



CPB Netherlands Bureau for Economic  
Policy Analysis

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# **Towards an EMU banking union:**

*Three scenarios*



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# 1 Towards an EMU banking union: three scenarios

There is currently much discussion about the future of the Economic and Monetary Union of the European Union (EMU). This month (June 2018), the European Council plans to discuss future reforms regarding the banking union. The European Commission has drafted a *roadmap*<sup>1</sup> containing proposals for a more comprehensive EMU, including rapid completion of the banking union.<sup>2</sup> A group of eight, mostly Nordic, countries is in favour of the banking union ultimately being completed, but believes that the first priority should be risk reduction.<sup>3</sup>

This publication discusses the need for an EMU banking union and describes three possible transition scenarios. The European Commission's roadmap also contains proposals for other types of EMU reform (e.g. a budgetary union, capital market union or the introduction of a European Monetary Fund), but this publication only addresses the banking union. In addition to this report, the CPB will also publish a background document, titled '*Capital position of banks in the EMU: an analysis of Banking Union scenarios*', in which calculations are presented that show the consequences of various elements of the banking union, for the largest banks within the EMU.

## 1.1 Current situation of the EMU

**Although economic growth in the eurozone is increasing, risks to the euro remain.**

Banks in multiple Member States carry substantial non-performing loans on their books, government debts are higher than before the crisis, and banks also have substantial amounts of government debt on their balance sheets. This shows the ongoing significant interdependence between banks and governments.

**Banks are better capitalised than at the start of the crisis, but some banks still carry substantial non-performing loans on their books.** In Italy, 16% of loans have been in arrears for more than 90 days (Figure 4.1, left) and although this percentage has been decreasing since 2015, it still remains high. Meanwhile, the percentage of non-performing loans in Spain has been halved. Banks today have more capital<sup>4</sup> than they did at the start of the crisis (Figure 4.1, right).

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<sup>1</sup> See the Communication from the Commission, 2017: *Further Steps Towards Completing Europe's Economic And Monetary Union: A Roadmap*, COM(2017) 821 final ([link](#)).

<sup>2</sup> See the Communication from the Commission, 2017: *On completing the Banking Union*, COM(2017) 592 final ([link](#)).

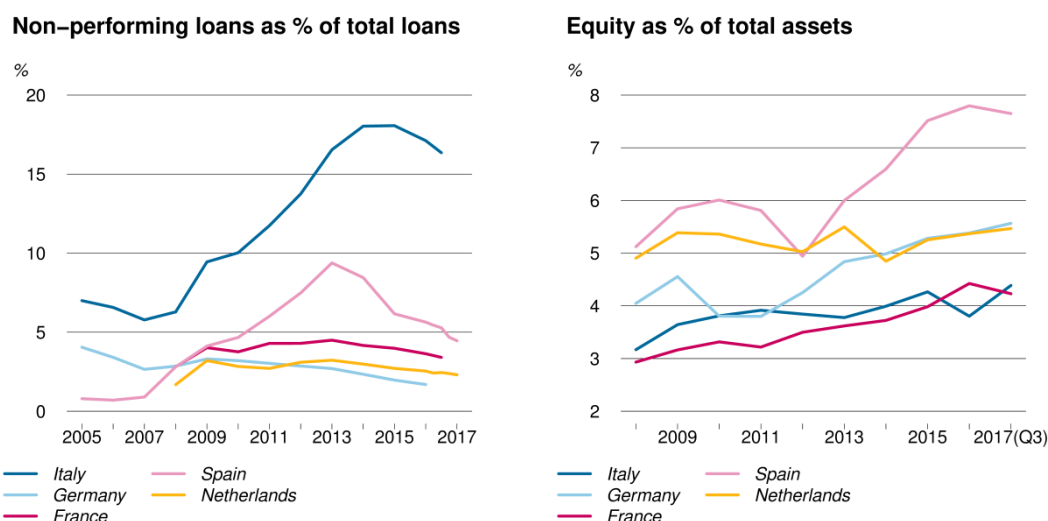
<sup>3</sup> The other countries are Denmark, Estonia, Finland, Ireland, Latvia, Lithuania and Sweden ([link](#)).

<sup>4</sup> Capital here is defined as Tier1 capital. In the remainder of the text, the definition of core capital (CET1) is used. Tier1 capital consists of core capital and additional Tier1 capital (AT1). This last category includes financial instruments with an infinite run time (e.g. the contingent convertible bonds, CoCos). For most banks, AT1 capital equals zero and, therefore, core capital equals Tier1 capital.

