

A BLUEPRINT FOR COMPLETING THE BANKING UNION

STEFANO MICOSSÌ

Summary

Completing the banking union is an urgent project facing the EU, given the eurozone's continued vulnerability to idiosyncratic liquidity shocks to national banking systems. The proposed changes to the European deposit insurance scheme (EDIS) under consideration by the European Commission could open the way to a satisfactory compromise between the twin needs to reduce legacy risks in banks' balance sheets and to provide greater risk-sharing and a fiscal backstop for both the Resolution and the EDIS Funds – while continuing to exclude any sharing of past losses. With such a compromise, financial fragmentation would likely recede rapidly, leading to a larger role by private capital in cushioning real and financial idiosyncratic shocks.

EDIS could move forward immediately by providing in its early phase that the European Stability Mechanism would provide a liquidity line to national deposit guarantee schemes that had exhausted their funds, with no sharing of losses. Meanwhile, risk-reduction would accelerate through the stronger policies already established by the Single Supervisory Mechanism for the reduction of non-performing loans and a fresh approach to the reduction of banks' sovereign exposures, based on a modified version of the large exposure prudential policy. Direct risk-weighting of national sovereigns would be excluded.

The ultimate anchor of a stable banking union would be credible policies to reduce excessive sovereign debt-to-GDP ratios. This paper argues that a combination of a strengthened debt rule in the Stability and Growth Pact and a market discipline mechanism entailing the obligation to issue junior bonds, subject to restructuring, for the countries violating the common budgetary rules, could offer a suitable way forward to restore the credibility of the Pact. It also argues that effective policy coordination within the eurozone also requires greater symmetry of policy obligations by the member states, which may be built into the European Semester through an appropriate revision of the macroeconomic imbalance procedure.



Stefano Micossi is the Director General of Assonime, a business association and think tank in Rome, the Chairman of the LUISS School of European Political Economy and a member of the Board of Directors of CEPS. He wishes to thank Fabrizia Peirce and Alexandra D'Onofrio for very useful discussions and outstanding research assistance in preparing this paper. It is being

published simultaneously as a CEPS Policy Insight.

CEPS Policy Insights offer analyses of a wide range of key policy questions facing Europe. As an institution, CEPS takes no position on questions of European policy. Unless otherwise indicated, the views expressed are attributable only to the author and not to any institution with which he is associated.

978-94-6138-650-2

Available for free downloading from the CEPS website (www.ceps.eu)

© CEPS 2017

Contents

1. Introduction.....	1
2. Tackling legacy risks	2
2.1 Non-performing loans	2
2.2 Banks' sovereign exposure	3
2.3 Capital strengthening measures	7
3. Getting EDIS off the ground	8
4. Strengthening eurozone governance arrangements	11
5. Conclusions.....	15
References	17

List of Figures

Figure 1. Ownership share of domestic banks in sovereign debt outstanding.....	4
Figure 2. Public debt and public deficit (% of GDP, 2009 and 2017).....	12
Figure 3. Current external imbalances, real wages and investment in the eurozone	14

A Blueprint for Completing the Banking Union

Stefano Micossi

1. Introduction

Following the elections in France and Germany, the time is ripe to resume constructive discussions on completing the banking union, together with related aspects regarding eurozone governance that are needed to underpin agreement on the banking union. These matters should be given priority for two reasons. Firstly, the current half-baked banking union –lacking a common system of (cross-border) deposit insurance (EDIS) and a fiscal backstop for the Resolution and Deposit Insurance Funds – leaves the eurozone exposed to idiosyncratic financial shocks capable of endangering its survival. Should such a shock happen, the ECB would likely not be able to stop speculation by means of an announcement, as it did in the summer 2012, and would need to activate its Outright Monetary Transactions (OMT) programme to buy distressed sovereigns – which presupposes the adoption of a European Stability Mechanism (ESM) adjustment programme for the country under stress (ECB, 2012). Sharp disagreement on policies and publicly-voiced recriminations could replicate the scenario of 2011-12, with the likely return of the bank-sovereign ‘doom loop’ and contagion spreading the shock to other sovereign markets. The political fallout within national public opinion may well make an agreement even more difficult to reach, bringing the Economic and Monetary Union (EMU) once again to the brink.

The second reason is that, with financial fragmentation overcome and financial stability secured, the eurozone could become the cohesive nucleus of further political integration – able to advance on other fronts, e.g. fiscal union, an EU-level minister of finance, the safe asset – and thus create the momentum required to induce the other member states to join EMU, as advocated by President Juncker in his latest State of the Union address (Juncker, 2017). In sum, completing the banking union is the key not only to attain financial stability for the eurozone, but also to open the way to further progress in European economic governance, with likely political fallout in other domains of the European construction (e.g. foreign policy, security and defence).

At present, the negotiations on banking union are stuck over the difficulty of reconciling the demand by some member states to free the balance sheets of (some) banking systems from the legacies of past financial crises, and the request by other member states to bring forward risk-sharing arrangements through cross-border deposit insurance and fiscal backstops in case of severe banking shocks. However, the improved economic conditions of the eurozone and policy proposals emerging from influential economic and policy circles in Europe show, in my view, a practicable path to an agreement – provided of course that there is the political will to proceed.

2. Tackling legacy risks

In its final stage the European deposit insurance scheme (EDIS) entails full mutualisation of banking losses threatening the reimbursement of depositors (for deposits below €100,000; see European Commission, 2015b). Therefore, the request that banks' balance sheets be cleared of legacy risks before moving to the full mutualisation phase is legitimate and should be heeded. In its latest communication on banking union, the Commission envisages that the initial phase of EDIS would involve no mutualisation and risks would continue to fall on national insurance schemes (European Commission, 2017b).

This approach opens the possibility of setting up EDIS before legacy risks are fully dealt with, and thus exploits its confidence-building effects to overcome market fragmentation – while establishing a credible process whereby legacy risks would effectively be reduced under the control of the ECB Banking Supervision and EDIS authority (which would coincide with the Single Resolution Board, or SRB). The subsequent transition to even partial mutualisation would be subject to effective progress in reducing legacy risks; prior to that, EDIS would essentially provide a liquidity credit line to national schemes that have exhausted their resources. We return to this aspect later.

Legacy risks mainly arise from the large stocks of non-performing loans (NPLs) and banks' exposures to their national sovereigns. A considerable strengthening of supervisory and other policies to deal with the former is already under way, while useful suggestions have been tabled to address the latter without placing unbearable burdens on the banks.

