

Two proposals to resurrect the Banking Union: the Safe Portfolio Approach and SRB+¹

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Abstract

Nearly eight years after its inception, the European Banking Union is crumbling. None of its two stated objectives—breaking future contagion between banks and sovereigns, and creating a true single market for banks—have been achieved. In fact, the banking market is more fragmented now than it was at the inception of the Banking Union, as home and host regulators for cross-border European banks fight to ensure sufficient capital and liquidity in each market that a bank might operate in. The reason for this state of affairs is that, of the planned “three pillar” structure of the Banking Union, only its “first pillar” (the Single Supervisory Mechanism), is working smoothly. The “second pillar”, the Single Resolution Mechanism, is being circumvented, along with the bank resolution framework, while Member States continue to spend taxpayer money to prevent investors from incurring losses. The “third pillar”, a European deposit insurance, has been paralyzed for four years. This paper aims to provide a politically and economically viable path to revive our Banking Union. This path rests on two legs. First, creating a model “Safe Portfolio” and incentivizing banks to move toward it. Such “Safe Portfolio” would be the basis for a market-provided European Safe Asset without joint liability. Second, empowering the Single Resolution Board by reforming the resolution framework and setting up a European deposit insurance.

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1. Introduction

Back in 2013, the European Council stated it was imperative to break the vicious circle between banks and sovereigns and to respect the integrity of the Single Market by creating a Banking Union (European Council 2013). During the financial and sovereign debt crises of 2011-2012, sovereigns suffered contagion from banking crises as they were held responsible for bank “rescues”. Banks, in turn, suffered contagion from sovereign crises through excessive sovereign bond holdings in their balance sheets. This “diabolic” (as Brunnermeier et al. called it (2011, 2016)) feedback loop between a Member State and its own financial system put the Union’s common currency at risk and, with it, the future of the European project.

Now, the Banking Union is agonizing. Why this grim diagnosis? The Banking Union was supposed to consist of three elements or, in the usual Euro-parlance, “pillars”. However, only the “first pillar”, a Single Supervisory Mechanism, has been fully implemented. The “second pillar”, the Single Resolution Mechanism, is failing, as the Single Resolution Board (“SRB”) finds itself “in office but not in power”—rather than banks being “resolved” through the use of investors’ money, Member States continue to spend taxpayer funds to maintain zombie banks afloat. Finally, Member States have not even been able to agree on a roadmap to set up a common deposit insurance (the “third pillar”) before 2024. Thus, the sovereign-bank nexus remains strong, and we are far from having a single market for banks. Concerning the contagion from sovereigns to banks, its causes have not been eliminated. During the crisis, the main reason for this contagion was the large exposure of Eurozone banks to their own sovereign’s debt, and it is clear from the figures below that this risk persists.

Figure 1. Risk of Sovereign-to-Bank Contagion remains (own calculations, EBA 2019)

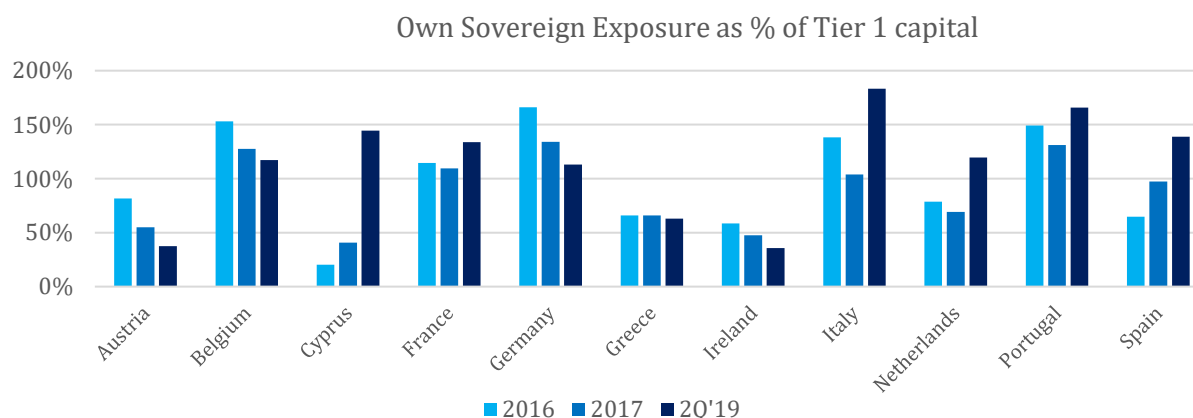
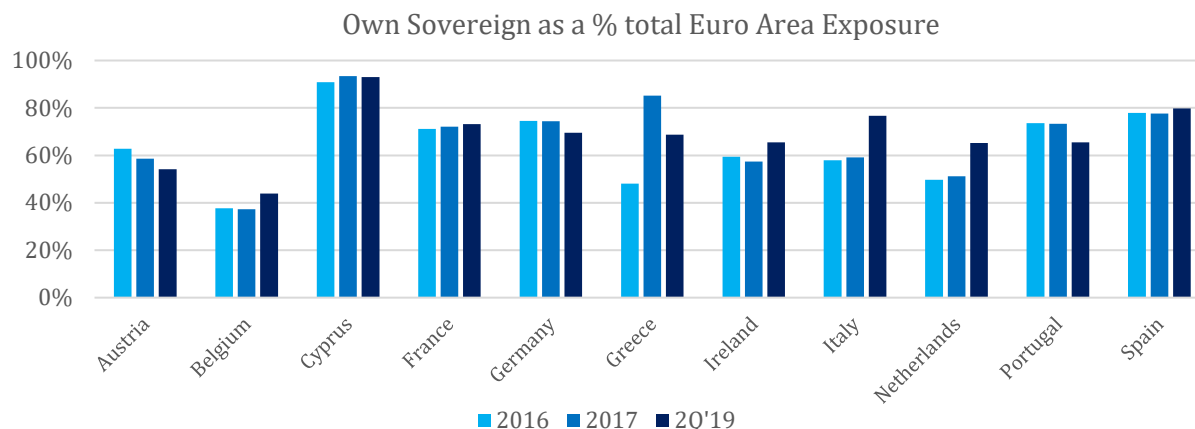


