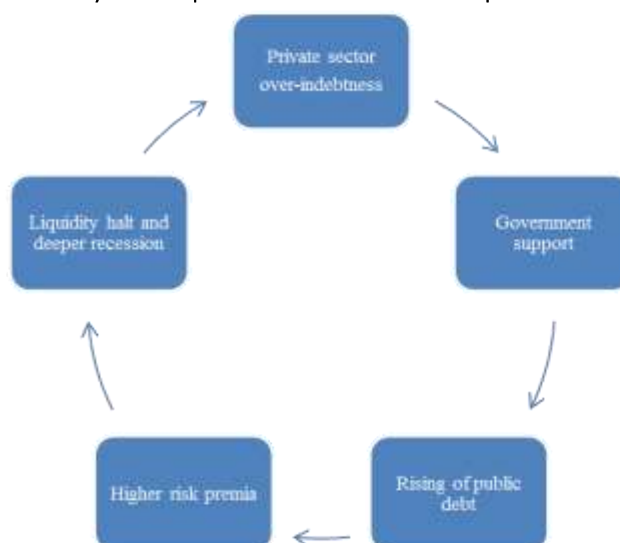
[4] Central bank liquidity came mainly in the form of 3-year long term refinancing operations (LTRO), with the interest rate fixed at the average rate of the main refinancing operations at the time (1% p.a.) and full allotment of the bids (for further technical details see ECB, 2011).

[5] A key reason for the failure of international capital markets to differentiate sufficiently between countries according to the state of their public finances was that the 'no bailout rule' was just not credible (Fuest and Peichl, 2012). In other words, before 2010 financial markets simply did not set incentives to limit government debt in the Eurozone, and very small borrowing premia were to be paid over German *safe-haven* rates.

EMU peers. This translated into higher public borrowing costs, a frailer banking system and overall larger bailout charges *ex post*.

Figure 1 proposes a stylized representation of the aforementioned European doom-loop.[6] In this representation, whatever the entry point is (private sector leverage, unsustainability of public finances, lack of structural reforms) there is a self-reinforcing effect relating to the classical problem of (ir)rational runs in which the market can push an economy into a "bad" equilibrium (see also De Grauwe and Ji, 2012). This amplification within the EMU had to do, firstly, with a collapse of confidence in certain markets and institutions at the same time, and the broader fragility of financial systems, because of increased counterparty risk or asymmetry of information (see also IMF, 2013a). Secondly, it was linked to the distressed financial sector inducing government bailouts (or private sector *deleveraging*; see Acharya *et al*. 2015). The latter, in particular, created a vicious interaction between asset prices (via banks' balance sheets) and borrowing constraints (Borio and Zhu, 2012; Brunnermeier and Pedersen, 2009; De Grauwe and Macchiarelli, 2015), where – simplifying – the fire-sale of government bonds in some countries (as the result of confidence loss and excessive debt taking) increased sovereign credit risk, in turn weakening the financial sector, with an ensuing liquidity dry-out and freezing of lending to the real economy. Overall this eroded bond holdings and the value of government guarantees, requiring further support, and so on.

Figure 1: A stylized representation of the European "doom-loop"



Why a banking union for Europe?

The governments' last-resort guarantees to their own financial institutions were initially granted in an uncoordinated manner within the EU.[7] Coordinated support happened only later and was led by the European Commission in the context of its State Aid policy, with the aim of preserving an EU integrated financial market. Before the Commission launched a bank recovery proposal, a number of EU countries, including Austria, Belgium, Denmark, France, Germany, Ireland and the UK had already put in place new rules for the resolution of their distressed banks. Such repeated bailouts not only increased sovereign debt but also imposed a large encumbrance on taxpayers. The used state aid measures in the form of

[6] This representation does not consider contagion or spillover effects from, or to, other countries, being broadly related to recent literature on doom loops in closed economies (see e.g., Acharya *et al*. 2015).

