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# Which Design for EMU's Missing Crisis Management Pillar?[1]

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The euro crisis has revealed gaps and shortcomings in the original architecture of Europe's Economic and Monetary Union (EMU) that have been partially addressed by the *ad hoc* layering of new rules and instruments and by the creation of the Banking Union in June 2012. The original EMU set up was indeed flawed (De Grauwe, 2013; Giavazzi and Wyplosz, 2015). Maastricht-designed EMU proved to be highly geared towards its monetary pillar, under-developed in its fiscal dimension, over-specified in its battery of rules and under-equipped in its arsenal of crisis management capabilities. Besides, EMU was established on the underlying notion (and one might add, cognitive approach) that all emerging risks potentially threatening EMU's sustainability would come from the fiscal side whose alleged perilous developments were to be contrasted to the proclaimed anchoring power of monetary policy.

As a result, no EU institutions and instruments were in place to deal with risks or vulnerabilities which originated in - or were largely amplified by – the financial sector. As neatly captured by Sapir and Schoenmaker (2017:1): 'there was no common instrument in case a sovereign faced a liquidity or solvency crunch. For banks, there was not even a common instrument for the surveillance of risk, and there was no common instrument in case of a liquidity or solvency crisis. Everything was left in the hands of individual member countries'.

Located at the intersection of Europe's Fiscal and Banking Unions, this analysis focuses on EMU's post-crisis crisis management capabilities. The question that this policy brief aims to provide a first answer to is the following: which institutional form should EMU's banking crisis management backstop take?

The brief is organized as follows: section 1 provides a 'Padoa-Schioppan' framing of the topic of crisis management that distinguishes between three solutions: 'private money solution', 'tax-payer money solution' and 'central bank money solution'. Concentrating on the tax-payer money solution, section 2 enters the core of the argument and claims that a credible crisis management tool is still missing in EMU. Section 3 substantiates the claim further and provides more details on the currently existing backstops. Section 4 suggests new reforms while section 5 concludes.

## 1. What is meant by crisis management?

It is almost impossible to travel back to the early days of EMU in Maastricht without thinking immediately of Tommaso Padoa-Schioppa. A founding father of EMU, and man of vision, he energetically advocated a European supervisory framework, insisted on the constitution of a European payments system and defended an embedded European Central Bank (ECB) which – he feared –

[1] This paper is based on two recent interventions given by the author, the first at a workshop on 'Europe's Economic and Monetary Union 25 years after the Creation' held on 29 May 2017 in Dublin and the second at a joint EP-EUI History Roundtable on the Political Theory of and Economic Background to Economic and Monetary Union – 25 years after the signature of the Maastricht Treaty, 31 May 2017 in Brussels.

would otherwise risk suffering from 'institutional loneliness' (Padoa-Schioppa, 1999). History proved him right on all those three accounts.

A fourth – often overlooked – foresight is worth mentioning. In line with the attention that he dedicated to financial stability (Maes, 2016), Padoa-Schioppa was also a believer of discretionary liquidity support. More broadly, he captured with lucidity the unsettled institutional nature of Europe's crisis management framework. In his 2004 monograph on the ECB, Padoa-Schioppa underlined the following, referring to the EMU original architecture: 'crisis management is the issue on which most of the criticism of the present arrangements has concentrated in the early years of the euro. It has been argued that in euroland responsibilities to manage a banking (or more broadly financial) crisis are neither clearly assigned nor openly disclosed, and that the sheer number of authorities potentially involved would make the efficient provision of emergency liquidity unmanageable' (Padoa-Schioppa, 2004: 116). Despite the transformation that the European polity has endured in recent years – in particular with the creation of the Banking Union – the post-euro crisis framework remains in line with this past fragmentation. Several liquidity instruments exist at the EU level, they are however spread among several EU actors namely the European Central Bank (ECB), the European Stability Mechanism (ESM) and the Single Resolution Board (SRB), mainly.

