

The European Union's new resolution framework

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Abstract

European policymakers created the European Monetary Union without clear guidelines on how to deal with bank liquidity, bank solvency, and financial instability. This paper is an empirical inquiry on how the individual Member States of the Eurozone dealt with bank insolvency during the financial crisis. It uses data to examine how each country resolved its failing banks. The study found that policymakers and regulators from the member states of the Eurozone viewed these issues from a very nationalistic point of view. Secondly, national bank regulation and supervision had not kept up with the pace of changes in the financial markets. Thirdly, they lacked the essential tools for the orderly resolution of financial institutions. These findings suggest that the Eurozone needs a single European resolution mechanism to handle efficiently and effectively issues of bank insolvency. Although the single European Resolution Mechanism is a vast improvement on the previous national bank resolution regimes, it is far from ideal.

Keywords:

Monetary Union, Banking Union, Bank resolution, Single resolution mechanism, Bail-in, Banking regulation.

JEL classification:

G18, G21, G33, E58, F33.

El nuevo marco de resolución de la Unión Europea

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Resumen

Las autoridades políticas europeas crearon la Unión Monetaria Europea sin unas directrices claras sobre cómo gestionar la liquidez bancaria, la solvencia bancaria y la inestabilidad financiera. Este artículo constituye una indagación empírica sobre cómo los estados miembro de la Eurozona gestionaron la insolvencia bancaria durante la crisis financiera. Se utiliza, por tanto, información cuantitativa para examinar la manera en que cada país resolvió sus problemas bancarios. Se concluye, en primer lugar, que las autoridades y reguladores de cada país miembro de la Eurozona adoptaron una perspectiva muy nacionalista a la hora de abordar estas cuestiones. En segundo lugar, la regulación y supervisión bancaria nacional no ha ido en línea con el ritmo de cambios habidos en los mercados financieros. En tercer lugar, se echaron en falta los instrumentos básicos para una resolución ordenada de las instituciones financieras. Estas conclusiones sugieren la necesidad de un mecanismo de resolución único en la Eurozona para gestionar de una manera eficaz y efectiva las cuestiones relativas a la insolvencia bancaria. Aunque este Mecanismo Europeo de Resolución único constituye un gran avance sobre los regímenes de resolución bancaria nacional precedentes, dista mucho de ser ideal.

Palabras clave:

Unión Monetaria, Unión Bancaria, resolución bancaria, Mecanismo de Resolución Único, Recapitalización, regulación bancaria.

■ 1. Introduction

In the wake of the financial crisis and the great recession, we realize at great cost that the European Union did not have an adequate framework for the orderly resolution of complex financial institutions. Since the foundation of the Euro, bank regulation and supervision had not kept up with the pace of changes in the financial markets and when the crisis occurred the regulators lacked the essential tools for the orderly resolution of financial institutions. In retrospect, we see that European policymakers did not see the financial crisis coming and did not fully understand the nature of modern financial crises.

The European Monetary Union (EMU) was a “flawed political bargain” from the start as policy makers viewed the major issues from very nationalistic perspectives. European policy makers did not set out to create a flawless monetary union but one that caused the least political resistance from member states. It could be said that it was a “minimalist” monetary union. The financial crisis proved that the Eurozone lacked a banking union and in particular, a European resolution framework.

■ 2. European Monetary Union

Academics and policymakers cautioned that the EMU would have serious difficulties in dealing with liquidity and solvency issues. Academic papers by Prati and Schinasi (1998), Prati and Schinasi (1999), Schinasi and Teixeira (2006) and Nieto and Schinasi (2007) highlighted the lack of clear guidelines for implementing the EU’s lender of last resort function in times of market turbulence when European banks lacked sufficient liquidity to deal with their short term financing requirements. Academic papers by Goodhart (2004), Goodhart and Schoenmaker (2006), Mayes *et al.* (2007) and Nieto and Schinasi, (2007) emphasized the lack of rules and regulations for the resolution of European banks.

Other authors, Eisenbeis and Kaufman had “*identified a number of issues and concerns about the present system design that are likely to result in higher than necessary costs of insolvencies in cross-border banking. To date, little progress appears to have been made in the EU in dealing with them. Indeed, as both cross-border branches and subsidiaries increase in importance in host EU countries, the resulting potential dangers of the current structure are likely to become large and may not only reduce aggregate welfare in the affected countries substantially when foreign banks with domestic branches or subsidiaries approach insolvency, but also threaten financial stability. Serious doubts are cast about the longer-term viability of the single passport concept for cross-border branch banking under the existing institutional environment*” (Eisenbeis and Kaufman, 2007, p. 43).

Harold James's (2012) research demonstrates that the European policymakers who created the Euro were concerned about by the disintegration of the dollar-based-fixed-but-adjustable exchange rate regime (i.e. Bretton Woods) and tensions created by German current account surpluses, but not about European banking supervision and regulation. The solution to their concerns about exchange rates and trade surpluses was to create a "pure" currency, the Euro and an independent institution, the European Central Bank (ECB), which was free of any prospect of political inference and designed with the sole objective of price stability.

European policy makers discussed the importance of giving the European Central Bank (ECB) supervision and regulatory powers over financial institutions in the Euro area but they felt that the role in maintaining financial stability might undermine the future central bank's ability to focus on price stability as the primary goal of monetary policy.

There was also opposition from existing national regulators who wanted to supervise their local markets and their "national banking champions." They evoked arguments based on the principle of subsidiarity. This principle is fundamental to the functioning of the European Union (EU). The principle states that the EU may only intervene if it is able to act more effectively than the Member States and that decisions should be taken as closely as possible to the citizen if that is not the case. The European policymakers regularly use three criteria to establish the appropriateness of intervention at European level:

1. Does the action have transnational aspects that cannot be resolved by the Member States?
2. Would national action or an absence of action be contrary to the requirements of the Treaty?
3. Does an action at European level have clear advantages?

Even though there are obvious advantages to European bank supervision and resolution, the policy makers, at that time, decide to keep it local. National bank supervisors in the Euro area tended to agree with the quip often attributed to Mervyn King, former Governor of the Bank of England that, "*international banks are global in life, but national in death*".