[7] Government asset support mainly took two forms (see also Gros and Schoenmaker, 2014): asset insurance schemes, which maintained the assets in the banks' balance sheet, and asset removal schemes, which transferred the assets to a separate institution (bad bank). Purchases of impaired assets often occurred after earlier government capital injections. In the case of bank debt guarantees, approximately half of those that received capital injections also received government guarantees for their bank debts.

recapitalisation and asset relief measures between Oct 2008 and Dec 2012 amounted to 591.9 billion or 4.6% of EU 2012 GDP, with the highest share belonging (in order) to Ireland, the UK, and Germany (European Commission State Aid Scoreboard, 2013). Including approved aids and guarantees, this figure jumps to over 12% of the EU GDP for the period 2008-12 only (European Commission State Aid Scoreboard, 2013). In the euro area, 37% of capital injections and 63% of the asset relief measures were granted to the three largest financial institutions (see also Gros and Schoenmaker, 2014).

Beyond government upkeep, central banks provided unprecedented liquidity support to illiquid (and insolvent) banks as well. Specifically, the European Central Bank during the first stage of the crisis focused – albeit not exclusively – its program on direct lending to banks,[8] reflecting the bank-centric structure of the euro area financial systems (see also Gabor, 2014).[9]

Looking at the recent history of bailouts, the advantage of a permanent bank supervision and resolution framework, as compared to the *ad hoc* measures that were employed during the crisis, primarily resides (i) in its transparency regarding the list of eligible institutions and the conditions of access to funding. Secondly (ii), it introduces limitation to *free-riding* derived from unlimited recourse to public money, allowing overall a balanced burden-share between private investors and taxpayers, possibly resulting in lower funding costs *ex- post*. At the same time, (iii) the BU's proposal recognizes the systemic nature of risk facilitated by the single currency, and the potential dangers and domino effect "systemically important" financial institutions would have, given their cross-border reach, within the E(M)U (see also Obstfeld, 2013; Gros and Schoenmaker, 2014; Goodhart, 2014). Finally, (iv) the proposal acknowledges the issue of the moral hazard of national governments both over time – with a tendency to offload the costs of restructuring the domestic banking sector to future governments – and across countries – particularly, relying on the ECB's and European Stability Mechanism's last resort support. The latter two points relate to the literature analyzing the combination of limited commitment on the part of the government *ex-ante*, and the possibility of bailouts *ex-post* (see, among others, Acharya and Yorulmazer 2008, Chari and Kehoe, 2013; Farhi and Tirole 2012). Particularly, this literature highlights a mechanism by which government bailouts are provided only when a sufficient number of financial institutions are in trouble *ex-post*, so that strategic complementarities in financial risk-taking arise: i.e. individual financial institutions may engage in higher financial risk-taking *ex-ante* the higher is the collective risk-taking, as this increases the likelihood of a government bailout *ex-post*. The existence of such complementarities and systemic risk thus provides a rationale for macro- and European measures.[10]

Legal underpinning

The legal foundation of the BU is contained in a single rule book made up of three main elements.

1. A set of **rules on capital requirements** (Capital Requirements Directive – CRD IV).

These rules entered into force on 1 January 2014, and replaced the original Capital Requirements Directives (2006/48 and 2006/49), transposed the international Basel III agreement into EU regulation and ensured that banks hold sufficient buffer to withstand potential losses.

2. The proposal for strengthening the **Deposit Guarantee Schemes Directive** (DGSD) (Revision of the Directive 94/19/EC).

The aim of the latter was to harmonize and simplify deposit guarantee rules in the EU and improve the functioning of the existing guarantees across the board, with a protection of deposits up to €100.000 (from the existing €20.000 limit). According to the directive, all credit institutions will be required to join the DGS

[8] See footnote no. 4.

[9] This was different from the Federal Reserve and the Bank of England which expanded their respective monetary bases by largely purchasing bonds in the first place.

[10] Broner *et al.* (2013) put forward another rationale for a banking union: a BU is thought to reduce discrimination between domestic and foreign investors.

instituted at the national level. The Council has reached a political agreement with the European Parliament on the revised directive, with the Parliament's formally adopting this revision in April 2014.

