Fiscal implications of a banking union

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8 September 2012[1]

Prepared for presentation at the Informal ECOFIN, Nicosia, 14 September 2012

Systemic banking crises are a threat to all countries whatever their development level. They can entail major fiscal costs that can undermine the sustainability of public finances. More than anywhere else, however, a number of euro-area countries have been affected by a lethal negative feedback loop between banking and sovereign risk. Disintegration of the financial system, real economic fragmentation and the large exposure of the ECB have followed. Recognising the systemic dimension of the problem, the euro-area summit of June 2012 called for the creation of a banking union with common supervision and the possibility for the ESM to recapitalise banks directly.

To tackle the bank-sovereigns feedback loop and contribute to restoring EMU resilience, banking union requires common supervision to cover most if not all of the banking sector's assets, a common resolution authority, and a common fiscal backstop (we argue that a common deposit insurance system is desirable but of secondary importance from a fiscal standpoint). As for supervision, there are noteworthy arguments for keeping resolution decentralised, but common supervision without common resolution would create perverse incentives and be ineffective. When centralisation is not feasible, a solution to the centralisation/decentralisation dilemma can be found in the combination of centralised authority and decentralised implementation. To minimise the fiscal cost of banking crises, it is also important to ensure that resolution is swift, effective and includes the bail-in of private creditors. But it would be unrealistic to believe that the need for a fiscal backstop can be eliminated altogether.

The organisation of a common fiscal backstop raises important questions about potential distributional biases, moral hazard created by the insurance, and contributions to the insurance pool. The design of the system should ensure that incentives are set right, always including the involvement of national taxpayers. Different options for a fiscal backstop can be envisaged. A European Resolution Fund financed by contributions from the financial industry would have major advantages but would unlikely have sufficient funds for the next 10 years. An ex-ante burden sharing agreement among countries may lack credibility in case of a major country-specific shock. Our preferred option is the EFSF/ESM as a fiscal backstop. While insufficient in case of a dramatic banking crisis, it has the advantage of a strong governance structure. In the long-run, contingent European taxation power with appropriate democratic legitimacy should be envisaged.

The current discussion is made difficult by the legacy of existing banking and fiscal problems in the euro area. Indeed, new insurance is rarely granted to sick patients, and fairness considerations would require those responsible for surveillance, i.e. creditors and national supervisors, to be held responsible for the financial consequences of their failings. Yet well-designed burden-sharing arrangements to be applied in specific circumstances are called for. Delaying the resolution of existing problems increases their costs and spillovers onto partner countries occur.

[1] Excellent research assistance by Chiara Angeloni and Carlos de Sousa is gratefully acknowledged.

1) Introduction

The first sentence of the Euro Area Summit Statement of 29 June 2012, "We affirm that it is imperative to break the vicious circle between banks and sovereigns", unambiguously specifies the motivation for creating a banking union in Europe. The overriding objective of such a union is to remedy an acute fragility in the euro area that had not been fully perceived before the 2010-2012 crisis. The potentially devastating consequences of this fragility have been illustrated by the parallel rise in sovereign and bank default risk indicators, and the on-going fragmentation of the euro-area financial market along national lines.[2] We concur on both the assessment and the priority, and take them as a basis for discussing the fiscal implications of a European banking union.

In doing so, we are making a choice that it is important to spell out, because there is another possible motivation for forming a banking union, with significantly different fiscal consequences. This other motivation is rooted in the logic of completing the single market, facilitating the resolution of cross-border banking failures and ensuring a level playing field in competition among EU banks. It is this logic that underpins the Commission proposals on the strengthening and reform of the common EU framework for banking.[3] While this motivation is undoubtedly strong, we consider that an overriding priority must be given to repairing the deficiencies of EMU and ensuring the stability of the European currency. At the same time, a banking union should allow for special provisions for EU member states that are intending to join the single currency, in order to make it possible for these countries to take part in important elements of the banking union and to prepare for eventual full membership.

Whereas the fiscal dimension is of second order if one prioritises the single market, it is of paramount importance for EMU. Indeed the very notion of a perverse feedback loop between banks and sovereigns highlights both the financial risk involved in keeping banks under the responsibility of fiscally weak sovereigns and the fiscal risk involved in letting national governments alone bear the responsibility for rescuing the banks headquartered on their territories.

The rationale for forming a banking union is to minimise these twin risks through a system of common insurance that breaks the feedback loop and thereby reduces both the frequency and incidence of systemic banking crises. Naturally however, whether there will actually be fewer banking crises and whether they will have less severe consequences depends on the design of the new regime, on its credibility, and on the degree of consistency that will be achieved between its main components. For any insurance system, it will also depend on whether all actors will be given the right incentives to behave prudently.

The main purpose of this paper is to discuss the fiscal dimension of a European banking union designed along these lines. We start in section 2 by reviewing the evidence on the fiscal cost of banking crises. In section 3 we discuss why and how a euro-area banking union may contribute to reducing financial and fiscal risks. In section 4, we discuss key choices as regards the allocation of responsibilities in a banking union. Section 5 addresses the fiscal arrangements specifically. Section 6 proposes principles for dealing with the current legacy of banking sector problems.

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[2] See ECB (2012) and Merler and Pisani-Ferry (2012).

[3] Commission proposals of June 2012 on the creation of an EU framework for bank recovery and resolution.