Figure 2. Risk of Sovereign-to-Bank Contagion remains (continued)



Concerning the risk of contagion from banks to sovereigns, it cannot be eliminated as long as generously taxpayer-funded rescues and liquidations (as opposed to European resolutions with suitable bail-in of investors' money) remain the rule and the SRB's system remains unused, as has predominantly been the case for the last few years. Middle-sized banks have been considered by the SRB not to "deserve" European resolution as the "public interest" criterion is found not to be met, while larger banks cannot credibly be resolved by the SRB with the resources currently at its disposal (€33bn in funds and a maximum €68bn from the potential ESM credit line (SRB 2019; Centeno 2019)). Moreover, absent a European deposit insurance, national Deposit Guarantee Schemes remain liable for banking rescues. Their backstop will continue to be, in most cases, the national treasury.

In considering this paralysis, it is crucial to understand the resources and intense pressures aligned against resolution and its essential tool: bail-in. Investors, always and everywhere, prefer a system of "one-sided-bets" (heads they win, tails taxpayers lose) than one where they are taking risks. When investors are politically powerful—for instance, when a large proportion of them are retail investors or are politically influential firms—the pressure to avoid burden sharing is enormous. The result is that comparatively poorer taxpayers are on the hook to prevent investors from incurring losses. If governments have been unable to safeguard public funds during good times, how will they do so in times of crisis? The answer is they will not, especially given that during crises financial markets are the only sources of finance and of knowledge about banks "needing to be rescued", giving banks the eager attention of deadly worried finance ministers (see Brunnermeier's (2016) notion of financial dominance). Hence, absent substantial reform, the next recession or crisis will again be associated with a wealth redistribution from taxpayers to investors.

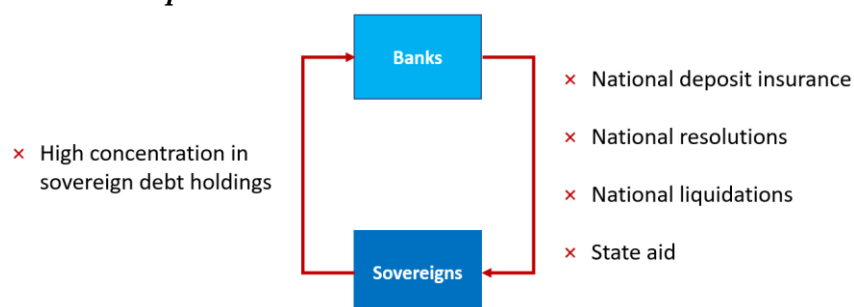
Moreover, a single market for banking services remains as elusive as ever. Banks, which were “global in life and national in death” (Huertas 2009), have become national both in life and in death. For instance, banks’ intra-euro-area exposures have declined by 24% from 2008 levels, while the percentage of euro-area cross-border loans has continued to decrease to reach 6% (Schmitz and Tirpák 2017; ECB 2018).

Last month, the publication of German Finance Minister Olaf Scholz’s “non-paper” (2019) provided an opening to unblock this debate. In it, Mr. Scholz took a significant leap forward as, for the first time, a German official made a specific proposal in favor of a common deposit insurance (albeit, it being a reinsurance in the form of loans, able to provide liquidity and only limited loss coverage). Simultaneously, he called for substantial reform on a breadth of issues, including strengthening our crisis management and resolution regimes, harmonizing bank insolvency law, achieving further risk reduction, and implementing a Common Consolidated Corporate Tax Base.

Mr. Scholz’s contribution gives a lease of life to a debate that appeared to be all but dead. Taking up this opportunity, in what follows I build on some of his proposals and suggest a two-pronged package to push forward and complete the Banking Union. First, we must introduce sovereign concentration charges that promote the establishment of a European “Safe Portfolio” (as coined by Mr. Scholz), moving our banks away from large exposures to their own sovereign (sovereign-to-bank part of the nexus) while preserving Member States’ access to finance and facilitating the path towards a European Safe Asset without joint liability. Second, we must profoundly reform and properly fund the SRB to break the link between bank failures and state intervention (the bank-to-sovereign part of the nexus).

In this paper I develop the two parts of this proposal. In Section 2, I point to the advantages of the Safe Portfolio approach and offer a precise definition of what it could be, of what its implementation would look like, and of how it could constitute a path towards a safe asset. In Section 3, I discuss the shortcomings of the current resolution framework and propose a three-step approach to ensure its effectiveness.

Figure 3. The Diabolic Loop is alive and well



2. A European Safe Portfolio

Traditional approaches to cutting the sovereign-to-bank nexus

The concentration of sovereign risk in banks was a central factor in the diabolic loop that triggered the crisis. As sovereign risk deteriorated during the crisis, and in the context of excessively high bank capital investments in the debt of their own sovereigns (“home bias”), such risk quickly spread from sovereigns to banks (Brunnermeier et al. 2011, 2016). How was this possible?

The most basic banking supervision principles require that banks set aside capital to face different kinds of potential risks. This entails that capital requirements be sensitive to credit risks, regardless of whether such risks are sovereign or not. In this line, Basel II requires the application of risk weights for bonds depending on their rating; however, it allows for an exemption of all sovereign holdings denominated in the sovereign’s domestic currency. In the European Union, the Capital Requirements Regulation makes use of this exemption, and allows for a 0% credit risk weight for sovereign bonds, as well as an exemption from the large exposure limit, which forbids any bank from allocating more than 25% of its Tier 1 capital into a single exposure. This lack of limits and capital requirements has led to the excessive concentration of banks to their own sovereigns at the root of the diabolic loop.