3. **Bank Recovery and Resolution Directive** (BRRD) (Directive 2014/59/EU)

The directive gives powers to authorities across the EU to act effectively to prevent bank crises and to ensure orderly restructuring and resolution in the event of bank failure. The aim is to avoid negative effects on financial stability and to reduce recourse to taxpayers' money, avoiding replicating the scenario seen during the first stage of the crisis. The directive followed a Commission proposal in June 2012. The European Parliament and the Member States reached an agreement on 11 December 2013. These new rules, which entered into force on 1st January 2015, established that the costs of bank failure will in the first instance be borne by bank shareholders and creditors, according to a clearly defined hierarchy, and thereafter met from dedicated resolution funds held by each member state.

Progress on achieving a banking union

Common bank supervision

A European single supervisor (SSM) became operational in November 2014 (see section on "Background to financial supervision in Europe"). Under the SSM, responsibility for bank supervision in the euro area was shifted from national authorities to the European Central Bank. The ECB is in charge of supervising "systemically important" banks directly (equal to more than 80 percent of euro-area banking assets, including banks with over €30 billion in assets or 20 percent of national GDP, or "if otherwise deemed systemic"). National authorities will continue to supervise smaller financial institutions.[11] The latter arrangement was essentially a political one, championed by some member states – Germany primarily – wanting to keep direct monitoring of "local" institutions. The federal approach that emerged in a concession to local banks' lobbies highlights how banks' management in some countries cultured a strict affiliation with the political establishment and local electorate (Valiante, 2015), largely through "not-for-profit" credit institutions such as foundations (e.g., the Spanish Cajas, the German Landesbanken). Overall, however, while smaller banks were *de jure* exempted from direct SSM supervision, the €30 billion threshold has *de facto* left the majority of the Eurozone banking assets under the SSM's umbrella – including almost all German Landesbanken (Posen and Véron, 2014). Furthermore, the ECB will set and monitor supervisory standards and work closely with the national competent authorities for these banks, with the option of expanding its remit and supervising them directly in order to ensure that SSM standards are applied consistently (ECB, 2015).

To conclude, while the design of a common bank supervisor is far from faultless, given the challenge to financial stability small financial institutions may pose,[12] these challenges in terms of supervision are for the moment not large. The current SSM design represents an adequate compromise given the existing trade-off between political feasibility and economic "first-best" in Europe. In addition, achieving a truly single market in banking services will possibly require more time than a couple of years, with further supervisory initiatives, as well as regulatory and legislative steps, having to be adopted in the future (see also Schoenmaker and Véron, 2016).

A Single Resolution Mechanism

The Single Resolution Mechanism (SRM) was first proposed by the European Commission in July 2013. This mechanism came to complement the Single Supervisory Mechanism (SSM) as of 1 January 2015. Countries

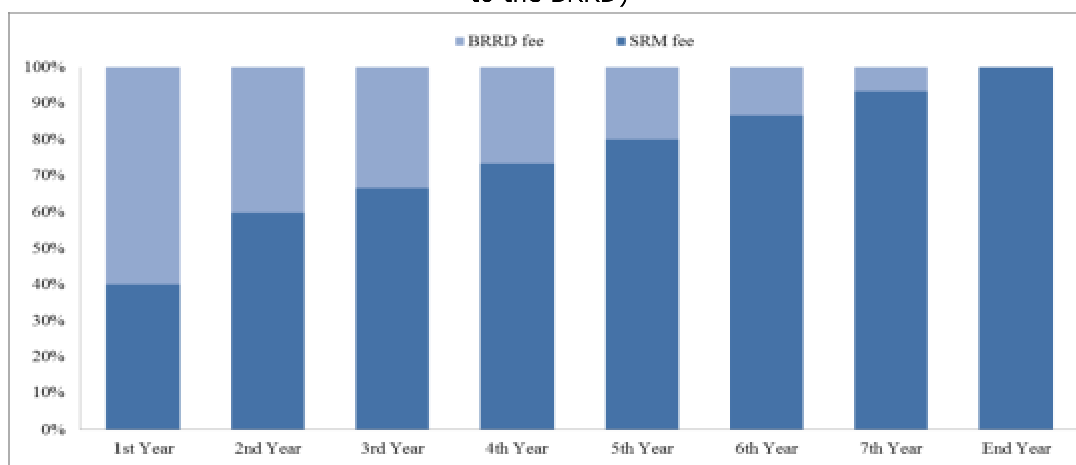
[11] In September 2014, the ECB published the list of significant supervised entities. The latest release (31 May 2016) with change in significance for some banks is published here https://www.bankingsupervision.europa.eu/ecb/pub/pdf/list_of_supervised_entities_20160331.en.pdf?54830cfdd60d51025d0fd0716d4376e2.