### The interdependence between banks and government has increased since the crisis.

Since the crisis, the government debts have increased as a share of GDP (Figure 4.2, left). In addition, in Italy, 17% of the total bank balance consists of Italian government debt, and in Spain 11% (Figure 4.2, right). In the case of a restructuring of Italian government debt, Italian banks would face serious difficulties, as their equity makes up only 4% of their balance sheets (Figure 4.1, right). Once Italian banks find themselves in trouble, this will in turn negatively impact the Italian government, and vice versa. The text box explores which other European banks could be affected by an Italian debt restructuring. Other countries also have a strong interdependence between banks and government.<sup>5</sup>

**Figure 4.1 Italian banks have many non-performing loans and little equity**



Source: IMF FSI. Loans in arrears of over 90 days, as a percentage of the total loans portfolio.

Source: ECB. Equity, here, consists of Tier1 capital.

**An increasing interest rate or new recession may create problems for both banks and governments.** An increase in the interest rate causes a —delayed— increase in government interest payments on government debt, particularly for countries with high public debt. Although this is not very problematic if the interest rate rises due to favourable economic conditions, a stronger than expected increase in the long-term interest rate could also be caused once the ECB or US Federal Reserve act to reduce their balance sheet acquired during their programs of quantitative easing. A new recession would affect both banks and governments, the more so due to the interdependence between banks and governments. At the same time, there is not much budgetary room to absorb shocks due to the generally high levels of government debt. Particularly southern European governments have little budgetary room available. In addition, the ECB's low policy interest rate also leaves little room for monetary policy stimulus.

<sup>5</sup> The background document, 'Capital position of banks in the EMU: an analysis of Banking Union scenarios', shows there is also a certain interdependence between Greek, Irish, Portuguese and Spanish banks and their own national governments. The direct exposure of other European banks appears limited.

## What would be the consequences of writing off part of the Italian debt?

It is possible that the market may start to doubt the sustainability of Italian government debt. This would then make the need to write off part of the Italian debt more likely (a). In recent years, the Italian government debt has increased to 134% of GDP, which makes it the second-largest debt ratio of all eurozone countries. Only Greece has a higher debt ratio of 181%. Italy's low economic growth, combined with a possible increase in interest rate due to the gradual reduction of quantitative easing by the ECB, may further lead the market to call into question the sustainability of Italy's government debt. Moreover, it cannot be ruled out that the Italian government may at some point be forced to rescue some Italian banks. The euro system currently has 358 billion in Italian government bonds on the balance sheet (b). The ECB however is a preferential creditor. This means that losses will mostly affect other parties, such as banks.

Italian banks are vulnerable to any write-offs of Italian government debt. The six largest Italian banks together hold 143 billion euros in Italian debt on their balance sheets. These banks are participants in the stress tests by the European Banking Authority (EBA). A 20% write-off on Italian government debt would cause these banks to lose 29 billion euros in capital, which is 29% of their total core capital.

### Consequences of a 20% write-off on the Italian debt for the banks in eurozone countries

	Exposure to Italian debt (billion)	Loss at a 20% write-off (billion)	Loss as a % of core capital
Germany	24	-5	3%
France	49	-10	3%
Italy	143	-29	29%
Netherlands	2	0	0%
Spain	29	-6	5%
All eurozone countries	279	-56	6%

Source: EBA 2017, adaptation by CPB.

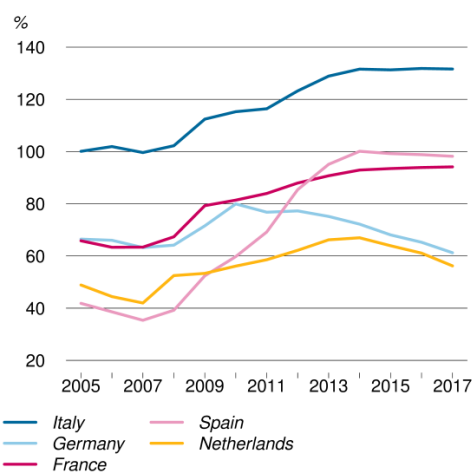
The effect of a write-off of Italian debt on banks outside Italy would be limited. Systemic banks in the rest of Europe hold a total of 137 billion euros in Italian debt on their balance sheets. This debt is mostly held by French, Spanish and German banks. A write-off of 20% of Italian government debt would cause the systemic banks in these countries to lose between 3% to 5% of their equity.