2) The fiscal dimensions of banking crises

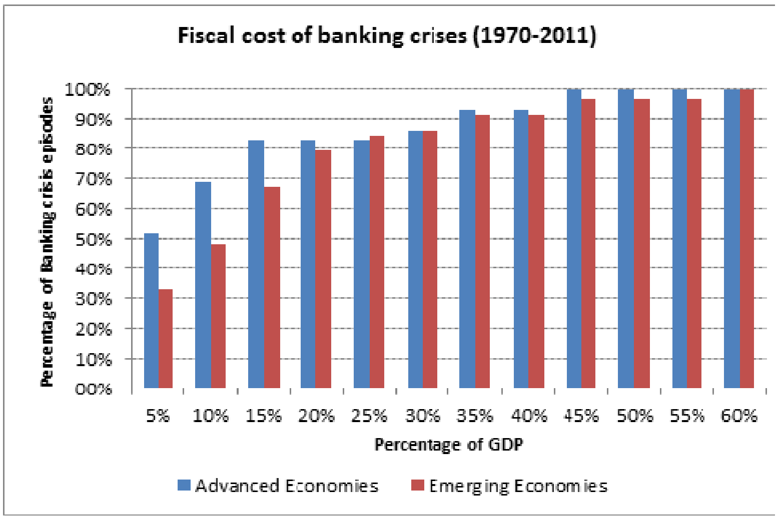
Systemic banking crises – crises that go beyond the failure of an individual medium-size institution - entail potentially huge fiscal costs. A comprehensive body of international evidence confirms that implicit or explicit state guarantees to banking systems represent major contingent liabilities, whose materialisation may jeopardise sovereign solvency. To the extent that markets expect this threat to materialise, the *fiscal risk* may lead them to price a sovereign default. Actual public finance costs result from assistance provided to financial institutions through recapitalisation and the liability guarantees – this is the *direct fiscal cost* – as well as from foregone tax revenues or additional expenditures implied by the adverse economic impact of banking crises – the *indirect fiscal cost*. Data collected by the IMF indicate that economies of very unequal development level can be subject to such shocks (Box 1).

Box 1: Determinants and fiscal consequences of banking crises

Banking crises are a risk not only for emerging markets but also for advanced economies. Even though they tend to occur more frequently in developing economies, crises are longer lasting and deeper in developed economies. According to an IMF database[4], the average duration, output loss relative to trend and direct fiscal costs of all banking crises during the period 1970-2011 were 2 years, 26% (cumulated output loss) and 10% of GDP (direct fiscal outlays due to financial sector rescue packages) for emerging markets and 3 years, 33% (cumulated output loss) and 3.8% (direct fiscal cost) of GDP for advanced economies. Other studies based on different methodologies find similar results.[5] In the case of the current crisis, the IMF data show that at end-2011 the cumulated output loss in the euro area amounted to 23% while the direct fiscal cost was estimated to be 3.9% of GDP.

[4] See Laeven and Valencia (2012).

[5] The literature identifies three main channels through which to assess the fiscal costs of financial instability, namely: (i) direct bailout costs, (ii) losses of tax revenues from lower capital gains, asset turnover and consumption, and (iii) effects of asset price changes on the real economy and the cyclical component of the budget balance(Eschenbach and Schuknecht, 2002). See Hoggarth, Reis and Saporta (2002) for more on fiscal costs of banking crises.



Source: Bruegel calculations with the Laeven and Valencia (2012) database.
Reading: in 50 per cent of the episodes in advanced economies, the fiscal cost was below or equal to 5 per cent of GDP; in 70 per cent of the episodes, it was below or equal to 10 per cent of GDP.

Banking crises can occur pretty much everywhere but low real GDP growth, high real interest rates, high inflation, low foreign reserve cover of broad money, positive credit growth, the existence of a peg of the foreign exchange rate, and an increase in exposure of banks to the private sector raise the probability of experiencing a banking crisis.[6]

One of the main determinants of the fiscal cost of crises is the resolution policies that are applied. Empirical evidence suggests that resolution policies that included open-ended liquidity support, regulatory forbearance and an unlimited depositor guarantee added a significant fiscal cost.[7] For example, Japanese forbearance in the 1990s and the early 2000s resulted in magnifying fiscal costs and prolonging economic stagnation, whereas swift Swedish resolution in 1991-1992 had the opposite effects.

Minimisation of both the economic and the fiscal cost of banking crises is a key policy objective. To this end, the resolution regime is of central importance. The extent to which costs can be distributed to the *private creditors* - while ensuring the restoration of financial stability - matters considerably. A well-designed resolution regime is also an incentive to prudent behaviour on the part of lenders. Overall, adequate resolution regimes can thus significantly reduce the fiscal cost of banking crises.

It would be an illusion, however, to believe that together with adequate micro- and macro-prudential supervision, a properly designed resolution regime can *eliminate* the fiscal risk. There are circumstances when the commitment of significant amounts of public money is the best or even the only economically efficient way to contain the consequences of a banking crisis. Access to budgetary resources in case of need is therefore an essential adjuvant to financial stability. Resources must be sufficient to cover the costs arising from direct re-capitalizations and bail-outs but also guarantees that help prevent bank runs and to stabilize the financial system. Even if the guarantees are not being called upon, they are taken

[6] See Demirgüc and Detragiache (1998), Duttagupta and Cashin (2008).
[7] See Honohan and Klingebiel (2000).

into account in sustainability assessments and may affect market perceptions of sovereign solvency. Corresponding fiscal resources must be available. A credible fiscal backstop is therefore an indispensable element of any crisis management and resolution regime.

3) Why banking union should contribute to reducing fiscal vulnerabilities

A robust stylised fact in the euro crisis is that in vulnerable countries, the market assessment of banks and sovereign default risks are highly correlated (see Figure 1 of Appendix 1). Over time, the correlation has been very high in Spain and Italy while it is less pronounced in France and virtually non-existent in Germany. Similarly to Germany, there is very little correlation between banking and sovereign risk in the US and the UK – despite, in the US case at least, a strong deterioration of bank default risks at the time of the global financial crisis.