**2. The argument: Europe still misses a credible crisis management tool**

Over the past nine years, much has been done to make Europe's banking system more resilient. It would be foolish to argue the opposite. On the prudential side, stricter and more intrusive capital rules have been adopted with the Capital Requirements Directive IV and the Capital Requirements Regulation package while a new, two-level micro-prudential supervisory regime has been established with the creation of the Single Supervisory Mechanism (SSM). As far as banking resolution is concerned, the Bank Recovery and Resolution Directive (BRRD) sets now clear rules on bank recovery and bank resolution and provides detailed provisions on loss absorption as well as on resolution tools and resolution strategies. Those rules are about to be strengthened with the adoption of the new Banking Package. Besides, the SRB has been established as the central actor of this new resolution process. Yet, despite all the advances made, the existing political narrative on EMU is that the latter 'is not yet fully shock-proof', to borrow the wording of the recent Commission Reflections Paper on EMU (Commission, 2017: 3). EMU's crisis management capacity remains weak as the elephant in the room has not been addressed: who is backstopping the Banking Union and with which instrument?

If one assumes that the European Central Bank cannot be the mother of all crisis management forever, then one has to face the bare truth that Europe is not prepared to address a systemic banking crisis of large magnitude. First, because its existing crisis management instruments are fragmented among too many actors and are therefore suboptimal in terms of firepower. Second, because their credibility is at stake. The very unlikely use of the ESM's banking recapitalization instruments (as will be explained further below) is a good illustration of the disconnect between the theoretical availability of crisis management tools at the EU level and the practice of too high operational burden and conditions to mobilize those tools. Third, because the crisis management arsenal still assumes the implicit support of the ECB whose shadow is cast on the whole crisis management system. After all, it was only with the 'whatever it takes' declaration by Mario Draghi and the following launch of the Outright Monetary Transactions that the concerns of a pervasive doom loop between fragile Southern European banks and fiscally vulnerable governments ebbed away. Fourth, because Europe's Banking Union remains by and large untested. In the same way that the credibility of the Stability and Growth Pact was only really tested when it had to be enforced fully on two large Member States (France and Germany) with the known result for its credibility, Europe's new Banking Union's real life test will come when one of

Europe's most systemic banks based in a large euro area economy will be declared 'failing or likely to fail'.

To help us enter into further details on the weaknesses of the current crisis management system we will rely on distinctions provided by Tommaso Padoa-Schioppa (2004). The latter narrowed down crisis management into three dimensions: (1) "the **private money solution**", (2) "the **tax-payers money solution**" and "the **central bank money solution**". We will review those three dimensions in turn.

**(1) The private money solution is at the core of Europe's contemporary crisis management regime.** The private sector is financing the Single Resolution Mechanism (both its Board and its Fund) and the spirit and letter of the BRRD revolves around preparing the financial sector to severe shocks by making it mandatory for them to develop the necessary tools to ensure that the lion's share of the loss-absorption is born by them. Yet, the contribution of a private sector involvement to crisis management should not be over-estimated either. As Avgouleas and Goodhart (2016:87) explained, currently 'there is a danger of over-reliance on bail-ins when the risk is not idiosyncratic'. Given the inter-connectedness of financial entities, a deep private sector solution, for a example a deep bail-in is unlikely to occur in the middle of a cross-border and systemic crisis. Schoenmaker in particular explained that to the extent that 'bail-in spreads the losses through the system and can thus cause contagion […],'the strength of a banking system ultimately depends on the strength of the sovereign behind it' (Schoenmaker, 2015: 42). This exposes Europe to self-fulfilling dynamics of insolvency as EMU is notoriously sovereign-less.

Over the years of the euro crisis, the **central bank money solution** (2) has been relied on extensively: unconventional monetary policy instruments have mushroomed to safeguard the euro and Emergency Liquidity Assistance (ELA) has been largely mobilized by Eurosystem central banks. It is obvious to recognize that central banking solutions are *par excellence* a cornerstone of crisis management solutions. Again as Padoa-Schioppa highlighted 'a strong central bank is an institution which is in the position to act in a discretionary way' (TPS, 1996). However the use of central banking solutions should be restricted to last resort situations and be subject to the real discretion of the central bank. During the crisis, the opposite seemed to be true as those instruments appeared to be increasingly of a business as usual nature and were used at times reluctantly by the ECB, simply because there was no other actor left to save the euro. So if it becomes the rule rather than the exception that the ECB intervenes as a provider of last resort liquidity, then it means that there is a risk that it is no longer a discretionary choice but rather an obligation. As of now, enough delicate tasks have been 'dumped' on the ECB. Delegating even more tasks to the ECB in an immediate future would cause a public uproar and would lead to a constitutional debate on the limits and financial risks of the ECB's task expansion. Surely, the possible appointment of Jens Weidman as a successor to Mario Draghi, despite the collegial nature of the ECB's Executive Board – is likely to put a halt to the ever expanding logic that characterised the ECB's action pattern during the crisis.

