The European Banking Union: Disrupting The Doom Loop?

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Experience gained over the past few years has painfully illustrated that the European financial system was and likely still is insufficiently robust to overcome a debt crisis. Attributed to the allegedly devastating spillover effects of a collapse, ailing banks were regularly bailed-out with taxpayers' money. This, in turn, made several countries experience refinancing struggles; eventually losing access to international money and capital markets. In an attempt to disrupt this vicious circle, policymakers have agreed upon the introduction of a banking union, which in its current form still displays several weaknesses, among them the incomplete privatisation and hence ongoing socialisation of losses. Paradoxically, only the next crisis will be decisive for the European banking union's success.

Keywords: financial crisis, banking union, liability cascade, single supervisory mechanism, TLAC

Doom Loop Threatening Banks – And Economies Alike

Experience gained over the past few years has painfully illustrated that the European financial system is insufficiently robust to overcome a debt crisis. Collapsing banks and stumbling economies, which, while trying to support ailing institutions with taxpayers' money, lost access to international money and capital markets and suddenly require financial support themselves, emphasise these dramatic dynamics. Despite recent measures such as establishing the EFSF or ESM, among others, this doom loop remains highly problematic and has thus far only been insufficiently addressed (The Economist, 2014).

Disrupting this doom loop is critically important for several reasons. On the one hand, collapsing credit institutions as could be observed in Spain, for example, posed a considerable threat to a country's fiscal stability or, as was the case in Ireland, among others, might even result in a country losing access to international money and capital markets. On the other hand, as was the case in Greece, for example, a country's mounting budget deficit and the market's subsequent loss of confidence can threaten the financial institutions' existence due to their investment in the very government bonds. As an exemplification: between October 2008 and 2011 EU member states approved as much as €5,080bn of bank aid; a volume which corresponds to more than 40% of the 2011 EU member states' gross domestic product (GDP). Thereof, a total of €1,610bn or more than 12% of GDP was actually used; €473bn alone for bank recapitalisation measures. On a national level, German banks were granted a total support of €646bn (25% of GDP) of which €259bn (10% of GDP) were drawn on (German Council of Economic Experts, 2014; European Commission, 2011). Based on preliminary estimates, German taxpayers might face costs of as much as €50bn just related to bank bailouts.

In this context, the European banking union's priority objective, i.e. the intention to protect taxpayers from being held financially liable for ailing banks as laid out in Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 (European Parliament (2014b), is a step into the right direction – but in its current form – still displays several weaknesses.

Disrupting the Doom Loop: Banking Union as Response to Debt Crisis

In response to the ongoing economic and financial crisis, EU member states have started fundamentally reforming European financial architecture by means of a single banking union. The range of this long disputed, political compromise and the related transfer of the respective national to a European banking supervision is often considered to be the most ambitious integration project since the introduction of the common currency in 1999 (Deutsche Bundesbank, 2014). The European Commission's original plans for a single European banking supervision date back to the bankruptcy of

US-investment bank Lehman Brothers in autumn 2008 but were first met with reservation on behalf of some EU member states which opposed any transfer of national supervisory competences. Among the more controversial issues (Deutsche Bundesbank, 2014) that had to be resolved first were questions concerning

- who decides when a bank is insolvent and needs to be wound down?
- who covers the costs related to a potential wind-down?
- how will potential losses be split?

In its current form the European banking union features parallels to the Basle-III-framework, particularly to the Capital Requirements Directive IV (CRD). This foresees that starting in 2015 and applicable for many years to come, banks will have to increase both quality and quantity of their equity as well as the volume of liquid, available-for-sale assets. At the same time, the European Central Bank (ECB) will initiate a three-stage assessment process. An evaluation of global systemic financial institutions shall improve transparency regarding the banks' risk situation in an attempt to regain and enhance market confidence.

Three-Stage Assessment Process in the Run-Up to the Banking Union

Ahead of the banking union's single supervisory mechanism a comprehensive assessment, i.e. an analysis of the euro area's financial institutions was conducted among 124 European banks. The procedure, which comprises risk assessment, balance sheet assessment and a stress test, was conducted in cooperation which the European Banking Authority (EBA) and began in November 2013 (European Central Bank, 2014b).