In all countries, a potential feedback loop exists between banks and sovereigns. Banks are exposed to sovereigns because of their domestic government bonds portfolios and their exposure to the domestic economy, and because the value of the implicit government guarantee they benefit from diminishes when the sovereign's solvency is put into question. Sovereigns are exposed to banks because of this very guarantee and the indirect fiscal cost of a financial crisis. In addition, there are several reasons why banks stress and sovereign stress are more correlated in the weaker euro-area countries:

- Correlation only sets in if markets assess sovereign default risk as significant. It does not show up if the fiscal position is strong, or if banking sector troubles are of potentially small fiscal consequences;
- The credit risk borne by banks is more diversified in the US than in national European economies where exposures are strongly geared towards domestic loans and assets. This renders European banks vulnerable to strong national cycles[8], including in the mortgage market;
- Banks in the US and the UK hold markedly less securities issued by their own governments than banks in most euro-area countries. In 2011, 2 per cent of US Treasury securities were held by domestic banks. The proportion was around 10 per cent in the UK and the Netherlands, around 15 per cent in France, Italy and Ireland, and around 20 per cent of more in Greece, Portugal, Germany and Spain. The home-biased asset side of their balance sheet makes continental European banks structurally more subject to the sovereign risk;
- Bank refinancing by the ECB through the three-year LTRO has alleviated concerns over the funding of banks but it has increased their exposure to their own sovereign.[9] Liquidity provisioning is not a structural response to the fragility and debt overhang exhibited in the crisis;
- Differences in bank resolution policies matter. Resolution policies that impose the largest part of the cost on private bank creditors reduce the fiscal risk. In the US, there have been on average

[8] Angeloni and Wolff (2012).
[9] See the Bruegel dataset on sovereign bond holdings, available on www.bruegel.org

90 bank closures per year since 2008 but reported fiscal costs since the onset of the crisis have been limited;[10]

- Participation in a monetary union increases the sovereign default risk on the face value of debt as monetary policy does not react to country-specific solvency fears and debt is not monetised.[11] Threats to public finance sustainability, including those arising from bank bailout risks, therefore translate into sovereign solvency risk instead of giving rise to expectations of exchange-rate depreciation and inflation.

Some of the vulnerability factors in this list are independent from participation in a currency union and can therefore be addressed separately from it. But some are inherent to it. What the crisis has revealed is that under conditions of financial stress, participation in monetary union magnified existing fragilities and the corresponding threats to fiscal and financial stability. In turn, increased worries about public finance sustainability and the health of national banking systems contribute to financial fragmentation, to the emergence of large disparities in funding conditions for banks and non-financial agents such as households and SMEs, and ultimately to the reinforcement of the very vulnerabilities at the root of market concerns. This vicious circle is a potentially lethal threat the common currency.

Hence, there is an overwhelming case for complementing Economic and Monetary Union in a way that will strengthen its resilience. A banking union can be seen in this respect as addressing the banking system's liability side of the adverse feedback loopthrough stringent supervision, adequate resolution and effective insurance against banking risk. It should help reduce the negative feedback loop in three ways:

- First, by protecting individual sovereigns from the adverse feedback loop;
- Second, by pooling risk. As in any normal insurance, increasing the number of insured banks with different, partially uncorrelated credit risks will render it less likely that banking risk becomes so large that sovereign risk increases. This will reduce the potential for major crises;[12]
- Third, by facilitating bail-ins. Resolution authorities currently have to consider the risk that bailing-in private creditors will accelerate capital flight. A banking union should reduce country-specific risk so that the European authority can more easily impose losses on private creditors of banks without undermining financial stability. A well designed banking union may therefore also reduce the global fiscal cost by increasing creditor involvement.

In addition, a banking union would help equalise funding condition across banks and therefore across ultimate borrowers of same creditworthiness. This would contribute to repairing the transmission of monetary policy and reducing disparities across countries.

It should be kept in mind, however, that a well-designed banking union would not address the asset side of the problem. Vulnerabilities arising from the banks' high exposure to country-specific credit risk and

[10] The full list of failed and assisted banks of FDIC is available at:
http://www.fdic.gov/bank/individual/failed/banklist.html
[11] See De Grauwe (2011).
[12] The introduction of insurance through a banking union changes the incentives for bank supervision and resolution. Addressing this incentive problem is important for a stable system and will be discussed below.

sovereign default should be addressed through different means – banking market integration, regulatory limits to single-borrower exposure or the creation of Eurobonds – whose discussion falls beyond the scope of this paper.

4) The structure of a banking union

It is widely accepted that banking union involves four pillars[13]:

- Supervision of financial institutions;
- Deposit insurance;
- Resolution of failing banks or systemic banking crises;
- A (common) fiscal backstop.

These four pillars are closely linked to each-other. In principle, a consistent approach to banking union therefore suggests allocating them to the same level of governance. For example, if bank supervision is organized at European level, central resolution functions should be allocated to the same level. Otherwise, the national resolution authority may rightly argue that it has to act because of supervisory failures at European level and that it lacks appropriate information. Similarly, national taxpayers would not agree to a system that would make them pay for the faults of a European institution on which they have no control. It is also easy to imagine cases in which the European supervisor would withdraw a given institution's banking licence, forcing national resolution and the commitment of public money, whereas national authorities would have preferred forbearance. To make national taxpayers pay for the consequences of a decision their own government opposes would be a recipe for serious troubles.

At the same time there are clear obstacles to complete centralisation:

- There are numerous practical obstacles to organizing a common supervision for a large number of banks;
- Even though deposit guarantee systems have the same aims, their organisation differs significantly across and even within countries (Appendix 2);
- Resolution involves the closing or absorption of financial institutions, which is organised differently in heterogeneous legal system, for example as regards bankruptcy and labour laws (Appendix 2);
- The complete pooling of the potential fiscal costs of banking crises would create incentive for countries to support the development of oversized banking sectors as potential losses would be socialised, while benefits in terms of jobs, profits and credit would remain mostly national.

To determine what the architecture of banking union should be, it should also be recognised that these four components do not carry the same weight.