Very few European policy makers saw financial instability as a major issue except for Padoa-Schioppa (1999), member of the ECB's Board, who was well aware of the risks to financial instability and in 1999 and wrote: "*I am convinced that in the future the needs will change and the multilateral mode will have to deepen substantially. Over time such a mode will have to be structured to the point of providing the banking industry with a true and effective collective euro area supervisor. It will have to be enhanced to the full extent required for banking supervision in the*

euro area to be as prompt and effective as it is within a single nation". The Maastricht Treaty (1992) did not give supervisory powers to the ECB but due to concerns of policy makers like Padoa-Schioppa, it added Article 127(6) which stated that supervisory powers could be given to the ECB based on a unanimous decision of the Member States at a later date.

The Eurozone had no mechanism to deal with a global financial crisis, systematically important financial institutions or medium sized national banks. De Grauwe (2012) criticized this precarious institutional arrangement by stating "*The Euro is a currency with out a country. To make it sustainable a European country has to be created*". De Grauwe was particularly troubled about the lack of a lender of last resort at the European level at times of financial crises.

According to Pisani-Ferry and Sapir (2009), "*The main responsibility for financial stability and crisis management in the European Union lies with national banking supervisory bodies, central banks, treasuries and deposit insurance schemes. However, a number of EU bodies and procedures exist that provide some degree of harmonization between national rules and cooperation between national authorities*". It was believed at the time this system of decentralization, information exchange and cooperation has would work in times of crisis. The European policymakers had to recognize that the European Union has no European taxpayer, (no fiscal backstop) and thus all financial aid to the banking sector has to be national.

Goodhart and Schoenmaker (2006) were concerned about the lack of rules for burden sharing in a banking crisis in Europe. Furthermore European governments did not update their laws to keep pace with the growth in international banking and finance. National regulators did not have experienced resolution authorities to resolve non-viable banks. Banks did not have resolution plans (Living wills) to facilitate an orderly restructuring of its assets and liabilities. Regulators did not have a set of resolution tools to apply to the specific circumstances of each bank failure. Regulators lacked the powers and expertise to apply efficiently and effectively the following resolution options and techniques:

- To dismiss and replace the top management of a non-viable bank;
- To oblige the private shareholders of a non-viable bank to accept a solution involving private sector acquisitions (parts of the bank can be sold to one or more purchasers by the resolution authority);
- To have the funds to nationalize a non-viable bank.
- To transfer parts or all the banks business to a temporary structure (such as a state-owned "bridge bank") to preserve essential banking functions or facilitate continuous access to deposits;

- To separate clean and toxic assets between “good” and “bad” banks through a partial transfer of assets and liabilities; and/or
- To legally be able to bail in creditors to pay for the credit write-downs or to convert their debt to equity, as a means of restoring the bank’s capital requirements.

If regulators had these resolution options, it would have allow a financial institution to be restructured or wound down in an orderly manner reducing the use of public funds and minimizing financial instability.

European policymakers were far more concerned about fiscal discipline than banking resolution, banking supervision and financial instability. To achieve fiscal discipline, member states would have to meet the convergence criteria and agree to adhere to the Stability and Growth Pact (SGP). The theory was that price stability, low public deficits and debts would ensure financial stability but European policymakers had not learnt the lessons of Hyman Minsky’s (1992) article on “The Financial Instability Hypothesis” (FIH). The FIH suggests that over periods of prolonged prosperity, capitalist economies tend to move from a financial structure dominated by stable financial flows to a structure that increasingly emphasizes speculative and unstable finance. The great moderation era running up to the financial crisis was characterized by “irrational exuberance” and supreme confidence in the financial markets.

In the Euro area, it was the private sector that experienced “irrational exuberance” and after a prolonged period of prosperity, large financial imbalances developed in the private sector, not the public sector. According to Constâncio (2013), Vice-President of the ECB, between 1999 and 2007, the ratio of public sector debt to GDP in EMU declined on average by around 6 percentage points while the ratio of private sector debt to GDP increased by almost 27 percentage points. He gives an example of Spain where the ratio of private sector debt to GDP increased by around 75 percent, while the ratio of public debt to GDP fell by around 35 percent. As this example shows, the narrative built upon the mantra that “it’s mostly fiscal” was completely a misunderstanding of the financial crisis and could only be really applied to the Greek crisis.

These massive private sector flows between European countries were intermediated by an over-leveraged banking sector but national supervisors did not have the mandates or the appropriate tools to identify these financial risks.

According to Posen and Veron (2014) the aggregate assets of Europe’s banks grew by the equivalent of almost the entire European GDP between 2003 and 2008. Gros (2013) believes that “*the banking sector is too large, has too little capital, and contains too*

many players that lack a viable long-term business model". In the face of these challenges, national policy makers at the highest levels were unprepared for the challenges of a systematic banking crisis and they were forced to choose between two suboptimal policy options: bank bankruptcy or taxpayer guarantees and bailouts.

■ 3. Fractional reserve banks and national champions

Banks are fragile and finance is the lifeblood of the markets. Banks performs essential market functions like credit creation, credit allocation, maturity transformation, etc. Banks are fractional reserve banks and they only keep a fraction of their deposits on reserve as they convert short-term deposits into long-term loans. Depositors may withdraw their money at any time but banks cannot call in their long terms loans before they mature. This maturity mismatch between deposits and loans makes banks vulnerable to self-fulfilling "bank runs" as described by Diamond and Dybvig (1983). There is always a risk of a panic if depositors lose confidence in banks. Depositors panic and try to be the first ones to get their money out knowing that the bank will not have sufficient liquid resources to return the money owed to all depositors. In the past, banks were required to maintain a minimum statutory liquidity and cash reserves but Diamond and Dybvig (1983) argued that the best way to prevent "bank runs" was to have a government guaranteed deposit insurance scheme.

Consequently, governments introduced deposit insurance schemes and dramatically reduced the minimum statutory liquidity and cash reserves for banks. According to figures from the Bank of England, UK banks were required to hold as much as 30% of their assets in a liquid form thirty years ago but that figure had come down to less than 1% by 2007. Calomiris (1990) foresaw the inherent risks in this institutional financial arrangement and explained why government guaranteed deposit insurance schemes are likely to lead to moral hazard. He states that these insurance schemes protect depositors against bank failure, which is an essential component of discipline in the market system. It gives depositors incentives not to be prudent in choosing where to deposit their money, and thus gives banks less incentive to lend carefully.