(a) See the background document 'Capital position of banks in the EMU: an analysis of Banking Union scenarios' for a more in-depth analysis.

(b) These are only Italian government bonds for monetary purposes, measured in December 2017 ([link](#)).

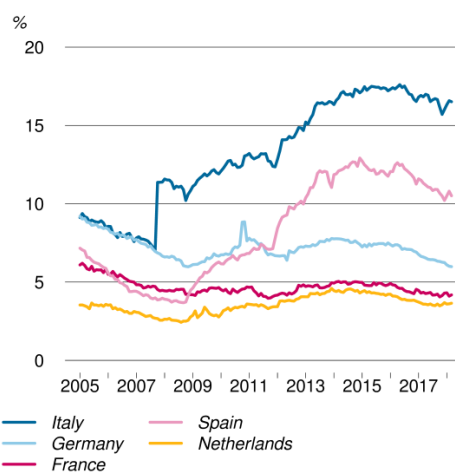
**Figure 4.2 Government debt has increased, a larger share of which is held by banks**

#### Government debt as % of GDP



Source: ECB.

#### Exposure of banks to own government



Source: ECB. Exposure as a % of the balance sheet.

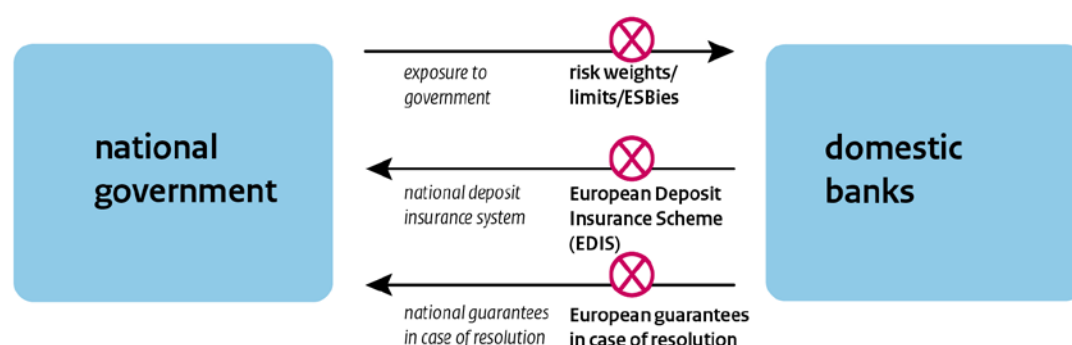
## 1.2 The elements of an EMU banking union

**The interdependence between European banks and governments increased during the crisis and continues to be too high.** Although the rules governing the EMU have been improved since the crisis, the EMU is still vulnerable due to the strong interdependence between banks and governments (bank–government nexus). Figure 4.3 shows the various relationships between European governments and their domestic banks. European banks hold relatively large amounts of their own government's bonds. This renders them vulnerable to government debt problems. The government (implicitly) guarantees the banks' deposits, should the deposit insurance system not suffice. Therefore, if banks become insolvent, national governments may be forced to step in again to save their banks.

The European Single Resolution Fund currently contains 17 billion euros and continues to grow, but is still not sufficient to save large banks. Moreover, the 'bail-in' system, whereby the owners of shares and bonds suffer the first losses, has yet to be sufficiently tested.<sup>6</sup> An additional source of risk is that there is also an indirect relationship between government and domestic banks via the real economy. This connection is difficult to sever.

**Figure 4.3 Options for reducing the interdependence between banks and governments**

### The Bank-government nexus



Based on a figure in Véron (2017).<sup>7</sup>

**Adjusting the regulation for banks would prevent them from purchasing too many of their own government's bonds again.** If banks hold fewer of their own government's bonds, they are less vulnerable to a sovereign debt crises by their own government. According to the current Basel III international regulatory framework for banks, government bonds receive preferential treatment, and are treated as if they involve no risk; banks are not required to reserve equity to cover these assets. One often-mentioned measure is the introduction of risk weights. This entails imposing capital requirements depending on the level of risk of the government bonds, the risk being based on the government bond rating. A

<sup>6</sup> See the text box 'Cracks in the banking union?' in the Macro Economic Outlook 2018 (in Dutch). In Spain, in line with the bail-in rules, taxpayers were not affected by the financial problems related to the collapse of the Banco Popular (BP). This is conform the EU's *Bank Recovery and Resolution Directive* (BRRD), which states the instruments that supervising bodies may apply in cases of bank resolution ([link](#)). Last year, however, weak banks in Italy were in fact provided with government support.