2.1 Non-performing loans

The stock of NPLs in the eurozone still hovers around €800 billion, or about 5.5% of bank loans,¹ and is concentrated in a few countries, notably Italy, Cyprus, Portugal, Ireland and to a lesser extent Spain. Large NPLs depress bank profitability, constrain the supply of credit to worthy borrowers and hinder the transmission of monetary policy. While it is true that the stock has been diminishing too slowly, the robust economic recovery is now adding momentum to their reduction. In Italy, the precautionary recapitalisation of Monte dei Paschi di Siena and the liquidation of two medium-sized Veneto banks and some other small banks will result in the reduction of NPL stock by about one-fourth in the current year.

In addition, new policies to address the issue have been adopted by the Supervisory Board of the Single Supervisory Mechanism (SSM) and the Ecofin Council. Last March the SSM issued its comprehensive Guidance to banks on non-performing loans (ECB, 2017a) asking banks with high levels of NPLs to define a strategy for their reduction “as a matter of priority and in a comprehensive manner by focussing on their internal governance” and setting their own quantitative targets, which will be the subject of scrutiny by Joint Supervisory Teams.² Banks'

¹ See ECB (2017d) and Draghi (2017).

² See Nouy (2017). Last October an *addendum* to that document was placed in consultation requiring banks to ensure full provisioning of new NPLs within two years when not guaranteed and within seven years when assisted by

performance in managing NPLs will be part of the SSM Pillar Two supervisory evaluations which, if considered unsatisfactory, may lead to additional bank-specific prudential requirements, possibly including the request to raise capital under the supervisory review and evaluation process (SREP).³ These measures are already leading to an acceleration in the disposal of NPLs.

Moreover, at its meeting on July 11th the Ecofin Council called for a comprehensive approach to NPL disposal combining policy action at national and European levels to improve the efficiency of judicial processes and debt recovery frameworks (including improved access to collateral and fast out-of-court procedures), develop secondary markets for distressed loans and foster restructuring of banking systems to adapt to the new business environment (Ecofin 2017). A proposal issued by the Chairperson of the European Banking Authority (EBA) (see Enria, 2017) to set up asset management companies (AMCs) to remove NPLs from banks' balance sheets and manage them through separate vehicles may soon be endorsed by the Council and lead to national schemes to speed up the disposal of NPLs.

There seems to be little doubt that these measures entail a significant strengthening of banks' balance sheets, and will continue to put pressure on banks to reduce NPLs. Buoyant economic growth is also likely to facilitate the reduction of NPLs as many failing companies could overcome their difficulties. All in all, it is reasonable to expect the NPL load to diminish in the coming years, with visible progress already in 2018.

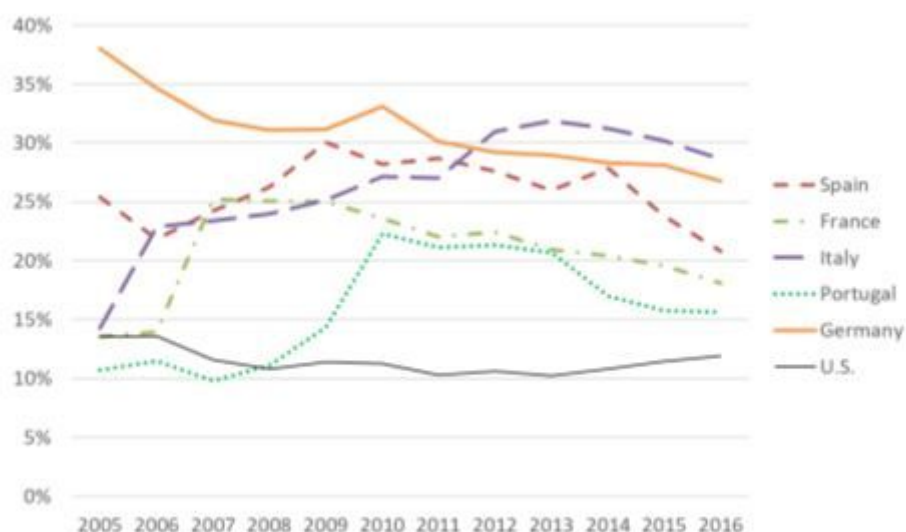
2.2 Banks' sovereign exposure

An even more important legacy risk in banks' balance sheets is their heavy exposure to their sovereign. The EBA 2016 transparency exercise has shown that some three-quarters of total sovereign exposure is vis-à-vis the home sovereign; and bank holdings of their national sovereign typically are on average around 140% of Tier1 capital, with some countries hovering around 200% of bank capital (e.g. Belgium, Germany and Italy) – representing between 15% and 30% of EU banks' home country debt (Figure 1). This situation raises the possibility of a re-emergence of the doom-loop between sovereign distress and banking crisis, in the event that investors lose confidence in the sustainability of the sovereign debt of one eurozone member state.

guarantees (ECB, 2017c). The European Parliament has contested the measure, claiming that it oversteps the ECB's legal powers. Therefore, its entry into force by 1 January 2018, as originally intended by the ECB, is now called into question.

³ Art. 97 of CRD IV provides for the supervisory review and evaluation process (SREP) which is part of the Pillar 2 of Basel Accords. The key purpose of SREP is to ensure that institutions have adequate arrangements, strategies, processes and mechanisms as well as capital and liquidity to ensure a sound management and coverage of their risks, to which they are or might be exposed, including those revealed by stress testing as well as other risks that institution may pose to the financial system.

Figure 1. Ownership share of domestic banks in sovereign debt outstanding



Source: Véron (2017).

Sovereign exposures and their domestic bias increased markedly during the financial crises of the past decade, especially for distressed countries, possibly reflecting the funding difficulties of sovereign borrowers with increased market fragmentation, and the lack of profitable alternatives for banks locked up in domestic markets. It may also have been a result of strategies to hedge against redenomination risks. However, zero risk-weighting of sovereigns and their exemption from prudential concentration limits must have played a significant role in encouraging banks to build up their large sovereign portfolios.