In Basel II, these exemptions were justified given that any sovereign, as controller of its currency, should be able to repay its domestically denominated debt (inflation-concerns aside). In the context of our Monetary Union, where some Member States have faced difficulties to repay their debt, most proposals have sought to limit banks’ sovereign exposure only to these more risky sovereigns. This has been proposed in two ways: through the introduction of credit risk weights on sovereign exposures based on the credit ratings of the particular sovereign (as in the usual Basel Committee approach) and by placing quantitative limits on banks’ exposure to them (as proposed by the German Council of Economic Experts (2015)).

In effect, both proposals would eliminate the exemptions allowed for under Basel II. However, both solutions are lacking, both politically and economically. Politically, because highly indebted Member States will not accept asymmetries in the treatment of their debt that might endanger their ability to fund themselves. Economically, the two proposals have been found to be ineffective: Alogoskoufis and Langfield’s (2019) simulations show that ratings-based risk weights “cannot be

relied upon to stimulate a reduction in credit risk exposure”, largely because of the unreliability and arbitrariness of the whole rating system. Additionally, they also find that hard concentration limits are even less effective, as banks would arbitrage within the cap towards the more risky (and profitable) exposures.

Thus, sovereign ratings are an uncertain and noisy approach to determining sovereign credit risk. At the same time, assigning a 0% risk weight to all EU sovereign bonds generates clear market distortions, and indeed is one of the key sources of the sovereign-bank nexus. Given that credit risk, and the subsequent appropriate weights, remain difficult to effectively measure and determine, it is clear that the market distortion should be corrected by targeting concentration risk, shown to be easier to quantify and weight. However, faced with the ineffectiveness of large exposure limits, an alternative approach, targeting concentration by setting up a system in which banks are rewarded for diversifying their portfolio, is needed.

The publication of the Basel Committee’s “The regulatory treatment of sovereign exposures” (2017) brought marginal concentration-based charges to the forefront of the sovereign exposures debate. Under their proposal, risk weights to sovereign bond holdings would be based on the ratio of the exposure to banks’ Tier 1 capital, with the severity of the risk weight increasing along with the degree of exposure. Based on this idea, Mr. Scholz’s proposes a system in which sovereign holdings are exempt from capital requirements (i.e. have a 0% risk weight) up to 33% of Tier 1 capital (a number originally suggested by Nicolas Véron (2017)). Once concentration surpasses the 33% exemption, a concentration factor would be multiplied by the base credit risk weighting, resulting in a credit risk-oriented concentration charge.

To understand this proposal, it helps to consider Véron’s (2017) on which it is based. Véron calibrates his proposal in a principled fashion. For liquidity purposes, banks should be allowed a 33% sovereign exposure relative to Tier 1 capital free of any risk weights. To prevent banks’ capital from being wiped out in the event of its sovereign’s default, Véron argues that sovereign exposures above 100% of Tier 1 capital should be meaningfully disincentivised while those above 200% should be effectively discouraged.

Figure 4. Nicolas Véron's proposal

Sovereign exposure relative to Tier 1	< 33%	33% - 50%	50% - 100%	100% - 200%	200% - 300%	300% - 500%	> 500%
Applicable risk weight	0%	15%	30%	50%	100%	200%	500%

The approach is reasonable, but it is unlikely that lower-rated Member States would agree to a substantial calibration of the charges for the same reason they prevented the creation of any European safe asset: both policies would decrease market demand for their sovereign issuances, hence increasing their funding costs and, such Member States argue, ultimately endangering financial stability.

A proposal: Towards a European Safe Portfolio

Mr. Scholz's non-paper suggests the germ of an idea that I develop here. It is based on establishing a model European "Safe Portfolio" (as he coined it). For instance, this "Safe Portfolio" could be defined by the capital contribution key of the European Central Bank—Germany constituting 26%, France constituting 20%, Italy 17%, and so on.

My proposal here is that banks would face capital charges (or "concentration" charges), depending on the distance of their own EU-wide sovereign portfolio from this model "Safe Portfolio". The degree of deviation would be calculated based on a distance metric, calculated from the vector difference between the ECB's capital key and banks' sovereign portfolio.

$$\begin{pmatrix} key_{DE} \\ key_{FR} \\ key_{IT} \\ key_{ES} \\ \dots \\ key_{MT} \end{pmatrix} - \begin{pmatrix} exposure_{i,DE} \\ exposure_{i,FR} \\ exposure_{i,IT} \\ exposure_{i,ES} \\ \dots \\ exposure_{i,MT} \end{pmatrix} = \begin{pmatrix} d_{i,DE} \\ d_{i,FR} \\ d_{i,IT} \\ d_{i,ES} \\ \dots \\ d_{i,MT} \end{pmatrix}$$

The distance from the model Safe Portfolio of the portfolio of bank i would be given by

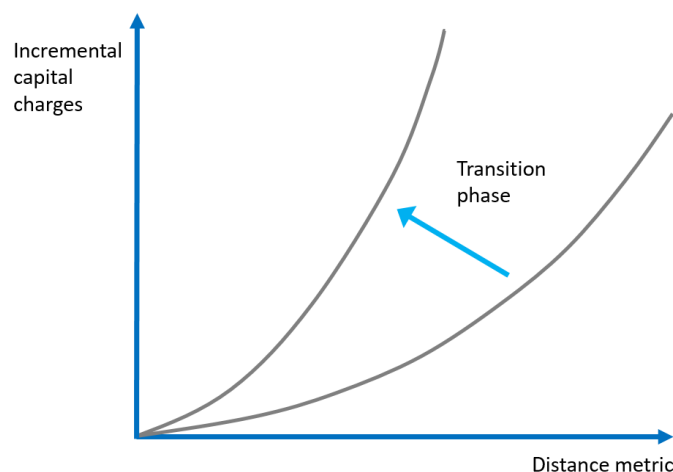
$$d = \sqrt{d_{i,DE}^2 + d_{i,FR}^2 + d_{i,IT}^2 + d_{i,ES}^2 \dots}$$

See for instance the application of the approach to BNP Paribas (figures as of 2Q'19 (EBA 2019)):

$$\begin{pmatrix} 26,4\% \\ 20,4\% \\ 17,0\% \\ 12,0\% \\ \dots \\ 0,1\% \end{pmatrix} - \begin{pmatrix} 10,9\% \\ 31,8\% \\ 21,2\% \\ 9,2\% \\ \dots \\ 0,0\% \end{pmatrix} = \begin{pmatrix} 15,4\% \\ -11,4\% \\ -4,2\% \\ 2,7\% \\ \dots \\ 0,1\% \end{pmatrix} \Rightarrow d_{BNP} = 24,3$$

Thus, banks would be subject to marginal risk weight add-ons that would increase along with this distance. As illustrated in figure 5, the marginal penalty could be small (following the flatter curve, with a slower increase along the distance from the Safe Portfolio) or large (following the steeper curve).