Starting point of the comprehensive assessment is, after 2010 and 2011, yet another stress test whose methodology and underlying economic scenario was presented by the EBA in April 2014. The test is mainly based on an assessment of the banks' asset quality, the so-called asset quality review (AQR). Principal objective of assessing the largest European banks' capacity to withstand external shocks such as an economic slump, for example, is the early identification of the banking sector's potential vulnerabilities in an attempt to adopt countermeasures as soon as possible.

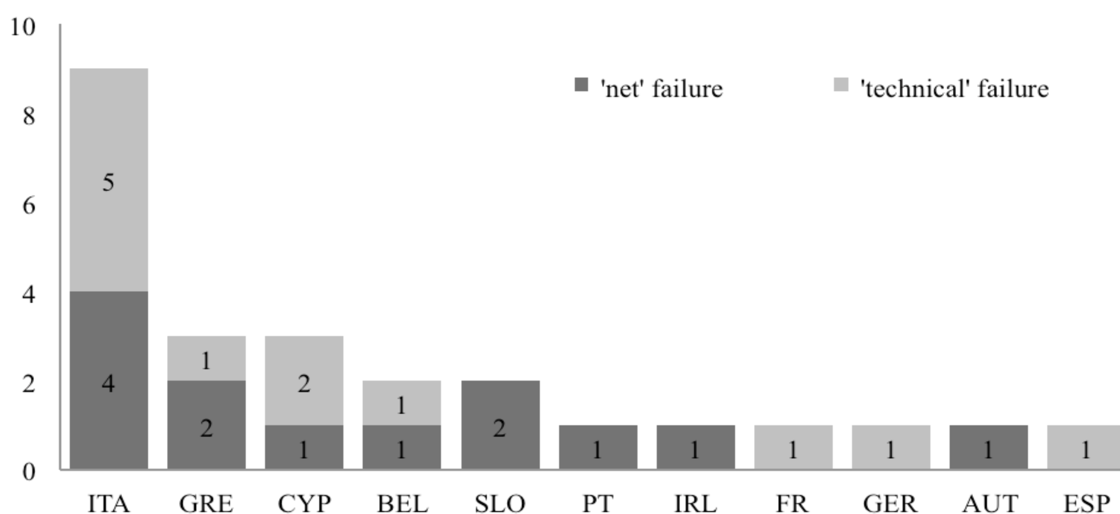

Figure 1: Bank failures according to 2014 stress test
Source: ECB, 2014

Within the scope of the stress test, global systemic banks will demonstrate how their core tier 1 capital will develop under certain assumptions over a three-year period. In addition to the base scenario, which is based on estimates on behalf of the European Commission and foresees a EU GDP growth of 1.5% y/y, 2.0% y/y and 1.8% y/y, respectively, in between 2014 and 2016, several different risks will be assessed, among them a cumulated GDP contraction of 2.2% y/y, 5.5% y/y and 7.0% y/y, respectively, in between 2014 and 2016. This scenario is accompanied by a marked increase in the unemployment rate. Furthermore, the stress test includes a rise in the non-performing loan (NPL) ratio, pronounced market price fluctuations (assuming a stock market crash of 19% and a 15% slump in real estate prices, respectively) as well as risks associated to securitizations, country and general financing risks (European Systemic Risk Board, 2014 and European Banking Authority, 2014).

In late October 2014, the results of the stress test were published. Across the euro area, some 25 banks emerged with capital shortfalls following the stress test, whose total shortfall (before capital raised in 2014) amounted to €24.6bn. Yet, twelve of the 25 failures were ‘technical’ failures as banks had already raised money after the December 2013 cut-off date (Figure 1). The remaining 13 banks were subject to a ‘net’ failure, i.e. they featured a capital shortfall and had to raise an aggregate €9.5bn in capital (ECB, 2014).

The Pillars of the European Banking Union

After the experience gained in the past few years, the European banking union’s priority objective is to protect taxpayers from being held financially liable for ailing banks. For this purpose, the banking union rests on three pillars, a single supervisory mechanism, a single resolution mechanism and a single deposit protection fund, which, however, is currently excluded from further discussions (Figure 2).

