EUROPA briefing

Banking Union: How stable are Europe's banks?

The euro crisis was, besides an economic and sovereign debt crisis, a full-blown banking crisis. The Banking Union was thus created precisely to break the vicious circle of ailing banks and weak government finances in the Eurozone. For the moment, it consists of a European banking supervision and a single resolution framework. But the project remains incomplete. How stable are Europe's banks almost eight years after the start of the euro crisis and what is in store for the Banking Union?

JACQUES DELORS INSTITUT BERLIN | BertelsmannStiftung

Why are national banking crises a European problem?

The global financial crisis presented particular challenges for the Eurozone. The introduction of the euro accelerated the integration of its banking sector. Banks from countries experiencing high levels of growth such as Spain and Ireland borrowed a lot of money from German and French banks. That may have been good for the economy, but it also led to a dependency on foreign financing. When the financial crisis started, the flow of credit from abroad stopped since it was unclear if governments in the crisis countries would be able to support their banking sectors. The loss of confidence between banks damaged the economy throughout Europe.

The interplay between banks and government finances contributed to the escalation of the euro crisis. This so-called sovereign-bank nexus took effect in two ways:

On the one hand, governments tried to prevent the collapse of the financial system during the crisis and supported their banking sectors with loans or guarantees. Such bank rescues, also called ➔ **bailouts**, amounted to roughly five percent of total economic output in the Eurozone between 2008 and 2014.

Some countries were overwhelmed by the financial burden of the bailout. For example, the Irish government overreached itself in bailing out its banking sector, with the effect that a banking crisis turned into a sovereign debt crisis.

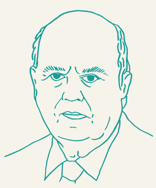
On the other hand, banks suffered from weak government finances since they traditionally hold a lot of their own government's sovereign debt. In the case of Italian banks, this is currently ten percent of all their assets. If paying these back becomes uncertain, confidence in the banks' stability declines.

Initially, the Eurozone lacked the instruments to prevent the spill-over of the banking crisis from one country to another. Each government had to cover their bailouts by themselves, which led to large distortions in the risk assessment of countries and banks. The creation of a joint supervisory authority and uniform rules for insolvent banks in the form of a ➔ **European Single Resolution Mechanism** for banks helped to weaken the link between banks and states as well as cross-border contagion.

➔

Bailout
In a bailout, the government protects a bank from insolvency by providing financial assistance. The alternative to a bailout is a bail-in. Here, the bank's shareholders and creditors take part in financing a fundamental restructuring or unwinding.

European Single Resolution Mechanism
There is a set decision-making and liability process for an insolvent bank. Initially, its owners and creditors share the losses, then aid is provided from a 55 billion euro fund, a collective European resolution fund financed by the banks themselves.



"It is important to ensure that savings are equally protected in all member states, thus further weakening the link between the banks and the sovereigns."

Michael Noonan, Irish Finance Minister
in Brussels on the sidelines of the EU Council of Ministers on 8 December 2015

"As regards non-performing loans, which is a problem in many countries, we recognise that there is much more to be done. And banks need some supervisory pressure to do what they need to do."

Danièle Nouy, President of the European Single Supervisory Mechanism
in an interview with La Repubblica on 30 January 2017

Has Europe made its banks safer?

The euro crisis reached a temporary peak in early 2012. Interest rates of Greek government bonds rose from five percent in 2009 to 49 percent in January 2012; yields on Portuguese bonds rose to 17 percent. The crisis even threatened to spread to Italy, the third-largest economy in the Eurozone.

The meeting of the European Council in June 2012 represented a turning point and defused the euro crisis on a sustainable basis. The heads of state and government gave the green light for a two-pillar banking union: a single resolution framework for ailing banks and a European banking supervision under the umbrella of the European Central Bank (ECB). These are important steps to mitigate the government-bank nexus. A common → **deposit insurance scheme** was also discussed, but has not been introduced for the time being.

The banking sector could not be freed from all risks overnight. In 2013 and 2014, the bulk of legislation required for the Banking Union was passed.

The new supervisory authority began its work in 2014 with the first stress test, a crisis simulation for bank balance sheets. The test revealed capital shortfalls in 13 of the 130 largest European banks. On average, banks have strengthened their balance sheets since then, but in some countries they still retain large amounts of → **non-performing loans** on their books.

