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Luigi Daniele  
Pierluigi Simone  
Roberto Cisotta *Editors*

# Democracy in the EMU in the Aftermath of the Crisis



Springer

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*Editors*

Luigi Daniele  
Department of Public Law  
University of Rome “Tor Vergata”  
Rome, Italy

Pierluigi Simone  
Department of Public Law  
University of Rome “Tor Vergata”  
Rome, Italy

Roberto Cisotta  
Italian Ministry of Foreign Affairs and  
International Cooperation  
Rome, Italy

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# Financial Challenges to Solidarity: Building the European Banking Union in Times of Crisis

Annamaria Viterbo

**Abstract** The purpose of this chapter is to single out the features of the European Banking Union that are most problematic to achieve solidarity among Member States. The focus will be on three elements of the European Banking Union where solidarity proves particularly difficult to be achieved: the Single Resolution Fund, the direct recapitalisation instrument of the European Stability Mechanism and the European Deposit Insurance Scheme.

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## 1 Introduction

The full realisation of the European Banking Union is faltering and, without solidarity, it will remain a half-way system unable to achieve its objectives.

Solidarity has always been a founding value of European integration. In the words of Robert Schuman “*L’Europe ne se fera pas d’un coup ni dans une construction d’ensemble: elle se fera pour des réalisations concrètes, créant d’abord une solidarité de fait.*”<sup>1</sup> In the 1980s, Jacques Delors defined his idea of Europe listing the three cornerstones of the Union: “Competition that stimulates,

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<sup>1</sup>Schuman (1950) Déclaration Schuman, 9 May 1950.

A. Viterbo (✉)

International Law, Department of Law, University of Turin, Turin, Italy

Collegio Carlo Alberto Law Affiliate, Turin, Italy

e-mail: [anna.viterbo@unito.it](mailto:anna.viterbo@unito.it)

cooperation that strengthens, and solidarity that unites”.<sup>2</sup> The principle acquired even more prominence with the Treaty of Lisbon, with its meaning formally broadened to include also solidarity among generations (see Articles 2 and 3 TEU, as well as Title V of the Charter of Fundamental Rights of the European Union).

Three different dimensions of solidarity can be identified: solidarity among Member States, solidarity between Member States and individuals subject to their jurisdiction, and inter-generational solidarity.<sup>3</sup> This article focuses on solidarity among States, which in the EU Treaties is strictly linked to the reciprocity principle.

In the aftermath of the financial crisis, inter-State solidarity helped avoid the worst, contributing to structure the new European economic governance, although not without tensions. Some Member States and political parties feared that the creation of a Banking Union would ultimately lead to a transfer union, with wealthier Countries like France or Germany forced to provide financial support to economically weaker ones like Greece.

Tension was partially caused by the different scope of the meaning given to the concept of solidarity across Europe.<sup>4</sup> In southern Countries solidarity entails helping people in need regardless of the circumstances, while in northern Countries, to prevent moral hazard, help should only be provided when deserved and under strict conditions.

Germany in particular continues to condition financial burden-sharing to structural reforms and austerity measures. In December 2015, Angela Merkel, commending the Country’s Minister of Finance Wolfgang Schaeuble for his role during the Greek negotiations, reminded that the German Government standards were and still are: “No aid without conditionality. Responsibility and solidarity go together and it must remain this way”.<sup>5</sup>

George Soros predicted that Germany’s fear of becoming the deep pocket of Europe would be fatal for the European Union: “Germany is afraid of becoming the deep pocket of Europe in a transfer union. That attitude has been fatal for the European Union. If you think about normal nation-states, every country is in some sense a ‘transfer union’. It is always the more-productive, more-successful parts of a country that have to support the less-developed regions.”<sup>6</sup>

A solidarity mechanism which makes assistance to other Countries mandatory certainly interferes with critical national sovereignty aspects. It follows that a clear definition of the criteria for its activation is of the utmost importance. Neither

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<sup>2</sup>Delors (2003), p. 462.

<sup>3</sup>Domurath (2013), Hilpold (2015), Ross (2010), Sangiovanni (2013). Over the years, forms of transnational solidarity have emerged, as mobile EU citizens seek access to social benefits in a host Member State: see de Witte (2015).

<sup>4</sup>Dammann (2014), p. 1066.

<sup>5</sup>Merkel (2015).

