A REALISTIC BRIDGE TOWARDS EUROPEAN BANKING UNION

In other words, and even leaving aside adjustments to the SSM that may be deemed important, a future 'steel-framed' banking union will require, among other things, a European fiscal capacity, a European insolvency regime for banks, and a European resolution authority. None of these is explicitly provided for in the current treaties.

Two existing articles of the TFEU might provide a potential implicit basis for part of this agenda, but arguably not for all of it and certainly not without controversy. Article 114 TFEU on the European Internal Market may provide a basis for a resolution authority, as it did for the creation of the European Banking Authority (EBA) and other European Supervisory Authorities (ESAs) in January 2011, and earlier for European bodies such as the European Aviation Agency or the European Medicines Agency. However, the Meroni jurisprudence of the European Court of Justice[7] places limits on the decision-making discretion that such agencies may enjoy, which could prove incompatible with the autonomy required for an effective resolution and/or deposit insurance body. Article 352 TFEU, also known as the 'flexibility clause', states that ***"If action by the [European] Union should prove necessary, within the framework of the policies defined in the Treaties, to attain one of the objectives set out in the Treaties, and the treaties have not provided the necessary powers, the Council, acting unanimously on a proposal from the Commission and after obtaining the consent of the European Parliament, shall adopt the appropriate measures"***. A literal reading of this article suggests ample scope for the introduction of new policies and instruments, given the breadth of the ***"policies defined in the Treaties"*** and the ***"objectives set out in the Treaties"***. However, there is a widespread reluctance among member states to interpret this article in an extensive manner, and the European Court of Justice has also occasionally placed limits on what it believes is the possible use of this flexibility clause.

Similarly, it is doubtful that the agenda described above can be entirely delivered on with one or several separate intergovernmental treaties outside of the EU framework, as was the case with the Treaty establishing the ESM (February 2012) and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (the so-called Fiscal Compact, March 2012). This is because of the need for resolution, insolvency and fiscal policy to be subject to adequate judicial review and political scrutiny. The interdependencies needed between these policies and the EU institutional framework as established by the TEU and TFEU are likely to be too pervasive to be practically handled in distinct treaties.

A separate question is if the needed treaty changes can be achieved through the 'simplified revision procedures' introduced by the Lisbon Treaty and specified in Article 48(6) TEU. The 'ordinary revision procedure' (Article 48(2) to (5) TEU) requires an intergovernmental conference, and in some cases a Convention, to make amendments to the Treaties, and the amendments must then be ***"ratified by all the Member States in accordance with their respective constitutional requirements"***. By contrast, the simplified procedures, while also requiring unanimity of member states, only require a decision of the Council, not a Convention or intergovernmental conference. Such a decision must be ***"approved by the Member States in accordance with their respective constitutional amendments,"*** which at least in some member states lowers the procedural bar compared to 'ratification', which might require a parliamentary vote and/or referendum. The simplified procedures can only apply to Part 3 of the TFEU, and the corresponding changes ***"shall not increase the competences conferred on the [European] Union in the Treaties"***. But it is difficult to see how at least some aspects of the above agenda could be construed as not increasing the EU's competences. Thus, the simplified revision procedures of Article 48(6) TEU could at best be used only for part but not all of the agenda to establish a steady-state banking union.

'It is doubtful that the banking union agenda can be entirely delivered on with intergovernmental treaties outside of the EU framework. This is because of the need for resolution, insolvency and fiscal policy to be subject to adequate judicial review and political scrutiny.'

7. Judgment of the European Court of Justice, Meroni & Co., Industrie Metallurgiche S.A.S. v High Authority of the European Coal and Steel Community, 13 June 1958.

Article 27(4) of the SSM Regulation states that ***"From the entry into force of the regulation [September 2013 in our baseline], in view of the assumption of its tasks [...], the ECB may require the competent authorities [national supervisors] of the participating Member States [in the SSM] and the persons referred to in Article 9 [individual banks and their staff] to provide all relevant information for the ECB to carry out a comprehensive assessment, including a balance-sheet assessment, of the credit institutions of the participating Member State. The ECB shall carry out such an assessment at least in relation to the credit institutions not covered by Article 5(4) [which means that all banks subject to the ECB's direct supervisory authority will be assessed]. The credit institution and the competent authority shall supply the information requested".*** Complementing this mandate, the European Banking Authority has indicated that it would conduct a new round of EU-wide stress tests with a timetable in accordance with the ECB's assessment, and that national supervisors should start conducting ***"asset quality reviews"*** before the end of 2013[12].