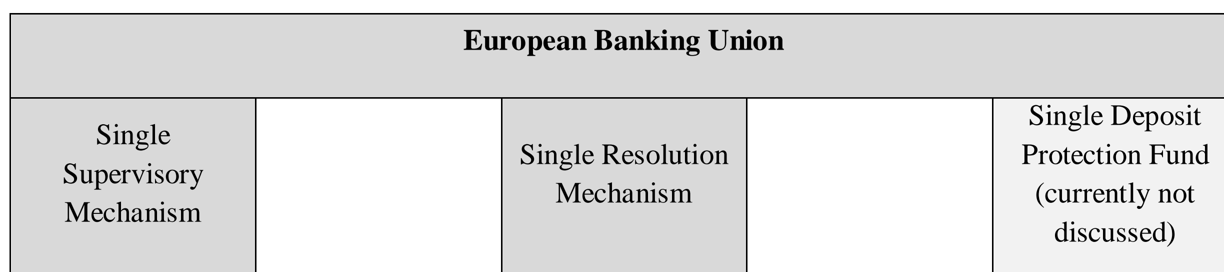

Figure 2: Pillars of the European banking union
Source: Dierks (2014)

Single Supervisory Mechanism

In November 2013, the legal framework for the single supervisory mechanism, the SSM, which consists of the ECB and the national supervisory authorities of the European Monetary Union’s (EMU) member states, came into effect. This marked the start of a twelve months transition phase after which, i.e. in November 2014, the ECB will assume full responsibility for the euro area’s banking supervision. In practise, however, the ECB will continue to be supported by the respective national supervisory authorities, including national central banks, which, in cooperation with a supervisory authority, will continue to be responsible for the national banking supervision.

For the time being, the ECB’s main focus will be on institutions whose total assets exceed €30bn or 20% of a country’s gross domestic process (GDP). Currently, this applies to 128 of roughly 6.000 institutions, thereof 24 in Germany. In case these criteria are not met, e.g. in Malta, the ECB will monitor a country’s three largest institution (in total assets).
The responsibility for financial institutions with a lower volume of total assets (and thus less systemic importance) will remain with national authorities. These realize their duties and responsibilities

according to the ECB's regulations and instructions. As a result of this procedure, banking supervision within the scope of the single supervisory mechanism will be increasingly harmonised.

Single Resolution Mechanism (SRM)

The banking union's second pillar is the single resolution mechanism (SRM), which largely implements the EU's common rulebook's Bank Recovery and Resolution Directive (BRRD). The priority objective is to efficiently wind-down banks at a minimal cost for European taxpayers on the basis of two legal instruments, a by-law regarding the single resolution mechanism, SRM, which covers the mechanism's major aspects and an intergovernmental agreement regarding specific aspects of the single resolution fund, SRF.

Single Resolution Board (SRB)

The European Parliament adopted the SRM, which consists of two elements, the Single Resolution Board (SRB), based in Brussels, and the Single Resolution Fund (SRF), in April 2014. The objective of these measures is to ensure, in future, the use of a common rulebook for distressed banks in the euro area as well as developing effective procedures for dealing with bank insolvencies, thereby minimising costs for taxpayers and the economy. The SRM applies to all 18 euro area countries. Member states, which do not belong to the euro area, may join on a voluntary basis, however (Bundesbank, 2014).

The by-law governing the SRM, which is based on the BRRD, will come into effect on January 1, 2015. It foresees that any decision-making regarding the winding-down of financial institutions will be transferred to a European level. In case of institutions being directly supervised by the ECB or those with cross-border operations, the Single Resolution Board will be responsible for providing wind-down plans as well as overseeing an eventual wind-down (European Central Bank, 2014a). The Single Resolution Board will assure that ailing financial institutions will, regardless of their domicile, be equally treated; if necessary even in opposition to their home country's desire. Further, each bank has to provide an emergency plan, the living will, which are supposed to show how the entities could be wound down without causing undue disruption.

In case of default of a financial institution, the ECB will inform the Single Resolution Board, the European Commission, the national supervisory authorities (e.g. in Germany the Federal Financial Supervisory Authority, BaFin) as well as the responsible ministries. Then, the Single Supervisory Board would assess the extent to which the default constitutes a systemic threat and whether a private solution, i.e. a merger or acquisition, is feasible. Provided no such private solution can be realised, the Single Resolution Board will establish a wind-down concept including details regarding the instruments of choice and the SRF's role. Ultimately, the European Commission has to approve.