<sup>6</sup>Soros and Schmitz (2014), p. 40.



overly strict criteria nor relaxed standards can contribute to the achievement of solidarity purposes. In fact, while extreme austerity may undermine the effects of solidarity, the opposite may lead some States to threaten the withdrawal of their support fearing that an endless call for support would be triggered.<sup>7</sup>

We can therefore agree with Lorenzo Bini-Smaghi: “The search for the correct balance between providing adequate support to those in need and avoiding moral hazard represents today the most complex point of the European political debate.”<sup>8</sup>

Before addressing the features of the European Banking Union standing in the way of an effective achievement of solidarity among Member States, it is worth to briefly describe its structure.

The European Banking Union (EBU) is made up of three pillars.<sup>9</sup>

The first pillar is represented by the Single Supervisory Mechanism (SSM),<sup>10</sup> under which the European Central Bank (ECB) became the central prudential supervisor for the most significant banks, with national supervisors continuing to monitor the remaining banks. Not all EU Member States take part in the SSM, as participation is mandatory only for Euro area Countries. Non-Euro Countries, however, may enter into “close cooperation agreements” with the ECB.<sup>11</sup>

The second pillar is represented by the Single Resolution Mechanism (SRM), which establishes uniform rules and procedures for the resolution of failing credit institutions.

The SRM Regulation<sup>12</sup> concerns banks covered by the SSM and, like the SSM, it includes all banks in the Euro area, with other States eligible to join. Its purpose is

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<sup>7</sup>On solidarity within the European Monetary Union see Hilpold (2015), p. 15.

<sup>8</sup>Bini-Smaghi (2015).

<sup>9</sup>Baglioni (2016), Baroncelli (2014), Bush and Ferrarini (2015), de Witte (2013, 2015), Hinojosa-Martinez and Beneyto (2015), Lastra (2013) and Pugliese (2014).

<sup>10</sup>The SSM founding texts consist of a Regulation that confers supervisory tasks on the ECB and an amended Regulation on the European Banking Authority: Council Regulation (EU) No. 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJEU L 287, 29 October 2013, pp. 63 et seq.; Regulation (EU) No. 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) No. 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No. 1024/2013, OJEU L 287, 29 October 2013, pp. 5 et seq.

<sup>11</sup>The main conditions for the establishment of a close cooperation between the ECB and the competent authorities of a Member State whose currency is not the Euro are defined in Article 7 of the SSM Regulation, while the procedural aspects are set out in a decision adopted by the ECB (Decision of the European Central Bank of 31 January 2014 on the close cooperation with the national competent authorities of participating Member States whose currency is not the Euro (Decision ECB/2014/5)).

<sup>12</sup>Regulation (EU) No. 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No. 1093/2010, OJEU L 225, 30 July 2014, pp. 1 et seq.

to ensure a timely and orderly resolution of failing banks, limiting the costs borne by taxpayers, further developing the principles contained in the Bank Recovery and Resolution Directive (BRRD), which applies across the EU.<sup>13</sup> The SRM has been fully operational since 1 January 2016.

When, in spite of stronger EU supervision, a bank is likely to fail, the Single Resolution Board (SRB) decides whether and when to place the bank into resolution *status*, defining the course of action to be followed. These measures are financed by the Single Resolution Fund (SRF) once all other options, including bail-in, have been adopted.

The third pillar is still under construction. The European Commission has recently put forward a proposal for a European Deposit Insurance Scheme (EDIS),<sup>14</sup> aimed at providing greater and uniform protection of depositors throughout the Euro area. The EDIS will consist of a common fund collecting contributions from banks in EBU Countries. Should a bank fail, its depositors across the EU would be protected up to a defined (harmonised) amount by national deposit guarantee schemes.<sup>15</sup>

These three pillars rest on a set of legislative acts (the so-called single rulebook) mandatory for all financial institutions in the EU and are not just limited to banks operating in euro area countries. These acts are intended to create a level-playing field in financial services, harmonising capital requirements standards, national deposit guarantee schemes and bank recovery and resolution procedures.<sup>16</sup>

The next paragraphs focus on the areas in which solidarity proved particularly difficult to be achieved: (1) the functioning of the Single Resolution Fund within the SRM; (2) the functioning of the Direct Recapitalisation Instrument of the European Stability Mechanism (DRI); and (3) the set-up of a pan-European Deposit Insurance Scheme (EDIS).

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<sup>13</sup>Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No. 1093/2010 and (EU) No. 648/2012, of the European Parliament and of the Council, OJEU L 173, 12 June 2014, pp. 190 et seqq.

<sup>14</sup>European Commission, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No. 806/2014 in order to establish a European Deposit Insurance Scheme (COM/2015/0586 final).