Supervision is of vital importance. Distribution of responsibilities in this field largely drives the degree of centralisation in other fields. It is also where the Euro Summit has taken the clearest stance. One issue

[13] See, for example, Pisani-Ferry, Sapir, Véron and Wolff (2012).

that is still heavily debated concerns the number of banks that should be covered by the common supervision, with suggestions varying between 20 and 6000 banks.[14] Clearly, direct responsibility for supervising all European banks cannot be given to the ECB. At the same time, limiting the scope of banking union to the very small number of banks that are systemic on the European scale would be insufficient to break the sovereign-banking feedback loop.[15] However the real choice is not between 20 and 6000. The banking industry being highly concentrated, the largest 200 banks represent more than 95% of assets of banks in the euro area (see Figure 2 of Appendix 1). This suggests a regime where legal responsibility for supervising all banks is given to the ECB, but supervision of the smallest institutions is delegated to national authorities. The implementation of monetary policy decisions within the Eurosystem and antitrust enforcement within the European Competition Network offer two examples where centralised decision-making powers are combined with a degree of decentralisation in implementation.

The relevance of *deposit insurance* seems to have been somewhat overemphasized in recent discussions. Pre-funding of Deposit Guarantee Schemes (DGSs) through contributions from the banking sector is currently of an order of magnitude inferior to the cost of a systemic banking crisis: a few tenths of percentages of GDP (see Appendix 2). These funds help insure depositors against the failure of a single small-size financial institution but they are vastly insufficient in case of a systemic crisis. Deposit insurance cannot credibly insure against threats to the integrity of the euro area either. From a fiscal standpoint, DGS centralisation is therefore a second-order issue. The case for further harmonising and centralising deposit insurance rests on consumer protection and financial stability arguments: the more European bank customers will benefit from the same protection, the lower will be the risk of deposit run. There is also a valid pooling argument: the more centralised the DGS is, the lower the probability that it will be exhausted in a crisis. At the same time concerns about the organization of deposit insurance should not stand in the way of forming a meaningful banking union.

The organisation of *resolution* involves trade-offs. As indicated the logic of centralising resolution is compelling once supervision is centralised, but at the same time full centralisation would require significant changes in national insolvency, labour and tax laws. In principle, banks could fall as any other corporation under normal insolvency law. Yet, the special function of banks and the central importance of banks for the real economies suggest that different mechanisms should be installed to be able to preserve the parts of banks that have vital functions for the broader economy. Yet currently, different national systems confer different degrees of power to authorities to wind down financial institutions in a special resolution framework and some countries do not even have an explicit bank resolution framework. The European Commission proposal for a new directive therefore aims at harmonizing the national resolution frameworks in the EU and to create special rules for the resolution of cross-border banks (see Appendix 2 for more details).

However, a fully harmonized system of rules with resolution still being exercised at a national level would not suffice for a banking union. In fact, even with fully harmonized rules, national authorities may

[14] This document was finalised before the publication of the Commission proposal on September 12.
[15] This approach would also raise potential competitive distortions, would imply different benefits across countries, for a detailed description, see Pisani-Ferry et al. (2012).

still interpret rules differently. As a result, they may distribute losses between creditors and tax payers differently. A common European fiscal backstop would create the incentive for the national authorities to shift burdens onto the European taxpayer. Ultimately, a common fiscal backstop will therefore require a much higher degree of centralization of bank resolution than envisaged in the proposals of the European Commission of June of this year.

The central conclusion on the structure of a banking union is thus the following. First, supervision, resolution and the fiscal backstop need to be allocated to the same level. Second, the coverage of banks should be wide enough to capture most if not all of the banking sector assets. Third, practical ways to combine centralised authority and decentralised implementation should be found, drawing on available European experience. Fourth, while centralisation of deposit insurance is desirable, it is of secondary importance in the creation of a banking union.

5) Options for a common fiscal backstop

The creation of a European banking union requires an agreement on how to organize the fiscal backstop that would be needed in case of a systemic crisis. As indicated in section 2 and as exemplified by the recent case of Ireland, banking crises can be *extremely* costly. It is therefore not sufficient to envisage pooling limited resources such as deposit guarantee funds or a specially designed small resolution fund while leaving the public finances in individual member states at the mercy of the tail risk of a catastrophic event. The status quo - a purely national organization of the fiscal backstop - is inconsistent with a financially integrated single currency area. It would not break the sovereign-bank feedback loop; it would not tackle financial fragmentation and the resulting real economic fragmentation; and it would leave intact the banks' dependence on ECB liquidity, thereby de facto shifting risk onto the ECB. Also a broad but unspecific agreement to share the burden of future crisis would be insufficient: the availability of resources would be subject to ex post agreement by national decision makers and parliaments and would therefore lack credibility.

The organisation of such a backstop nevertheless raises important questions.

- The first question is whether a common insurance would lead to a distributional bias of tax resources from some countries to others. The empirical evidence does not suggest this would be the case. As pointed out by Carmen Reinhart and Ken Rogoff, banking crises are "an equal opportunity menace" that can affect all countries rich and poor[16];
- The second question is about the incentives that a common fiscal backstop creates. It is well known that the introduction of insurance creates moral hazard. The pooling of risk at a European level would increase the incentive of countries to run irresponsible banking policy as potential losses can be socialised while the benefits in terms of jobs and credit would mostly be national. A robust system needs to deal with this incentive problem;

[16] Reinhart and Rogoff (2008).

* The third question relates to the contribution key to the common insurance. In principle, contributions to insurances should be commensurate to risk.

These questions suggest that a common fiscal backstop requires a centralized supervision and resolution regime as indispensable ingredients to mitigate the moral hazard problem. Moreover, ex-ante contribution to resolution and the contribution to the fiscal backstop should be linked to the size of the banking sector in the country. Finally, even with a fully centralised supervision and resolution framework, other still- national policies matter for banking sector risk. Therefore, co-insurance should be aimed at, through always making national taxpayers partly liable for fiscal casualties. The exact distribution between the national and the supranational fiscal backstop should be based on clear ex-ante rules.