<sup>7</sup> N. Véron, 'Sovereign Concentration Charges: A New Regime for Banks' Sovereign Exposures', 11 September 2017, ([link](#)).

second alternative would involve setting limits on the amount of government debt that a bank would be allowed to hold from its national government: for instance, a maximum of 50% of its core capital.<sup>8</sup> And, finally, there is the option of restricting the provision of zero risk treatment to bank investments in ESBies (see text box) or Eurobonds. All of these options would reduce the interdependence between banks and governments (also see Figure 4.3).

**The introduction of risk weights for government bonds would result in a limited increase in bank buffers.** Setting the risk weights equal to those of corporate bonds would eliminate the preferential treatment of government bonds. These risk weights could be based on commercial ratings.<sup>9</sup> Eliminating the preferential treatment for government bonds would, in itself, represent a positive development, but the requirement of additional buffers would not contribute appreciably toward making the EMU more stable. Italian banks, for example, would only need to attract 11 billion euros in additional capital in order to reach their old capital ratio (Table 4.1).<sup>10</sup> For other countries, this amount would be even lower.<sup>11</sup> Moreover, the implementation of risk weights could lead to an increase in interest rates and a decrease in the price of more risk-bearing government bonds.

**Limiting the level of government debt on bank balance sheets would be an effective measure to reduce the interdependence between banks and governments.** The amount of debt a bank would be allowed to hold from its national government would be limited to 50% of a bank's core capital. This would limit the bank's dependence on its own government; this puts a cap on the size of the effect represented by the top arrow in Figure 4.3. Assuming a limit of 50% of core capital, various banks would need to dispose of a large share of their government debt (Table 4.1). Italian banks would, for example, need to sell 77 billion euros in Italian government debt. Banks would presumably exchange a share of their national government's debt for debt of other countries with a comparable interest rate. This would result in more diversified bank portfolios that are less dependent on their own government.

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<sup>8</sup> Véron (2017) proposes a hybrid form of limitations and risk weights in case the exposure of a government exceeds this limit (pricing). On average, assets with a magnitude of 50% of the core capital would require 5% in additional capital, and for double this magnitude associated with 50% this would require 18%.

<sup>9</sup> As proposed by the Bank for International Settlements (BIS), in 'Revisions to the Standardised Approach for Credit Risk', 10 December 2015, ([link](#)).

<sup>10</sup> Banks may already have reserved capital in preparation for new measures.

<sup>11</sup> Dominik Meyland and Dorothea Schäfer, 'Risk Weighting for Government Bonds: Challenge for Italian Banks', *DIW Economic Bulletin* 7, no. 28/29 (2017): 283–90.



**Table 4.1 Effects of risk weights or debt limits, with respect to government debt on banks' balance sheets**

At risk weights				At limit of 50% core capital	
	Additional risk-weighted assets (billion)	As % of existing RWA	Required for the recovery of capital ratio (billion)	Allowed debt of own government (billion)	Debt above the limit (billion)
Germany	22	2%	4	103	184
France	37	2%	5	191	202
Italy	88	11%	11	66	77
Netherlands	4	1%	1	75	32
Spain	49	5%	6	78	69
All euro countries	282	4%	39	606	705

Source: EBA 2017, adaptation by CPB. Risk weights are set equal to those for commercial obligations; e.g. 0% for AAA, 50% for BBB (Italy). For current ratings, see [Fitch](#).

**A European deposit insurance scheme would reduce the likelihood of insolvent banks inducing a crisis in either government bonds or other banks.** The guarantee of consumer deposits (of up to 100,000 euros) is currently provided on a national level. Each Member State has a fund for this purpose, to which domestic banks contribute. The national government functions as backstop. However, this measure has a potential downside. If consumers no longer believe that their government is able to guarantee their deposits, this could cause a bank run.<sup>12</sup>

A deposit insurance system on a European level would reduce this risk. It would ensure an external mechanism to absorb losses and protect deposits, without compromising the solvency of the national government. The European Deposit Insurance System would consist of a combination of national funds paid for by bank contributions. This would create risk sharing on a European level (see Figure 4.3), which would likely also reduce the incentive for national governments to strengthen the banking sector.