<sup>15</sup>Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes, OJEU L 173, 12 June 2014, pp. 149 et seqq.

<sup>16</sup>The single rulebook includes the BRRD and the deposit guarantee schemes Directives mentioned above as well as: Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential credit requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012, OJEU L 176, 27 June 2013, pp. 1 et seqq.; and Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, OJEU L 176, 27 June 2013, pp. 338 et seqq.

## 2 Solidarity Within the Single Resolution Mechanism: The Functioning of the Single Resolution Fund

The SRM Regulation ensures the orderly restructuring of failing banks operating under the Single Supervisory Mechanism.<sup>17</sup> After all other financing sources—including bail-in<sup>18</sup>—have been exhausted, resolution is financed by the Single Resolution Fund (SRF), with a view to limit resort to taxpayers' money. Decisions on resolution schemes and on the use of SRF's resources are taken by the Single Resolution Board (SRB).

The SRF is not intended to replace private investors in absorbing losses and in providing new capital to a bank, but its backing support is essential since it enables a bank (either in its original form, by means of a bridge bank or through an asset management vehicle) to continue to operate while it is being restructured. In the short to the medium-term, the Fund provides guarantees or loans to a bank being restructured, restoring its full business viability while at same time safeguarding the Euro area financial stability.<sup>19</sup>

As set forth by the SRM Regulation, the SRF is directly financed by *ex ante* contributions from the banking sector: all credit institutions within the scope of the mechanism contribute to the Fund in accordance to their size and risk profile.<sup>20</sup>

One of the key issues during negotiations revolved around the most appropriate way to provide adequate funding to the SRF. Another item of discussion, no less contentious, concerned the achievement of a smooth transition from the existing national resolution funds to the SRF, pooling national contributions while gradually increasing mutualisation of their usage.

The adoption of an intergovernmental agreement was made necessary because some Member States, concerned about their budgetary sovereignty, maintained that the imposition of an obligation to mutualise resolution funds would require amending the EU Treaties.<sup>21</sup>

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<sup>17</sup>The SRM is fully operational since 1 January 2016.

<sup>18</sup>A bail-in occurs when a bank's investors are forced to bear some of the burden by having a portion of their holdings written off to avoid bankruptcy.

<sup>19</sup>Fabbrini (2014), Zavvos and Kaltsoumi (2015), p. 140; Gortsos (2015), Huhtaniemi et al. (2015), p. 114.

<sup>20</sup>See Council Implementing Regulation (EU) No. 2015/81 of 19 December 2014 specifying uniform conditions of application of Regulation (EU) No. 806/2014 of the European Parliament and of the Council with regard to *ex ante* contributions to the Single Resolution Fund, OJEU L 15, 22 January 2015, pp. 1 et seqq.

<sup>21</sup>See de Witte (2013); Fabbrini (2014); Kern (2015), p. 176; Moloney (2014), p. 1658. See also the legal opinion delivered by the Council Legal Service: Council, Opinion of the Legal Service, 2013/0253 (COD), 13524/13, LIMITE, JUR 458, ECOFIN 787; and European Parliament Committee on Economic and Monetary Affairs, Letter to the Council Presidency of the EU regarding the intergovernmental agreement negotiated within the framework of the SRM Regulation, 15 January 2014.

The creation of a supranational fund was deemed crucial for the correct functioning of the SRM. If the cost involved in a bank's resolution were to remain national, the link between sovereigns and the banking sector would not be fully severed, and investors' behaviour would continue to be influenced by the fiscal position of the State where the bank is established rather than to its creditworthiness.

The Agreement on the transfer and mutualisation of contributions to the SRF (SRF Agreement)<sup>22</sup> details how bank contributions are collected by national authorities and how they are gradually pooled at Union level during an 8-year transition period.

Only in 2024 the Fund is expected to reach the target level of €55 billion (estimated to be equivalent to 1% of covered deposits of all credit institutions authorised in the Banking Union), a sum which nevertheless appears to be inadequate when considering that the Euro area banking sector is worth €22 trillion.<sup>23</sup> Legitimate concerns were therefore expressed that the SRF would not be able to withstand a major banking crisis.

Capacity constraints are even more likely in the initial years, as the Fund will be structured in separate national compartments. Pursuant to Article 4 of the SRF Agreement, contributions levied on banks at domestic level are kept by the Fund in separate "national compartments". These compartments will only be used for the resolution of institutions established or authorised in the contributing State.

National compartments will be gradually abandoned to shift to a system in which contributions from all compartments may be used, irrespective of their origin or of the Country where the banks in distress is authorised to operate.