In January 2014, the Governors and Heads of Supervision of countries represented in the Basel Committee on Banking Supervision (BCBS) called for a review of the regulatory treatment of sovereign exposures, leading the BCBS to set up a task force on sovereign exposures in early 2015. So far, however, they have not been able to reach agreement on the best way to address the problem, also in view of very large sovereign exposures in some non-EU countries (e.g. Japan and Mexico). In 2015 a report by the European Systemic Risk Board (ESRB) identified two main options to address the problem: i) to introduce risk-weighting for sovereign holdings by banks (mainly based on market ratings), thus raising capital requirements, or ii) to apply to those holdings the prudential rules on large exposures – whereby the exposure to a single counterparty cannot exceed 25% of eligible high-quality capital (Tier1 plus a share of Tier2 not exceeding one-third of Tier1). A report by the German Council of Economic Experts (GCEE, 2015) advocated the simultaneous adoption of both measures.⁴

The matter is highly sensitive because any new regulatory incentives and disincentives to reduce excessive holdings of sovereigns must not only be based on a full assessment of the impact on both the sovereign and the banking markets, but also consider the role played by these securities in banks' operations and the provision of liquidity and collateral (e.g. in repos) to financial

⁴ For a full description of the regulatory treatment of sovereign exposures in banking regulations, see. Enria et al. (2016) and Lenarcic et al. (2016).

markets. A new specific requirement in this regard is the new Liquidity Coverage Ratio (LCR) mandated by Basel III, which will be fully operational in 2018 and requires banks to hold liquid means and high-quality (Level 1) assets to fully cover their needs for a 30-day liquidity-stress scenario. At present a large share of those high-quality assets is provided by national sovereigns.

Risk-weighting national sovereigns would inevitably affect sovereign markets of highly-indebted countries, in the expectation of large sales by banks; the adverse impact on spreads would be magnified by the diversification of banks portfolios favouring best-rated sovereigns. Thus, at least during the transition to full application of the new rule, market fragmentation would likely increase – in a market environment already affected by the termination of the ECB’s expanded asset purchase programme. It is also possible that banks would also further diminish their presence in sovereign markets as dealers on own account, which would become capital-absorbing, with adverse effects on liquidity in those markets; and that the yield curve could become steeper, to the extent that shorter maturities could be less affected by higher risk-weights. Another notable drawback of risk-weighting is its pronounced pro-cyclicality, as risk-assessment varies with economic and financial conditions, so that too little capital would be held in upturns, and possibly too much would be required in downturns. Averaging risk weights over lengthy periods – as was proposed by GCEE (2015) – would leave investors guessing as to the true amount of any emerging capital shortfall and raising uncertainty on the actual state of many banks. And, finally, unless risk-weighting was also adopted by non-eurozone regulators, it would place eurozone banks at a severe competitive disadvantage. In any event, no agreement on this seems in sight within the BCBS.

A rigid application of the large exposure threshold of 25% may also prove disruptive both for banks’ balance sheets and (some) sovereign markets, if strong cliff effects forced banks to undertake massive liquidations of sovereigns. However, a gradual entry into force and careful calibration of the new prudential limits could limit such adverse effects and yet provide sufficiently strong incentives for bank portfolio diversification – while steering away from the much more perilous waters of sovereign risk-weighting. This approach to foster the diversification of banks’ sovereign portfolios was advocated by Gros (2013), and more recently was also endorsed by Sapir & Schoenmaker (2017). Useful proposals for its implementation have been developed by Enria et al. (2016) and Véron (2017). Under their approach, sovereign single-name exposure would be considered risk-free up to a given threshold, thus leaving sufficient room for banks’ liquidity management, with gradually increasing risk-weights applied to exposure above the threshold.⁵ In this manner, direct penalisation of sovereigns issued by more indebted countries would be avoided, but some indirect effects on the markets for these sovereigns could still happen due to the relatively larger size of banks’ sovereign portfolios in some countries.

⁵ Under the Enria et al. (2016) approach, capital requirements would increase with concentration risks, according to a metric compatible with the LCR. EBA has estimated that if a bank uses solely a single-name sovereign exposure to fulfil the minimum required Level 1 assets, this would roughly correspond to 100% of Tier1 capital. The second element would be to require mark-to-market valuations of a significant share of sovereign portfolios in banks’ accounting books. This would introduce a strong incentive for banks to actively manage their sovereign portfolios while, at the same time, increase the transparency of banks’ balance sheets to outside investors.

Such exposure curbs would eschew the drawbacks of sovereign risk-weighting. They would be set independently of any credit risk-assessment and therefore would also avoid pro-cyclical effects. They would not produce cliff effects, since exposure charges would rise gradually, leaving room for the banks to manage them flexibly. And nor would they distort the level playing field relative to other jurisdictions. At the same time, exposure curbs would create genuine incentives for banks to diversify their sovereign portfolios, thus helping sever the perverse bank-sovereign nexus.

Sovereign portfolio diversification would be favoured by, and indeed require, the establishment of a European ‘safe asset’ that investors, including banks, could turn in their quest for sovereign risk diversification (Véron, 2017 and Enria et al., 2016). Various proposals to establish such a ‘Eurobond’ were discussed earlier this decade, e.g. the red-and-blue bond proposal by Delpla & von Weiszächer (2010) and the Redemption Fund advocated by the GCEE (2011). These proposals proved controversial for they entailed some backup by the European institutions or the member states, which was seen as a fresh source of moral hazard for highly-indebted member states.

More recently, Brunnermeier et al. (2011 and 2016) have proposed the use of securitisation structures to create a liquid multi-country sovereign exposure – so-called European Safe Bonds, or ESBies – by pooling member states’ sovereigns according to pre-defined rules. ESBies would not entail any public backup nor sharing of losses that might arise from single sovereigns, but would nonetheless create highly-rated ‘tranches’ least exposed to sovereign credit risks, thanks to structured finance technology. The idea is taken up for further examination by the European Commission (2017b), where it is argued that sovereign bond-backed securities could not only support portfolio diversification in the banking sector, but also provide an instrument suited for cross-border financial transactions; and in his State of the Union address, President Juncker has pledged to present before the end of 2018 “an enabling framework” for the development of sovereign bond-backed securities (Juncker, 2017). Unfortunately, initial market tests to verify the attractiveness for investors of those securities have so far not revealed a strong interest in their development.

An alternative possibility would be to let the ESM advance the portfolio diversification process by offering to exchange banks’ excess sovereign holdings to be disposed of under the new prudential rules with newly-issued ESM bonds. The credit risk on sovereigns thus acquired by the ESM should remain with the selling banks and, in case of need, fall back onto the national deposit insurance funds. Therefore, the ESM Triple A credit rating would not be endangered, but the liquidity provided by the ESM would accelerate the disposal of sovereign portfolios by banks while smoothing their market impact.⁶

At present, the capital requirements Regulation (CRR) precludes the application of the large exposure limits to sovereign exposures, including all zero-risk-weighted sovereigns (Art. 400). Therefore, to proceed along this route the Regulation would need to be amended, which may be done through the ordinary EU legislative procedure. As to the ESM liquidity line, since this new

⁶ Daniel Gros has called to my attention the possible need, in this context, to make sure that the ESM exposure vis-à-vis individual sovereigns does not exceed certain prudent limits to avoid a situation in which the ESM margins of manoeuvre become overly restricted, notably in the case of debt restructuring.