According to Calomiris and Haber (2014), academics at Columbia and Stanford universities, banks are "fragile by design". Political rules and institutions shape bank strategies and aptitudes towards risk and moral hazard. Unstable financial systems are due to the political "game of bank bargains". Calomiris and Haber demonstrated that the United States has had twelve systemic banking crises since 1840, while Canada did not have any. They show that political influence in the banking sector is stronger in the US than Canada and consequently the US banking system is more unstable and prone to financial crises than the Canadian banking system. Leo Tolstoy

(1878) begins his book *Anna Karenina* stating that “*Happy families are all alike; every unhappy family is unhappy in its own way*”. The banking sectors in each European country have different histories and structures due to the economics and politics of each state and they are all “unhappy” in their own way.

For example, the largest private bank in Germany, Deutsche Bank was founded in 1870 to finance international trade as German importers and exports were dependent on English and French financial institutions that favored their companies and charged them higher transactions costs and fees. In 1870, the British Empire controlled a large part of international trade and tried to prevent other nations from trading with its colonies. The Second French Empire opposed Prussian ambitions to encompass German unification. Prussian chancellor, Otto von Bismarck provoked and won the Franco-Prussian war to the chagrin of the French.

Under these circumstances, Deutsche Bank was born as a “national champion”. National champion is a governmental policy whereby governments encourage large domestic organizations to maximize their profits and to “advance the interests of the nation.” Governments make policy to protect and give unfair advantages to their “national champions.” Deutsche bank’s objectives were to compete vigorously with British and French banks and to ensure that German companies had the capital to compete internationally.

All other European nations followed suit and competed forcefully which eventually led to two World Wars on European soil. After World War II, leading policymakers like Alcide De Gasperi, Jean Monnet, Robert Schuman and Paul-Henri Spaak believed that European integration and would temper the extreme nationalism that had destroyed the continent. The European Union would create a framework of rules and regulations in many sectors starting with coal and steel in 1951, but even the Maastricht Treaty (1992) left bank supervision and resolution in national hands. Most European countries had national champions in the banking sector and, as we will see, that this nationalistic mindset does not promote an optimal European banking system.

In the competitive market system, as endorsed by the European Commission, weak companies are usually taken over by stronger competitors before they fail but banks tend to be protected by their national regulators and politicians. It is only natural that the strongest and most successful European banks would want to expand outside their home markets and become pan European banks. In 1999, the European Commission had to intervene to prevent the Portuguese government from blocking Banco Santander’s acquisition of the Portuguese banks of the Champalimaud Group. Another successful Spanish bank, BBVA tried to enter into the Italian banking market with a takeover bid for the Italian bank Unicredito in 1999 and for Banco Nazionale

di Lavoro (BNL) in 2005 but after many meetings with Mr. Antonio Fazio, the governor of the Bank of Italy, they were informed that “No green light has been given regarding the hypothesis of a BBVA takeover bid.” In the end, Mr. Antonio Fazio had to resign as he used his supervisory authority unlawfully to favor the bid from Italy’s Banca Popolare Italian (BPI) and to prevent the takeover Banca Antonveneta by the Dutch bank, ABN AMRO. In these illustrative cases, national champions were protected by their central banks until the European Commission intervened to promote fair competition.

The European Commission also had to intervene in the German banking market to prohibit unlawful “State Aid”. Germany has a three-pillar banking sector that comprises public sector savings banks, co-operative banks and private banks (Krahn and Schmidt (2004). Historically the publically owned, local savings banks – the Sparkassen banks (SBs) - and publically owned regional banks – the Landesbankens (LBs) - were given state guarantees to ensure that creditors suffered no losses in the event of bank failure. These state guarantees were very important for the SBs and LBs to get an AAA credit rating and lower their cost of funding. These public sector banks are subject to less market discipline than most private banks and their governance is strongly influenced by the role of local politicians on the supervisory board (IMF, 2011).

The competition directorate of the European Commission ruled in 2001 that these state guarantees were unlawful state aids (favoring national champions) as they gave these banks a competitive advantage compared to other German and European banks. The Commission gave the LB’s a transition period and stated that “For liabilities created between 19 July 2001 and 18 July 2005, Gewährträgerhaftung [state guarantee] will be maintained only for those maturing before the end of 2015” (European Commission, 2001). To maintain their profit margins, some LBs borrowed heavily in the international short-term financial markets with public guarantees between 2001 and 2005 and they invested in risky financial products often through off-balance sheet vehicles with disastrous consequences.

Hau and Thum (2009) demonstrate that public banks in Germany, not only had unlawful “state aids” but they also had governance issues. The members of the supervisory board lacked the necessary financial and managerial skills compared to private banks. They did not have a viable business model. They could not compete for market share with the local savings banks, as these local savings banks were their public shareholders and wanted to protect their own businesses. They had to compete with the more efficient private commercial banks in international financial markets but they did not have the skills to compete in investment banking. This unstable business model included weak banking skills, poor governance structures and political influence, all of which increased the financial fragility of the LB’s.

■ 4. The financial crisis and insolvent banks

The first signs of the financial crisis in the Eurozone occurred in July of 2007 when a medium sized German bank, IKB had financial difficulties because of losses linked to U.S. subprime mortgages. IKB lost money speculating on the subprime mortgage financial crisis in the US. They were on the losing side of a complex and controversial trade called ABACUS. ABACUS was a collateralized debt obligation (CDO), which is a type of structured asset-backed security (ABS) that was created and designed by Goldman Sachs. John A. Paulson, a leading hedge fund manager, bet that the subprime mortgage holders would default against the ABACUS CDO and IKB bet the subprime mortgage holders would not default. The subprime mortgage holders defaulted in 2007 and Paulson made approximately \$1 billion from this trade. It was controversial because Goldman Sachs let Paulson choose the subprime mortgages without the knowledge of IKB.