When the funds of a compartment are insufficient to finance a particular resolution, Article 7 of the SRF Agreement envisions the possibility of temporary transfers among national compartments.

In spite of the above, solidarity is difficult to be achieved. In fact, the Agreement contains a number of safeguards. For instance, a State may reject lending requests on different grounds: when a transfer request exceeds a given threshold, when a Member State is going to face other resolutions in the near future, or when the receiving Member State cannot provide sufficient guarantees of repayment (Article 7.4 of the SRF Agreement).

Even the most recent developments are showing lack of political will and of a common vision. To avoid funding shortfalls as well as loans among national compartments, in December 2015 Member States agreed to put in place a system

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<sup>22</sup>Agreement on the transfer and mutualisation of contributions to the SRF (Council Document 8457/14, ECOFIN 342), available at <http://register.consilium.europa.eu/doc/srv?l=EN&fst%208457%202014%20INIT>. The Agreement was signed on 21 May 2014 by all EU Member States except Sweden and the United Kingdom, and ratified by all Euro area Member States by December 2015, with Luxembourg joining on 11 January 2016. The obligation to transfer the contributions raised at domestic level to the SRF does not derive from EU law. Besides, the Agreement affirms that all the rights and obligations laid down in its articles are valid provided that the principle of reciprocity is respected (see recital 20 of the Preamble).

<sup>23</sup>See IMF (2015), p. 18, which also advocated for an acceleration in the mutualisation of national compartments from the planned eight-year transition period. See also IMF (2013).

of public bridge financing arrangements for the transitional period, committing to back their national compartments through loans to the SRB.<sup>24</sup>

In practice, by the end of 2016, each participating Member State will enter into harmonised Loan Facility Agreements with the SRB in order to provide a national credit line to the latter. These national credit lines will be used to back national compartments in the SRF in the case of funding shortfalls stemming from the resolution of banks within the Member State concerned. Banks operating in the requesting Member State will be ultimately liable for the repayment of the amounts withdrawn from the credit line.

EBU Member States also acknowledged that the current set-up does not entirely eliminate the risk that public funding may be required for bank resolution operations. For this reason, they agreed to develop a common backstop to temporary mutualise fiscal risk to be used only as a last resort measure.<sup>25</sup> However, to sever the bank-sovereign link, the common backstop to the SRF will have to be fiscally neutral in the medium term: public funds will be reimbursed over time by banks via *ex post* contributions to the SRF. The mechanism is expected to be fully operational at the latest by the end of the transitional period, at the end of 2023.

Nevertheless, heated debate over the new system of bridge financing and the common fiscal backstop makes it clear that Euro area Member States are not ready to share risk, not even on a temporary basis. Consequently, it is reasonable to assume that full and effective solidarity within the SRM pillar of the Banking Union will take far more than the 8 years initially planned.

### **3 Solidarity Within the European Stability Mechanism: The Direct Recapitalisation Instrument**

Another tool through which Euro area Member States may implement solidarity is the Direct Recapitalisation Instrument (DRI) of the European Stability Mechanism (ESM).<sup>26</sup>

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<sup>24</sup>Statement of the ECOFIN Ministers on Banking Union and bridge financing arrangements for the Single Resolution Fund of 8 December 2015. In December 2013 Member States had already committed to put in place a bridge financing mechanism to back national compartments in case of funding shortfalls during the transition period (see Statement of the Eurogroup and of the ECOFIN Ministers of 18 December 2013). See also: Five Presidents' Report (2015), p. 11.

<sup>25</sup>Statement of the ECOFIN Ministers on Banking Union and bridge financing arrangements for the Single Resolution Fund of 8 December 2015. See also Statement of Eurogroup and Ecofin Ministers on the SRM backstop, 18 December 2013, [http://www.consilium.europa.eu/en/council-eu/eurogroup/pdf/20131218-SRM-backstop-statement\\_pdf](http://www.consilium.europa.eu/en/council-eu/eurogroup/pdf/20131218-SRM-backstop-statement_pdf).

<sup>26</sup>The ESM is the permanent crisis resolution mechanism for the Euro area Countries. It provides financial assistance to Member States experiencing, or threatened by, severe financing problems. The Treaty establishing the ESM was originally signed by Finance Ministers of the 17 Euro area Countries on 11 July 2011. However, a modified version of the Treaty, incorporating amendments aimed at improving the effectiveness of the mechanism, was signed in Brussels on 2 February 2012. The ESM Treaty entered into force on 27 September 2012. The current version of the Treaty, amended following the accession of Latvia and Lithuania to the ESM, entered into force on 3 February 2015.