Against this background, several options for the common fiscal backstop can be envisaged.

A European Resolution Fund

The first option would be the creation of a large common resolution fund calibrated to cover a large proportion of potential banking crises costs. Contributions to the fund would be paid in over 10-20 years to build up a fund of significant size, say 5% of euro-area GDP. The contributions could come from a specific levy based on the assets of financial institutions. Different formula could be envisaged depending on the exact base chosen, the temporary or permanent character of the levy, etc..

This option would have a number of important advantages. To start with, potential resources are available to this end – there have even been discussions on the value of taxing the financial sector on purely Pigouvian grounds, i.e. to limit excessive financial development rather than to raise revenues.[17] Second, a prefunded scheme would be very credible and the immediate availability of resources would mitigate banking panics.

However, there are also potential shortcomings. First, under current circumstances one may question the wisdom of accumulating in a fund instead of reducing public debt. Second, a fund of such size would have difficulties finding safe assets in which it can invest and which can be liquidated in crisis times.[18] Third, a fund of even significant size cannot provide a full guarantee in case of a generalized banking crisis. Overall, the idea of a fund deserves to be considered but it appears unlikely that Europe will agree on building up in the short to medium run a fund of sufficient size. Until it is built up, other fiscal resources will be needed.

An ex ante burden-sharing agreement

The second option for a common fiscal backstop is a system in which there is an ex-ante agreement on distributing the fiscal costs of banking crises. The agreement would consist of a clear rule spelling out how much of the cost would be borne by national tax payers and how much by the tax payers of the

[17] See IMF (2010).

[18] Government bonds cannot be used for such a purpose as exactly in times of banking crisis one wants to prevent fire-sales of governments. Assets in countries outside the euro area suffer from the drawback of being subject to exchange rate risk. Only gold appears to be an asset that has the right properties for times of financial crisis.

European partners. The rule could be based on the ECB capital key or a variant of it taking into account the size of each country's banking sector. A clear governance structure would be needed to call in the national resources.

This solution, however, would make the intervention capacity dependent on ex post approval in the participating states by parliaments and decision makers. Experience with assistance to countries in distress has shown the limits of such schemes and the risks they represent to the credibility of the insurance. Burden-sharing arrangements therefore entail the risks that states, which retain the ultimate decision, will backtrack from commitments. An ex-ante agreement therefore requires strong institutions in order to be time consistent and credible ex post.

The ESM as a fiscal backstop

In a third option, the EFSF/ESM could serve as a fiscal backstop. If all of the resources available in the ESM were to be allocated to that purpose, the EFSF/ESM would be an institution of sufficient size to cover the median direct fiscal cost of a banking crisis as identified in Laeven and Valencia (2012) of around 4% of GDP. However, the option has a number of disadvantages. First, many banking crises cost significantly more as we have shown above. Second, in current conditions the EFSF/ESM cannot provide the ex-ante guarantees (or blanket guarantees) that may need to be given to prevent a generalized panic. The big advantage of the EFSF/ESM option would, however, be that the institution is already being put in place, that it has resources and that it is equipped with burden-sharing agreements. Moreover, it has strong governance mechanisms that render it able to take swift decisions in emergency situations.[19]

Under current arrangements the EFSF/ESM option would fall short of providing the guarantee that may become necessary in exceptionally adverse cases. It has, however, the big advantage of being operational and is therefore our preferred short-term option.

Contingent European taxation

In a fourth option, the euro area could be granted a limited and contingent taxation capacity. The big advantage of this option is that it would not only create the capacity to raise fiscal resources to pay for bank resolution. This option would also allow creating an institution that could issue a credible blanket guarantee in case of a major systemic confidence crisis into banks. It is, therefore, an option we consider desirable for the long term. In the short run, however, this solution is unlikely to command broad enough support within the EU and it would require a much more significant advancement in terms of the governance and democratic legitimacy than the other options.

6) Dealing with the legacy

All our discussion this far has been conducted under a "veil of ignorance" – which is known to be the right condition for achieving justice in the discussion of distributional issues. This veil, however, does not apply to current conditions. Introducing a common fiscal backstop in the current situation is made

[19] The note was written before the ruling of the German constitutional court in Karlsruhe of September 12. We will discuss the issue of parliamentary legitimacy in the last section.

difficult by the legacy: some banking system are in worse shape than others; some sovereigns are more at risk of becoming insolvent than others; some countries have already drawn on euro-area assistance while others have contributed. In this context a few points deserve short discussion.

First, delaying resolution increases the size of the problem at hand. As illustrated by the Japanese example in the 1990s and the 2000s, forbearance is indeed very costly (ESRB, 2012). The earlier European decision makers can agree on acting and on distributing the burden of the current crisis, the lower will be the overall cost. Unfortunately, Europe has already started experiencing a Japanese-style scenario where losses in banks are not recognized and overall credit provisioning to the real economy is subdued for a prolonged period of time.

Second, fairness considerations require that legacy costs should be borne by those creditors and governments that have failed to exercise appropriate surveillance. The creation of a fiscal insurance should therefore ideally not apply to existing problems but rather to future ones. The mutualisation of legacy costs may nevertheless be warranted on a number of grounds. To start with, banking problems in some countries express to some extent a common failure. For example, the absence of a common supervisor has allowed for regulatory arbitrage which has effectively put limits on the scope of national supervisors in some countries to prevent excess risks. Also, unresolved banking problems in some parts of the monetary union have negative repercussions on the union as a whole. In particular, when banking problems cause a sovereign debt crisis due to the negative feed-back loop between banks and sovereigns, a much more significant financial stability risk emerges which also affects strong countries. Finally, legacy costs that prove too high may eventually get mutualised one way or another. Concerted support is probably preferable to sovereign debt restructuring or inflation.