The ECB's direct access to information under Article 27(4) of the SSM Regulation is a crucial enabler for the pre-handover assessment to constitute a credible process of 'triage' that would divide the examined banks into three broad categories: those which are sufficiently capitalised; those with capital needs that can realistically be met by arm's-length investors; and those which are severely undercapitalised or insolvent, and thus require some form of public intervention as an alternative to a court-ordered insolvency. Such combination of publicly-led triage, recapitalisation and restructuring has been the key to the resolution of most systemic banking crisis in the past (Posen and Véron, 2009). Prominent cases include Sweden in 1992-93, Japan after 2002 (following many years of

ers from national authorities who participate in the process, either on behalf of their national employer or seconded to the ECB or recruited by it, will have strong incentives to serve the ECB's objectives even if that involves highlighting the past supervisory failures of the national authori-

Options to address the pre-handover restructuring of problem banks are further explored in the next two sections, with emphasis on the financial and governance aspects respectively.

THE FINANCIAL EQUATION OF 2014 RESTRUCTURING: LEGACY, BAIL-IN, AND ESCAPING THE DOOM LOOP

As previously emphasised, it is not possible to predict at this point how many problem banks will be identified in the ECB's 2014 pre-handover assessment, assuming it is rigorous, or in which countries they will be located or how large their capital gaps will be. If the capital gaps identified are small, the 2014 pre-handover restructuring as described in the previous section will be comparatively easy to carry out. However, based on the observation of past systemic crises and of moderate current growth prospects in Europe, policymakers must prepare for the possibility of important capital gaps with an impact that may be macroeconomically significant. The debate on how to share the burden associated with future restructuring has been dominated by three concerns: assigning responsibility for past supervisory failures, referred to as 'legacy' in the European policy discussion; shifting at least part of the cost to private claimants, often referred to as 'bail-in' in contrast to past bail-outs; while escaping the doom loop crisis-propagation mechanism as identified since 2011, and more generally preserving financial stability. Addressing jointly these three concerns will involve difficult trade-offs and political decisions.

Legacy

In a joint communication after a meeting near Helsinki on 25 September 2012, the three finance ministers of Finland, Germany and the Netherlands declared that ***"principles that should be incorporated in design of the instrument for [future] direct recapitalisation [of banks by the ESM] include: (...) the ESM can take direct responsibility of problems that occur under the new supervision [by the ECB within the SSM], but legacy assets should be under the responsibility of national authorities"***. This position was intended to restrict the scope for direct recapitalisation of banks by the ESM, the possibility of which was introduced in the 29 June 2012 statement that marked the start of the banking union endeavour and stated 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 recapitalise banks directly"***. The European Council conclusions of 14 December 2012 mention in a more open-ended manner that ***"an operational framework, including the definition of legacy assets, should be agreed as soon as possible in the first semester 2013"*** for future direct bank recapitalisations by the ESM.

The reference to 'legacy assets', however, gives the misleading impression that assets that carry risks from the past can be neatly separated from the rest of a bank's balance sheet on. This is generally not the case. A major share of assets in a typical European bank have long maturities and thus may be considered 'legacy' long beyond any specific cut-off date, and thus the separation of legacy assets from non-legacy assets is bound to be impractical.

The relevant distinction is not between legacy and non-legacy assets, but rather between legacy and non-legacy losses. The 2014 pre-handover assessment would force banks to crystallise losses that had not been properly acknowledged until then, and these legacy losses would determine the identification of the capital gap that may result at least partly in a recapitalisation or a restructuring by public authorities, possibly entailing a public cost. The assumption of such public cost at the European level, eg by the ESM, would more effectively contribute to breaking the doom loop, but the perception (and in at least some cases, reality) of past supervisory failures at the national level can be expected to make it politically impossible. Thus, it appears inescapable that public costs resulting from legacy losses in the 2014 pre-handover restructuring should be borne by the national public purse. For European banks with a significant level of cross-border activity, the capital gap may be filled by an ad-hoc combination of national contributions from different member states, as was the case in 2008 and later with Fortis and Dexia banks.