activity would be coherent with the other functions currently carried out by the ESM, a revision of its Treaty would not seem necessary; its Board of Governors could decide the matter under Treaty Art. 19, by unanimity.⁷

2.3 Capital strengthening measures

Finally, additional risk-reduction measures were included in the Commission's November 2016 Banking Package, which is now under negotiation in the European Parliament and Council. They include the implementation of the total loss-absorbing capacity (TLAC) standard set by the Financial Stability Board (FSB) for systemic financial institutions and its coordination with the Minimum Requirement for own funds and Eligible Liabilities (MREL) framework for minimum bail-inable liabilities to be issued by banks as buffers in resolution; a proposal on bank creditor hierarchy to improve legal certainty in case of resolution; and revisions of the CRR/CRD package to introduce an absolute leverage ratio (hopefully higher than 3%) and the net stable funding ratio (NSFR) provided for by the Basel III Accords. It may be recalled in this regard that Basel III implementing measures have already led to capital increases on the order of €200 billion between 2013 and 2015 in the EU (against estimates of the capital shortfall around €115 billion in 2013; see Enria et al., 2016 and Enria, 2017), and that at the end of 2016, the CET1 capital ratio stood at 14% of risk-weighted assets, after rising by some 500 basis points since 2011.

Moreover, the Basel Committee on Banking Supervision appears close to an agreement on a measure to limit excessive variations in the proportion of risk-weighted assets in banks' balance sheets, notably when they are calculated with internal models – essentially by putting a floor on the acceptable deviations of the risk-weighted asset ratios derived from internal models relative to the results obtained from standard models.⁸ This measure is an important complement to the strengthening of capital ratios achieved under the Basel III Accords; it also fosters the creation of a level playing field in EU banking markets by eliminating egregious instances of aggressive use of internal models to lower capital requirements.

It may also be recalled that in 2016 the ECB Banking Supervision also completed its project to harmonise supervisory practices in the SSM by publishing its Regulation and Guide on Options and National Discretions (OND) (see ECB, 2016a and 2016b), covering some 130 supervisory options and discretions in the prudential framework, thus reducing the regulatory divergences that existed before the SSM inception. Applying these instruments will allow banks directly supervised by the SSM to carry out cross-border operations in participating member states under uniform rules and consistent criteria for supervisory assessment. Especially important in this context are the OND waivers from liquidity requirements and the exemptions from intra-group large exposures from regulatory limits – which allow banks to apply those requirement at group level rather than at the level of country entities – that will facilitate the free flow and centralised management of funds of cross-border banking groups (ECB, 2017b).

⁷ This procedure was followed for the introduction of the possibility of direct recapitalisation of banks by the ESM banking facility in 2014. See [ESM Board of Governors' Resolution No. 4 of 8 December 2014](#).

⁸ See BCBS (2016), Bingham (2017) and Lubochinsky (2017).

3. Getting EDIS off the ground

The previous section describes the considerable efforts under way to reduce NPL legacy risks in the EU banking sector and suggests that progress on this front is likely to accelerate. On the other hand, the reduction of sovereigns in banks' portfolios requires further action. In the view of many member states, this represents an insurmountable obstacle to joint deposit insurance, which might entail that some national deposit guarantee schemes (DGS) may have to share in the losses of banks on their sovereign holdings in other member states. This section argues that a strong case can be made to establish a European deposit insurance scheme (EDIS) and start its operations in parallel with stepped-up risk reduction efforts, without waiting for all legacy risks to be eliminated. One key benefit of financial integration is that integrated credit and asset markets make it possible to hedge against country-specific sources of risk and thus smooth income and consumption growth. More importantly, EMU should be resilient, i.e. it should not unravel and become *per se* a source of instability, in the face of large financial and economic shocks.

The ECB's indicators of financial integration (ECB, 2017b) show that aggregate integration stalled in 2016: the price-based indicator of financial integration, reflecting asset price and interest rate convergence, displays a much higher volatility, while the quantity-based indicator of cross-border flows of credit and asset exchanges flattened out (see Figure 1, p. 10). Moreover, new indicators on the *quality* of financial integration point to another important aspect, i.e. that the contribution from private risk-sharing through credit and capital markets to the smoothing of country-specific shocks to real GDP has been very low, so that a large share of these shocks ended up hitting real consumption (see Figure 2 of ECB, 2017, p. 12).

The persistence of market fragmentation within the eurozone seems to reflect to an important extent the uncertainty generated by political events, calling into question the future of the monetary union. Thus, the poor showing of integration indicators in 2016 was likely influenced by mounting nationalistic forces throughout Europe, which were galvanised by the Brexit referendum outcome in the UK and the election of Donald Trump in the US, and by the looming electoral cycle in many European countries, including France and Germany, which was widely seen as posing an existential threat to the common currency and the EU itself. Now those fears have been put to rest by the strong showing of pro-European forces in the elections; the spreads on sovereigns have narrowed and tensions in capital markets have receded. Integration indicators will no doubt show a much better picture in next year's report, but the improvement would be immediately reversed by renewed political instability. The system is neither stable nor resilient.

As has been established by solid academic research, following the seminal paper by De Grauwe (2011), this happens because of a special externality created by the combination of a common currency managed by an independent central bank, and fiscal and economic policies managed at national level. When the latter diverge, doubts are likely to arise on the sustainability of the sovereign debts of some countries, since the liquidity for their orderly roll-over depends on the willingness by the ECB to intervene as lender of last resort for distressed sovereigns – an intervention that persistent divergence in economic fundamentals makes highly controversial

within the ECB Governing Council and official policy circles. In the presence of large sovereign portfolios in banks' balance sheets, distress in the sovereign markets can readily spill over onto banks, and the reverse is also possible if banks are confronted by a liquidity shock. In sum, the 'doom-loop' between the sovereigns and bank crises has not gone away but is only temporarily being held at bay. The problem will take up more relevance once the ECB brings its non-conventional monetary policies to an end.

There is an evident paradox here. We can effectively reduce market fragmentation and obtain more private risk-sharing from credit and capital markets only to the extent that investors in financial markets believe that the likelihood of a fresh financial crisis in highly indebted countries is very low – but this requires that the institutional arrangements of EMU provide strong insurance against liquidity shocks hitting either sovereign markets or the banks.

This should be recognised as a strong argument in favour of completing the banking union – while of course continuing work for risk reduction – by launching the missing pillar of EDIS immediately because this would eliminate or reduce to a minimum the possibility that a large liquidity shock in one national banking system will again set in motion the doom-loop between banking and sovereign crises. By moving ahead with EDIS, we would permanently reduce market fragmentation, thus raising the potential for private risk-sharing and curtailing the potential need to bail out a member state with common eurozone facilities.