Applying a common fiscal backstop to legacy problems requires careful design in order to reduce major incentive problems and ensure fairness. There is a need for a robust screening process, in which a neutral institution is assessing the actual cost of the problems accumulated in individual banks and national banking systems as a whole. Once this is established, the cost of the legacy will need to be distributed so that incentives for good policy are preserved. Different options can be discussed: allocate the first loss always to the national tax payer (the European fiscal backstop would step in only if costs exceed the threshold where national sovereign solvency is endangered); a burden-sharing starting with the first euro of loss; provide backstop to governments that would still be held uniquely responsible for bailing out banks (this option, however, would be insufficient to break the sovereign banking feedback loop). We do not want to enter into details of this discussion here.[20]

7) Conclusions

The creation of a European banking union is a major endeavour. The euro area is characterized by the particular weakness that banking and sovereign risk are mutually reinforcing. The euro-area summit therefore called for the creation of a banking union to break this link. A viable banking union requires common supervision, a strong common resolution framework and a common fiscal backstop. Indeed, while good bank resolution policies with creditor bail-in are central to reducing fiscal costs, they cannot

[20] Pisani-Ferry et al. (2012) includes a more developed discussion, especially of the screening process.

fully eliminate them. A mechanism for a common fiscal backstop is therefore needed and its design should be such that perverse incentive problems are avoided. Beyond the actual fiscal costs of banking crises, arrangements need to be found under which implicit or explicit government guarantees can be provided to backstop the financial system.

As the creation of a meaningful banking union has far-reaching consequences for resolution policies and fiscal policy, a strong and robust governance system needs to be put in place. In particular, clear decision-making power needs to be allocated so that decisions about bank resolution and distribution of costs are taken quickly and effectively. Moreover, the democratic legitimacy of those decisions needs to be strengthened significantly.

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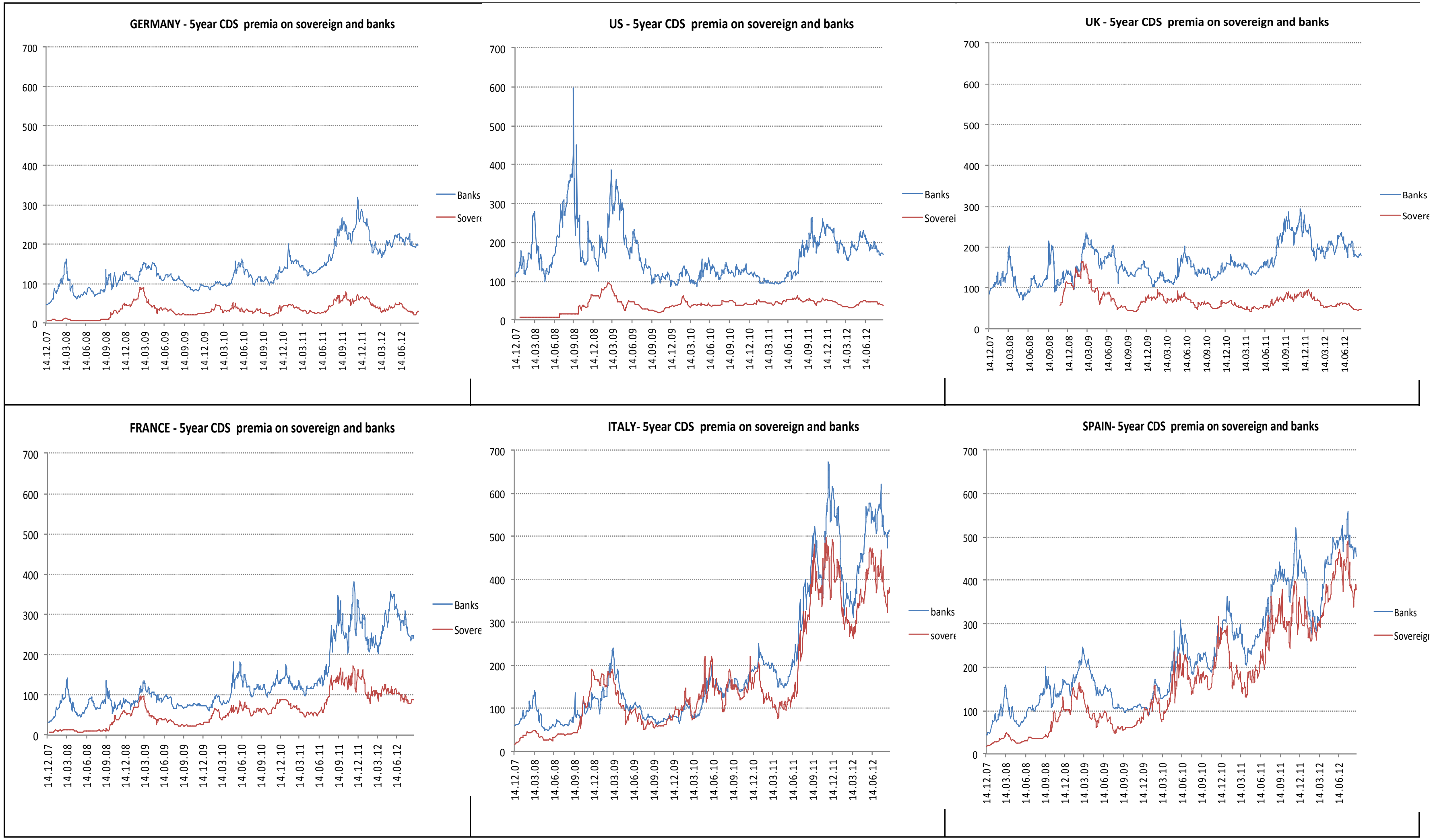
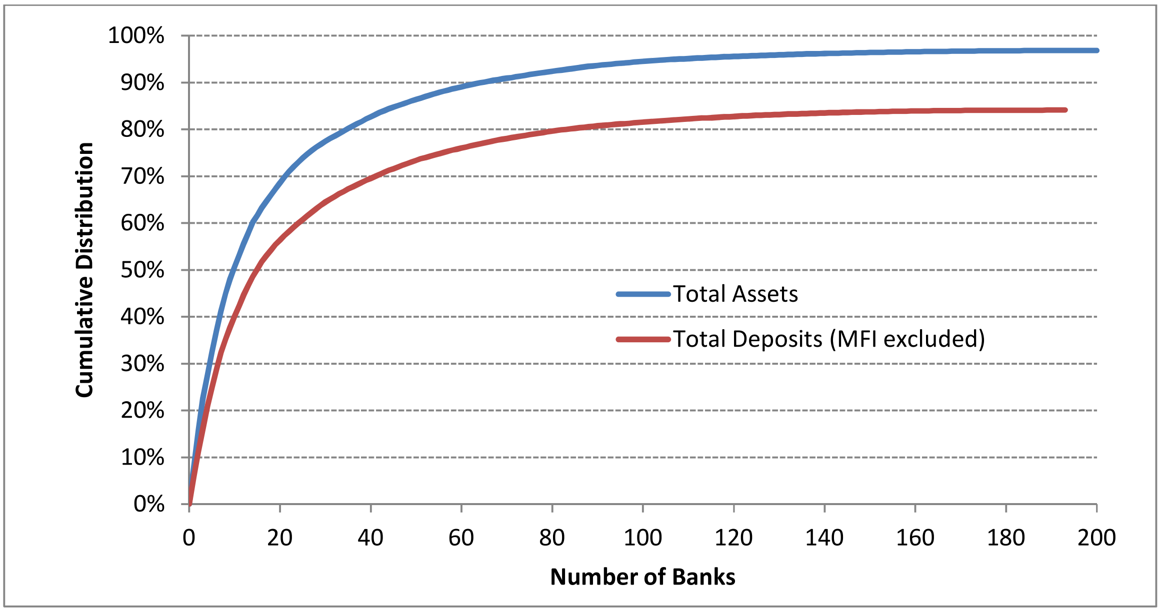
Appendix 1: Figures