**The Single Resolution Fund (SRF) for banks needs a credible backstop.** The ECB supervises Europe's systemic banks, the Single Resolution Board (SRB) liquidates banks when necessary. Currently, a fund is being created from which resolution costs can be financed. According to the current planning in 2024 this fund should represent 1% of all covered deposits, or 55 billion euros.<sup>13</sup> In the event that the SRF should prove insufficient to finance the resolution of a bank, it should be clear how the remaining costs are financed. It is necessary to reduce the implicit guarantee currently provided by national governments to their domestic banks (see Figure 4.3). A disadvantage of the SRF is the creation of moral hazard due to the Euro wide risk sharing of banks within the banking union.

<sup>12</sup> D.W. Diamond and P.H. Dybvig, 1983, Bank Runs, Deposit Insurance, and Liquidity, *Journal of Political Economy*, Vol. 91, No. 3., pp. 401–419.

<sup>13</sup> During the banking crisis of 2007, 72 billion euros would have been required (Gros and De Groen, 2015, The Single Resolution Fund: How much is needed, [link](#)).

## ESBies; European bonds without risk-sharing

Many European banks hold large numbers of bonds from their respective national governments, in part due to the preferential treatment of government bonds under the Basel regulation. This represents one of the causes of the excessive level of interdependence between banks and governments. This problem was exacerbated during the Euro crisis by capital flows to safe countries from weaker ones. As a result a group of economists proposed the creation of European Safe Bonds (ESBies). ESBies would represent a safe investment for Eurozone banks. It is argued that this additional safe asset would increase financial stability (a).

ESBies would represent the senior share of a financial product in which the proceeds of the government bonds of all EMU countries are divided into a senior and a junior tranche. The figure shows how an issuer (yet to be established) would buy government bonds from the euro countries according to for example via the capital key of the ECB. The issuer would sell two new products: ESBies (70% of the nominal value) and a junior tranche (EJBies). Any losses suffered on the underlying government bonds would then first be incurred by the junior bonds. ESBies, thus, would profit from diversification (a broad-spectrum portfolio) and seniority. If the regulation were adjusted in such a way that ESBies did not carry any risk weight, they could be attractive for banks to hold. The preconditions for banks holding bonds from their own national government would then need to be more stringent. In addition, EJBies, at the right price, could be more attractive to investors with a preference for more risk-bearing investments (b).

### The balance sheet of an ESBies- and EJBies-issuing institution

Assets	Liabilities
Diversified portfolio government bonds euro countries	EJBies Junior Tranche (30%)* ESBies Senior Tranche (70%)
* Simulations by Brunnermeier et al. (2017) show that a junior tranche of 30% turns the remaining senior tranche of 70% (ESBies) into a safe asset.	

The aim is for ESBies to increase the supply of safe assets within the eurozone. A number of studies (c) show an increase in the demand for safe assets, in part due to the need for liquidity and collateral. However, the supply of safe government assets would decrease in the event of a government debt crisis. In any case there is no direct evidence of a shortage of safe assets; and it is unclear whether ESBies could take on the role of government bonds as safe assets. For example, a preliminary assessment by Standard & Poor's Financial Services (d) has classified ESBies as investment-worthy bonds (BBB+ or BBB-), which is much lower than the AAA rating for safe assets, such as the German government bonds. S&P is particularly worried about the high correlation of Eurozone sovereign default risk.

A second aim of ESBies is to reduce the interdependence between banks and governments. If banks were to hold ESBies, they would be less dependent on the financial sustainability of their national government. The seniority of the bonds would offer additional protection. However, ESBies would require large adjustments to the assets on the balance sheet of banks.

The introduction of ESBies would not necessarily lead to risk sharing between countries. Each government would retain responsible for its own debt. This would obviously not be the case for Eurobonds, where all members jointly guarantee the bonds. Therefore, Eurobonds, in contrast to ESBies, would be vulnerable to the problem of moral hazard where one country could issue too many bonds which in turn would force other countries to help bear the costs. Risk sharing for ESBies would only occur if governments —without legal obligation— still decide to support ESBies; for example, in the event that banks were running into problems due to a decrease of the value of ESBies.

(a) Markus Brunnermeier et al., 'European safe bonds (ESBies)', *Euro-nomics.com*, 2011.

(b) Markus Brunnermeier et al., 'ESBies: Safety in the Tranches', *Economic Policy* 32, no. 90 (2017).

(c) See the literature section in Cabellero and Farhi (2017).

(d) S&P (2017), 'How S & P Global Ratings Would Assess European "Safe" Bonds (ESBies)'.