This connection is worth stressing. Insisting on risk reduction as a precondition for launching EDIS leaves the eurozone banking system more exposed to shocks that might require the bail-out of a member state, since market fragmentation prevents sufficient private risk-sharing through capital markets. Indeed, since the Five Presidents Report (Juncker et al., 2015), the fundamental role of EDIS in the banking union has been the establishment of an effective protection against idiosyncratic liquidity shocks hitting national banking systems (European Commission, 2015b). In addition, the provision of equal protection for depositors across the Union would also remove all national risk-notation of banks and render them equal in the eyes of depositors across the EU, thus severing (or at least substantially weakening) the sovereign-bank nexus.

In its original proposal, the Commission envisaged that EDIS would cover losses ultimately incurred by participating national guarantee schemes (DGS) for compensating depositors or contributing to the resolution of a failing bank. The scheme would be phased in gradually, starting with a re-insurance phase providing limited funding and loss cover, then followed by a co-insurance phase with increasing loss cover over time (up to 80%), and then complete sharing of losses in a final full-insurance phase.

Gros (2015 and 2017) has argued that the liquidity function of EDIS – preventing bank runs – could be effectively addressed by proper design of the re-insurance phase, and that the two subsequent phases would then become superfluous. Under his scheme, any national DGS would have to make good the losses suffered by its own resident depositors (provided retail operations in the different national markets are organised via subsidiaries rather than branches). He accepts, however, that national DGS would not suffice to maintain the confidence of depositors when a member state's

entire banking system comes under stress. Any national fiscal backstop would likely prove insufficient, as the sovereign market would also be hit by the shock. Therefore, such a systemic crisis requires some form of supra-national insurance. Beyond that, there is no need for further risk-sharing.

Under this scheme, the insured subjects would not be the banks, but national DGS; insurance would be provided by a European deposit insurance fund (DIF) funded by risk-based fees paid by national DGS. Thus, re-insurance in this sense would be a macroeconomic function protecting national DGS; accordingly, the risk parameters for setting national fees would effectively measure country risk, and would be calculated under the aegis of the ESRB in such a manner as to minimise cross-country transfers. The drawback of this approach is that, rather than helping to separate country (sovereign) risk from bank risks, it links them inseparably. The very purpose of banking union, which is to make banking risks independent of country risks, would be utterly frustrated. Nevertheless, the notion whereby the first phase of re-insurance could be designed to tackle liquidity risks even before any loss sharing is useful, as I have argued.

Precisely in this sense, the European Commission (2017b) has now aired the idea that in the initial phase of re-insurance, EDIS would only provide a liquidity line, up to a certain proportion of the liquidity shortfall of national DGS (rising from 30% in the first year, to 60% in the second and 90% in the third and final year of Phase One). The rest would be covered by national DGS with the resources not transferred to the EDIS Fund, and if needed by additional *ex-post* contributions by the banks in that country.

A further idea floated by the European Commission (2017b) is that the transition to Phase Two of co-insurance – involving some loss cover – would be subject to conditions to be assessed by a Commission decision, based on a targeted Asset Quality Review (AQR) to verify progress in the reduction of NPL and Level-III assets. In addition, it must be recognised by all parties that the mutualisation of the protection of depositors will only be feasible after the sovereign risks in the banks' balance sheets are diversified (Gros, 2015).

The Commission's approach would seem to go a long way towards accommodating concerns about legacy risks and moral hazard, since the transition to a regime where losses would be shared across national boundaries would take place under the control of a European authority.

As to the fiscal backstop, this could again be provided in all phases by a liquidity line from the ESM, to be activated once the DGS and the EDIS Fund had exhausted their resources. ESM financing would be temporary and not entail any eventual sharing of losses, as the liquidity line would have to be reimbursed in full by raising *ex-post* the banks' contributions to their national DGS and EDIS. In this manner, the ESM would effectively provide a fiscally-neutral public backstop – that therefore could be activated even before the eventual mutualisation of losses. Once again, this new task by the ESM could be decided with the procedure of Art. 19 of its Treaty, as it is just an extension of the ESM functions of financially assisting eurozone member states in conditions of stress.

4. Strengthening eurozone governance arrangements

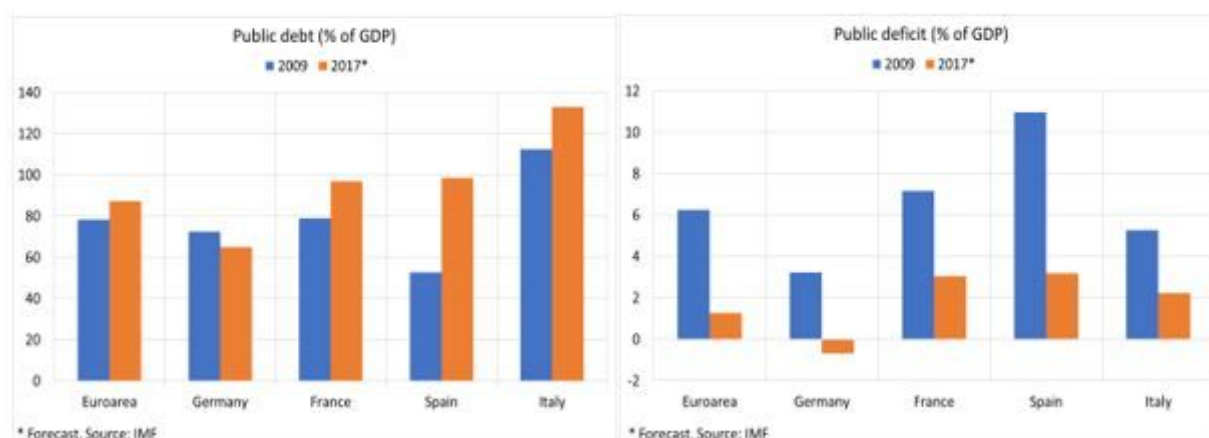
Systemic sovereign debt and bank crises are likely to be rooted in divergent national macroeconomic policies – which is why strengthened governance is an important part of re-building confidence between the member states. In this context, the strong economic recovery under way in the eurozone will help, but it cannot remove underlying fundamental imbalances, which continue to stand as a main impediment to unlocking the negotiations on banking union and more broadly the completion of EMU (as outlined in European Commission, 2017a).

A central issue to be tackled is how to bring sovereign debt-to-GDP ratios down to sustainable values, which still stand close to or well above 100% of GDP in several eurozone members (Figure 2, left quadrant). If debt-to-GDP ratios were on a well-established descending path everywhere, the question of sovereign risk diversification in banks' balance sheets would still be relevant, but much less compelling. The question then arises of how best to reinforce the constraints and incentives on member states to reduce debt-to-GDP ratios.