[12] It is worth noticing that the majority of "local" banks in the EMU are concentrated in Germany, and, to a lesser extent, Austria and Italy; see Véron's blog entry on Bruegel "Europe's Single Supervisory Mechanism: Most small banks are German (and Austrian and Italian)" 22 September 2014.

joining the SSM are to join the SRM too, which means the SRM applies to banks in the euro area member states under the SSM, plus those EU countries wishing to opt-in. The SRM is built on the national resolution authorities established by the BRRD. The Single Resolution Mechanism aims to ensure that if – despite SSM supervision – a bank faces serious difficulties, its resolution would be managed in a centralized manner, with minimal cost to taxpayers and the real economy; which is one of the focal points of BU.

The SRM consists of a resolution authority (or Single Resolution Board – SRB) and a Single Resolution Fund (SRF). The SRB became operational in January 2015, but it started to work at full capacity one year later, on 1 January 2016, the date when the SRF was also on the schedule. The Finance Ministers of the Member States have decided to keep some elements of the functioning of the future Single Resolution Fund in the form of an intergovernmental agreement, which complements the SRM regulation. According to the terms of reference of the agreement, the Fund is to be financed by bank levies raised at the national level. As a general rule, banks taking higher risks will pay higher contributions. Contributions, initially consisting of national compartments, which will be progressively mutualized and eventually merged into a single Fund administrated by the Board, start with 40% of resources in the first year. National compartments would cease to exist when the Fund reaches the target funding level of 1% of covered deposits in the participating member states or after an eight-year transitional period – i.e. by 2024.

Figure 2: Evolution of phasing-in (-out) of contributions to SRF (from national target levels in accordance to the BRRD)



Source: ECB's (2015) data

Under the SRM Regulation, the SRB is required to calculate the contribution from each individual bank to the SRF each year.[13] The establishment of the SRF will thus entail a shift from national to European resolution, which has the implication that each Member State's banking sector will progressively contribute more to the European resolution fund with respect to what they will be contributing to the national fund under the BRRD. This is summarized in Figure 2.

The SRF has an overall target level of €55 billion. While this amount may seem little in principle – given the need to signal to the markets that a reliable backstop exists (see also Macchiarelli, 2014; Gros and Schoenmaker, 2014) – one should consider that the Fund has been given the ability to borrow directly from the market, if decided by the Board (ECB, 2015); the terms and conditions of which have not been disclosed yet. Secondly, explicit provisions for bailing-in exist, as detailed by the revised BRRD.[14] Bailing-in would apply

[13] Contributions are determined by applying the method detailed in a Commission delegated act and the specifications provided for in a Council implementing act, adopted respectively on 21 October and 19 December 2014.
[14] Single Resolution Fund's website, https://srb.europa.eu/en/content/bail (accessed August 2016).

until at least 8% of banks' total assets had been used. After this threshold, the resolution authority may grant the bank the right to use the resolution fund, up to a maximum of 5% the bank's total assets.[15]

Bank contributions to the Single Resolution Fund began in January 2016. However, a plan on bridge financing was put in place in the context of the Five Presidents' Report (see Juncker et al., 2015), in order to avoid a situation in which the SRF would run out of monies while bank contributions were being consolidated. The agreement, which was reached by the Council of Ministers in December 2015, introduced public support through the establishing of national credit lines that would provide a loan to the SRF in the case of capital shortfalls before 2024. As well as providing support where needed, the establishment of credit lines is intended to enhance the standing of the SRF. Importantly, a common backstop to the SRF itself should follow before the end of the transitional period, as a last resort measure, in order to ensure the durability of the BU project as a whole, as the Five Presidents' Report also recognizes (see Juncker et al., 2015).[16] This will be difficult to achieve short-term as it will require a more far-reaching fiscal agreement among the member states (for an extended discussion see Section on "Banking Union and fiscal backstops").