**In addition to completing the banking union, the implementation of a restructuring mechanism for governments is also needed.** A restructuring mechanism for governments is not yet part of the banking union<sup>14</sup>. This measure would reduce risk by strengthening the no-bail-out clause.<sup>15</sup> The no-bail-out clause states that EMU countries are not permitted to help governments of countries which are suffering from excess debt levels. The credibility of the no-bail-out clause was reduced during the euro crisis. Meanwhile, the European Stability Mechanism (ESM) has created a fund to help Member States by providing loans against strict policy preconditions in the event that a country should lose access to financial markets. However, it remains to be seen what measures EMU countries and institutions ought to take to deal with countries that have unsustainable government debt. Effective measures in this area would ideally also provide incentives for financial markets as well as to EMU countries to keep their debt at a sustainable level. In assessing the sustainability of the debt, the specific circumstances of the indebted countries would need to be considered.

#### **The elements of a banking union are interconnected**

**The European deposit insurance system and the backstop for the Single Resolution Fund (SRF) for banks are related.** Both organise implicit guarantees to banks on a European level, and it seems logical to consider them together.<sup>16,17</sup> As explained earlier, a European Deposit Insurance Scheme (EDIS) would provide a fund which would be provided by contributions from the banks themselves to cover deposits. A backup for the Single Resolution Fund (SRF) would then ensure that any resolution costs of insolvent banks would not be solely born by the national supervising body.<sup>18</sup> The European Deposit Insurance Scheme and the backup would together represent a strong guarantee, which in turn would help to prevent problems at banks more effectively and reduce the risk of contamination.

**The implementation of only one of these two elements at the European level may lead to friction.** Should a bank become insolvent national supervisors may be tempted to shift the costs on to European supervisors, or vice versa. If only the European deposit insurance system is implemented, national supervisors will be tempted to transfer the costs of a bank's resolution to the European supervisor. If, on the other hands, only the SRF is implemented, the European supervisor may try to transfer as much of the cost as possible onto a country's national deposit insurance system. Neither situation would lead to the best possible way of dealing with a bank in trouble.

**The restructuring mechanism for governments and the regulation of government debt on bank balance sheets are two measures that will each enhance the other.**<sup>19</sup> The regulation of banks' balance sheets partly determines how much government debt banks will

<sup>14</sup> See the Communication from the Commission, 2017, *On completing the Banking Union*, COM(2017) 592 final ([link](#)).

<sup>15</sup> See the [report by the European Parliament](#) about the Sovereign Debt Restructuring Mechanism ((SDRM).

<sup>16</sup> Daniel Gros and Dirk Schoenmaker, 'European Deposit Insurance and Resolution in the Banking Union', *JCMS: Journal of Common Market Studies* 52, no. 3 (2014): 529–546.

<sup>17</sup> The aim is to create a *Single Resolution and Deposit Insurance Board* to manage the European Deposit Insurance Scheme. It will be part of the *Single Resolution Board*, which has caused the deposit insurance and the resolution to both be organised under the *Single resolution board* ([link](#)).

<sup>18</sup> Every EU Member State must create a fund equal to 0.8% of guaranteed deposits; should this prove insufficient, the current national supervisory bodies must organise alternative funding (see the [explanation in a memo by the European Commission](#)). These funds, under the new proposal, would merge to form a joint, single fund.

<sup>19</sup> The German Council of Economic Experts is in favour of this combination, see the German Council of Economic Experts, 'European Banking System Unstable, Reforms Must Continue', in *Annual Report 2016/17*, 2016, 242–82.

be permitted to hold in the future. The restructuring mechanism for governments formalises how to address government debt that has become unsustainable. It provides an incentive to national governments to keep their debts on a sustainable level, by strengthening the no-bail-out clause, but it may also have certain consequences for the balance sheets of banks. A proper restructuring of government debt may lead to some or all of the government debt being written off. However, implementing capital requirements or debt limits related to a bank's own national government may directly impact banks' balance sheets. The regulation and restructuring mechanism will both lead to an adjustment to the banks' level of exposure to their national governments' debt.