The origins of the DRI stem from the 2008 European financial crisis, when a number of banks in distress had to be recapitalised by the States in which they operated.<sup>27</sup> As a common resolution framework did not exist at the time (and until the entry into force of the 2014 BRRD Directive<sup>28</sup>), the recapitalisation of banks was considered a national problem. Bail-outs were mainly financed with taxpayers' money, increasing the vicious circle between banks and sovereigns.

Moreover, in the cases of Ireland and Spain, the costs of national recapitalisation proved to be particularly burdensome and spurred a sovereign debt crisis that prompted the two States to request a European rescue package.

The ESM financial assistance programme for Spain had, for the first time, as its very objective the recapitalisation and restructuring of that Country's banking sector. ESM financial assistance was provided in the form of debt securities to the Spanish national recapitalisation fund. Therefore, this recapitalisation was indirect since it was carried out through ESM loans granted to the Government, which in turns allocated and transferred the funds to the concerned financial institutions. Such assistance, however, had the effect of increasing the recipient Country's budget deficit and public debt, prompting doubts over its creditworthiness in financial markets, with sovereign ratings plummeting as a consequence.

It was in this broader context that, in June 2012 (a few weeks before Spain made an official request for financial assistance) the Eurosummit started to discuss the introduction of a direct recapitalisation mechanism to allow banks to strengthen their capital position without placing a heavy burden on the Country where they are incorporated.<sup>29</sup>

In December 2012, the European Council recognised the urgent need to sever the link between banks and sovereigns and to proceed towards a Banking Union.<sup>30</sup> It was then agreed that, once the SSM would enter into force, the funding arrangements of the SRM were to include the direct recapitalisation of banks by the ESM (that is: the ESM would have the ability to acquire ordinary shares of troubled financial institutions without first channelling resources through the State).

This meant that the burden of recapitalisation would be partially shifted on all ESM Member States, even if only temporarily.<sup>31</sup> However, not all ESM Members were ready for this new kind of solidarity and, as a result, defining the features of the DRI proved highly contentious.

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<sup>27</sup>Corti Varela (2015); Merler (2014).

<sup>28</sup>See *supra*.

<sup>29</sup>Euro Area Summit Statement, Brussels, 29 June 2012.

<sup>30</sup>European Council Conclusions on completing EMU, Brussels, 14 December 2012.

<sup>31</sup>The ESM has a total subscribed capital of €704.8 billion, with a paid-in capital of €80.5 billion, and it raises funds by issuing bonds on capital markets. The liability of each ESM Member is limited to its quota in the ESM capital (cf. the ESM shareholder contribution key annexed to the ESM Treaty).

The DRI was finally introduced in December 2014 through a unanimous resolution of the ESM Board of Governors,<sup>32</sup> and once all Euro area Members completed their national approval procedures.<sup>33</sup> The DRI was, however, received with criticism, especially for its overly restrictive eligibility criteria.<sup>34</sup> In fact, the DRI features seem to undermine the very purpose for which it was conceived.

First of all, Member States of the ESM agreed a self-imposed ceiling, capping at €60 billion the amount of resources available under the DRI. The decision was taken by the Board of Governors with a view to preserve the ESM's lending capacity for other instruments, to protect its creditworthiness and minimise the risk of loss. The IMF however considered the ceiling too low to handle stress in the case of large banks.<sup>35</sup> As a comparison, in 2012 the ESM provided €41.3 billion to Spain for the indirect recapitalisation of the banking sector.

Second, the request for DRI funding still has to be made by a Member State, with sovereigns remaining firmly at the center of the mechanism. The requesting State should be unable to provide financial assistance to troubled institutions (through a national recapitalisation process or an indirect recapitalisation via an ESM loan), as this would greatly affect the Country's fiscal sustainability or its continuous market access. The DRI is, therefore, available to a Member State only as a last resort.

This notwithstanding, pursuant to Article 9 of the ESM DRI Guideline, before the ESM becomes a shareholder of the institution, the State has to make a contribution to the recapitalisation operation. This contribution can be waived by the ESM Board of Governors only under exceptional circumstances related to the Country's weak fiscal position or difficult market access. In this case, though, the Country should commit to indemnify the ESM for any further loss incurred and to accept supplementary macroeconomic conditionality. In other words, even a State in distress has to contribute to the recapitalisation of its banks, thus increasing its public debt.