Any financial support for a wind-down of an ailing institution on behalf of a national government has to be approved by the European Commission before the Single Resolution Board can ultimately approve the concept. Furthermore, the process of decision-making is to be simplified to the extent that in case of emergency, the wind-down of a bank can occur over the course of a weekend, i.e. in the period between the closure of the New York Stock Exchange on a Friday night and the markets' re-opening in Tokyo on a Monday morning.

In case of banks exclusively operating on a national level and thus not being subject to ECB supervision, decision-making will remain with national authorities, provided no SRF funds are used in the case of a wind-down. Still, member-states can opt to transfer the imminent responsibilities for all domestic banks to the Single Resolution Board. Generally, the Single Resolution Board will always assume responsibilities in case the wind-down of a bank requires the use of means paid into the SRF – even in case a bank is not per se subject to ECB supervision (European Commission, 2014).

Single Resolution Fund (SRF)

Within the superstructure of the SRM, a Single Resolution Fund (SRF) will be created; funded by contributions from all banks domiciled in an SSM member state. Over the course of the next nine years, banks of the 18 euro area member countries will transfer a total of €55bn into the SRF, whose sole owner and administrator is the Single Resolution Board (SRB). According to the Bank Resolution Directive adopted by the European Parliament, the banks of all 28 EU member states need to set up a national resolution fund by 2026, which will ultimately have resources equivalent to one per cent of the respective country's covered deposits. Within the scope of the so-called liability cascade, the banks' shareholders and creditors are to be bailed-in first in case a bank becomes insolvent (Bundesbank, 2014).

In 2015, German institutions, for example, will contribute as much as €15bn, of which as much as 10% (or €1.5bn) and thus a multiple of the hitherto foreseen amount of €600mn annually will be paid-in. In early 2016, the first tranche will be transferred to the SRF. The remainder will be installed in eight equal tranches of which the first is also due in 2016. The criteria upon which the financial participation of individual banks are determined is to be defined before the European Parliament's summer break.

As a result of the communisation, 40% of the funds transferred to the SRF will be made available for all Euro area banks by early 2017. An additional 20% will be added until early 2018. The remaining 40% will be communitised in equal tranches in the six years to follow (European Parliament, 2014a). Further, just like the EFSF, the SRF will have the opportunity to refinance itself on the international money and capital markets in order to enhance its scope – which, especially in the first two years, when merely 60% of the €55bn endowment (i.e. €33bn) is paid in – appears to be comparatively modest.