The Germans fearing a financial panic adopted a pro-bailout policy at the start of the crisis with the rescue of IKB in late July 2007. The KfW, a German government-owned development bank, along with numerous commercial and coop banks (including Deutsche Bank and Commerzbank), formed a rescue fund to bail out the IKB bank to the tune of €3.5 billion. According to Goldstein and Véron (2011), the German policymakers remembered the last wave of bank failures in Europe, which in 1931 played a prominent role in enabling the subsequent rise to power of Adolf Hitler's National Socialists and World War II.

Soon after the IKB bank failure, Bear Stearns disclosed on July 16 that two affiliated hedge funds had lost a very significant part of their value. On August 7, BNP Paribas suspended withdrawals from three investment funds, as they were not able to price them to market. Francesco Papadia, responsible for market operations at the European Central Bank (ECB), called Jean-Claude Trichet, president of the ECB and two Executive Board members, Jurgen Stark and Jose Manuel Gonzalez-Paramo on the 9th of August 2007. He informed them “The money market is not functioning at all. There are no lenders, only borrowers. Interest rates are skyrocketing. There are no transactions”.

In economic literature, this phenomenon is called “a sudden stop” and it happens when there is a rapid reduction in private capital flows into a country and it leads to a dramatic decline in credit, private spending and economic output. The ECB reacted rapidly to this “sudden stop” and provided full allotment liquidity at a fixed rate and calmed the financial markets for a short period. According to Dornbusch and Werner (1994) “*it is not speed that kills, it is the sudden stop*”. It typically causes a real exchange rate depreciation but in the Eurozone crisis hit countries cannot de-

preciate and thus they usually experience an internal devaluation, a reduction in labor costs. Sinn (2014) explains in his book, *The Euro Trap* that internal devaluations are much more difficult for economies and societies to deal with than external devaluations.

Germany experienced an economic slowdown not a “sudden stop” in economic activity. The publically owned savings banks (Sparkassen) did relatively well as they lent money to German households and medium sized companies (known as the *Mittelstand*) in contrast to the publically owned regional banks (*Landesbanken*) that accumulated large losses on speculative trading in international financial markets. According to the OECD (2010), “*German banks accounted for around 7% of global write-downs on such assets in the period January 2007 to October 2009. Although almost all groups of banks are affected, the state-owned Landesbanken stand out, accounting for one third of all losses even though their share of business volume is only 20%*”.

Many Germans were shocked and wondered how in the world, were small and medium sized publically owned banks had been allowed to expand beyond their core business and speculate with depositors and taxpayers money on the international financial markets where they were clearly out of their depth in terms of their financial expertise. They called for political responsibility and many important regional politicians such as Georg Milbradt, the conservative premier of the eastern German state of Saxony who was responsible for the Sachsen LB, were forced to resign.

The financial crisis also revealed several corporate and political weaknesses in the Spanish banking sector, especially in the savings banks (*Cajas*) sector. The scale of the financial crisis in Spain was so great that it had to apply for a € 100 billion rescue package provided by the European Stability Mechanism (ESM). The *Cajas* were semi-state banks run by regional governments, political parties and unions to provide financing in their respective regions. These semi-public savings banks were not subject to market discipline like most Spanish private banks. The Spanish government liberalized the banking sector in 1977 and the *Cajas* became universal banks. They expanded their activities across Spain and lent enthusiastically to property developers, contributing to the build-up of excess capacity in the property market and risk concentration in the Spanish economy.

Cuñat and Garicano (2009) found that performance of the *Cajas* correlated with corporate governance and human capital of the *Cajas*. They demonstrate and state “(1) *Cajas* whose chairman was previously a political appointee have had very significantly worse loan performance; (2) *Cajas* whose chairman did not have postgraduate education have significantly worse performance; and (3) *Cajas* whose chairman had no banking experience had significantly worse performance.”

They concluded that Spanish bank supervisors were not able and willing to stand up to the politicians and they did not have a strong resolution framework to deal with failing banks.

Former savings banks were also the first to fail in the UK. Northern Rock, originally a savings bank chose to demutualize and it converted to a full service bank on 1st October 1997, and then it floated its shares on the stock market. It was a relatively small British bank that expanded rapidly by lending the depositor's money to un-credit-worthy borrowers. Northern Rock experienced a classic and very visible deposit run, with customers queuing outside branches as described by Diamond and Dybvig (1983). The Internet also played a role in Northern Rock's problems as and electronic payment systems make bank runs more contagious and tougher to contain. In the Internet age, transferring money out of banks is as easy as a click of an electronic mouse and it can happen within a matter of hours at any time.

On the 14th September 2007, Northern Rock sought and received liquidity from the Bank of England to stop the first bank run on a British bank in 140 years. After an analysis of its assets and liabilities, the Bank of England concluded that Northern Rock was insolvent and the bank was nationalized on the 22 of February 2008. Northern Rock was easy for the British authorities to resolve as it was not a systematically, important financial institution (SIFI). Nonetheless, Northern Rock was the first warning in the UK to market participants, bank supervisors and policymakers that financial institutions lacked high quality capital liquidity.

Lehman Brothers, a systematically, important financial institution, was the fourth-largest investment bank in the US and a global financial services firm. It made huge losses in the subprime mortgage crisis and no financial firm was willing to acquire it. Martin J. Gruenberg, Chairman of the Federal Deposit Insurance Corporation (FDIC) made a speech on May 12, 2015 and stated, *“No agency had the authority to manage the orderly resolution of a large, complex financial institution, even if the failure of that institution could significantly destabilize the financial system and severely impact the economy. Rather, the only option available for the resolution of such an institution was a bankruptcy process that lacked the tools essential for facilitating the orderly unwind of a financial firm of the size, complexity, and international reach of the largest, most complex financial institutions”*.

Consequently, the US authorities decided to let Lehman Brothers file for Chapter 11 bankruptcy protection on September 15, 2008 and market liquidity dried up.