### 1.3 Three scenarios for the completion of a banking union

**There is little agreement about the order and pace at which the elements of a banking union should be introduced.** This is very understandable, considering the current state of banks and governments finances within the EMU. Some countries would like to first reduce risks, particularly in the banking sector, before adopting additional elements of risk sharing. They argue in favour of reducing non-performing loans held by banks, the lowering of government debt and structural reforms to strengthen EMU economies. Others call for a rapid completion of the banking union, to improve the EMU as soon as possible. We outline three possible scenarios for the transition process. More scenarios are possible, but these three demonstrate the trade-offs between risk sharing and risk reduction.<sup>20</sup>

**Table 4.2 Effects of writing off 20% of non-performing loans on the capital position of banks**

	Non-performing loans (billion)	Loss at a 20% write-off (billion)	Loss in % of core capital
Germany	56	-11	7%
France	137	-27	9%
Italy	128	-26	26%
Netherlands	41	-8	8%
Spain	81	-16	13%
Euro countries	656	-131	14%

Source: EBA 2017, adaptation by CPB.

**All scenarios require a reduction in the number of non-performing loans within the EMU.** Although banks do hold reserves for the expected losses due to non-performing loans, it is unclear whether they would prove to be sufficient. Table 4.2 shows what the losses would be if banks were required to write off 20% of their non-performing loans.<sup>21</sup> The first column shows that Italian banks have 128 billion euros in non-performing loans on their balance sheets. A write-off of 20% represents a loss of 26 billion, equalling over a quarter of their current core capital. It is unclear who would be willing to provide this capital. As a

<sup>20</sup> Agnès Bénassy-Quéré et al., 'Reconciling risk sharing with market discipline: A constructive approach to euro area reform', CEPR Policy Insight, 2018.

<sup>21</sup> This 20% write-off is based on the net write-offs of UniCredit (after new capital has been attracted) in the sale of a large share of their non-performing loans of a value of around 16 billion euros. See the [press release by Bloomberg](#).

comparison, the recapitalisation of Monte dei Paschi di Siena required 5.4 billion<sup>22</sup> euros to keep the bank afloat and 13 billion were needed to fund the sale of non-performing loans of Unicredit.

### 1.3.1 Simultaneous risk reduction and risk sharing

**Under the first scenario, risk-reduction and risk-sharing measures are implemented simultaneously.**<sup>23</sup> In its roadmap, the European Commission envisages completion of the banking union by 2024.<sup>24</sup> Risk reduction is achieved by the implementation of regulation concerning the exposure of banks to their national governments and the reduction of non-performing loans. Under such regulation, the risks of banks would be shared on a European level via a European Deposit Insurance Scheme and a backup for the Single Resolution Fund (SRF) for banks.<sup>25</sup> In this way, the probability of a new economic shock turning into a new euro crisis would be lower. Each EMU country could find itself at some point in a position in which it needs to apply for risk sharing within the banking union.

**This scenario for completing the banking union may mean that countries and banks that are in relatively good shape will be burdened with the risks of others.** Those risks originate from the past, when problems were not always addressed properly. For this reason, opposition to this scenario exists particularly in the northern EMU countries. There is reluctance to accept the idea that the risks will be shared before they have been substantially reduced. And when a bank in one country is having problems, the burden of solving those problems would also be on other countries, such as through the European Deposit Insurance Scheme.

### 1.3.2 Reduce the risks first

**Under the second scenario, the problems at weaker banks must be solved first, before the banking union could be completed.** In this scenario, the emphasis is on risk reduction and only at a later stage on risk sharing.<sup>26</sup> This means that first certain risks would need to be addressed, such as non-performing loans, the regulation of government debt on the balance sheets of banks, and the creation of a restructuring mechanism for governments. Addressing the problem of non-performing loans would take some time. Additional capital would need to be attracted (or, alternatively, less dividends paid out for a number of years). The implementation of risk weights for government bonds would also require additional capital. Italian banks would need a total of 37 billion euros in additional capital in order to be able to write off 20% of non-performing loans and implement risk weighting.<sup>27</sup> By first requiring risk reduction, risk sharing would not begin until after 2024.

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<sup>22</sup> See the [explanation of the European Parliament](#) about the recapitalisation of Monte dei Paschi.

<sup>23</sup> See Rishi Goyal et al., 'A Banking Union for the Euro Area', Staff Discussion Notes, 12 February 2013, [link](#).

<sup>24</sup> See the Communication from the Commission, 2017, Further Steps Towards Completing Europe's Economic And Monetary Union: A Roadmap, COM(2017) 821 final ([link](#)).

<sup>25</sup> Erik F. Nielsen, 'Risk-Weighting Sovereign Debt Is the Wrong Way to Go', *European Economy*, no. 1 (2016): 119–28.

<sup>26</sup> This idea has been put forward by the Dutch Minister of Financial Affairs, Hoekstra, in his parliamentary letter 'Risicoreductie Europese bankensector' [risk reduction European banking sector], submitted 24 April 2018 ([link](#)).