Figure 5. Capital risk charges as a function of concentration



By suitably modulating the rewards for the distance from the Safe Portfolio, we can span all the potential distance between the current bank portfolios. This would allow us to calibrate between a penalty which would not increase with distance and an approach where banks are induced to have a portfolio equal to the capital key of the ECB (with risk weights quickly increasing with distance).

This proposal has two key advantages that could allow it to overcome the political deadlock the completion of the Banking Union faces. First, it is in keeping with the demands of high-rated countries to reduce the degree of sovereign exposures of all European banks, that is, the sovereign-to-bank part of the diabolic loop. Second, the proposal would end the preferential risk-free treatment of sovereign exposures while a substantial calibration of it could be agreed to by low-rated countries given that the proposal ensures that demand for their sovereign issuances will be maintained.

From the Safe Portfolio to the Safe Asset

There is a common weakness to my proposal and Mr. Scholz's. As Alogoskoufis and Langfield's (2019) simulations show, a "quantity based" concentration limit or a "price based" incentive, such as the one above, would reduce concentration, but might increase credit risk. Their paper thus shows that quantity and price-based measures to reduce credit risk will increase

concentration risk, and that quantity and price measures targeting concentration risk will increase credit risk. They argue that, in order to reduce credit risk, a new “safe” asset must be part of a proposal targeting concentration.

Aside from the political advantages of my proposal mentioned above, a central advantage of the Safe Portfolio approach is that it would constitute the path towards a market-developed European Safe Asset (no intermediating agency would be required). Once the concentration charges I propose were in place, as discussed, banks would be regulatorily incentivized to diversify their sovereign holdings towards the Safe Portfolio. In an effort to obtain the diversification bonus, they would demand securitizations composed of sovereign bonds according to the ECB’s capital key since these would help them achieve the Safe Portfolio efficiently through a single transaction.

Were it to be accompanied with complementary policies, including a successful implementation of the European Distribution of Debt Instruments Initiative to integrate our sovereign debt markets and the removal of the necessary charges and discounts which currently apply to securitizations, the Safe Portfolio approach would constitute a path towards a safe asset.³ It is worth noting that the removal of these charges would be justified given that the content of the securitizations would be liquid and well known and hence the non-neutrality principle would not apply. Hence, the market would compete to offer a securitization of sovereign portfolios along the ECB’s capital key as demanded by banks—providing, then, a market-developed safe asset.

However, this market-provided asset would still not be a completely “safe asset”. The Algouf and Langfield (2019) critique may still apply: bank portfolios would be more diversified, but their portfolios could be potentially riskier. No bank would be exposed excessively to the default on their own sovereign, but all banks would be somewhat exposed to the default of that sovereign.

To avoid this problem, the obvious solution, while still ensuring that there is no implicit or explicit cross-country guarantee (no country is “on the hook” for the bad decisions of others) and only market provision, safety could be ensured through *tranching* this asset into a senior and a junior tranche, in the manner of the ESBies (Brunnermeier et al. 2011, 2016) proposal I made in 2011

³ At the technical level, the proposal would have to be designed to prevent banks from “gaming” with different bonds durations, which would allow them to move along sovereigns’ yield curves and would prevent the creation of a homogeneous safe asset. Additionally, it is worth clarifying that exposures to central banks would be exempted from the approach.

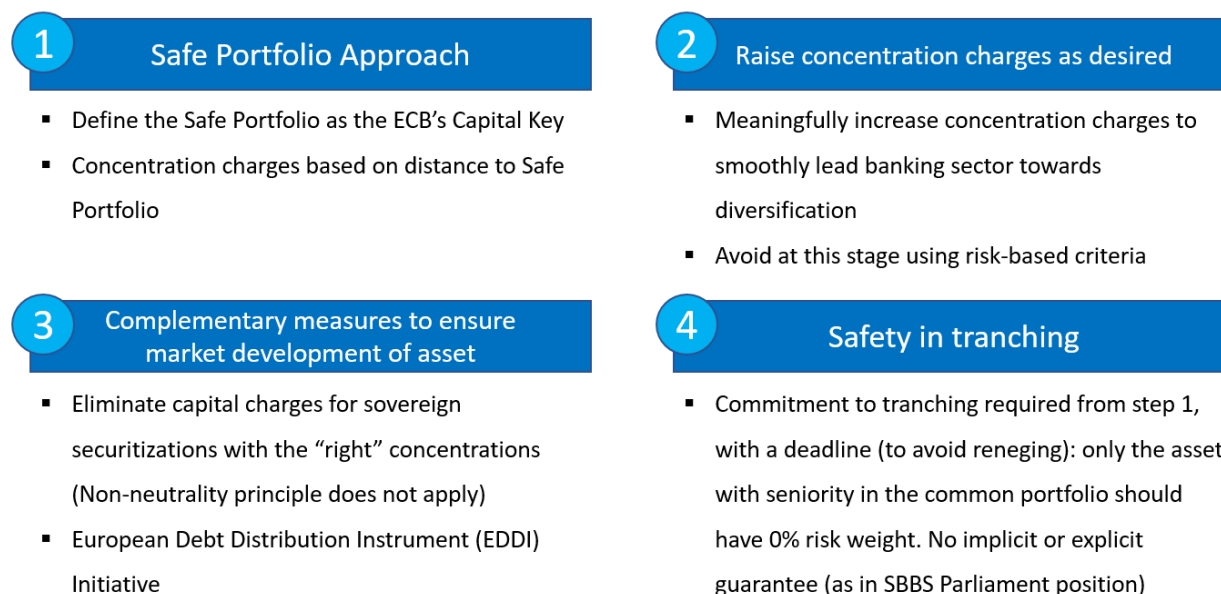
with a group of co-authors and which was, under the name of SBBS, adopted by the European Parliament in April 2019.