This was not a classic bank run, like Northern Rock, as suggested in the work by Diamond and Dybvig (1983), but a bank run, as described by Gorton (2009). Gorton explains it was the creditors who started the “bank run”, not depositors of retail

banks. Creditors suddenly lost confidence in bank debt and stopped acting as the counterparties of investment banks in the repo and commercial paper markets. Vulnerable banks, even in the most advanced economies, lost valuable access to short-term bank debt and if they had insufficient liquidity and capital to cover their short term financing needs, they became insolvent. Many banks during the crisis claimed that they were solvent but lacked liquidity due to frozen financial markets.

In 1873, Walter Bagehot pondered on these issues in his book, *Lombard Street* and came to the conclusion that central banks should lend to the entire financial system and lend to “illiquid but not insolvent” banks. He contended that policymakers should lend speedily, lend only for the short term, charge penalty interest rates and lend against collateral that would be good “in ordinary times”. He also insisted that policy makers let insolvent institutions fail. He argued that these conditions should be known well in advance of any crisis, so that the market will know exactly what to expect. Unfortunately, no one knew what to expect in a systematic financial crisis.

After Lehman’s dis-orderly bankruptcy, the Dow stock exchange index fell by almost 1,000 points and financial contagion spread like a deadly virus. The leading central banks around the world pumped liquidity into the financial markets but it was not enough as many banks were insolvent not illiquid. Leading US policymakers like Timothy Geithner, the US Secretary of the Treasury, who made the initial decision on Lehman Brothers had to reverse their “no bailout policies” and proposed a \$700bn bailout program to save the financial markets from collapse.

In his book on the financial crisis, Geithner (2014) later confessed that he suffered from “Lehman syndrome” and admits that he opposed anything that would weaken confidence or stability. On October 10, 2008 the finance ministers and central bank governors of G-7 countries met in Washington, DC, and “*agreed to take decisive action and use all available tools to support systemically important financial institutions and prevent their failure*”. The “Lehman syndrome” also influenced leading European policy makers and they agreed that no bank should be allowed to fail. On October 15-16, 2008, European leaders met and confirmed their “*commitment that in all circumstances the necessary measures will be taken to preserve the stability of the financial system, to support the major financial institutions, to avoid bankruptcies, and to protect savers’ deposits.*”

The Spanish Prime Minister, José Luis Rodríguez Zapatero, visited Wall Street bankers, nine days after the collapse of Lehman Brothers in September 2008, and he communicated to them that “*Spain has perhaps the most solid financial system in the world. It has a standard of regulation and supervision recognized internationally for its quality and rigor.*”

Two weeks after Lehman's collapse on the 29th September 2008, Brian Lenihan, the Irish Minister for Finance issued a broad state guarantee for all creditors of Irish banks, without consulting his European colleagues, to demonstrate to the international financial markets that the Irish government had confidence that Irish banks were illiquid but not insolvent. Lenihan naively said at the time that the bank guarantee scheme was "*a necessary first step*" and "*the cheapest bailout in the world so far*". This unilateral Irish communication was criticized by a number of European countries that feared that deposits would flow across European countries in search of better guarantees but their fears never materialized due to the harmonizing of deposit schemes at a higher level by the European Commission.

On the other hand, some European policy makers, like Jean Claude Trichet, president of the ECB, welcomed the bank guarantees because they did not want the Irish government to "bail in" senior bondholders as they believe that it would add to financial contagion and increase the fragility of the European banks. For this reason, some Irish people believed that Ireland bailed out the European bondholders and banks. These actions and reactions were purely nationalistic responses because there was no clear European alternative to address the issues affecting Irish banks at the European level.

Ireland was the first Eurozone country to fall in recession during the financial crisis. The "Celtic Tiger" era (1995-2006) was a period of unprecedented economic growth for Ireland but it was financed by a leveraged Irish banking systems which were over of 400% of GDP. This is an exceptionally large, highly leveraged banking system for a relatively small Eurozone economy. Irish banks acquired short-term loans (usually 3 months) in the international interbank market and then lent them out long term, mainly to Irish property developers. Property prices peaked in 2007 and tax revenues declined dramatically. The Irish economy suddenly slowed down to a standstill in 2008 due to lack of credit. The Irish Minister of Finance, Brian Lenihan had to act.

As a member of the Eurozone, the Irish central bank could not expand its balance sheet and could not print out money to finance its growing public deficits and to bail out its insolvent banks. It could only use "Emergency Liquidity Assistance" with permission of the ECB. The ECB was an effective liquidity provider to the Eurozone banks ensuring that banks could borrow at reasonable rates against collateral that would be good "in ordinary times".

Fearing financial contagion and knowing that a systematic bank crisis would lead to sovereign defaults, the European policy makers established in 2010, the European Financial Stabilization Mechanism (EFSM) and the European Financial Stability Facility (EFSF) to provide financial support to member states of the European Union that were unable to access the financial markets at reasonable rates. In November of 2010,

Irish banks accounted for approximately 25% of all the ECB's lending and Jean Claude Trichet, President of the European Central Bank, sent a letter to Brian Lenihan informing him that further ELA lending was dependent on accepting financial support from the "Troika" to restructure the Irish economy and its banks.

On the 28th November 2010, Ireland was the first Euro area country to apply for financial assistance and the EFSM agreed to provide loans of 22.4 billion euros between 2010 and 2013 and the EFSF agreed to provide loans up to €18 billion over 2011 and 2012. The Irish banking crisis led to a sovereign debt crisis as Ireland did not have the sufficient funds to bailout the banks and the financial markets would not lend to Ireland at reasonable interest rates.

During late 2009 and 2010, the Irish government recapitalized and nationalized the Irish banks with the approval of the EU competition authority on the basis of the standard rules on rescue and restructuring aid even though EU state aid legislation was not designed for the purposes of maintaining financial stability but it was the only tool that the European Commission had to deal with bank failure. This was carried out at great cost to the Irish taxpayers because it could not "bail in" the bank creditors due to the bank guarantees.