Banking union and fiscal backstops

While it is widely recognized that the proposals and reached compromises to deal with deposit insurance and resolution represent an exceptional step forward, many member states underscore that a well-functioning BU will require an unlimited burden-sharing mechanism, where fiscal authorities have to be involved. As highlighted above, the current design of the Banking Union still leaves a role for an intergovernmental agreement, particularly in deciding the role and functioning of the future Single Resolution Fund – as a complement to the SRM regulation – before its final consolidation by 2024. Furthermore, the Commission's deposit insurance mechanism (EDIS) is still on the negotiating table. Hence, the stage in the governance framework that is lacking is the fiscal backstop.

The existing national DGSs and resolution funds – before a common backstop is created – may quickly run out of money and need last-resort support from sovereigns. This, however, was at the origin of the so-called "doom-loop" pushing even countries with a sound fiscal record into a wrecking spiral, as the cases of Ireland and Spain show. Should this be the case, the sovereign will then need a backstop itself. In Figure 4 (a) and (b) we have used the "doom-loop" representation of Figure 1 to summarize this discussion. The Figure particularly compares (a) the current state of the BU, with a representation of (b) the fully-fledged BU in the context of the GEMU.

The current state of the BU is an incomplete banking union which could create coordination failures and be costly overall (Posner and Véron, 2014). As mentioned above, leaving resolution funding and safety nets predominantly at the national level or, equally, limiting the BU's "federal" reach and burden-sharing capacity, would mean perpetuating the bank-sovereign doom-loop; which is what the BU is intended to break. Alternative arrangements exist but it remains to be asked whether those are convincing.

Figure 1(a) highlights a role for the European Stability Mechanism (ESM), as a last resort support. The ESM was primarily created with the purpose of providing a fiscal backstop for member countries and (more recently) their banking systems. However, the stability of banking systems can be assured only if investors know that such a backstop is not limited *ex-ante*. This is why many commentators have defined the ESM as a "poor surrogate" of a last-resort lender (De Grauwe, 2011). The main reason why the European banking sector needs a common backstop is fundamentally *macro*economic and has to do with the very nature of systemic risk (Gros and Schoenmaker, 2014; see also Allen *et al*., 2011). Once all of the above is in place (SRF plus EDIS), in the great majority of cases, no public support will be needed. But in exceptional circumstances,

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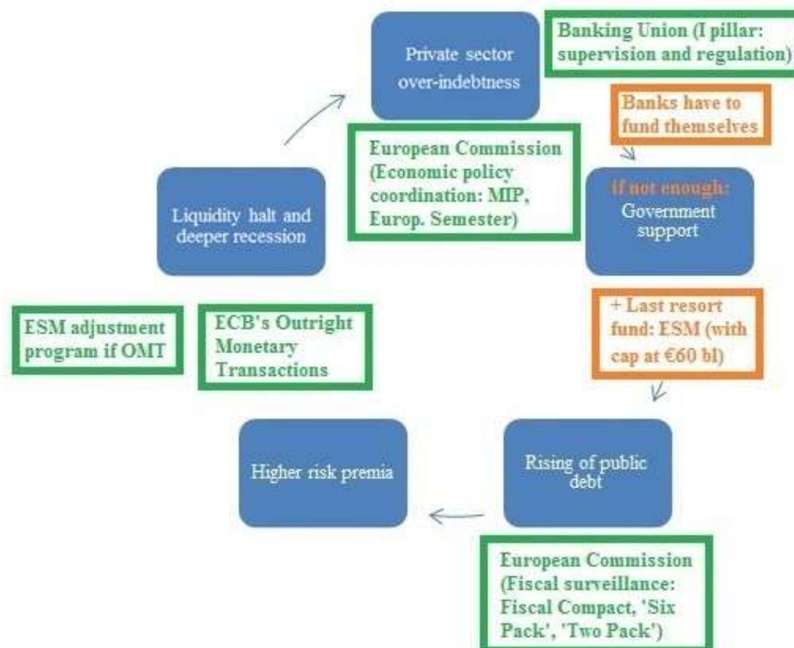
[15] Some have observed how the actual procedures for bailing-in may not only risk cut credit in already fragile economies, but could also reduce the willingness of lenders to extend new credit, having overall a negative effect on the financial conditions of that country.