The key advantage of this proposal is that tranching provides a European wide safe asset without any need for implicit or explicit cross-country guarantees. After the European Systemic Risk Board conducted hundreds of simulations and stress tests of the different safe asset proposals, it has received the endorsement of the European Commission and the European Parliament, but for the moment the Council has declined to approve it. The main critique we have received has come from the Debt Management officers (DMOs) in some countries' treasuries, which have expressed their fears about the possibility that the interest rate of the marginal debt (debt outside any securitization) would increase.

These fears however are unfounded. First, such an increase in the interest rate of marginal debt was not apparent in the many simulations conducted by the ESRB (ESRB HLTF 2018). Second, a reduction in the flight to safety and bail-out risk and in the risk of contagion induced by the introduction of a safe asset reduces sovereign risk and thus allows sovereigns to access cheaper financing. Third, the law of one price still holds: like in Modigliani-Miller (1958), the price of the slices of the pizza adds up (through arbitrage) to the prize of the pizza—these are not unknown mortgages, but government bonds: absent any asymmetric information, tax differential or liquidity issues, the bonds outside the securitization trade at the price of the bonds inside.

A different question is whether the existence of a common asset that is the only one with 0% risk weight reduces the ability of DMOs to “nudge” (or, often, explicitly ask) banks to buy the sovereign's debt in certain times. The answer is it may. And it is desirable that it does, unless the desired outcome is a market where investment decisions are made based on mutual implicit guarantees to be provided between the banking sector and the state—that is, precisely, the diabolic loop. To ensure that we walk the path all the way towards SBBS, the key role played by tranching would have to be announced from the very beginning of the path proposed. That is, governments would have to introduce a calendar at the end of which only the senior tranche of a security resulting from the Safe Portfolio would be eligible for 0% risk weight. Otherwise some governments are likely to renege on this path and stop at stage 3, with the untranching government securitization. As we have argued, this would reduce concentration risk, but would increase sovereign risk in bank portfolios. The following chart summarizes the path towards the safe asset.

Figure 6. The Path towards a European Safe Asset



3. A new resolution framework: SRB+

Economically, progress on the sovereign-to-bank link must be tied to progress on the bank-to-sovereign link. Politically, and this is clear to all stakeholders, the package to complete the Banking Union must include appropriate measures to cut both of the links in the nexus. Consequently, significant risk reduction as it relates to sovereign exposures must be paired to the risk sharing to be attained through a stronger resolution framework and a common deposit insurance. Having proposed a politically tenable solution to the problem of sovereign exposures, the Safe Portfolio approach, I propose a politically tenable approach to the risk sharing measures: SRB+.

Veneto and Nord LB: the end of resolution

Five years after the approval of the "Bank Recovery and Resolution Directive" (BRRD) and the "Single Resolution Mechanism Regulation" (SRMR) Member States continue to step in to save failing banks at the expense of their taxpayers. I illustrate how our system has been rendered ineffective with a discussion on the liquidations of Veneto Banca and Banca Popolare di Vicenza (the "Veneto banks") and the recapitalization of Norddeutsche Landesbank ("Nord LB").

The Veneto banks and the Public Interest Assessment

At the end of 2016, Veneto Banca and Banca Popolare di Vicenza were the 15th and 16th largest banks in Italy, totalling around €60bn in assets.⁴ Throughout 2016 and into 2017 both banks faced capital shortfalls and severe profitability problems. During this time, the banks persistently sought to raise private capital. However, they were only able to do so from Atlante, a fund set up with contributions from Italian banks and the government to clean up Italy's financial system. Months later, after two cash injections by Atlante, the Veneto banks' capital position continued to deteriorate, and after the fund ran out of capital to invest, the banks were declared failing or likely to fail in June of 2017 (Magnus et al. 2017).

Following this determination, it was the role of the SRB to determine whether the banks fulfilled the public interest assessment to be “resolved” according to the European regime or “liquidated” according to the national law. The discontinuity between these two possibilities is sharp. The resolution mechanism can be triggered for a bank that is failing or likely to fail for which there is no potential private buyer as long as the SRB determines that resolution is in the “public interest”. In this case, the resolution regime kicks in, most notably with a bail-in equivalent to 8% of the bank's total liabilities if the Single Resolution Fund is used. In its counterpart case, the liquidation regime depends entirely on national legislation: it can be court-based or administrative, it can be initiated by a range of triggers, it can involve different creditor hierarchies or claims, entail varying degrees of power for liquidators and administrators, etc. (see Buckingham et al. 2019). Clearly, absent a strong determination by the SRB, national incentives are to “wash the dirty laundry at home” and use taxpayer money to avoid political problems.

In this case, despite the size of the Veneto banks, the SRB declared it was not in the public interest for the banks to be resolved. This allowed the Italian authorities to structure a liquidation that saw the bulk of assets and deposits transferred to Intesa San Paolo, with taxpayers bearing the cost of a €4.8bn capital injection to Intesa and €12bn in guarantees. This taxpayer-funded liquidation was carried out in accordance with the national liquidation regime, which in Italy's case allows for such measures if they are in the interest of preserving financial stability and the economy.