As far as the design of an EU level backstop for the Banking Union is concerned, it thus seems to be wise to consider that 'depending on the ECB alone is economically dangerous and politically unsustainable' (De Geus, Enderlein and Letta, 2017:2). Similarly, one can assume that central banking solutions cannot include a permanent crisis management instrument of the scale that would be necessary to safeguard the Banking Union. To recapitulate: private money solutions are already relied on a lot in Europe and it is fair to assume that their contribution to financial stability is over-estimated; central banking solutions have been used a lot in the past and will tend to be relied on less in the future both for constitutional reasons and political reasons; what thus remains is the third component of crisis management that Padoa-Schioppa termed 'the tax-payers money solution'. The problem is that the

tax-payers money solution to banking crises remains a taboo in the current bail-in regime which is also the reason why the few existing EU instruments are fundamentally under-developed in their design. The not too distant public interventions to support ailing Italian banks are a timely wake-up call in that regard as they remind us that the only operational taxpayer's money solutions are of a national nature, thereby fuelling the doom loop between sovereigns and banks.

My understanding is that when a serious crisis kicks in and a huge impact looms, then the tax-payers money solutions will be activated again. We should therefore consider the most intelligent way to engineer and prepare for such a scenario instead of pretending this will never happen again. In other words, EU leaders will have to formalize soon enough an EU level function of last resort liquidity that can directly contribute to risk-absorption through crisis management measures but also indirectly, via a re-insurance and recapitalization function to other EMU actors. This way EMU would be finally equipped with a formal and mutualized crisis management facility and would also be armed with an actor that performs the crisis intervention tasks traditionally performed by a sovereign and exceptionally executed in Europe by the ECB. Before formulating this recommendation in more detail, one should first understand the existing EU banking crisis management tools on the tax-payer side. For this, one has to travel back to June 2012.

**3. The Banking Union's tax-payers' money recapitalization instruments**

The Banking Union was created out of concern for the doom-loop between the banking sector risks and the sovereigns, following the acknowledgment that Member States' fiscal sustainability was threatened by financial dominance. These malicious dynamics were illustrated most tellingly by Ireland first and then Spain which ended up in the eye of the cyclone in June 2012. Following this, the Banking Union, as has been well documented by Gloeckler, Lindner and Salines (2016) 'came about as the result of a situational package deal that linked the SSM to a short term crisis management measure, namely direct bank recapitalization (DBR) via the European Stability Mechanism' (Gloeckler et al, 2016: 2). A similar interpretation has been provided by De Rynck (2016).

The original idea was that the doom loop would be broken by a sufficiently strong and direct banking recapitalization tool which would be a new ESM instrument set up right after the SSM's creation and which would directly address ailing banks without burdening national governments' balance sheet. The original euro area summit statement of 29 June 2012 specifies the following: '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' (Euro Area Summit, 2012: 1). Meanwhile, a transitory instrument was created for the purpose of Spain. The so-called indirect recapitalization instrument, formally known as the 'loans earmarked for the specific purpose of recapitalizing the financial institutions of its members, under a financial assistance recapitalization facility', is the instrument used by the Spanish government to recapitalize its banks. Its added value is that conditionality is only attached to the financial sector and that market access problems is not a condition of the loan activation, its downside is that it increases fiscal deficits since loans are channels by governments but are also contracted by them.