Fourth, to reduce moral hazard, various forms of conditionality are attached to the DRI, including compliance with State-aid rules. Conditions can be institution-specific or addressed to the requesting State; in the latter case, reform may relate to the Country's financial sector or to its general economic policies. A Memorandum

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<sup>32</sup>The resolution of the ESM Board of Governors (that is, the Finance Ministers of the Countries of the Euro area, chaired by the Eurogroup President) was taken on the basis of Article 19 of the ESM Treaty. ESM, Board of Governors Resolution No. 4 of 8 December 2014: Establishment of the Instrument for the Direct Recapitalisation of Institutions (SG/BoG/2014/05/04). See also ESM, Guideline on Financial Assistance for the Direct Recapitalisation of Institutions, 8 December 2014 as well as ESM, Guideline on Financial Assistance for the Recapitalisation of Financial Institutions (which applies to the ESM indirect bank recapitalisation instrument under Article 15 of the ESM Treaty).

<sup>33</sup>A political understanding was reached already in June 2014. See Statement by the President of the Eurogroup on the ESM Direct Recapitalisation Instrument, 10 June 2014.

<sup>34</sup>Five Presidents' Report (2015), p. 11.

<sup>35</sup>IMF (2015).



of Understanding will be negotiated by the European Commission, in liaison with the ECB, the ESM Managing Director and, wherever appropriate, by the IMF.

Besides, the DRI is available only for systemically relevant institutions operating under the ECB's supervision, that would pose a serious threat to the financial stability of the Euro area as a whole or of the requesting Member State. The instrument concerns institutions breaching capital requirements which are unable to raise capital from private investors.<sup>36</sup>

Finally, according to Article 8 of the ESM DRI Guideline, a set of preconditions should also be met: the bail-in by private investors, which will have to contribute for not less than 8% of total liabilities; a contribution by the SRF covering up to 5% of total liabilities; and the write-down or conversion in full of all unsecured and non-preferred liabilities other than eligible deposits.

In conclusion, Euro area Members consented to the introduction of the DRI but only under the condition of an appropriate burden sharing structure and of the application of adequate conditionality.<sup>37</sup>

The activation of the DRI in fact requires the bail-in of private stakeholders and the avoidance of public assistance which is limited only to the most extreme circumstances (these also being the characteristics of the European approach to bank resolution set forth in the BRRD). Thus, the primary responsibility for resolution remains at national level, with mutualised financial assistance provided by the ESM only as a last resort. Moreover, even in the unlikely event that a State seeks financial assistance under the DRI, it will have to contribute to the recapitalisation of banks, thus increasing its public debt, impairing market access and reinforcing the vicious circle between sovereigns and banks, rather than severing it.<sup>38</sup>

#### **4 Solidarity and the Protection of Deposits: The Establishment of a European Deposit Insurance Scheme**

The third pillar of the Banking Union, a pan-EU deposit insurance scheme, is still under construction, its negotiations proving rather difficult.

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<sup>36</sup>See Article 1 of the ESM Guideline on Financial Assistance for the Direct Recapitalisation of Institutions as well as footnote 2, which broadens the concept of systemic relevance.

<sup>37</sup>It is worth mentioning that according to Article 4(1)2 of the German implementation law of the ESM Treaty (ESM *Finanzierungsgesetz* of 13 September 2012, as amended on 29 November 2014), the disbursement of ESM financial assistance for the direct recapitalisation of institutions will require the prior approval of the Bundestag's plenary session.

<sup>38</sup>Hadjiemmanuil (2015), p. 22.



In 2010, the European Commission put forward a proposal to amend the Directive on Deposit Guarantee Schemes (DGSs)<sup>39</sup> to increase confidence and further harmonise existing national schemes.<sup>40</sup>

In its impact assessment, the Commission highlighted the disproportion between the financing level of national DGSs and the worth of covered deposits in the EU, with some DGS not even able to withstand a medium-size bank failure. The situation was made worse by the lack of solidarity among schemes.

Being the establishment of a single European DGS unfeasible at the time, the European Commission proposed the introduction of a “mutual borrowing facility”, granting a national scheme the right to borrow from other schemes, should its resources be insufficient.<sup>41</sup>

In 2013, once an agreement on the new Directive<sup>42</sup> was finally reached, the text adopted was watered down compared to the proposal put forward by the Commission. In the version approved, Article 12 of the DGS Directive read:

Borrowing between DGSs: 1. Members States *may allow* DGSs to lend to other DGSs within the Union *on a voluntary basis* [emphasis added],

provided that a set of conditions was met.