[16] See also Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, "Towards the completion of the Banking Union" COM (2015) 587. Available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52015DC0587.

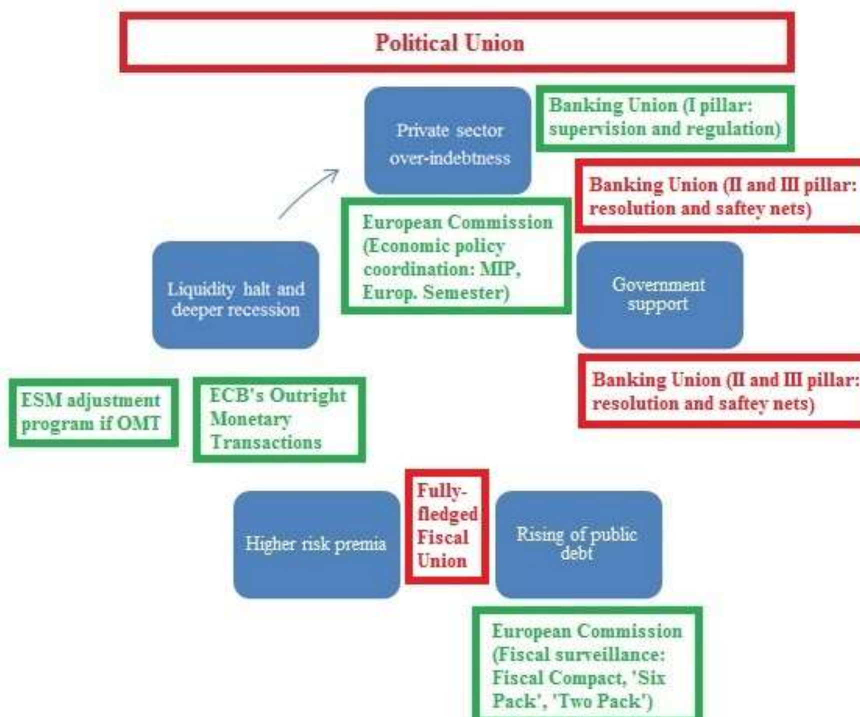
for relatively large shocks, additional resources might be necessary, and clear arrangements on backstops should be made. Thus, the stability of banking systems can be assured only if investors know that such a European backstop exists, and the current ESM capacity can hardly be credible (see also Gros and Schoenmaker, 2014).

Figure 4: The European Banking Union

(a) Current state of the European Banking Union



(b) The European Banking Union in the context of the GEMU - in theory



Note: The pictures include the main reforms of the European economic governance framework already in place (green); measures to be adopted during the transition to a BU (orange), and measures not yet in place (red). They do not consider measures which are temporary in nature such as unconventional monetary policy.

Secondly, there are agency costs to consider as the ECB/SSM may itself be trapped in a fiscal dominance game (see also Goodhart and Schoenmaker, 1995; European Parliament, 2012). The existence of a transition period before the SRM and the EDIS (whose deadlines for full functioning are aligned) makes it possible that, until resources are fully mutualised, the SSM will have an incentive to offload the fiscal cost of any problem to national authorities if it thinks that any given bank is insolvent and needs to be restructured or closed down. The SSM would do this on the basis of its comprehensive assessment of the viability of the bank and any danger it might constitute for financial stability. By contrast, national authorities in charge of bank restructuring would have a tendency to minimize their own costs by keeping the bank (even if illiquid) solvent through ECB support. This leaves some "shaded areas" in the crisis management capacity of the BU (ECB, 2015), with this type of conflict being prevalent between now and the start of the new system, when mutualisation is low. The end game would be accelerating the process of consolidation of European deposits' insurance and resolutions schemes, thus minimizing potential costs and avoiding providing the SSM and national authorities with the wrong incentives.[17]

The nature of fiscal backstops beyond resolution and safety nets will be a crucial issue to define in the coming years.