On the 27 of September 2008, Belgium, Luxembourg and the Netherlands intervened to rescue the Fortis group, which was active in banking, insurance and investment management in the Benelux countries. In 2007, it was the 14th largest business in the world according to the list of the Fortune 500 companies but it forecasted net losses for 2008 were approximately €19bn. The three governments could not agree on burden sharing in the resolution of the Fortis group. After many difficult negotiations, they decided that the only solution was to break up the group on based on the nationally of its businesses as there was no European solution. Hence, the Belgium government nationalized the parts of Fortis's business in Belgium and the Netherlands and Luxembourg did likewise. The Belgium and Luxembourg governments then sold a majority stake to the French bank, BNP Paribas. The Dutch decided to create a "strong Dutch bank" with a merger between Fortis Bank and ABN-AMRO. This case demonstrates a lack of information sharing and consequently the lack of trust between national supervisors and policy makers in Europe. According to the IMF (2013), Fortis's *"breakup along national lines constitutes a setback to financial integration in the Benelux and was likely more costly than a first-best joint solution for the group"*.

On the 30th of September 2008 the governments of Belgium, France and Luxembourg rescued the Belgo-French bank Dexia. In 2007, it was the 20th largest business in the world according to the list of the Fortune 500 companies. The bank failed in 2008 because it borrowed heavily in the short term financial markets to fund its €650bn

balance sheet, which had a €125bn exposure to US subprime property. According to report by Cour des Comptes (2013), France’s national auditor, France, Belgium and Luxembourg were forced to inject €6.5bn in to Dexia – at the time the world’s biggest municipal lender – in 2008, but had to stump up a further €90bn in state guarantees to keep it afloat when it was hit by the European sovereign debt crisis of 2011. A final bailout was agreed when France and Belgium put up a further €5.5bn capital injection. Didier Migaud, head of the Cour des Comptes, concluded his report stating, “*Dexia’s case illustrates the absolute necessity to improve banking supervision and resolution mechanisms in Europe.*”

■ 5. From bail-out to bail-in

After the expensive bailouts of banks in Germany, France, Belgium, Netherlands, and Ireland leading European policymakers started to reflect and discuss alternatives. On the 4th of October 2010, the Centre for Economic Policy Research (CEPR) held a conference on “The Future of Regulatory Reform” in London. Jochen Sanio, head of the German regulator BaFin, gave a speech explaining that he and other European regulators are enthusiastic about “bail-in” measures explaining, “*The real goal is that all the stakeholders get a haircut before the taxpayers*”. This conference proved to be a historic turning point as European policy makers started to consider bailing-in bank creditors.

The Government of Ireland nationalized Anglo Irish Bank in January 2009 through the expropriation of existing shares under the Anglo Irish Bank Corporation Act, 2009. The Irish government guarantee covered all retail and corporate deposits in excess of deposit insurance coverage, interbank deposits, senior unsecured debt, asset-covered securities, and even dated subordinated debt up to and including 29 September 2010. After September 2010, the Irish government started to bail in creditors except for all eligible deposits up to EUR 100,000 that were covered by the Deposit Guarantee Scheme. The Irish government bail-in of creditors was partial, as Ireland did not have a bank resolution laws in place that could be applied to all types of creditors.

The Danish government passed a bank resolution law in October 2010, which enable them to bail in senior bondholders and depositors. In February 2011, the government resolved the Amagerbanken bank by bailing in all eligible deposits and senior bondholders and then, transferring the assets to a state-owned bridge bank, which was later, sold to Nordik Bank.

Policymakers in Spain, in contrast to Ireland and Denmark, carried out on a large-scale regulatory forbearance program to protect the balance sheets of the system. The banking crisis was concentrated in the regionally based and unlisted savings banks

(Cajas) that were not subject to the disciplines of the financial markets. A general assembly and the supervisory boards that were made up of political appointees, local businessmen and depositors controlled the Cajas.

The policy makers in Spain decided that the best way to confront the crisis was to merge the troubled savings banks (Cajas) and try to create strong financial groups. Bankia was the result a merger of seven Cajas that were controlled by the right wing party, the Partido Popular. The largest Cajas in the Bankia group were Caja Madrid and Bancaja. Bankia became Spain's third largest bank and largest real estate in 2010. During the Bankia merger, the bank recognized a substantial amount of real estate losses and the regional government shareholders and other social groups accepted the write-downs.

Bankia needed capital to meet its core capital requirements and the management decided to create a holding company Banco de Financiamiento de Ahorros ('BFA') and the Spanish State injected EUR 4.47 billion capital into BFA. BFA then, floated its subsidiary, Bankia on the Spanish stock exchange in an effort to raise EUR 3.1 billion of fresh capital from investors through an Initial Public Offering (IPO). International institutional investors were not interested in buying shares in Bankia and thus it ran an aggressive advertising campaign and sold most of its shares to its customers and individual Spanish retail investors. The Bank of Spain also allowed Bankia to sell preference shares, a complex financial product not suitable to unsophisticated investors. The head of the Bank of Spain, Miguel Ángel Fernández Ordóñez resigned from his position before the end of his term due to the lack of prudent supervision of the Spanish banking sector during the financial crisis.

Maria Draghi, president of the ECB, gave a speech to the European Parliament on the 31st of May 2012 and he criticized the European government's approach to banking resolution. In response to a question from a lawmaker in the European Parliament on whether the recapitalization of Bankia had been bungled from the start, Draghi replied: *"What Dexia shows — and Bankia shows as well — is that whenever we are confronted with the dramatic need to recapitalize, if you look back, the reaction of the national supervisors [...] is to underestimate the problem, then come out with a first assessment, a second, a third, fourth... "That is the worst possible way of doing things, because everybody ends up doing the right thing but at the highest possible cost and price,"* Draghi said.

In 2012, European policy makers were very skeptical about the solvency of the Spanish banks and they asked Oliver Wyman to carry out a series of Stress tests on the Spanish banks. Oliver Wyman worked under the supervision of the European Central Bank and International Monetary Fund and was aided by the Big Four auditors. According to the Oliver Wyman (September 2012) report, the Cajas used accounting tricks and

internal valuation techniques to reclassify, refinance, and extend loans to cover up their losses in the real estate sector. The Spanish banking system only started to fully recognize the losses on their toxic assets after the Wyman report and the collapse of Bankia in May 2012. Bankia was nationalized and their shareholders and creditors suffered large losses on their investments.

