EU Banking Union: Recipe For Renewed Disaster

Thomas Fazi 1 February 2016

On 1 January 2016 the EU's banking union – an EU-level banking supervision and resolution system – officially came into force. The move to a banking union has been the most significant regulatory outcome of the crisis – 'a change of regime, rather than an act of institutional tinkering', as Christos Hadjiemmanuil of the London School of Economics writes in a comprehensive paper on the topic – and it is widely agreed that 'even in its current incomplete form, [the banking union] is the single biggest structural policy success of the EU since the start of the financial crisis'. A closer look, though, reveals the banking union – as it stands at least – to be simply the latest step in the EU's post-crisis creditor-led path of austerity and asymmetric adjustment and one that could potentially put the final nail in the EMU's coffin by exacerbating core-periphery imbalances and even increasing the risk of banking crises.

In its original intention, the banking union was supposed to 'break the vicious circle between banks and sovereigns' by mutualising the fiscal costs of bank resolution. This was the result of a belated acknowledgement by European decision-makers of the need to relieve individual countries of the fiscal responsibility for bank-rescue operations and put an end to the fragmentation along national lines of banking and monetary conditions (rightly deemed to be one the main causes of sovereign distress in the monetary union). The establishment of a joint public funding mechanism – a so-called common 'fiscal backstop' – for the whole euro area was considered essential for this purpose. The prerequisite for a mutualisation of bailout costs, however, was the centralisation of the responsibility for banking supervision and resolution in the euro area, so as to preclude the externalisation of the fiscal costs of regulatory failure by countries with lax regulatory regimes. Such were the considerations that drove European leaders on 29 June 2012 to explicitly affirm the need to break the 'vicious circle between banks and sovereigns', adding that 'when an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalize banks directly'.

In the course of constructing the banking union, however, something remarkable happened: 'the centralization of supervision was carried out decisively; but in the meantime *its actual premise (that is, the centralization of the fiscal backstop for bank resolution) was all but abandoned*', Christos Hadjiemmanuil writes. Within a year, Germany and its allies had obtained:

1. the exclusion from the banking union of any common deposit insurance scheme;
2. the retention of an effective national veto over the use of common financial resources;
3. the likely exclusion of so-called 'legacy assets' – that is, debts incurred prior to the effective establishment of the banking union – from any recapitalisation scheme, on the basis that this would amount to an *ex post facto* mutualisation of the costs from past national supervisory failures (though the issue remains open);
4. critically, a very strict and inflexible burden-sharing hierarchy aimed at ensuring that (i) the use of public funds in bank resolution would be avoided under all but the most pressing circumstances, and even then kept to a minimum, through a strict bail-in approach; and that (ii) the primary fiscal responsibility for resolution would remain at the national level, with the mutualised fiscal backstop serving as an absolutely last resort.

Bailing In For Distressed Banks

In short, when a bank runs into trouble, existing stakeholders – shareholders, junior creditors and, depending on the circumstances, even senior creditors and depositors with deposits in excess of the guaranteed amount of €100,000 – are required to contribute to the absorption of losses and recapitalisation of the bank through a write-down of their equity and debt claims and/or the conversion of debt claims into equity.

Only then, if the contributions of private parties are not enough – and under very strict conditions – can the Single Resolution Mechanism's (SRM) Single Resolution Fund (SRF) be called into action. Notwithstanding the banking union's problematic burden-sharing cascade (see below), the SRF presents numerous problems in itself. The fund is based on, or augmented by, contributions from the financial sector itself, to be built up gradually over a period of eight years, starting from 1 January 2016. The target level for the SRF's pre-funded financial means has been set at no less than 1 per cent of the deposit-guarantee-covered deposits of all banks authorised in the banking union, amounting to around €55 billion. Unless all unsecured, non-preferred liabilities have been written down in full – an extreme measure that would in itself have serious spillover effects – the SRF's intervention will be capped at 5 per cent of total liabilities. This means that, in the event of a serious banking crisis, the SRF's resources are unlikely to be sufficient (especially during the fund's transitional period).

If a bank remains undercapitalised even after all the aforementioned sources of resolution financing have been exhausted – and even then, under very strict conditions – countries may request the intervention of the existing European permanent bailout fund, the ESM, through its new direct recapitalisation instrument (DRI). The way in which the instrument has been implemented, however, raises doubts as to its practical significance. As Hadjiemmanuil notes, the DRI's rules 'raise significant barriers to the activation of the DRI even in situations where recapitalisation with public funds appears justified'. Most importantly, the country eligibility criterion takes explicitly into account the alternative of indirect bank recapitalisation by the ESM, by way of a loan to the relevant national government; unless this form of assistance is bound to trigger by itself a drastic deterioration of the recipient country's fiscal prospects, it should be preferred over the DRI. In other words, the DRI is only available in situations where a country is unable to finance on its own account a bailout without thereby undermining its fiscal prospects; in all other cases, *the national government must provide itself financial support to the troubled bank(s)*, either by raising the requisite sums in the capital market or, in the worst case, by accessing the ESM for a loan. In the latter case – reliant upon the approval of the Commission, in liaison with the ESM's managing director, the ECB and, wherever appropriate, the IMF – requesting member states will not be spared the troika's dreaded conditionalities, 'including where appropriate those related to the general economic policies of the ESM Member concerned'. In other words, those states whose banks (not governments) run into trouble and thus require financial assistance by the ESM will likely be forced to implement the same kinds of austerity and structural adjustment programme – public-sector cuts, wage reductions and so on – as the recipients of sovereign loans have been forced to implement in recent years.