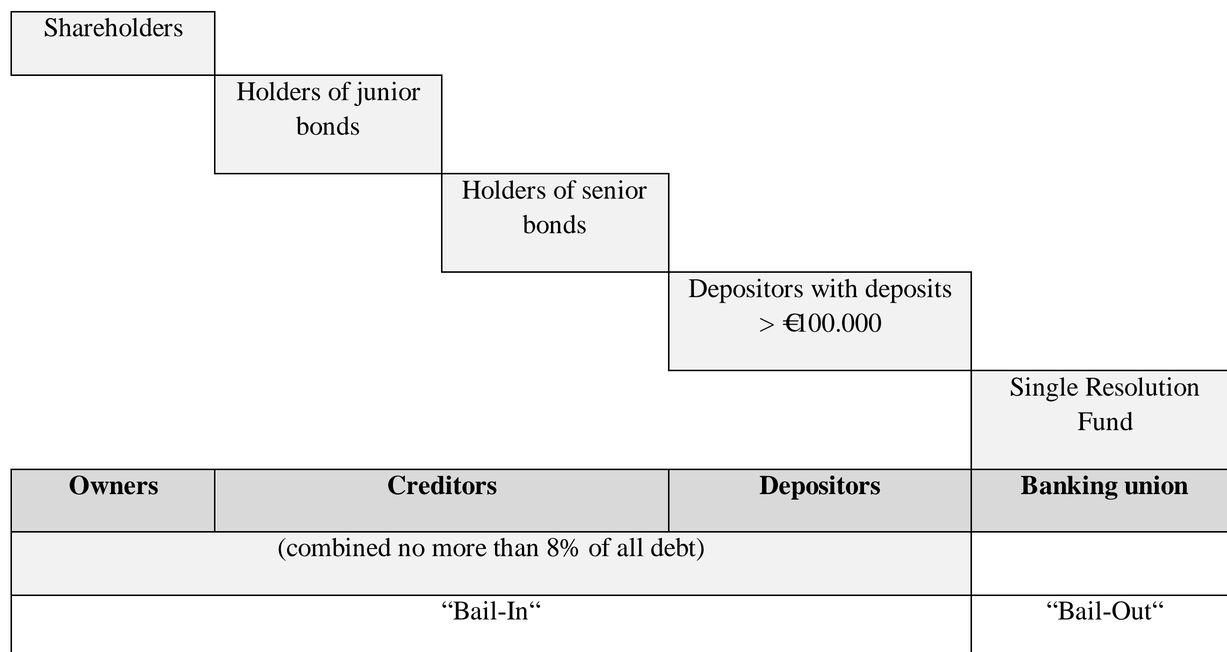

Figure 3: The European banking union's liability cascade
Source: European Parliament (2014b) and Dierks (2014)

The banking union's liability cascade, which will come into effect in January 2016, foresees that in case of distress, shareholders of an ailing financial institution will be held liable for potential financing needs. Only then, in declining order, i.e. depending on the risk taken, creditors will be held liable. First, those holding bonds with subordinated, i.e. junior status, then those holding bonds with

preferential, i.e. senior status. Finally, depositors with deposits exceeding €100.000 will be held liable. Within the scope of the bail-in, shareholders, creditors and depositors together will be held liable for as much as 8% of an institution's total liabilities: "where the losses cannot be passed to other creditors, the resolution financing arrangement may make a contribution to the institution under resolution subject to a number of strict conditions including the requirement that losses totalling not less than 8 % of total liabilities including own funds have already been absorbed" (European Parliament, 2014b). Only in case this proves to be insufficient, SRF funds will be made available within the scope of a bail-out (Figure 3).

Single Deposit Protection Fund

There are currently no plans to create a single deposit guarantee scheme within the scope of the European banking union. Still, this should not belie the fact that demands have not been forgotten – but merely been postponed.

In December 2013, the European Council and the European Parliament agreed to further harmonise the national deposit guarantee schemes. In March 2014, EU-wide requirements concerning national deposit guarantee schemes were adopted. These are based on the principle governing Germany since 2011, which foresees that customer deposits are protected up to a maximum amount of €100.000. In the case of an ailing bank, the member state will guarantee the respective amount within seven days. If not yet the case, member states will create own customer deposit guarantee schemes to safeguard their guarantees. The customer deposit guarantee fund will be filled over the course of the next ten years through risk-based contributions on behalf of a country's financial institutions, which, on average, will amount to 0.8% of the deposits held or a total of approximately €60bn.

Having set up own customer deposit protection schemes, German savings and co-operative banks, among others, oppose a single customer deposit insurance, claiming that they cannot be held liable for institutional risk from other euro area member countries.

Recent Developments – Total Loss Absorbing Capacity (TLAC)

More recently, on November 10, 2014, the Financial Stability Board (FSB) proposed a new rule under which the biggest banks will have to hold buffers, the so-called total loss-absorbing capacity (TLAC), equivalent to 16 to 20% of their total assets. This will come in two forms. First, banks need to hold more equity relative to their assets. Second, analogous to the concept of the European banking union, bondholders will be required to absorb losses after shareholders have been held liable. Yet, the TLAC is expected to come into force in 2019 but will only apply to 27 global systemic banks. Smaller lenders are exempted (FSB, 2014, and The Economist, 2014).