Safety nets

Authorities are now equipped with a broad set of tools to ensure that the costs of bank failure will, in the first instance, be allocated to bank shareholders and creditors following a clearly defined hierarchy (bailing-in), and only later involve dedicated resolution funds held at the national level (bailing-out).[18] Particularly, as far as deposit protection goes:

- Citizens' covered deposits up to €100.000, representing about 48.6% (47.3%) of total euro area (EU) deposits, will be exempt from any loss. This number goes up to 70.9% (66%) for the euro area (EU) if the eligible over total deposits' ratio is considered.[19]
- Deposits of natural persons and SMEs above €100.000 will benefit from preferential treatment (they will not suffer any losses before other unsecured creditors do).

The Deposit Guarantee Schemes Directive (DGSD), which was transposed by the member states into national law in July 2015, concentrated on harmonizing existing national deposit guarantee schemes without any common funding element. While regulators agreed to an increase in the minimum coverage of insured deposits from 20.000 to 100.000 euros and an increase in the speed of repayment for insured depositors, the most worrying gap is that of the unification of deposit insurance within the banking union.

In November of 2015, the Commission put forward a legislative proposal to fill in this gap, i.e. a European deposit insurance scheme (EDIS), taking a concrete step towards completing the third leg of the Banking Union. This is a very significant proposal, as the absence of a Union's deposit guarantee that could credibly back it underscores the dangers of incompleteness indeed. A DGS funded at the European level would, in this case, make a material difference because it would provide an external loss absorption device that will be independent of the fiscal position of that sovereign (Posen and Véron, 2014). Yet, the EDIS has to be approved, and it is currently stalling owing to political opposition.

The DGSD stipulates new thresholds for the financing of the national Deposit Guarantee Scheme (DGS), notably by requiring a significant level of *ex ante* funding (0.8% of covered deposits – or, where viable, a target level of 0.5% of covered deposits for highly concentrated banking systems) to be built up by 2024 by each Member State. By that date, the Commission's proposal envisages resources will be mutualised in the European deposit insurance scheme. With the EDIS, the protection of deposits would be fully guaranteed at the European level, supported by close cooperation with national DGSs (Figure 3). Given that national DGSs

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[17] Other inter-agency conflicts and fiscal dominance may arise in the context of keeping two different coffers for European deposit insurance and resolution, respectively (for an extended discussion see Gros and Schoenmaker, 2014).

[18] Higher coverage will be granted for deposits related to certain transactions (e.g. real estate transactions and payment of insurance benefits). See ECB (2015).

[19] Author's computation from Cannas *et al.* (2014) data.

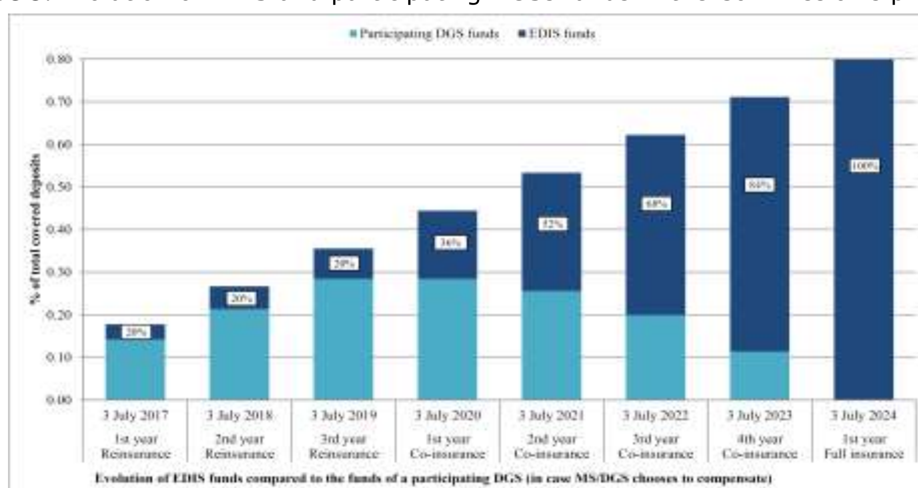
may remain vulnerable to idiosyncratic shocks, the purpose of EDIS would be to ensure equal protection of deposits in a centralized manner.