A preliminary observation on this concerns the general impression in Germany and other countries in the 'core' and in Northern Europe that existing governance arrangements have completely failed to enforce budgetary discipline. As may be seen in the right quadrant of Figure 2, between 2009 and 2017, public sector deficits have been reduced everywhere, and by next year all eurozone members are expected to respect the 3% limit. However, it is not sufficient to bring debt-to-GDP ratios back to well below 100%, if not to the full respect of the 60% Maastricht target. Moreover, deficit-reduction exercises have frequently been adopted and implemented in a climate of public confrontation between national authorities and the European Commission, fuelled by Commission bashing by national politicians in search of consensus. The communication on flexibility (European Commission, 2015a), which created appropriate room for managing budgetary consolidation in the context of a still-fragile economic recovery, has added to the frustration of those who wanted stricter budgetary policies.

One possible way out worth considering is tightening the screws in the Stability and Growth Pact (SGP) by bringing the debt reduction rule back to the centre of monitoring (preventive arm) and enforcement (corrective arm) procedures, and strengthening enforcement of the debt rule by removing from the Commission the power to grant 'flexibility' exemptions to take account of the state of the economy. The task of relaxing debt reduction obligations in adverse economic conditions could be entrusted to the European Fiscal Board. The decision would thus be cleared of any political interference by the Commission or the member states, and there would be no longer political negotiations on the implementation of the debt rule. Such adaptation of the SGP would also allow the scrapping of both the flexibility matrix provided for by the European Commission (2015a) and the algorithm for the calculation of the output gap, thus radically simplifying the SGP – which has become too complex and difficult to read to retain its credibility. The timing for such a change would be right now, since the economic expansion under way, and the likely return of inflation will help a great deal in placing excessive sovereign debts on a credible reduction path.

Figure 2. Public debt and public deficit (% of GDP, 2009 and 2017)



Such a change, however, would restore confidence in the SGP only to the extent that highly indebted member states in the eurozone were willing and able to commit credibly to the revised debt rule – which could always be called into question by a new government elected on a platform of open defiance of European rules on fiscal discipline.

In this context, an often-heard proposal has been to introduce an element of market discipline to constrain highly indebted countries by convincing or forcing them to accept a sovereign debt restructuring mechanism (SDRM), whereby their creditors would need to accept a maturity extension or a straight haircut on their outstanding sovereign securities (e.g. the Schäuble non-paper circulated at a recent meeting of the Ecofin, but also Corsetti et al., 2016; Pisani-Ferry, 2016 and Sapir & Schoenmaker, 2017). The risk of losing their money would then lead investors to price those securities more in line with actual risks and thus discourage excessive borrowing.

Tabellini (2017) has convincingly argued that the reasoning behind these proposals is analytically faulty. The most important criticism is that embedding any such mechanism into outstanding sovereign securities could bring us back to explosive financial instability, as already experienced in 2010-11, following the (in)famous Deauville announcement by Chancellor Merkel and President Sarkozy in October 2010, that private holders of Greek debt would have to accept a deep haircut (SEP Scholars, 2017). The jump in financial markets to an unstable path would certainly follow the introduction of an automatic, *ex-ante* restructuring triggered by certain events, such as the breach of the debt path under the SGP or a request for financial assistance from the ESM; but it could also be set in motion by an *ex-post* mechanism applied case-by-case to a distressed sovereign, and entailing an obligation of bond holders to accept the restructuring decided by an arbiter and enforced by a specialised court, as in Sapir & Schoenmaker (2017).

Thus, we face a policy dilemma: the straight solution of hardening the debt rule enforcement in the SGP could lack credibility (as time-inconsistent), while introducing elements of market discipline through an SDRM could prove utterly destabilising. An approach combining elements of both approaches that might help tackle their weaknesses has been proposed by Fuest and Heinemann (2017). Their proposal is that a eurozone member violating the SGP would be required

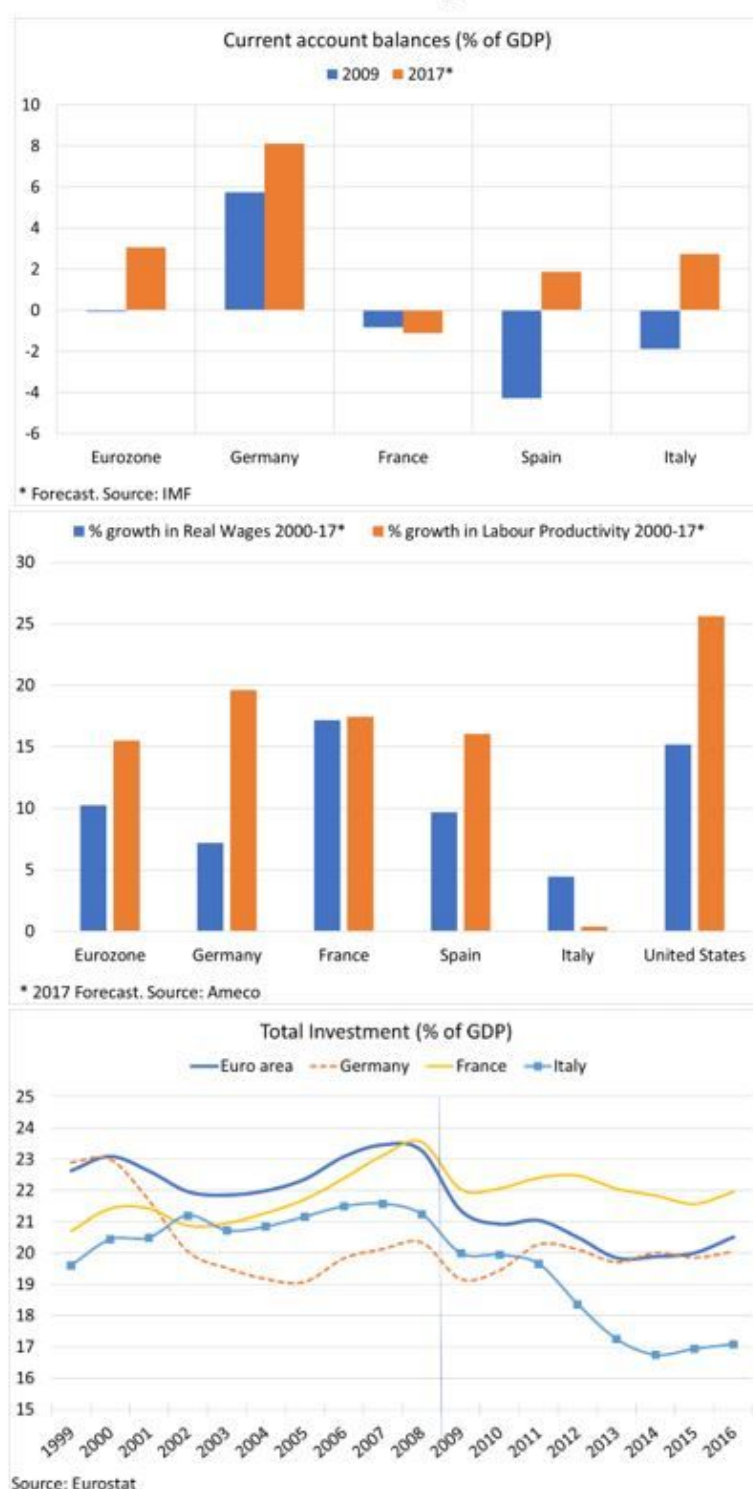
to issue junior bonds subject to restructuring, but only to cover the excess financing requirement generated by the part of the yearly deficit in violation of the SGP rules. The obligation to issue junior debt would not apply to the renewal of expiring debt.