The nationalization of Bankia sparked Spain's official request for European financial assistance for its banks. The Eurogroup and the European Stability Mechanism (ESM) agreed to give Spain a loan of up to €100 billion. The money was transferred to the Fondo de Reestructuración Ordenada Bancaria (FROB), the bank recapitalization fund of the Spanish government. The FROB then transferred €2.5 billion to Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria (SAREB), the asset management company (bad bank) for toxic assets arising from bank restructuring. According to the IMF (2014), Spain's ESM-supported program of financial sector reform was a success.

After this Spanish program, the European policy makers finally felt that they had the basis for a successful bank resolution model but then the financial crisis blew up again in Cyprus. In 2009, the size of the banking sector in Cyprus was nine times GDP. Its banking sector was very large because it was a tax haven with low taxes and low transparency. It had a double taxation treaty with a number of countries including Russia. Many rich Russians deposited their savings in Cyprus and set up businesses there to trade with the rest of the world. It was estimated that approximately 25 to 40 per cent of all cash in Cyprus's banks was held by a Russians.

Cyprus has close political and cultural affinity with Greece and the economies are thoroughly intertwined. Historically, Cyprus banks invest in Greek government bonds. In 2012, Greece defaulted on its government bonds. The Greek bondholders agreed to trade in their bonds for new longer-dated ones with less than half the face value of the old ones and with a lower interest rate.

Cyprus's two biggest banks, the Bank of Cyprus and Laiki Bank, held large amounts of Greek government debt and lost over 50% of their investment. Both banks had liquidity and solvency issues and the government was forced to step in and apply for a bailout from the EU and IMF in the summer of 2012. After months of negotiations, European policy makers finalized a bailout deal where Cyprus would receive €10 billion in Troika loans, as long as it came up with €7.2 billion itself. Unlike the Spanish and other European banks, Cyprus's banks, had virtually no senior bondholders because they rarely needed to raise money due to the large Russian deposits. Junior bondholders would be bailed in, but this would only amount to approximately €1.4 billion. This left a funding gap of €5.8 billion.

The Cyprus government proposed to finance the €5.8 billion gap taking money from depositors. It was the most controversial proposal of the history of European debt crisis. The idea was that accounts with balances over €100,000 would be hit with a levy of 9.9 percent and more controversially accounts under €100,000 would also be hit with a levy of 6.75 percent. The Eurogroup accepted this exceptional proposal to violate the European deposit guarantees of €100,000 but, fortunately, the Cyprus parliament wisely rejected this controversial initiative a few days later. This shows that the Eurogroup does not have the experience, expertise, tools and leadership to make decisions regarding bank resolution and that late night backroom deals between politicians can lead to serious miscalculations and mistakes.

The European Commission asked Cyprus to come up with a “Plan B” for how it would raise the €5.8 billion and the ECB issued an ultimatum, saying it would stop offering emergency loans to Cyprus’s banks on Monday 25 March 2013 if a deal had not been reached. The ECB can only offer liquidity assistance to solvent banks and it believed the two big banks, Bank of Cyprus and Laiki, were insolvent. The Cyprus came up with a “plan B” to restructure their banking sector to protect all insured depositors with €100,000 or less in their bank accounts. Laiki Bank, Cyprus’s second largest bank was closed down and deposits above €100,000 were moved into a “bad bank”. Deposits below €100,000 were moved into Bank of Cyprus, the country’s biggest bank. The government used deposits of over €100,000 at Bank of Cyprus to contribute billions towards the bailout. To prevent a bank run, the government applied controls on bank withdrawals and capital controls.

■ 6. The financial trilemma and banking union

Since the banking crisis in Cyprus in 2013, the Eurozone has not experienced another systematic banking crisis but there are still many lessons that have to be applied to prevent another systematic banking crisis. The current system of decentralization, information exchange and cooperation has not worked. According to the De Larosière (2009) report, they “did not seem to share their information properly with their counterparts in other Member States or with the US”.

Schoenmaker (2009) demonstrates that the Eurozone suffers from a malady called “the financial trilemma”. He claims that policymakers can only choose two out of the following three objectives: financial stability, financial integration, and national financial policies. In this paper, I have shown that national competitive spirits and local political influences have combined to create a banking system that is prone to financial instability. To achieve greater financial stability, member states need to give up sovereignty to independently run European authorities regarding bank supervision and resolution.

According to the IMF (2013) a banking union comprises of three important elements, a single supervisory-regulatory framework, a single resolution mechanism, and a safety net. It would ease the fragmentation of financial markets, diminish deposit flight, and weaken the vicious loop of rising sovereign and bank borrowing costs. European policy makers have focused on creating strong supervision and resolution mechanisms and but, they did not create a strong safety net. For example, deposit insurance regulation has been harmonized but it has not been centralized at the European level.

The European heads of state began the 28th-29th of June 2012 summit meeting with a declaration of intent, “*We affirm that it is imperative to break the vicious circle between banks and sovereigns*”. They approved the creation of a Single Supervisory Mechanism (SSM) regulation under the European Central Bank’s authority, using Article 127(6) of the Treaty on the Functioning of the European Union during the summit and the European Commission published this legislation on the 12 of September 2012. All Eurozone members are obliged to join the SSM and the other EU States have the option to become members. The Danish government announced in April 2015 its intention to join the banking union.

The SSM transfers the power to grant or withdraw banking licenses and related supervisory duties from national authorities in the euro area to the ECB, effective since 4 November 2014. The ECB will decide when a bank is failing or is likely to fail. The ECB will carry out its supervisory work with the other EU institutions to ensure that all the EU financial sector laws (a single rule book) will be applied correctly. These EU laws include the Capital Requirements Directive (Basel III), the Deposit Guarantee Scheme Directive and the Bank Recovery and Resolution Directive (BRRD), which is the framework for the recovery and resolution of non-viable banks.

A Supervisory Board was created within the ECB to serve as the SSM’s main decision-making body. The ECB will directly supervise all systematically significant banks in the Eurozone. Eurozone banks are considered to be “systematically significant” when they meet one of the following five conditions:

1. The value of its assets exceeds €30 billion.
2. The value of its assets exceeds both €5 billion and 20% of the Gross Domestic Product of the member state in which it is located.
3. The bank is among the three most significant banks of the country in which it is located.
4. The bank has large cross-border activities.
5. The bank receives, or has applied for, assistance from Euro-zone bailout funds (the European Stability Mechanism or European Financial Stability Facility).