In this way, after the SRB rejected that public interest was at stake, Italian authorities structured a taxpayer-funded liquidation justified by the need to preserve the public interest. The incoherence

⁴ According to Magnus et al. (2017), as of 2016 Veneto Banca had €28.1bn in assets and Banca Popolare di Vicenza had €34.4bn.

of our framework for dealing with troubled banks was laid bare, as was best expressed by Andrea Enria: “two different definitions of “public interest” have been applied, one at the EU level and another one by national authorities” (Sciorilli Borrelli 2017).

Norddeutsche Landesbank and the role of State Aid

Nord LB is Germany’s ninth largest bank by assets, and one of Germany’s largest Landesbanks. Landesbanken are state-owned banks, predominantly focused on wholesale banking. They participate in the Sparkassen system, and provide central and clearing banking services to it. For almost a decade, Nord LB had been struggling with the consequences of poor business decisions with respect to its integration of money-losing peer Bremen Landesbank and its core lending business to the shipping industry, for which it had persistently incurred write-downs and maintained high NPL ratios (Choulet 2019).

In 2012, the controlling shareholder of Nord LB, the State of Lower Saxony, recapitalised the bank with a capital injection of €2.6bn and €700mm in asset guarantees. The Commission approved the transaction under State aid rules, requiring some burden sharing and a restructuring plan to ensure the bank’s solvency. Despite this, in 2018 the bank faced capital shortfalls again (for the same reasons it did in 2012), and was allowed to operate below its capital requirements while it sought private capital.

As a part of these efforts, Nord LB turned down offers from private investors, as well as a merger proposal from another member of the Sparkassen system (Reuters 2019). Subsequently, the bank sought a transaction with the current shareholders (led by the government of Lower Saxony) and the Sparkassen group, resulting in a total capital injection of €2.8bn (€1.7bn in total from State governments) and €800mm in guarantees on shipping NPLs by the government of Lower Saxony. On December 5th of 2019, the Commission found the transaction to have been structured on market terms, hence leaving it free from any State aid rules and protecting creditors from any potential bail-in as mandated in our resolution framework. Central to the Commission’s decision was whether the transaction could have been structured on similar terms with private investors. This is hard to imagine given that, according to rating agency reports, the only offer from strictly private investors saw 49.8% of the bank valued at €600mm (Mullin and Brandenburg 2019).

The case of Nord LB illustrates the weakness of our system, as it relies too heavily on State aid rules and the flexibility they provide. Nord LB has shown that, when Member States are dealing

with troubled yet politically connected financial institutions, they remain able to intervene with public funds beyond the rules established in our resolution framework.

A non-solution: Harmonize liquidation

Since the implementation of BRRD and SRMR, numerous cases have laid bare the weaknesses and ambiguities of our current regime, during which Member States (sometimes through their DGSs) have provided €20bn in capital injections and €20bn in guarantees.⁵ With these figures in mind, and especially the two cases I have covered in depth, it is understandable that many are calling for a tightening of State aid rules. Politically, at this point this does not seem feasible. If anything, the European Commission and Member States are moving towards authorizing more (rather than less) State aid to create European champions in the digital area.

An alternative solution others have proposed, including Mr. Scholz (2019), is that we move towards a harmonized European insolvency regime, perhaps through a special common administrative regime (IMF 2018), for our system to resemble that of the United States and its Federal Deposit Insurance Corporation (“FDIC”). However, without negating the benefit of the common insolvency regime in the US, the FDIC does not draw the bulk of its power from the resolution and insolvency framework within which it operates. Instead, its influence derives from its ability to act independently from other political institutions, and from having access to the necessary funds to do so. As Gelper and Véron (2019) argue, its control and management over the deposit insurance system gives the FDIC significant negotiating power and sets up strong incentives for other regulators to cooperate with it.

Nevertheless, the harmonization of insolvency regimes would require a harmonization of Member States’ Company and Civil laws, a process that would easily take decades—this being especially the case were we to create a special administrative regime across the EU. In this context, some have argued for an incremental approach of harmonizing, to the extent possible through tweaks to the BRRD, the essential parts of our regime. This approach would see a harmonization of insolvency triggers, of creditor and depositor hierarchies, and of the tools available to national regulators through the use of funds of national deposit guarantee schemes (Buckingham et al. 2019;

⁵ These figures are based on publicly available information at the time of publication and take into account the following controversial cases: market exit of Cyprus Cooperative Bank, precautionary recapitalization of Monte dei Paschi, recapitalization of Caixa Geral de Depósitos, recapitalization of Banca Tercas, liquidity support to Banca Carige, orderly liquidation of Veneto Banca and Banca Popolare di Vicenza, restructuring aid to Nord LB, recapitalization of Banca Popolare di Bari.

Restoy 2019a) to enable them to perform Purchase and Assumption transactions and other alternative measures (Aldisio et al. 2019).

As discussed below, I agree we should implement some of these modifications to the BRRD; indeed, our current resolution system makes it excessively difficult to undertake alternative measures (which tend to preserve the most value for the financial system). However, entrusting national resolution authorities with expanded powers would go against the aims of the Banking Union. It is clear from the cases of the Veneto banks and Nord LB that national regulators are not willing to enforce market discipline on banks and put an end to the one-sided bets investors in credit institutions face today.

Further, this would endanger the development of a European deposit insurance. Martin Sandbu (2019) has correctly observed that an EU-wide insolvency regime would pave the way for the approval of a European deposit insurance. Leaving aside the feasibility of harmonising insolvency regimes, the crux of this observation is that many Member States are reluctant to have their European banks contribute to a European system that might allow national regulators to undertake expensive actions to keep zombie banks afloat.

Hence, the politically feasible approach should be to reduce the number of nationally led liquidations and the extent to which State aid rules come into play. To achieve this, we would need strong European institutions, with an expanded scope, to coordinate and manage how we deal with troubled banks. This entails that we strengthen the SRB. In what follows, I delineate a politically feasible package, coined as SRB+, to do so.