Figure 1: 5-year credit default swap (CDSs) risk premia on sovereigns and banks in selected euro area countries, the UK and the US



Source: Datastream

Figure 2: Distribution by Asset and Deposit Size of the Euro-Area Banking Sector



Source: The Banker Database and ECB

Notes: 2010 year-end data

Reading: the assets of the 20 largest banks represent 68.6 per cent of total bank assets in the euro area.

Appendix 2: Banking policy disparity in the euro area and recent initiatives to overcome them

1. Resolution

Resolutions regimes differ significantly across countries of the EU. Some countries do not even have an explicit resolution regime. The resolution authority is the central bank in some cases, in others it is the bank supervision authority or a different institution. Funding can come from restructuring funds, deposit guarantee schemes or directly from tax payers. The table below provides a simple overview of resolution regimes in the four largest euro area countries.

Table A1: Resolution regimes in selected European countries

	Germany	France	Italy	Spain
Types of Resolution Regimes[21]	Special Resolution Regime	Special administration or management regimes	Special administration or management regimes	Special Resolution Regime
Resolution authority	BaFin in consultation with Deutsche Bundesbank	French Prudential Supervisory Authority (ACP)	Bank of Italy	Bank of Spain
Funding of resolution	Restructuring Fund administered by Financial Markets Stabilisation Agency and distinct from deposit guarantee schemes	Deposit guarantee schemes can be used to fund resolution, under certain conditions	Deposit guarantee schemes can be used to fund resolution, under certain conditions	Deposit guarantee schemes can be used to fund resolution, under certain conditions
Covered entities	Credit institutions	Credit institutions and Investments banks	Credit institutions and Investments banks	Credit institutions

Source: BIS (2011) and resolution authorities' official websites

Recognizing this heterogeneity, the European Commission has proposed a directive[22] to harmonize resolution regimes across the EU. It is a recovery and resolution framework and its legal basis is Article

[21] Special resolution regimes allow authorities to take control of banks before or upon insolvency and provide a wider range of resolution or stabilization powers thereafter. Special administration or management regimes are hybrid administrative/judicial regimes in which the banking supervisors or resolution authorities appoint special officials to implement resolutions (BIS, 2011).

114 of the TFEU. The proposal harmonizes national laws on recovery and resolution of credit institutions and investment firms. The framework also recognizes the existence of large cross-border groups for which it establishes special rules concerning the transfer of assets between entities affiliated to a group in times of financial distress. The Commission chose a directive so that transposition at the national level can be made compatible with the non-harmonized areas of national law such as insolvency and property law. A further noteworthy element is the bail-in tool so that the write down of claims of unsecured creditors as well as the debt-equity convertibility is made possible. Finally, the directive recognizes that additional funding may become necessary. It foresees to achieve a minimum target level of 1% of covered deposits to be paid-in in a period of 10 years. National financing arrangements are combined with borrowing mechanisms between the national systems and the mutualisation of national arrangements in the case of the resolution of cross border groups.

Even the best designed resolution regime cannot exclude the need for fiscal resources in a crisis. The empirical evidence clearly shows that in significant financial crises, the governments will usually be called upon to support the process of restructuring of banks with fiscal resources. In the case of the current crisis in the euro area, this recourse has been very substantial. Laeven and Valencia (IMF, 2012) estimate the direct fiscal costs of gross restructuring (excluding liquidity support and asset purchases) to amount to 1.8% of GDP in Germany, 40.7% in Ireland, 25.4% in Greece, 12.5% in Spain (including the new €100 billion financial rescue package).