On 25 June 2012, the Spanish government requested financial assistance for the recapitalization of its banking sector. On 20 July 2012, the Eurogroup approved such a request. 100 bn euros of financial assistance were thus agreed to the Spanish government which in turn provided funds exclusively to its banking sector restructuring. Ultimately, only 41.3 bn euros were requested by the Spanish government and disbursed by the ESM. With hindsight, the 'Spanish deal' was a success. As of 31 December 2016, the average interest rate on ESM loans to Spain was 0.9%. The Spanish government exited the programme one year and a half after it entered it. The loan will be fully repaid at the end of

2027 so in 10 years time. In the meantime, Spain has made 6 voluntary requests (needless to say that they were all accepted) to accelerate repayment of the loan. Judging by the analysis of the Commission's latest country report on Spain, the medicine seemed to have had a positive impact on the health of the Spanish financial sector: 'the financial sector has continued to show a high degree of stability, supported by its ongoing restructuring, low funding costs and the economic recovery. The banking system further strengthened its capital buffers and the six largest Spanish banks comfortably met their capital requirements in the EBA stress tests of July 2016. The aggregate non-performing loan ratio fell to just above 9% in November 2016' (Commission, 2017: 2).

Despite this resounding success, the use of this indirect recapitalization instrument in June 2012 was a one off and was complemented by another direct recapitalization instrument. One can assume that its relevance has been downsized with the adoption of new rules and conditions on loss absorption and recapitalization (as part of the BRRD) and that Northern Member States will not indulge Southerners to rely on it too much in the future thereby pushing them to the 'atomic' ESM solution, the Macro-Economic Adjustment programme.

The second existing back-stop instrument is the Direct Bank Recapitalization, which is limited to 60 bn euros given that it is a considered a more risky instrument. The DRI took more than 2 years to be created, has an incredible list of conditions required for its activation, requires unanimous consent and is judged by policy-makers from the field as an instrument that will probably never be used. This point is actually eloquently illustrated on the website of the European Stability Mechanism in its 'Explainers' section: 'when the instrument was first proposed, it was to cut the link between troubled banks and sovereigns. However, it soon became clear that banking union mechanisms could achieve this aim without resorting to the direct recapitalisation instrument. More specifically, the bail-in of private investors, in accordance with the Bank Recovery and Resolution Directive (BRRD), and the contribution of the Single Resolution Fund (SRF), has shifted the bulk of potential financing from the ESM to the banks themselves, along with their investors and creditors' (ESM, 2017).

The irony is therefore that the instrument that triggered the Banking Union will therefore probably never be used and that the one which has been used to temporarily – yet successfully solve Spain's problems – will probably not be used in the future either. Under the current institutional architecture I therefore believe that in case of very severe banking crisis, what is very likely to happen is that existing EU backstop mechanisms (the two ESM bank recap instruments) will be difficult to use because they are expected to come in too late to solve crises, are too small to be effective and overall do not address the doom loop.

Therefore, it is likely that to address future large scale banking crisis, a mixture of national bank recapitalizations and of central banking liquidity provision will have to be relied on again. And this would then illustrate in the best possible way that the sovereign bank nexus has not been addressed. It is hence in my view better to anticipate things and design a fiscal backstop that is capable to address the self-fulfilling dynamics of banking crises. Against this background, how should the Banking Union's fiscal backstop be designed?

**4. A two-legged reform proposal to address the drawbacks of Europe's crisis management**

My deduction from the above is that the only type of crisis management instrument that is likely to genuinely provide confidence to market actors about Europe's and the euro's financial stability is a tax-payer money instrument. However, how should this instrument look like?[2]

Several contributions (Mayer and Gros, 2010; Enderlein and Haas, 2015) suggested the creation of a European Monetary Fund and of a European Treasury able to provide sustained stability to EMU. Compared to some time ago, the political context looks more prone to the discussion of this solution as it seems to become a common denominator between France, Germany (FT, 2017)[3] and the European Commission. The common thread of those EMF proposals is that the EMF is imagined to act as a single actor that financially assists sovereigns in their reform efforts. It would thereby regroup lending and monitoring activities currently scattered among several EMU actors. However, one of the lessons to draw from the euro crisis is that whenever such institutional consolidation opportunities in EMU presented themselves, they have been ignored. The Commission, after having been historically granted with the operation of the Balance of Payments and of the European Financial Stabilization Mechanism has been systematically kept in distance from all delegations of financial management as EU Member States were keen to keep control over the centralized funds. Likewise, attributing the role of resolution authority to the European Stability Mechanism was briefly envisaged during the crisis but very swiftly abandoned for reasons of political feasibility (back then, re-opening the ESM Treaty only a few months after its ratification and amending it for a third time was seen as too risky). As a result, financial assistance and crisis management instruments are now spread between the Commission, the ESM, the Single Resolution Board and the ECB. Among those actors however, the ESM stands out because it manages several existing EU crisis management instruments (this paper has covered two of them). This means that the ESM is also the most realistic starting point for reform.