The same principle, however, also applies after the handover, to the second span of the bridge. To the extent that the balance-sheet assessment conducted by the ECB in 2014 is comprehensive, losses that might materialise at a later stage (in or after 2015) will no longer be attributable to national legacy responsibilities. It would thus be contentious to assign such future losses to individual member states, including against assets that entered a bank's balance sheet before 2014 but were vetted during the pre-handover assessment. We return to this aspect below in the subsection on the doom loop.

Bail-in

During the first few years of the financial crisis starting in mid-2007, most EU member states appeared to see no alternatives to bailouts of private creditors (and even in some cases of shareholders) to resolve banking crisis situations. This stance, which was both generous to the private sector and onerous to the public purse, started with the rescue of Germany's IKB in late July 2007, and was uniformly applied for more than three years until late 2010, in contrast to parallel developments in the US (Goldstein and Véron, 2011). Gradually however, from late 2010 until late 2012, losses were more frequently imposed on at least some creditors, under various (and sometimes contested) legal frameworks and far from systematically. In almost all cases until early 2013, such 'haircuts' only affected junior or subordinated creditors, while senior unsecured ones have remained whole[13]. In early 2013, losses were imposed on senior unsecured creditors and also on uninsured depositors of Laiki Bank and the Bank of Cyprus. Thus, the European consensus has moved considerably over a few years, from systematic bailouts towards a more significant recourse to bail-ins.

Special resolution regimes for banks did not exist in most EU member states in 2007, but have been introduced in many of them since 2008. They are in the process of being harmonised, and in many cases reinforced, through the Bank Recovery and Resolution Directive (BRRD), initially proposed by the European Commission in early June 2012 and currently under discussion. It is expected that the BRRD will enshrine a clearer hierarchy of bank liabilities into European legislation, signaling that the use of public funds should only be envisaged after all (unsecured) creditors, and possibly uninsured depositors as well, have shared some of the restructuring burden. However, significant discretion is also likely to remain in the hands of national resolution authorities.

Bail-ins and special resolution regimes represent progress for the EU but they are not a magic formula. Even under the somewhat optimistic assumption that the BRRD will have been adopted and fully transposed into national legislation by all member states at the time of the 2014 pre-handover restructuring, the extent to which they will enable policymakers to avoid bailing out private-sector claims on problem banks will depend on circumstances. Concerns about contagion within the banking system, the imposition of losses to systemically or politically important creditors (such as pension funds), loss of public trust in the financial system (which forced the Cypriot authorities to impose capital controls, an experience that euro-area policymakers may be wary of repeating) or negative shocks to the economy will all play a role, again depending on the magnitude of the capital gaps identified by the ECB's assessment. It would be entirely unrealistic to envisage bank resolution regimes, the aim of which is to maintain trust and to preserve financial system stability, as purely mechanistic, rules-based processes. Also, the BRRD in its current version envisages private-sector-funded resolution funds at the national and possibly European level, but such funds will take time to build up and they therefore are unlikely to play a major role in the 2014 pre-handover restructuring.

Escaping the doom loop

As previously noted, the aim to ***'break the vicious circle between banks and sovereigns'*** has been affirmed forcefully in successive declarations of the European Council, and is likely to be reaffirmed in the future. One year later, the doom loop has not been broken but several developments are bound to affect policymakers' thinking:

- Market conditions have improved and risks of euro-area break-up have receded, making

13. Denmark was an exception, with a more rigorous treatment of creditors and uninsured depositors of two problem banks in 2011, even though its policy framework was later modified. Cases of losses imposed on junior creditors included Anglo Irish Bank in 2010; Agricultural Bank of Greece, TT Hellenic Postbank, and a number of Spanish banks in 2012; and SNS Reaal in the Netherlands in early 2013.

contagion prospects less immediate;

- The discussion about legacy, including in the context of the German general election cycle, has made it near-impossible to envisage direct recapitalisations by the ESM until at least some time after the 2014 handover, contrary to the initial hopes of some observers, particularly in Spain and other member states;
- The divergence of credit conditions across member states has been confirmed and increasingly documented, not least by the ECB. Misallocation and/or scarcity of bank credit represent an increasingly evident drag on Europe's economic recovery prospects, particularly in the periphery (eg Darvas, 2013).