As a result, under the current legal framework, borrowings among DGSs are based on voluntary lending arrangements rather than on a mandatory scheme. Moreover, the lending procedure can only be activated when: a DGS is unable to fulfil its obligations because of lack of means; the DGS has already made recourse to the extraordinary contributions of its members; and the DGS has repaid previous loans.

Besides, the amount of money requested by a DGS cannot exceed 0.5% of its covered deposits and the loan and interests have to be repaid within 5 years.

However, as pointed out by the Five Presidents’ Report<sup>43</sup> and also by the IMF,<sup>44</sup> the current national set-up remains vulnerable to sizeable local shocks, in particular when both the sovereign and its national banking sector are perceived as frail.

<sup>39</sup>Directive 94/19/EC on deposit guarantee schemes was first amended in 2009 by Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009, OJEU L 68, 13 March 2009, pp. 3 et seqq., in particular with a view to increase deposits coverage level from €20,000 to €100,000 by the end of 2010.

<sup>40</sup>European Commission, Proposal for a Directive on deposit guarantee schemes, COM(2010)368 final, 12 July 2010.

<sup>41</sup>See Article 10 of the European Commission’s proposal: “1. A scheme shall have *the right to borrow* from all other Deposit Guarantee Schemes referred to in Article 1(2) within the Union provided that all of the following conditions are met: [...] [emphasis added]”.

<sup>42</sup>Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes, OJEU L 173, 12 June 2014, pp. 149 et seqq. On the EDIS see Gros (2014, 2015a, 2015b); Klefouri (2015).

<sup>43</sup>Five Presidents’ Report (2015), p. 11.

<sup>44</sup>IMF (2015), p. 18: “To discourage liquidity ‘ring-fencing’ within national jurisdictions, a pan-European DGS should be established. Since such a pan-European DGS will take time,

Moreover, in case of a large or systemic crisis, it is not possible to exclude recourse to a public backstop if ultimately needed. In such case, Member States will continue to bear the burden of protecting deposits, at least temporarily.

It is in this context that the European Commission has recently put forward a proposal<sup>45</sup> for a European Deposit Insurance Scheme (EDIS) and a Deposit Insurance Fund (DIF) on the basis of Article 114 TFEU.<sup>46</sup>

The Single Resolution Board would administer both the DIF and the SRF, which would coexist. The DIF would complement existing national deposit guarantee funds and it would serve the purpose of reassuring citizens that the safety of their savings does not depend on geographical location. Participation in EDIS would be mandatory for Euro area Members, but it would also cover DGSs of non-Euro States which have established a close cooperation with the ECB on a voluntary basis.

Like in the case of the SRF, the DIF would be privately funded through *ex ante* fees paid by the banks of participating Member States. Riskier banks would be requested to make higher contributions. The DIF would gradually pool the funds: banks' contributions to national schemes would be gradually reduced, in parallel with their increased contributions to the DIF.

Moreover, to reduce moral hazard risk and avoid free riding, the EDIS would only be available to Countries complying with EU rules<sup>47</sup> and to DGSs reaching the harmonised target level of funding in accordance with the prescribed path.

According to the Commission's proposal, the EDIS would be implemented in three phases: i.e. re-insurance, co-insurance and full insurance.

In an initial 3-year phase, the EDIS would function as a joint re-insurance fund, supplemental to existing national DGSs. Access to EDIS funds would be granted only when a DGS depleted its own resources. The reinsurance scheme would cover the liquidity shortfall or excess losses of a participating DGS, up to a certain

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consideration should be given now to developing a common fiscal backstop to national DGSs, perhaps through the ESM".

<sup>45</sup>European Commission, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme, 24 November 2015, COM(2015) 586 final. See also Communication from the Commission to the European Parliament, the Council and the European Central Bank, On steps towards completing Economic and Monetary Union, 21 October 2015, COM(2015) 600 final; Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, Towards the completion of the Banking Union, 24 November 2015, COM(2015) 587 final.

<sup>46</sup>In its April 2016 legal opinion for the German Banking Industry Committee, prof Matthias Herdegen considers Article 114 TFEU not an adequate legal basis for the EDIS. Transferring fiscal competence to an EU body which would collect financial contributions from banks would require recourse to Article 352 TFEU and unanimity in the Council. See <https://die-dk.de/themen/pressemitteilungen/opinion-confirms-inadequate-legal-basis-european-deposit-insurance-scheme-edis/>.

<sup>47</sup>In particular, with the DGS Directive, the Bank Recovery and Resolution Directive and the obligations that will arise from the EDIS Regulation.

percentage and with an overall cap on EDIS contributions. At this stage, EDIS coverage would be limited to resolution proceedings conducted by the SRB.