Since 2016 there are also uniform rules and mechanisms in place in the event of a bank failure. The Single Resolution Board first decides on whether and how an ailing bank can be aided. Accessing the funds within the Single Resolution Mechanism in any restructuring requires the creditors to cover a portion of the losses themselves (bail-in). This should protect taxpayers from incalculable costs of a banking crisis. Furthermore, it helps to align the competitive conditions in the Eurozone since even banks from financially strong countries can no longer count on government aid.

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Deposit insurance scheme
To prevent a bank run caused by panicky depositors during a banking crisis and protect their savings, the government guarantees deposits. In the EU, savings deposits of up to 100 000 euro are protected. Since no pan-European fund has been set up, this must be met by national funds in any serious case for now.

Non-performing loans
If households and companies are behind hand in repaying their debt for 90 days or more, their loans are considered to be at risk of default or non-performing. Such loans have very little value and damage the bank's balance sheet as a result.

"The [banks] should be liable themselves, not the taxpayers. It is no argument that the risk should be shifted from the taxpayers in one country to the taxpayers in other countries."

Wolfgang Schäuble, German Federal Minister of Finance
in a speech to the German Parliament on 8 September 2015

"We are the EU country that paid the least for the bank bailout. The Italian banking system as a whole is not in a crisis. In Italy we have roughly 600 banks; eight of them have problems."

Pier Carlo Padoan, Italian Finance Minister
in an interview with Die Welt on 11 January 2017

BANKING UNION

A look ahead

SCENARIO 1

Comprehensive and collective clean-up

There is now a dangerously high number of non-performing loans (NPLs) in six euro-area countries. The banks need to be freed of these loans as quickly as possible in order to regain profitability and grant new loans to companies. Banks in Cyprus, Greece, Italy and Portugal are particularly affected.

If they wish to get their banks on solid footing swiftly, governments and European institutions could jointly set up a state-backed fund that buys their NPLs at a reasonable price. The losses resulting from this would have to be covered initially by the owners and creditors under the new rules of the Banking Union. This could require the restructuring of some banks and even lead to insolvencies.

If the European banking sector is freed of most of its bad debt, it would also be easier for the Eurozone countries to complete the Banking Union. On the one hand, risks would have to be further reduced by allowing banks to retain only a limited number of their country's sovereign bonds. On the other, the remaining risks would have to be increasingly shared, for example, through a European deposit insurance scheme that collectively guarantees citizens' savings deposits.

SCENARIO 2

Member states vs. EU supervision

A rapid and complete clean-up of banks may not be attractive since recognition of the losses on NPLs could mean insolvency for some of them. In this second scenario, some governments might wish to help their domestic banking sector with a state-financed bailout, albeit banned since the entry into force of the Single Resolution Mechanism. Any violation of these rules could lead to an open dispute between governments and the European supervisory authorities.

If individual countries break with the principle of "same rules for all", that will put at risk the necessary mutual trust for future cooperation. It would also fail to result in a long-term compromise between risk sharing and risk reduction – and thus the Banking Union would remain incomplete.

Any failure in the effort to keep moving ahead with the Banking Union is risky for two reasons: First, a showdown between governments and European institutions would slow down even further the already protracted reduction of distressed debt, and a weak banking sector would continue to harm the economy. Second, the sustainability of sovereign debt in some euro-area countries could come under renewed question in the next crisis without the completion of the Banking Union.

SCENARIO 3

Exceptions subject to conditions

Since the ban on bailouts, banks can only rely on financial support from the European Resolution Mechanism if creditors cover a portion of the losses themselves. The risk here is that banks lend money to each other and thus the insolvency of one bank may cause losses at the next. Accordingly, even with the new regime contagion in the banking sector cannot be ruled out.

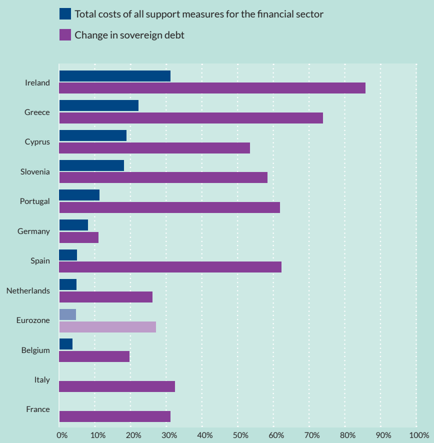
In this third scenario, individual member states would be allowed to restructure their banks at their own cost and under strict conditions and thereby settle once and for all the hangover from the crisis. Here, shareholders and creditors would share the losses to a limited extent only. Banks in crisis countries could then supply their economies with sufficient credit again. The price for this would be higher sovereign debt.