There are approximately 6000 banks in the Eurozone and about 150 banks are considered systematically significant according to the criteria above. They embody approximately 80% of bank assets in the Eurozone and they will be supervised directly by the ECB. National supervisors will supervise the other smaller banks and the ECB will oversee the national supervisors and have the final authority on supervisory issues.

The negotiations to create the Single Resolution Mechanism (SRM) with a Single Resolution Board (SRB) and a Single Fund for the resolution of banks (SRF) were very difficult, as many countries did not want to give up their sovereignty or their public funds to a new European Resolution Authority. The European Commission proposed the regulation for the Single Resolution Mechanism (SRM) in July 2013. The Parliament and the Council of the European Union reached an agreement on the Regulation on 20 March 2014 and the European Parliament approved the Regulation on 15 April 2014 and the Council followed suit on 14 July 2014, leading to its entry into force on 19 August 2014. The SRM Regulation of July 2014, which establishes the SRB, is based on Article 114 TFEU, the common basis for internal market legislation, which had already been used to create new EU agencies.

The SRM Regulation also establishes the SRF under the authority of the SRB, but its financing arrangements are detailed in a separate intergovernmental agreement signed in May 2014. The SRB will start working as an independent EU Agency as of 1st January 2015. Throughout 2015, it will work on developing resolution plans for credit institutions and will be fully operational, with a complete set of resolution powers, from January 2016.

The Single Resolution Board (SRB) is directly responsible for the resolution of significant banks under ECB supervision, while national authorities would take the lead in smaller banks. Its mission is to ensure an orderly resolution of failing banks with minimal costs for taxpayers and to the real economy. It works in close cooperation with the national resolution authorities of the participating Member States, the European Commission and the European Central Bank.

The SRB will also be in charge of bailout funds collected by the SRF from the all credit institutions. The SRF will have funds valued at 1% of covered deposits, approximately 55 billion euros after an eight-year collection period.

The SRB will play an important role in maintaining financial stability during a financial crisis by ensuring the continuity of critical banking functions. It will ensure that non-viable banks are resolved in an orderly manner. It will ensure that the losses are borne by mostly by bank shareholders and creditors.

■ 7. Conclusion

The SRM is a vast improvement on the previous national bank resolution regime, but it is far from ideal. The SRM will cover only the 120 systematically important banks that are under the ECB's direct supervision. A financial crisis may start with a number of small banks and thus many believe that SRM should be in charge of all banks in the Eurozone.

Gros (2014) believes that the European banking union has broken the fatal, insolvency doom loop between banks and sovereigns and explains, *"In many member countries the largest banks have a balance sheet that is larger than their GDP, but even the largest banks are small when viewed in relation to the GDP of the entire euro area"*.

Unlike the SSM, the SRM is not a single independent authority that can make and take its own decisions. As Merler (2014) elegantly explains, *"The resolution scheme is adopted by the Board of the SRM, but within 24 hours the Council can, on proposal by the Commission, object or request amendments to the resolution scheme. In case of disagreement, a back and forth interaction would start between the Council and the Board. The Council, can object or request amendment only on a set of specific matters, but these matters are fundamental ones, such as for example "the assessment made by the Board on whether the criteria [triggering resolution] are met" or "the adequacy of the resolution tools chosen by the Board including [...] any use of the exemptions" and "the extent to which the use of the Fund respects its purposes". It should be self-evident that these are politically sensitive issues that could trigger discussion, disagreement and dangerous delay"*.

The experts on bank resolution at the IMF and the Bank for International Settlements advise that the process to resolve banks should be done rapidly and over the weekend, so that nervous investors and depositors will not experience dangerous delays. The new European decision-making process is far too complex as the decision to resolve a bank would involve too many committees and too many people. The boards and committees would include the SSM Board (24 members), the ECB Governing Council (24 members) and the Board of the SRM (23 members). If there were disagreements, then the Commission (28 members) and the Council (28 members) would get involved. Even though they are making efforts to streamline the process, it still will be an incredibly complicated decision-making process.


The European policy makers have harmonized deposit insurance at 100,000 euro during the financial crisis. One of the main objectives of deposit insurance is to prevent bank runs and this is the case for financially strong sovereigns. Beck (2013) explains, *"The case of Cyprus has shown that when the solvency of the sovereign is itself in question, savers lose faith in a deposit insurance scheme"*. He believes that *"ultimately, this lack of confidence*











can only be overcome by a Eurozone wide deposit insurance scheme with public back-stop funding by ESM and a regulatory and supervisory framework that depositors can trust". Unfortunately, the European policymakers were very shortsighted in not creating a Eurozone wide deposit insurance scheme.













A Single Resolution Fund (SRF) will be set up and will equal 1% of insured deposits in the banking union, around €55bn. This will be built up by bank contributions over eight years. It will be financed by bank levies raised at the national level. It would initially consist of national compartments that would be gradually merged over eight years. The size of the SRF has often been criticized as being insufficient but Gros (2014) explains "that €55 billion would be enough to deal with all but the very largest banks in Europe. It would also be sufficient to deal with even a systemic crisis in small- to medium-sized countries like Ireland or Portugal". Huertas and Nieto (2014) also believes that €55 billion would be adequate if you take in account the "broader architecture resting on four pillars: prudential regulation and supervision, 'no forbearance', adequate 'reserve capital', and provision of liquidity to the bank-in resolution".





On the 10th of June 2014, Eurozone policy makers agreed that the European Stability Mechanism (ESM) could be used up to 60 billion euros to directly recapitalize a non-viable bank as an additional measure of last resort. The ESM funds can only be used once 8 percent of a bank's total liabilities are written off and when the national resolution fund's cash has been fully used in the rescue of a failing bank. Schoemaker (2014) believes that "Without a credible backstop, depositors will run on a troubled banking system causing a bad equilibrium with a full breakdown of the banking system. Only the government can provide such a credible backstop." It will be very interesting to see in the coming years if the ESM can provide an adequate fiscal backstop to the European Resolution Mechanism to prevent a full breakdown of the banking system.

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