In a 4-year intermediate period, the EDIS would also apply to purely national resolution proceedings, providing funding and covering losses. During this co-insurance phase, the EDIS would contribute from the moment in which depositors are entitled to be reimbursed, even if DGS's resources have not been depleted. Over the years, the EDIS would cover an increasing share of liquidity needs and losses of participating DGSSs. There would be no cap on the intervention by EDIS.

Finally, from 2024, the EDIS would fully insure depositor risk across the Banking Union, providing participating DGSSs full funding of their liquidity needs, also covering any losses arising from a payout or a request to contribute to resolution.

The establishment of the EDIS as the third pillar of the Banking Union would fill a gap in the current framework: while banks are already subject to common European supervision and resolution rules, responsibility for deposits protection is still at national level. Because of this asymmetry, depositor confidence continues to be negatively influenced by a sovereign's weak fiscal position. This may lead to market fragmentation and competitive distortion and, possibly, to bank runs and financial instability.

However, money can be truly single only if confidence in the safety of bank deposits is the same irrespective of the Member State in which a bank operates.<sup>48</sup> According to the ECB,

Full monetary union and a single banking system cannot exist without 'single money', which has to be fungible whatever form it takes, independent of its location within the euro area. Therefore, the concept of 'single money' requires deposits to inspire the same degree of confidence, regardless of the Member State of the banking union where they are located. An EDIS would be an effective tool to promote a uniform level of depositor confidence and to help ensure the true 'singleness' of the euro.<sup>49</sup>

For these reasons as well as others, the ECB declared to fully support the establishment of the EDIS.<sup>50</sup> In its opinion on the proposal presented by the Commission, however, the European Central Bank also expressed the view that the EDIS would need to be complemented with a credible common public backstop, intervening in a scenario in which EDIS resources are insufficient to fully reimburse depositors, and *ex post* contributions from the banking sector are not enough. A mechanism similar to the one about to be introduced for the SRF should be adopted also for the EDIS. The ESM could be the institution in charge of providing this kind of last resort funding.

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<sup>48</sup>Five Presidents' Report (2015), p. 11.

<sup>49</sup>ECB (2016), p. 36, Financial Integration in Europe 2016, Frankfurt am Main.

<sup>50</sup>See European Central Bank (2016), p. 9, Opinion on a proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No. 806/2014 in order to establish a European Deposit Insurance Scheme (CON/2016/26), 20 April 2016.

In spite of support by the ECB, some Member States fear that the EDIS would result in a mutualisation of losses. Countries with a strong fiscal position, a sound banking system and a well-capitalised DGS are not willing to pay for the shortcomings of others. Indeed, in the case of a systemic crisis, the EDIS might lead to potentially large transfers among national banking sectors.<sup>51</sup> Furthermore, if recourse to a public backstop is required, this may also lead—at least temporarily<sup>52</sup>—to burden-sharing among participating States.

As advocated by Andrew Duff in his Protocol of Frankfurt: “The Banking union will remain inherently unstable in the absence of a federal European deposit insurance scheme, enjoying the joint and several guarantee of the eurozone members [. . .].”<sup>53</sup>

To win support on the EDIS proposal, it seems however that the European Commission should devise further measures to avoid the risk of moral hazard (like a cap on banks’ holdings of domestic government bonds).<sup>54</sup>

Otherwise, the fully mutualised scheme proposed by the European Commission would not win support, with some observers advocating that implementing the re-insurance stage would be enough to achieve the desired objective.<sup>55</sup>

What described above demonstrates that the major obstacle in building a true Banking Union is the absence of solidarity. Without further risk-sharing, the Banking Union would remain incomplete and unable to delink the funding cost of weak sovereigns from that of their banks.

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<sup>51</sup>In some Member States, banks have large holdings of domestic sovereign bonds and of non-performing loans.

<sup>52</sup>Banks will have to pay back any funds used from a public backstop through ex post contributions.

<sup>53</sup>Duff (2016).

<sup>54</sup>Italy and Spain are strong opponents of a common upper limit on banks’ holdings of domestic sovereign debt. Almost 22% of the Italian sovereign debt is owned by its banks. It is worth noting that Germany made the adoption of sovereign debt ceilings a precondition for further discussions on the EDIS.

<sup>55</sup>Daniel Gros of the Centre for European Policy Studies expressed this view on 23 May 2016 during the public hearing of the Committee on Economic and Monetary Affairs of the European Parliament which was held on the EDIS.

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