- In this context, I believe that the short-term step to instil further credibility in the EU's current fiscal backstop should be to bolster and expand the capacity of the ESM. The first reform dimension should be to increase the real financial capacity of the ESM's bank recapitalization instruments and ensure that their design and conditions help to break the doom loop across EMU. As was argued in the 5 Presidents' Report: 'in due course, the effectiveness of the ESM's direct bank recapitalisation instrument should be reviewed, especially given the restrictive eligibility criteria currently attached to it, while respecting the agreed bail-in rules. A more easily accessible mechanism for direct bank recapitalisation would boost depositor confidence by keeping distressed sovereigns at arm's length in the governance of restructured banks, and it would break the sovereign-bank nexus at national level' (5 Presidents Report, 2015). This solution is close to what De Geus, Enderlein and Letta (2017) have coined 'ESM+'. The general purpose of such a capacity increase would be to ensure that the ESM has sufficient firepower to withstand a large banking crisis in Europe; one that would involve Europe's largest financial institutions, including the three largest French banking groups. The second reform dimension is not a new idea but requires further elaboration: it would consist in attributing the task to the ESM of backstopping the Single Resolution Fund. It has been formulated in the past by the 5 Presidents' Report and by the IMF notably. This scenario is also mentioned by the more recent Reflections Paper on EMU by the European Commission (Commission, 2017: 19) and therefore seems to appear as the most

[2] Another intrinsically linked question is how to ensure that it provides value for taxpayers' money. However answering such a question would go beyond the scope of this paper.
[3] https://www.ft.com/content/8d4b3414-2756-11e7-8995-c35d0a61e61a?mhq5j=e1

operational and politically acceptable solution. One can question however whether such a bridge will prove sufficient to instil credibility in the system.

- Symmetrically, I am convinced that political realism shouldn't however prevent us from exploring a third, even more ambitious long-term solution to the EMU's sustainability: the artificial creation of the functional equivalent of an EU sovereign. Instead of being a replica of the International Monetary Fund whose function is to directly interface with borrowers, its role would be to act as EMU's re-insurance facility (Schlosser, 2016), providing both limited recapitalization support and thus shock-absorption to the ESM's crisis management instruments, thereby de-risking the euro area's banking system and sovereigns. In other words, the role of this re-insurance facility would be to enhance the real firepower and capacity of existing EU institutions and instruments rather than replacing them or taking them over. Put differently, the current EMU eco-system made up of fragmented elements (EC, SRB, ECB, ESM) would stay intact. What would change however is that whenever additional recapitalization would be required, a common pool of funds could be accessible on short notice to ensure that the instruments' firepower is sustained and guaranteed.

  If such a scheme proves efficient to support the stability of banks in EMU, then the next step – along similar lines but with much higher implementation barriers – would be to use this re-insurance facility as a backstop to other existing or future mechanisms who currently risk suffering a lack of *ex ante* mutualisation. The European Deposit Insurance Scheme as well as the European Investment Bank – as has been mentioned in the Commission's White Paper in its most ambitious scenario – could represent other actors that the re-insurance facility could backstop. Lastly, a central actor who could benefit from it is the European Central Bank, which, precisely because of the absence of an EU or EMU treasury, suffered from a Padoa-Schioppian 'institutional loneliness' during the crisis. Compared to other OECD central banks whose long-term sustainability is implicitly provided by the Treasury of the country in which they are based, I argue that the ECB could only take on limited credit risk as it knew that in case it exposed its balance sheet to too high risks, its recapitalization would prove problematic as it would have to occur through national channels. On 16 December 2010, the ECB Governing Council had autonomously decided to increase its subscribed capital from 5.76 bn € to 10.76 bn €. The latter number is the figure foreseen as maximal cap by Council Regulation No 1009/2000 which means that the capital leeway that the ECB had at its disposal was exhausted. In other words, any further capital increase to the ECB during the crisis would have had to be subject to qualified majority in the Council.