Implementing SRB+

Three steps are needed. First, the Public Interest Assessment must be refined and clarified to ensure the SRB's jurisdiction over all European financial institutions that might require substantial funds to resolve or liquidate. Second, the SRB must be given sufficient funds to resolve the banks to be brought under its scope, to be achieved by entrusting the SRB with coordination powers over national Deposit Guarantee Schemes ("DGSs") and by expanding the potential use of DGS funds. Third, to secure the appropriate funding, and ensure that national DGSs cooperate with the SRB, a hybrid common European deposit insurance must be put in place.

These three measures would only be effective if implemented simultaneously. As discussed below, reforming the Public Interest Assessment and expanding the number of banks under the

jurisdiction of the SRB would not be possible without entrusting it with coordination powers over additional resources. Moreover, and keeping in mind the kernel of the FDIC's authority, it would be difficult to ensure adequate cooperation of national DGSs with the SRB+ unless it had a substantially funded EU-wide deposit insurance at its disposal. It is also important to emphasize that this proposal would only be in place until full alignment and convergence among Member States is achieved, and would set the scene for a mutualisation of national DGSs, analogous to the mutualisation undertaken in the Single Resolution Fund.

Public Interest Assessment and other tools

The case of the Veneto banks has set a worrying precedent for the SRB's Public Interest Assessment by establishing an excessively high bar for a bank to be considered to be in the public's interest to resolve (at least €60bn in total assets). A simple comparison with the decisions taken by the Danish resolution authority is enough to understand the worrisome state of the Euro Area's resolution framework. There, authorities have resolved (not liquidated) institutions of around €50 million in assets under positive public interest tests. Depending on whether a bank is inside or outside the Eurozone, the definition of "public interest", as it pertains to resolution, is dramatically different.

It is clear that the Public Interest Assessment should be clarified, objectivized and strengthened. It is vital to add predictability and much needed certainty. In effect, the aim should be for the Assessment to cover the bank "middle class", as identified by Restoy (2018): banks that are too small to be resolved by the current SRB but too large to be liquidated under national law without causing serious problems for Member States. The expansion of the assessment would be done by clarifying it in three ways:

1. The assessment should be positive, by construction, for all SSM supervised banks (119 banks as of the time of writing).
2. The assessment should be positive, by construction, for all banks operating in more than one Member State.

3. There should be objective thresholds that, if attained, would automatically lead to a positive assessment. Such thresholds could be set by indicators such as total assets of the bank or the bank's market share in the given Member State.⁶

Coordination powers over national DGSs and eliminating the Financial Cap

Part of the difficulty of the “middle class” problem is that these banks rely mostly on depositor funding and are too small to raise MREL instruments in the market (these are the debt instruments that are subject to bail-in). Thus, to prevent senior bondholder and depositor bail-in, the main challenge that the SRB+ would confront, should it resolve these institutions as proposed, would be a lack of funding. To solve this, the SRB+ would transition to an “outpost” model that, through a structured governance framework, would entrust it with co-decision and coordination powers over national DGSs and resolution authorities during these resolutions. This model would grant the SRB access to the €28bn currently in our DGSs, which would reach at least €45bn when DGSs meet the 0,8% target of covered deposits (own calculations, EBA 2018). It would also grant the SRB the ability, akin to the ECB's under the current SSM framework, to take over if the competent national authorities fail to effectively deliver on their mandates.

Simultaneously, for the SRB+ to be able to use these funds, the super-preference of DGSs in liquidation would have to be eliminated as Fernando Restoy (2019b), Buckingham et al. (2019), and Aldisio et al. (2019) have proposed. Today, DGSs have preference over non-covered depositors and over any unsecured creditor during a bank liquidation. Although this super-preference was intended to minimize losses to DGSs under liquidation, because DGSs simultaneously follow a least-cost-principle, a “financial cap” is established which effectively forbids DGSs from undertaking any alternative measures to protect depositors. If the cost to DGSs during payout is guaranteed to be minimal (because of the super-preference), it will never be cheaper for DGSs to use funds in any way besides depositor payout. Eliminating the financial cap, then, would allow the SRB+, in coordination with DGSs, to use national DGS funds to resolve these middle-sized banks. Simultaneously, depositors would not be any less protected given that they would remain insured.

⁶ It is worth noting that the second and third criteria I propose would serve as extensions of the criteria already used to determine whether a bank should be SSM supervised. In the case of the second criteria, whether the total assets or liabilities of cross-border activities exceeds €5bn and at least 20% of these assets or liabilities are in another Member State; in the case of the third, whether a bank's total assets exceed €30bn.

European Deposit Insurance

To fully ensure that the SRB+ has sufficient funds to resolve banks, and that national DGSs and regulators have incentives to cooperate with them, the above reforms would have to be implemented along with a European deposit insurance. Towards this, I propose a scheme that would follow the outpost governance system outlined above, and which would be in place as a first step, pending the full mutualisation of our national schemes. Also in line with the little consensus attained in the Council, this first step would be a hybrid system that would see the coexistence of national deposit guarantee schemes and a European central fund (HLWG on EDIS 2019).

In terms of the system's payout, the scheme would be two-phased, during both of which national funds would have to be depleted before the SRB+ could approve the intervention of the European fund. The first phase would see the initial build-up of the European fund and would only provide liquidity support. The second phase, as corresponds to a true Banking Union, would guarantee both liquidity support and loss coverage.