Markets are forward-looking, and the doom loop is framed by expectations about the future. Escape is possible only if investors are convinced that idiosyncratic sovereign liabilities associated with national banking sectors stop once the legacy issues are dealt with. This entails a credible commitment that any future public cost following the 2014 restructuring will be borne at the European level, and that the pre-handover restructuring will be implemented in a way that does not discriminate between claimants on the basis of their nationality or the nationality of the problem
incompatible with the principle of national

European Commission in the context of such restructuring. Through state aid control, the Commission's Directorate-General for Competition Policy (DG COMP) has become a prominent player in determining bank restructuring strategies throughout the EU, and has developed a unique operational capability in this area. The continued need to ensure consistency of competition policy enforcement suggests that DG COMP's financial crisis task force will play an important and possibly central role in any European framework for the restructuring of problem banks in the 2014 transition. DG COMP's competition policy mandate makes it an awkward agent for system-wide bank restructuring, but it may have to assume leadership – as it has already done to a significant extent in the case of Spain – only because it has more of the required experience than any other player, and for lack of a better alternative.

Even assuming that the experience and authority of DG COMP is leveraged to the maximum possible extent, there is probably no perfectly elegant way to resolve this challenge. Still, Europe's leaders have a window of opportunity to agree on a joint and/or delegated decision-making process that ensures sufficiently swift and uniform handling of the 2014 restructuring in a manner that preserves financial stability, mitigates the doom loop, and minimises the public cost. But, at the time of writing, it is not possible to say with confidence that this opportunity will be taken advantage of.

A POSSIBLE SEQUENCE

Bringing together all the pieces, we present here a possible sequence of events that illustrates the possibility, at least in principle, of a successful transition towards a banking union.

This of course is not intended to be a forecast: the current European circumstances are far too complex for such predictability. The aim is only to demonstrate that, assuming a sufficient degree of lucidity and diligence in the policy process, the numerous constraints that apply to the European banking debate can be simultaneously addressed in a reasonable manner. Market and political risks will remain high at each step of the process, but the banking union equation is not (yet) impossible to resolve.

First span of the bridge: addressing the legacy (2013-14)

- Q3 2013: publication of the final SSM Regulation; start of operational buildup of the ECB's own supervisory capability; decisions by non-euro EU member states to join or not the SSM from the outset; progress towards finalisation of the BRRD.
- Q4 2013: adoption of the BRRD and of the DGS directive; preliminary asset quality reviews by national authorities in anticipation of the 2014 handover; clarification of the European decision-making system for bank restructuring in the pre-handover phase; negotiation of the agreement between the ECB and national supervisors on the conduct of the 2014 pre-handover assessment and future modalities of cooperation.
- Q1 2014: start of transposition of the BRRD into national legislation of member states; finalisation of the European decision-making system for pre-handover bank restructuring; start of the pre-handover balance sheet assessments by the ECB with the cooperation of national supervisors.
- Q2 2014: completion of transposition of the BRRD in individual member states; completion of pre-handover balance sheet assessments and corresponding stress tests coordinated by EBA; start of preparation of restructuring plans for problem banks.
- Q3/Q4 2014: decisions on restructuring plans

'Europe's leaders have a window of opportunity to agree on a joint and/or delegated decision-making process that ensures swift and uniform handling of the 2014 restructuring in a manner that preserves financial stability, mitigates the doom loop, and minimises the public cost.'

states to the extent needed and bail-in to the extent possible; if any member states experience liquidity shortages as a consequence, negotiation of ESM assistance to those member states; effective handover of direct supervisory authority to the ECB.

Second span of the bridge: the 'timber-framed banking union' (starting late 2014/early 2015)

- Further buildup of the ECB's supervisory capabilities; adjustment of European bank resolution mechanisms on the basis of lessons learnt during the handover; any new public expenditure in newly emerging banking situations covered by European resources (including the ESM and/or contributions from the European financial sector); further harmonisation of EU banking regulation; preparation and negotiation of treaty change.

Third span of the bridge: building the 'steel-framed banking union' (following treaty change)

- Implementation of treaty change and transition towards permanent banking union: adjustments to the SSM, including possibly more autonomy from monetary policy and equal governance rights and responsibilities for non-euro EU member states; creation of a European insolvency regime for banks; establishment of a European special resolution regime for banks and of the European Resolution Authority to administer it; creation of a European deposit insurance system with adequate funding and European fiscal backstop; broader EU reform

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