<sup>27</sup> The CPB background document titled 'Capital position of banks in the EMU: an analysis of Banking Union scenarios' studies the impact of the combination of these two and other measures. An alternative would of course be to reduce the bank balance.

**EMU remains vulnerable during this period of transition.** In the short run the bank–government nexus would not be severed and there would still be conflicts of interest on both national and European levels. This would partly be due to the fact that a European Deposit Insurance Scheme would not yet be implemented, and, therefore, any bank insolvency could still have a national impact (e.g. see the solution that was chosen in the case of the Italian bank Monte dei Paschi di Siena). The interdependence between banks and governments would, thus, be prolonged. Although the uncertainty that this would cause could be an incentive for countries to reform, a new shock might also result in a new crisis for the EMU. The current scope for new policies to address these problems is limited for many governments due to high government debt levels. It is therefore difficult to determine what effects an improvised solution to a new crisis would have in such a case. With the risk of contagion, a new crisis would likely involve significant financial pain for all EMU countries, whether this is with or without risk sharing.

### 1.3.3 Risk sharing conditional on risk reduction

**Adopting a middle course would make further risk sharing conditional on achieving risk reduction.** In this scenario, the pace of implementing risk sharing depends on the progress made in risk reduction. Such progress could be assessed on an annual basis, and any subsequent steps would only be taken after a certain amount of progress had been established. Each year, the European Deposit Insurance Scheme could, for instance, cover a larger share of deposits, which could be made contingent on sufficient numbers of non-performing loans being reduced.<sup>28</sup> This would provide the incentive to reduce the existing risks as well as allowing for more sharing. A reduction in the bank–government nexus would be achieved in the short term. A complicating factor, here, would be the annual assessments and/or negotiations about the progress made on risk reduction.

### **Risk sharing could also be made conditional on structural reforms in weaker nations.**

In this case, the introduction of risk sharing would depend on structural reforms being implemented in problem countries. This is in line with the IMF's *Highly-Indebted Poor Countries* (HIPC) initiative, under which high debts can be written off if after a period of six years they still prove unsustainable, despite economic reform.<sup>29</sup> This would have the advantage of spurring on the banks in problem countries to clean up their balance sheets (risk reduction). Subsequently, risk sharing could be implemented.

### 1.3.4 There is no perfect scenario

#### **Completion of the banking union involves both economic and political considerations.**

From an economic perspective, it is important to complete the banking union. Reducing risks and guaranteeing them on a European level would make the EMU less vulnerable to new shocks. However, the EMU countries' political climates tend to be strongly influenced by the starting positions of the various EMU countries. Politicians from countries that are in good shape tend to place more weight on risk reduction ahead of risk sharing, while politicians

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<sup>28</sup> Gros and Schoenmaker, 'European Deposit Insurance and Resolution in the Banking Union.'

<sup>29</sup> See the [IMF initiative](#) on the policy to write off high government debts on the condition of structural reform.

from countries in less favourable circumstances tend to stress the benefits of more risk sharing. The third scenario tries to weigh both types of interests.

**Tackling the existing risks in the southern EMU countries is unappealing, but there is no guarantee that the north will be able to escape the fallout of a debt crisis.**

Particularly problematic is the interdependence between weak Italian banks and high Italian government debt. It is unclear whether Italy is currently able and/or willing to reduce this interdependence on its own. In the event of a new crisis, should a resolution prove unsuccessful, writing off part of the debts could prove to be unavoidable. This would have financial consequences for Italian banks and citizens, but also for other banks and countries with interests in Italian banks. The economic impact of the resulting recession would certainly also be felt elsewhere in Europe. Conceivably a new crisis could therefore result in an increase in the sense of urgency about the need for change.

**None of the scenarios is optimal.** Under the first scenario, in which both risk reduction and risk sharing is implemented relatively rapidly, there is the chance of the northern countries being presented with part of the bill. Under the scenario in which first all problems must be addressed and solved, the EMU would remain vulnerable to shocks for a longer period of time. The scenario in which risk sharing is made contingent on risk reduction will lead to a more even distribution of the burden and the benefits, but would require making complex, annual political choices. Waiting too long with implementing measures may lead to a situation in which solutions need to be found under the pressure of a new crisis. Although the pressure of a crisis might conceivably force decisive action, it most likely would not result in the most efficient outcome. Any repercussions would then also be felt in other European countries.



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