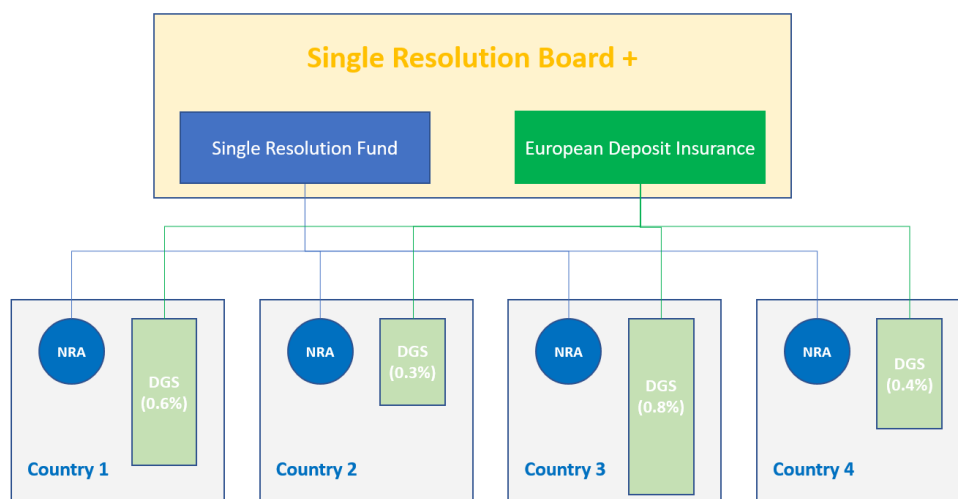
In terms of the system's funding, banks would contribute to both funds, and contributions would be carefully set to prevent any moral hazard. First, contributions to the central fund would be risk-based (determined on an EU-wide basis), to potentially include a fee component reflecting country-specific risks, as envisaged by Schnabel and Véron (2018). Second, during the loss coverage phase, following suggestions made by the German Council of Economic Experts (2018), the size of a given national fund relative to its European counterpart would depend on the degree of risk present in a given Member State's financial system. Such variable targets would be central to prevent the cross-subsidization that Carmassi et al. (2018) argue would take place under hybrid systems with fixed coverage targets.⁷

During the build-up phase, the target in the loss coverage phase would be determined in a rules-based fashion based on the level of risk in each national financial system, to be assessed through an Asset Quality Review and key risk metrics such as NPL levels. In this way, Member States would have strong incentives to achieve further risk reduction during the initial liquidity support phase, since the degree of risk in their systems would determine the size of their own DGSs. With this approach, we avoid setting hard-targets and entry conditions, instead setting up a rules-based

⁷ It is worth noting that variable targets are already envisaged under Article 10(6) of the 2014 Deposit Guarantee Schemes Directive (2014/49/EU), which allows for a 0,5% target of covered deposits if certain conditions are met.

incentive system for Member States to improve the health of their banking sectors. The next chart summarizes the approach. Notice the national (light colored) deposit insurance rectangles have different coverage sizes.

Figure 7. Visualizing SRB+



Ultimately, a deposit insurance must lead to an authentic single market, and that can only happen if the “price” banks pay for the coverage, and the coverage they receive, is equal for each bank. This necessarily requires that the “country specific” component (the green coverage) in the chart above be eliminated, so that a Greek bank may be as safe and as competitive as a German one. Sadly, in the transition this is hard to accomplish. We must choose between a system with high barriers to entry and one that recognizes the existing differences and seeks to incentivize Member State convergence. Clearly, at a later stage, national differences must be eliminated and all national compartments must be mutualized and be of equal size.

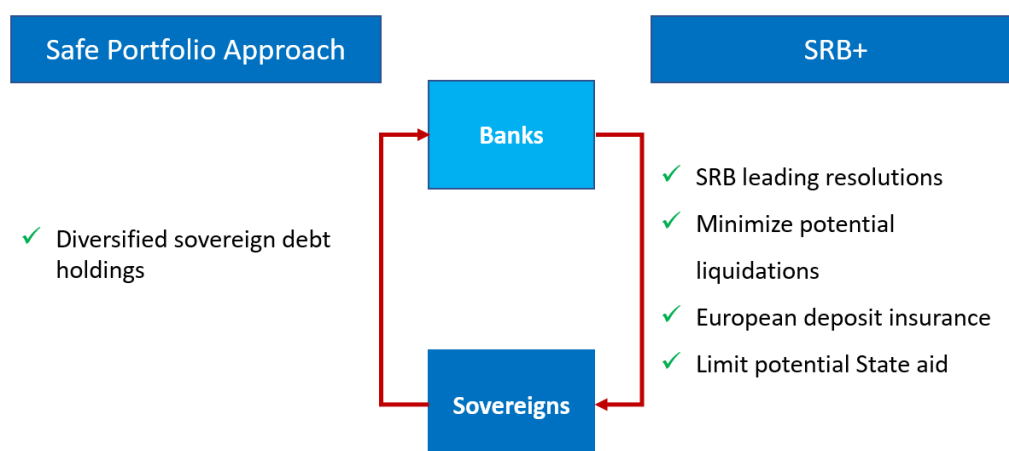
Conclusion

A few years of economic growth have lulled European policymakers into a false sense of security, yet the risk of a return of the diabolic loop is alive and well. The factors causing contagion from banks to sovereigns have not been eliminated (thanks to a broken resolution framework and an inexistent common deposit insurance) and the factors causing contagion from sovereigns to banks also remain. The recent German non-paper presents an opportunity to move forward. European and national policymakers and legislators should take up this chance.

This paper presents a possible way forward. My proposal is to cut the link from sovereigns to banks by leaving aside credit-risk charges and incentivizing banks to diversify their portfolio in the direction of the ECB's capital key—facilitating the market development of a system-wide asset to be followed by a truly safe asset without implicit or explicit cross-country guarantees (in the manner of SBBS approved by European Commission and European Parliament)—, and to cut the link from banks to sovereigns by creating a reinforced European resolution authority, the SRB+.

Politically, I believe that this proposal is within the realm of the doable in a short-term horizon (as opposed, for example, to proposals to harmonize liquidation in all Member States, which would take decades): there are no permanent transfers between countries in the above, and I have aimed to eliminate the risks of moral hazard that rightly worry some stakeholders. Economically, I believe this proposal cuts both sources of contagion in the diabolic loop as illustrated by the chart below: the fact that banks have a diversified portfolio eliminates the link from sovereigns to banks, while the fact that we have a true European resolution system that covers all banks and includes deposit insurance eliminates the link from banks to sovereigns.

Figure 8. The Banking Union Resurrected



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