2. Deposit insurance

Deposit insurance systems are designed to increase the trust of depositors into their deposits and thereby prevent sudden withdrawals of funds. This increases the stability of the funding base of banks by reducing the likelihood of bank runs. The deposit insurance is thereby contributing to lower risks for governments to have to bail-out banks.

Again, there is a wide range of different systems of deposit insurance in the EU. Even within countries, different credit institutions have different deposit guarantee systems (DGS). In some countries, the DGS is pre-funded, in others, it is an arrangement as regards the ex-post burden sharing. An EU directive harmonizes the level of deposit insurance.

All EU countries have an explicit DGS. However, huge differences exist across the different jurisdictions. Some countries are characterized by a single DGS covering all the credit institutions, while multiple systems are implemented by other jurisdictions with the aim of covering depositors in various types of institutions. In most of the counties, DGSs are completely funded by banks. However, the type of financing may vary – with some deposit insurance schemes funded ex-ante and others funded ex-post. Even though mostly founded on risk-based premiums, the criteria for the fee determination in ex-ante funded DGSs are heterogeneous. Directive 2009/14/EC harmonizes the different DIS across jurisdictions

[22] Proposal for a “Directive (…) establishing a framework for the recovery and resolution of credit institutions and investment firms (…)”, COM(2012) 280/3.

and sets the coverage equal to 100,000 euro per depositor per institution. All domestic banks and all local branches of foreign banks are required to join the national deposit insurance schemes. Foreign branches of domestic banks may join the schemes on a voluntary basis. The tables provide an overview of the different DGS in 5 euro area countries.

Table A2: Deposit guarantee schemes in selected euro-area countries

Jurisdiction	Deposit insurance organization	Coverage	Participation
France	Fonds de Garantie des Dépôts (FDG)	All banks	Compulsory
Germany	German Private Commercial Banks Compensation Scheme for Depositors and Investors	Private banks	Compulsory
	Depositor Compensation Scheme of the Association of German Public Sector Banks	Public banks	Compulsory
	Private Association of German Banks: Deposit Protection Fund	Private banks	Voluntary
	Deposit-Protection Fund of the Association of German Public Sector	Public banks	Voluntary
	Protection Scheme of the National Association of German Cooperative Banks	Cooperative banks	Institutional protection schemes
	Protection Scheme of German Saving Banks Association	Savings banks	Institutional protection schemes
Italy	Interbank Deposit Guarantee Fund (FITD)	All banks	Compulsory
	Mutual Bank Depositor Guarantee Fund (FGDCC)	Mutual banks	Compulsory
Spain	Fondos de Garantía de Depósitos (FDG)	All banks	Compulsory
The Netherlands	Deposit Guarantee Scheme	All banks	Compulsory

Table A3: Comparison of deposit guarantee scheme features[23]

Jurisdiction	France	Germany	Italy	Spain	The Netherlands
Multiple Systems	No	Yes	Yes	No	No
Type of System	Government legislated and privately administered	Government legislated and privately administered	Privately established and administered	Privately administered[24]	Government legislated, administered by DNB
Funded by	Banks	Banks	Banks	Banks	Banks
Financing	Ex-ante	Ex-ante	Ex-post	Ex-ante	Ex-ante[25]
Risk-based Premiums	Yes	Yes		Yes	Yes
Deposit Coverage	100,000 €	100,000 €	100,000 €	100,000 €	100,000 €
Set-off[26]	No	Yes	Yes	No	No

[23] Information shown in this table refers to the two German statutory Deposit Guarantee Schemes (DGSs) and to the Italian Interbank Deposit Guarantee Fund (FITD).
[24] The Royal Decree Law 16/2011 of the Spanish Council of Ministers set up the Deposit Guarantee Fund of Credit Institutions as merger of the three deposit guarantee funds for banks, savings banks and credit cooperatives.
[25] The Netherlands has introduced the ex-ante financing in July 2012.

By depositor and institution		Yes	Yes	Yes	Yes	Yes
Deposits(% of the total)[27]	**Eligibible**	92%	~40%	45%	65%	59%
	Coverage	67%	n/a	31%	47%	48%

Note: n/a=not available

Source: FSB (2012), official website of the DISs and of IADI (International Association of Deposit Insurers)

One question related to deposit insurance is whether funds should be used for purposes other than the deposit insurance itself. In fact, in the US, the deposit insurance and the resolution authority draw on the same fund and are one authority (FDIC). Within the euro area, some countries have chosen such an approach while other countries are adamant not to mix deposit insurance funds for any other purposes. In certain specific circumstances, it may be preferable to use the DIS funds to save the bank instead of allowing for a bank failure and afterwards rescuing the depositors. Yet, it comes with significant risks in terms of distorted incentives.

The guarantee of governments and the government's ability to assume fiscal risk renders DIS credible in case of a systemic banking crisis. DIS as such rarely have enough accumulated funds to ensure deposits resulting from the failure of several large banks. In case of a more systemic crisis, depositors will therefore tend to panic despite the existence of a DIS. DIS therefore typically have an explicit or implicit guarantee of the governments and tax payer behind them. In the EU, the European Council of October 2008 last gave an explicit blanket guarantee by declaring that in the EU all deposits were safe. Since the declaration was perceived credible, depositors all across Europe kept their deposits in the banks and a major banking crisis was prevented. The value of the government guarantee depends on the credibility of the government to be fiscally viable. The government guarantee of a country with weak fiscal fundamentals is of comparatively little value and may not be enough to avert a panic on deposits.

[26] Set-off implies that a depositor's deposits at a failed bank are netted against his liabilities owed to the failed bank, in case of the depositor reimbursements.

[27] They represent the percentage of eligible and covered deposits over the total domestic deposits; these figures have been disclosed by each DIS in the occasion of the FSB's report (2012).