In the period elapsing between now and the EDIS, harmonized national deposit guarantee schemes will be necessary, meaning that the member states concerned by a particular resolution plan will have to provide bridge financing from national sources (see ECB, 2015). Particularly, in case capital shortfalls are identified, the Council clarified on 15 November 2013 the order of the backstops. In the case of insufficient *ex-ante* funds, the DGS must collect *ex-post* contributions from the banking sector. Exceptional contributions should not exceed 0.5% of covered deposits per year. In a first instance, banks will thus have to raise capital in the market or raise capital from another private source. Should this not be sufficient, public money could be engaged at the national level in line with State aid rules and, if needed, through the provision of public backstops. Here, the DGS may have access to alternative funding arrangements, such as loans from public or private third parties. The DGSD also establishes a voluntary mechanism of mutual borrowing between DGSs from different EU countries (see ECB, 2015), the viability of which still has to be tested, particularly given the possibly competing interests of debtor and creditor countries.

Should national backstops not be sufficient, instruments at the European level may finally be enabled, including the ESM, consistent with the ESM's agreed procedures. On the latter point, the Eurogroup agreed that the ESM would have the possibility to recapitalise "systemic and viable" banks directly, with a maximum exposure for direct bank recapitalisations capped at €60 billion (equal to 12% of the ESM's maximum lending capacity).

Given the uncertainty about the full viability of the project in the medium to long term, information to markets and depositors should be prepared and coordinated.

Figure 3: Evolution of EDIS and participating DGSs funds in the Commission's proposal



Source: European Commission's website - European deposit insurance scheme

Managing "the outs"

One issue with the current approach to the European BU is that it minimizes the importance of cross-border externalities of bank failures across the EU. Given the skewed design of the BU towards the euro area Member States, the problem of funding is likely to be more severe when it involves guarantees to or resolution of banks which are systemic in both euro area and EU-non-euro area countries. For that reason, some of the 'outs' may make use of their option to opt-in to BU going forward (Gros and Schoenmaker, 2014), provided that European resolution and deposit insurance schemes will be available. In this respect, the UK's vote to stay out of the EU will leave both the EU and the UK in uncharted waters, given the large presence of important European banks in London, and in the absence of clear rules on cross-border banking supervision and resolution under the BU across EU and non-EU member states.

Final remarks

A European banking union centered on the idea of single supervision, single resolution, and a common deposit insurance system may be the most far-reaching reform to date since the inception of the euro (Constâncio, 2013), if successful. Overall, however, the political resistance of creditor countries may restrain the effectiveness of crucial elements of the banking union such as resolution and safety nets. A credible banking union would entail moving responsibility for potential financial support from the national to the supranational level, implying transfer of resources and risk, and, henceforth, requiring an explicit agreement on fiscal European support in the longer term. The latter agreement is a necessary step in the broader context of the European governance framework (see Genuine Economic and Monetary Union), in particular in achieving long-term "sustainability" (see also Pisani-Ferri, 2012; Gros and Schoenmaker, 2014; Posner and Véron, 2014; Schoenmaker and Véron, 2016). For the time being, political resistance mainly focuses on the issue of permanent and unlimited vs. temporary and limited burden-sharing, leading to a "small steps" approach.

An incomplete banking union can create coordination failures and can be costly overall (Posner and Véron, 2014). An incomplete union can be interpreted in two ways. One is that it is a sequence in which much remains to be settled, but with reasonable clarity about the eventual destination. In this interpretation, the principal policy challenges will be how to manage the transition until 2024. The alternative explanation is that political resistance to burden-sharing will mean that only an incomplete banking union can be attained in fact. As mentioned above, leaving resolution funding and safety nets predominantly at the national level – i.e. the current state of the BU – or, equally, limiting the BU's "federal" reach and burden-sharing capacity, would mean perpetuating the bank-sovereign doom-loop; which is what the BU is intended to break. The nature of fiscal backstops beyond resolution and safety nets will be a crucial issue to define in the coming years.

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