Oddly, even in the unlikely event that a bank is granted access to the DRI, before it can receive direct injections from the shared fund, the requesting government must either provide the capital needed to raise the bank's minimum capital ratio to 4.5 per cent of its assets, or if the institution already meets the capital ratio, make a contribution ranging between 10 and 20 per cent of the ESM contribution. As noted by Hadjiemmanuil, what this means is that under the present arrangements, *national governments will be saddled with the primary financial responsibility in relation to publicly assisted bank bailouts*.

Too Big To Bail

More in general, even the IMF has openly expressed doubts about the planned backstop, noting that 'centralized resolution resources may not be sufficient to handle stress in large banks'. The overall amount that the ESM will be allowed to disburse for all bank recapitalisation has been capped at a

relatively puny €60 billion (though the limit is allegedly flexible), more or less the same amount expected to be raised through the privately funded SRM. Though a large sum, it is a drop in the ocean compared with the balance sheets of Europe's massive banks. To get an idea, the average balance sheets of the EU's 30 and 15 largest banks (€800 billion and €1.3 trillion respectively) are 13 and 21 times larger than the proposed recapitalisation limit. Not only are these banks too big to fail – *they are too big to bail*. The failure of any of them – even assuming that it would take place in isolation, rather than as part of a wider systemic crisis – would require the mobilisation of huge financial resources. This is also proven by the recent crisis, with certain large banks receiving public assistance in excess of €100 billion.

With all this in mind, one could still argue that the bail-in mechanism represents a step forward vis-à-vis the bailouts of recent years, by limiting the burden placed on sovereigns and thus the 'socialisation' of banking crises. The bail-in is indeed a great tool to have at one's disposal, as there are undoubtedly numerous cases where it might be preferable to a bailout. But this has to be decided *on a case-by-case basis*. The problems arise when member states are *forced* to resort to the bail-in as the primary method of bank resolution, regardless of the potential consequences of such a move, of the nature of the bank's problems, of the wider macroeconomic context, etc. – which is precisely what the banking union prescribes. This is especially true in light of the extreme disequilibrium between banking systems in the EU, itself a reflection of the wider social and macroeconomic imbalances between core and periphery countries. As the ECB's recent stress tests have revealed, the banks with the largest capital shortfalls are all located in periphery countries, hit the hardest by the crisis: Italy, Greece, Portugal, Ireland and Cyprus. This is not surprising: various studies have shown that there is a clear pro-cyclical link between a country's negative macroeconomic performance and the capital adequacy of its banks. This is evident from the dizzying and rapidly-growing volume of non-performing loans (NPLs) in these countries – a direct result of the austerity policies pursued in recent years and, of course, the main reason why periphery banks failed the ECB's stress tests.

Italian Bad Banking

Which leads us to the paradoxical situation in which Italy finds itself today. The country's banks fared relatively well during the financial crisis and therefore didn't require almost any government aid at the time; since then, due to the country's unprecedented socioeconomic collapse as a result of EU-sanctioned austerity, the balance sheets of Italian banks have severely deteriorated, and today – after a seven-year-long build-up of non-performing loans – they are facing a system-wide crisis. For this reason, the Italian government has been in talks with the Commission for months over its plan to create a 'bad bank' to help offload some of the banks' bad debt; at the time of writing, though, the Commission – the same Commission that by mid-2009 had approved €3 trillion in guarantee umbrellas, risk shields and recapitalisation measures to bail out Europe's banks – has finally agreed to give the green light to the government's debt-guarantee plan 'so long as it does not violate state aid rules', which is likely to render it utterly useless (Italian bank stocks crashed upon news of the 'deal'). At best, it will amount to little more than a Band-Aid, and one that the Commission is unlikely to grant to other countries.

As a result, Italy – and any other country that faces a similar situation – will have little choice in dealing with its ailing banks other than to (a) force losses on the banks' bondholders – often amounting to small savers/taxpayers, as we have seen in the case of the recent resolution of four medium-sized crisis-hit banks – or (b) to accept a take-over of Italian banks by foreign capital (given the limited availability of national capital). Viewed through the lens of the unresolved inter-capitalist struggle between core-based and periphery-based capital, as argued most notably by Emiliano Brancaccio, we can posit that this will almost certainly lead to an increased 'centralisation' of capital, characterised by a gradual concentration of capital in Germany and the other core euro area countries, through mergers, acquisitions and liquidations, and to the relative 'mezzogiornification' – otherwise known as 'southification' or 'Chinesification' – of the weaker countries of the union. In this sense, *the banking union is likely to*

exacerbate, rather than reduce, the core-periphery imbalances.

The new bail-in rules also make countries susceptible to bank-run-style self-fulfilling panics. There is reason to believe that this process is already underway: by looking at the ECB's TARGET balances, an excellent measure of intra-EMU capital flows, it would appear that periphery countries are experiencing massive capital flight towards core countries, almost on par with 2012 levels. It wouldn't be far-fetched to imagine that this is due to depositors in periphery countries fleeing their banks for fear of looming bail-ins, confiscations, capital controls and bank failures of the kind that we have seen in Greece and Cyprus. Almost eight years on, the European nightmare continues.