In this manner, one could introduce a market sanction of SGP violations, which would be fully reflected in the cost of debt issued to cover excess deficits, while the mechanism would play only a marginal role in the overall amount of outstanding debt, thus excluding, at least in principle, the possibility of destabilising financial repercussions.

The credibility of the SGP seems also to require some broader modifications of the common economic policies to introduce greater symmetry of obligations among eurozone members regardless of their sovereign indebtedness. This boils down in practice to a need to revise the Macroeconomic Imbalance Procedure (MIP; see European Commission, 2016) to correct the strong deflationary bias of current arrangements – for such a deflationary bias directly endangers the sustainability of the sovereign debt of highly-indebted countries more than it does for the other member states.

A cursory look at some data illustrates the point. The upper quadrant of Figure 3 shows the evolution of current account imbalances of the eurozone and its main members. As may be seen, between 2009, the last year before the sovereign debt crisis, and 2017, the burden of eliminating external imbalances has fallen exclusively on deficit countries. Over the same period, the German surplus has increased, pushing the eurozone into a substantial surplus (some 3% of aggregate GDP). The fact that one of the largest economic areas in the world economy continues to draw its main stimulus from net exports can't be right, and may in due course generate protectionist reactions, in a world environment in which protectionism is again riding high.

Figure 3. Current external imbalances, real wages and investment in the eurozone



Moreover, the centre quadrant of Figure 3 shows that real wages have been falling behind productivity gains, with the only exception of Italy, and that Germany has led the pack on this with a *proportional* divergence that is even higher than that observed in the United States. The fact that productivity gains have so scantily been distributed to labour has been an important determinant of low demand growth in Germany, and a constant element of deflationary pressure on real wages in other eurozone members, which were trying to rebuild their competitive edge. *De facto*, the rate of growth of aggregate demand in the German economy has become the trend

(medium-term) ceiling of sustainable demand growth in the other member states and the eurozone.

Finally, the lower quadrant of Figure 3 shows the substantial fall in investment in Germany since the euro inception, a fall from which it has not been recovered since. Thus, it appears that the shift of the German economy into low gear preceded the twin crises of 2008-09 and 2010-12, and took place in parallel with the fall in real wages engineered by the Hartz reform of the labour market. Low real wages may have been a factor in the fall of investment by making the need to raise productivity via investment less compelling.

Be that as it may, the evidence above leaves little doubt that the combination of low real wages and demand growth in Germany maintains a constant deflationary pressure on the periphery of the eurozone – via the balance-of-payments (financial) constraint and the cost-competitiveness (real) constraint – thus endangering the sustainability of high sovereign debts and creating the conditions for renewed financial distress.

The MIP procedure provides the right instrument to tackle this issue, but its application has so far been biased against financial imbalances in the high-cost high-debt countries. Some redress to make economic policy obligations more symmetric is in order. Suffice it to recall, in this regard, that under the MIP alert procedure, Germany has been classified as a country ‘experiencing imbalances’ – related to excessive savings and exceedingly low investment – rather than ‘excessive imbalances’, despite the threat they pose to the eurozone’s financial stability.

Excessive imbalances requiring stronger corrective action are only seen in six countries (including Italy and France), which will therefore need to undertake further deflationary measures within an unsupportive aggregate policy environment in the monetary union. Their task would be facilitated by stronger market opening measures in Germany and elsewhere to stimulate investment and aggregate demand.

5. Conclusions

This paper has argued that completion of the banking union is urgent, because the eurozone remains exposed to idiosyncratic liquidity shocks in national banking systems; and that the proposed changes to the EDIS under consideration by the Commission could open the way to a satisfactory compromise between the twin needs to reduce legacy risks in banks’ balance sheets and to provide greater risk-sharing and a fiscal backstop for both the Resolution and the EDIS Funds – while continuing to exclude any sharing of past losses. With such a compromise, financial fragmentation would likely recede rapidly, leading to a larger role by private capital in cushioning real and financial idiosyncratic shock.

EDIS could move forward immediately by providing in its early phase that the ESM would offer a liquidity line to national DGS that had exhausted their funds, with no sharing of losses. Meanwhile, risk reduction would accelerate through the stronger policies already established by the SSM for the reduction of NPLs and a fresh approach to the reduction of banks’ sovereign exposures, based

on a modified version of the large exposure prudential policy. Direct risk-weighting of national sovereigns would be excluded.

The ultimate anchor of the banking union would be credible policies to reduce excessive sovereign debt-to-GDP ratios. A combination of a strengthened sovereign debt rule in the SGP and a market discipline mechanism entailing the obligation to issue junior bonds, subject to restructuring, for the countries violating the common budgetary rules, could offer a suitable way forward to restore the credibility of the SGP. The paper has also argued that effective policy coordination within the eurozone also requires greater symmetry of policy obligations among the member states, which may be built into the European Semester through an appropriate revision of the macroeconomic imbalance procedure.

As recently stated in a public letter signed by an impressive list of French and German economists (Bénassy-Quéré et al. 2017), it will not be possible to build a resilient euro without some compromise between the opposing views that continue to plague the debate on common economic policies in the eurozone. The technical components of such a compromise are available, thanks to a wealth of contributions by economists and think tanks. The stumbling block remains political will. It is hoped that the European Council will be able to build a compromise to complete a banking union that is acceptable to all the main parties, to the great benefit not only of financial stability, but also of its citizens.