Half A Banking Union – But an Entire Paradigm Change

In its current form, the banking union is a step into the right direction as it aims to limit taxpayers' liability for ailing banks. This clearly constitutes a paradigm change, as previously, it was common practise to socialise the financial sector's losses, claiming that the latter would inevitably cause spillover effects onto the real economy. Profits, in contrast, were usually privatised. The liability cascade, whose priority objective is to considerably reduce the taxpayers' liability in case of a bank's default, assumingly has a disciplining impact on the banks' risk appetite, as, in contrast to previous years, they can no longer expect to be bailed-out with taxpayers' money. Still, the banking union does not foresee a complete privatisation of potential losses, i.e. a certain portion will nonetheless be socialised – whilst profits will continue to be privatised. This rather limited deterrent could well trigger further moral hazard, i.e. the closure of potentially risky transactions for which owners, creditors and depositors of a bank are only partially liable.

Even if the liability cascade of the banking union addresses precisely this issue, the hitherto agreed upon measures will prove to be insufficient in case of another financial crisis. Considering the SRF's volume of merely €55bn, scepticism is justified – as ailing European financial institutions required a multiple of this amount since October 2008. This could well be highly problematic during the first eight years, i.e. during the period in which banks still pay into the fund. In early 2018, for example, only €33bn will be available within the scope of the SRF. Under certain conditions, particularly in light of having adopted a stricter capital endowment, this amount might perhaps be sufficient to recapitalise one or two ailing banks in exceptional cases. Still, should more or larger institutions be affected – remember that almost €80bn of federal guarantees were required to wind-down Belgian-French Dexia in a reasonably orderly manner – €55bn will hardly be more than the literal drop in a bucket.

In case owners, creditors and depositors have reached the threshold corresponding to 8% of all debt outstanding and should the SRF's capital be used up, the respective country domiciling the ailing bank will likely again provide support based on taxpayers' money. Should this be impossible, however, e.g. because of the country being overly indebted, the European Stability Mechanism (ESM) might be re-activated (as before).

Further, coordinating more than 100 political, financial and economic decision makers within only 24 hours raises severe concerns regarding the complexity and practicability in the event of a crisis.

When assessing the European banking union, the decision's political dimension should not be underestimated. First, discrepancies could arise as soon as the currently nationally administered tranches (national compartments) within the SRF will be communitised, thereby moving from a national liability for national banks to a single liability in the event of a crisis. In this context, the outcome of an ongoing legal dispute in Germany over whether the banking union in its current shape is consistent with the constitution needs to be carefully monitored. Second, in its current state, the banking union continues to be subject to political influence when deciding whether to wind-down a bank or not. This will be particularly problematic in case of winding-down systemic national champions. Third, several exceptions regarding the bail-in, especially those concerning large corporations, threaten to weaken the liability cascade. Fourth, in light of their market power, the banking union should also include those parts of the financial industry which have so far remained unaffected, among them auditors, rating agencies, pension funds or the hitherto little regulated shadow-banks, e.g. hedge funds or private equity funds.

Policymakers should consider fostering the principle that all economic agents need to fully bear the consequences of their actions. As long as current regulations abet moral hazard, the financial markets' efficient functioning cannot be warranted, as market participants will not necessarily need to assume full responsibility for their actions.

In contrast to the banking union's current concept, any bail-out should be replaced with a complete bail-in. Strictly speaking, there is no reason whatsoever why a bail-in needs to be limited to a combined (random) 8% of an institution's total debt. Clearly, any such liability for owners, creditors and depositors reduces a bank's incentive to engage in overly risky economic activities – but ultimately does not fully preclude it. If, in contrast, banks were solely responsible for their actions, or if the banking union indeed foresaw a mutual responsibility of European banks, i.e. a shared collective fund which would be drawn upon in case of an institution's default, the incentive to take on excessively large financial risks would be significantly reduced; not least due to pressure arising from counterparties which might elsewise incur losses. Any such mechanism, however, does not require policymakers' involvement.

Finally, the European Commission expects that the creation of a banking union will have a positive impact on lending to the real economy (European Commission, 2014). This, however, appears to be questionable as there is no (empirical) evidence whatsoever that the modest pace of bank lending, especially in Southern Europe, is attributed to the absence of a banking union (Dierks, 2013).

In its current form, the European banking union, still incomplete due to the absence of a single customer deposit protection scheme, can only be a first step towards a comprehensive regulation of the financial sector. Still, the respective European supervisory authorities as well as the newly developed supervisory methodology need to prove their worth in practice. Paradoxically, it is the next crisis that will be decisive for the European banking union's success.

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