Whether there would be any extension of the Banking Union after such exceptions depends on the extent to which the member states are confident that the rules will be complied with in future. Countries with no interest in easing the rules could conceivably require commitments to reduce sovereign debt and economic reforms in crisis countries as the price for allowing any exceptions.

FACT #1

Costs of bank bailouts and sovereign debt in the Eurozone between 2008 and 2014

In percent relative to GDP in 2014



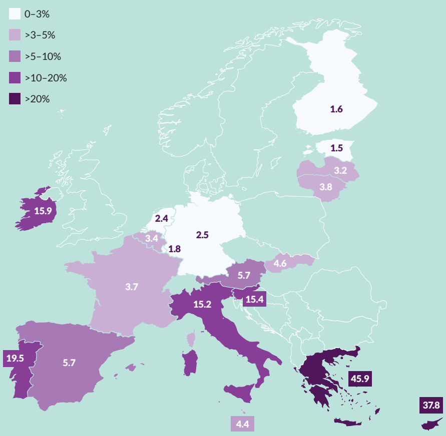
The relationship between the costs of the bank bailouts and the rise in sovereign debt is not entirely clear in the Eurozone. In Germany, the bank bailout was responsible for a majority of the increase in sovereign debt; in Italy and France, by contrast, there were no net costs from bank bailouts until 2014. Nonetheless, sovereign debt rose rapidly in these countries during the economic crisis.

Source: ECB.

FACT #2

Non-performing loans on bank balance sheets

As share of all bank loans in percent, 2016



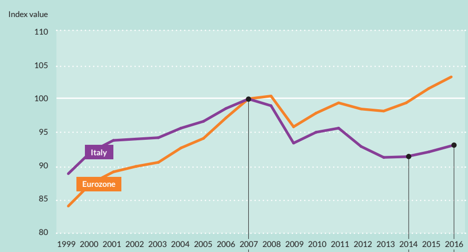
Non-performing loans rose throughout Europe as a result of the euro crisis. Since 2013, however, they have been falling again on average in the EU. Particularly banks in Ireland, Slovenia and Spain have been able to greatly reduce their share of non-performing loans. In Cyprus, Greece, Portugal and Italy, by contrast, there has not been any sustainable recovery to date.

Source: ECB, European Banking Authority, author's calculation.

FACT #3

The Italian banking crisis

Index: Gross domestic product (GDP) in 2007 = 100



The **economic crisis** has not yet come to an end in Italy. In 2016, GDP was still seven percent below the level in 2007.

As the number of corporate insolvencies rose, **non-performing loans** climbed to 18 percent in 2014. Italian banks hold roughly 30 percent of all loans at risk of default in the Eurozone.

Four of the 13 banks that have failed **European stress tests** due to capital shortfalls since 2014 came from Italy. Not all of them have been able to recapitalise themselves sufficiently in the following years.

Between December 2016 and March 2017, three of the four banks at risk requested government aid in the form of a **precautionary recapitalisation**. Italy has already approved 20 billion euro for this.

The **ECB and the European Commission** must decide individually for each bank on the admissibility of a recapitalisation by the national government.

Source: Eurostat, author's calculation.

"The Banking Union played a key role in defusing the euro crisis. Today, taxpayers and bank depositors are better protected against the consequences of a bank failure thanks to the new rules and institutions. But some member states joined the Banking Union with large amounts of distressed debt. The priority should be to free the banks in crisis countries from non-performing loans. Then the rules in the Banking Union will be easier to apply in the future."

Philipp Ständer
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EUROPA briefing

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Translation
ETC Europe scrl, Brussels

Edit
David Gow, Edinburgh

Design
ressourcenmangel
an der Panke GmbH, Berlin

Production
druck.haus rihn gmbh, Blomberg

Persons responsible according to
the German Press Law
Prof. Dr. Henrik Enderlein,
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