References

- Basel Committee on Banking Supervision (BCBS) (2016), "[Consultative Document – Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches](#)", March.
- Bénassy-Quéré, A., M. Brunnermeier, L. Feld, M. Fratzscher, P. Martin, H. Rey, I. Schnabel, N. Véron, B. Weder di Mauro, J. Zettelmeyer, H. Enderlein, E. Farhi, C. Fuest, P. Gourinchas and J. Pisani-Ferry (2017), "[A resilient Euro needs Franco-German compromise](#)", Bruegel Blog, 27 September.
- Binham, C. (2017), "[Basel III reforms package closer to being finalized](#)", *Financial Times*, May 25.
- Brunnermeier, M.K., L. Garicano, P. Lane, M. Pagano, R. Reis, T. Santos, S. Van Nieuwerburgh and D. Vayanos (2011), "[ESBies: A Realistic Reform of Europe's Financial Architecture](#)", VoxEU, 25 October.
- Brunnermeier, M.K., S. Langfield, M. Pagano, R. Reis and S. Van Nieuwerburgh (2016), "[ESBies: Safety in the tranches](#)", ESRB Working Paper Series No 21 / September.
- Corsetti, G., I. Feld, R. Koijen, L. Reichlin, R. Reis, H. Rey, B. Weder di Mauro (2016), "[Reinforcing the eurozone and Protecting an Open Society](#)", CEPR, May.
- De Grauwe, P. (2011), "[The Governance of a Fragile eurozone](#)", CEPS Working Document No. 346, CEPS, Brussels, May.
- Delpla, J. and J. von Weizsäcker (2010), "[The Blue Bond proposal](#)", Bruegel Policy Brief 2010/03, Bruegel, Brussels, May.
- Draghi, M. (2017), "[European banking supervision three years on](#)", Welcome remarks at the second ECB Forum on Banking Supervision, Frankfurt, 7 November.
- ECB (2012), Press Release – [Technical features of Outright Monetary Transactions](#), 6 September.
- ECB (2016a), [Regulation \(EU\) 2016/445 of the ECB on the exercise of options and discretions available in Union law](#) (ECB/2016/4), 14 March.
- ECB (2016b), [ECB Guide on options and discretions available in Union law](#), March.
- ECB (2017a), [Guidance to banks on non-performing loans](#), March.
- ECB (2017b), "[Financial Integration in Europe](#)", May.
- ECB (2017c), [Addendum to the ECB Guidance to banks on nonperforming loans: Prudential provisioning backstop for non-performing exposures](#), October.
- ECB (2017d), [Supervisory Banking Statistics Second Quarter 2017](#), October.
- ECOFIN (2017), Council conclusions on Action plan to tackle non-performing loans in Europe', 11 July.
- Enria, A. (2017), "[Where there is a will, there is a way: completing the repair of the banking sector in Europe](#)", Speech at the CIRS Annual International Conference, Lisbon, 1st July.

Enria, A., A. Farkas, and L.L.J. Overby (2016), "[Sovereign Risk: Black Swans and White Elephants](#)", *European Economy*, 8 July.

ESRB (2015), ESRB report on the regulatory treatment of sovereign exposures', European Systemic Risk Board, Frankfurt /Main.

European Commission (2015a), Communication to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions [on making the best use of the flexibility within the existing rules on the stability and growth pact](#), COM(2015) 012 final, 13 January.

European Commission (2015b), [Proposal for a Regulation of the European Parliament and of the Council amending Regulation \(EU\) 806/2014 in order to establish a European Deposit Insurance Scheme](#), COM (2015) 586 final, 24 November.

European Commission (2016), [The Macroeconomic Imbalance Procedure – Rational, Process, Application: A Compendium](#), Institutional Paper 039, November.

European Commission (2017a), "[Reflection Paper on the Deepening of the Economic and Monetary Union](#)", Brussels, 31 May.

European Commission (2017b), [Communication to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions on completing the Banking Union](#), COM (2017) 592 final, 11 October.

Fuest, C. and F. Heinemann (2017), "[Accountability Bonds – Reconciling Fiscal Policy Based on Market Discipline with Financial Stability](#)", EconPol Policy Brief 03/2017 Vol. 1, November.

German Council of Economic Experts (GCEE) (2011), "[Euro Area in crisis](#)", Annual Report 2011/12, Third Chapter, GCEE, Wiesbaden, 18 November.

German Council of Economic Experts (GCEE) (2015), "Focus on Future Viability, Annual Report 2015/16", Chapter I: Economic policy: Focus on future viability, 11 November.

Gros, D. (2013), "[Banking Union with a Sovereign Virus: the self-serving regulatory treatment of sovereign debt in the euro area](#)", CEPS Policy Brief No. 289, CEPS, Brussels, 27 March.

Gros, D. (2015), "[Completing the Banking Union: Deposit Insurance](#)"; CEPS Policy Brief No. 335, CEPS, Brussels, December.

Gros, D. (2017), "Try again to complete the Banking Union!", in Bénassy-Quéré A. and F. Giavazzi (edited by), [Europe's Political Spring: Fixing the eurozone and Beyond](#), VoxEU eBook, 31 May.

Juncker, J.C. (2017), [State of the Union Address 2017](#), Brussels, 13 September.

Juncker, J.C., D. Tusk, J. Dijsselbloem, M. Draghi and M. Schulz (2015), "[Completing Europe's Economic and Monetary Union](#)", 22 June

Lenarcic, A., D. Mevis, and D. Siklos (2016), "[Tackling sovereign risk in European banks](#)", ESM Discussion Paper 1, Luxembourg: European Stability Mechanism, March.

Lubochinsky, C. (2017), "[France balks at reforms that will standardize banking rules](#)", *Financial Times*, 23 October.

Nouy, D. (2017), [Introductory statement at the Presentation of the ECB Annual Report on supervisory activities 2016 to the European Parliament's Economic and Monetary Affairs Committee](#), Brussels, 23 March.

Pisani-Ferry, J. (2016), "[The eurozone's Zeno paradox – and how to solve it](#)", VoxEU, 10 April.

Sapir, A. and D. Schoenmaker (2017), "[The time is right for a European Monetary Fund](#)", Policy Brief ISSUE 4 | October, Bruegel, Brussels.

SEP Scholars (2017), A Rebuttal to an editorial on eurozone reform proposals.

Tabellini, G. (2017), "Reforming the eurozone: Structuring vs Restructuring Sovereign Debts", Voxeu.org, November.

Véron, N. (2017), "[Sovereign Concentration Charges: A New Regime for Banks' Sovereign Exposures](#)", prepared in the context of the Economic Dialogues between the European Parliament Economic and Monetary Affairs Committee with the President of the Eurogroup, November.