Needless to say, all EU Treaties would therefore need to be amended to accommodate for those changes which would bring in quite some headaches to EU lawyers. Yet, the EMU as a whole would benefit from it, institutional actors would too, in particular the ESM (directly) and the ECB (indirectly).

**5. Conclusions**

This paper has argued that, in spite of the creation of the Banking Union and its constitutive set of rules, instruments and actors, Europe's financial stability is not safeguarded because the continent over-relies on private and central banking crisis management mechanisms. In other words, while the new regime foresees several recapitalization instruments, it still misses a credible and operational EU fiscal backstop. Judging by the existing institutional outlook of the Banking Union it is thus fair to consider that Europe still believes in rule enforcement as its principal line of defence against future banking crises. The continent is therefore trapped in a conundrum: it has proven unable to move from a rules-based regime to a regime based on common capacities to manage common risks.

However, if political momentum gathers pace on the creation of a new joint capacity to support EMU's resilience, then chances are high that the ESM would be the central actor supporting this capacity. Why? Because the modification of the ESM Treaty appears to be the easiest thing to do politically, in particular compared to the two functional alternatives: the revision of the EU Treaties on the one hand and the adoption of yet another intergovernmental agreement on the other. This is quite ironic: the ESM Treaty revision was precisely the political option that was dismissed four years ago when the SRM was about to be established.

Today, a revision of the ESM Treaty lends itself neatly to a targeted institutional engineering. Why exactly? First, because the number of Member States involved is only 19 Member States, compared to 27 (or 28) at the EU level. Second because negotiations can occur under more controlled and predictable political conditions insofar as the ESM Treaty has been ratified in all euro area Member States through the parliamentary channel (with the 'help' of the Pringle Case Law for Ireland). Although the shadow of a referendum will hover around Ireland, generalized parliamentary ratification significantly increases the chances of success of the whole enterprise. Those reasons speak in favour of privileging the ESM as the beacon of Europe's fiscal backstop, as rightly anticipated by Enderlein and Vannahme (2014). Should a treaty revision be out of the cards, some elements of the ESM design can even be modified without Treaty change: for example, capital increases at the ESM can be performed through the simple activation of the procedure foreseen by article 10 of the ESM Treaty which specifies that the Board of Governors (i..e. Eurogroup finance ministers) are entitled to 'change the authorised capital stock and amend article 8 and Annex II accordingly').

A more centralized approach will bring up challenges. Connecting the dots of Europe's currently highly fragmented fiscal regime will be arduous but perpetuating the current status quo will come at a cost too. Risks of inconsistencies and distorted incentives loom large. This was demonstrated in the rather recent rescue case of Northern Italian banks as contradicting signals came from the enforcement of the parallel but connected resolution and state aid regimes. Another connection point between the grand idea of the ESM becoming EMU's last resort re-insurer and the fiscal framework is the distribution of the burden-sharing of such a mechanism which is unlikely to be shielded away from participating Member States' fiscal performance.

In that regard, one could be even more imaginative in establishing further connections within the existing EMU fiscal regime. The way the ESM is financed could be amended for example. As things stand[4], the ESM is financed via national contributions whose volume are determined on the same basis as the ECB's contribution key, i.e. the contributor's share in the overall EU population and GDP. A possible reform would consist in moving away from those structural and generic variables and head towards more cyclical and politically loaded indicators, such as the fiscal performance or the performance of the contributing country's banking sector. Such inflections could be considered as the counter-parties to insert in the North-South package deal that such a reform would be part of. Some will say that this is unrealistic. And it is probably true. However, it is not more unrealistic than the current conventional expectation of a full enforcement of the Stability and Growth Pact's Excessive Deficit Procedure. After all, isn't it time to stop pretending that the SGP sanctions have any future at all?

[4] Further details can be found in article 42 of the Treaty establishing the European Stability Mechanism.

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