EUROPEAN BANKING UNIION: CURRENT STATE OF PLAY AND HOW TO FIX ITS WEAKNESSES[1]

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Abstract:
This paper evaluates the main shortcomings and potential risks of the current shape of the EU's banking union. The institutional set-up of the single banking supervision is called into question; the rationale behind its establishment is explained and possible drawbacks are pointed out. Further and mainly, the paper concentrates on the analysis of the single banking resolution and its supporting legislation in the form of the Bank Recovery and Resolution Directive (BRRD). The BRRD's main innovation, the "bail-in" principle of resolving failing banks is assessed, both in terms of clear advantages as compared to the classic public bailout, and of potential drawbacks, especially concerning the contagious effects and adverse impact on specific groups of creditors with political repercussions. The European bail-in is also compared to the US "Dodd-Frank Act solution", yet there has not been found any straight forward inspiration for the European scheme. Finally, the need for a common fiscal backstop is identified given the resource inadequacy of the current single resolution fund, especially if a major systemic crisis occurs. Thus, various arrangements of the fiscal backstop are proposed; it is argued that the European Stability Mechanism would serve the backstop purpose better than the options involving national budgets.

Keywords: Banking union, European central bank, banking supervision, resolution, bail-in, bailout, fiscal backstop

Shrnutí:

EVROPSKÁ BANKOVNÍ UNIE: SOUČASNÝ STAV A JAK NAPRAVIT JEJÍ SLABINY

Článek hodnotí hlavní nedostatky a potenciální rizika současné podoby evropské bankovní unie. Kriticky hodnotí institucionální nastavení jednotného bankovního dohledu; jsou vysvětleny důvody pro jeho zavedení a zároveň je poukázáno na možná úskalí. Dále se článek především zaměřuje na analýzu jednotného řešení bank v problémech a jeho podpůrnou legislativu v podobě směrnice o ozdravných postupech a řešení krize bank (BRRD). Hodnotí též hlavní inovaci směrnice BRRD, tzv. princip "bail-in" řešení bank v problémech, jak co se týče jasných výhod ve srovnání s klasickým bailoutem z veřejných prostředků, tak potenciálních nevýhod spojených zejména s efekty systémové nákazy a negativních dopadů na určité skupiny věřitelů, což může mít politickými dopady. Při komparaci evropského nastavení principu bail-in s americkým ekvivalentem v podobě legislativy Dodd-Frank Act však nebyla nalezena žádná přímočará možnost inspirace pro evropské schéma. Nakonec je identifikována potřeba účinného mechanismu jištění (backstop), vzhledem k nedostatečným zdrojům současného jednotného fondu pro řešení krizí, a to zejména, pokud dojde k větší systémové krizi. Autoři tak navrhují různé možnosti

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aranžmá fiskálního zajištění; a je argumentováno, že Evropský stabilizační mechanismus by tuto roli plnil lépe, než řešení zahrnující napojení na národní rozpočty.

Klíčová slova: Bankovní unie, Evropská centrální banka, bankovní dohled, řešení bankovní krize, bail-in, bailout, fiskální zajištění
JEL Classification: E62, G18, G21, G33, H63

1. Introduction

The aim of this article is to analyse the currently functional pillars of the European banking union (EBU), namely the single supervision and resolution mechanisms, and to propose options to further tune the current EBU's architecture. The EBU has been conceived as a new milestone on the path to complete the financial union which in turn is one of the strategic responses of the EU to the recent global financial and European sovereign debt crises. Two of three national pillars of the EBU are already in operation. Before adopting the third and final part, the European deposit insurance scheme (EDIS), it is worth to assess the pros and cons of the mechanisms in question. In our analysis, a great emphasis will be put on the resolution procedure which is inherently connected to the new EU-wide resolution and recovery rules. We attempt to spot the main advantages and downsides of the new procedures, compare it to the existing framework outside the EU and to propose possible options to improve the current set-up.

The initial impetus and inspiration for the authors has been the article *A Critical Evaluation of Bail-Ins as Bank Recapitalisation Mechanisms* by Avgouleas and Goodhart (2014). Goodhart's and lots of other papers go in depth to analyse a particular part or mechanism of the EBU. This article, however, offers a more complex perspective of the current state of play and tries to draw out consequences of the existing institutional set-up.

The article is organized as follows: In the section 2 we describe the Single Supervisory Mechanism (SSM) and its main features and components. We explain the rationale behind the shift from national to the European oversight and point out potential institutional drawbacks. In the section 3 we analyse the overall resolution scheme with a particular focus on the newly introduced bail-in principle. In 3.1 the rationale behind as well as the downsides of this mechanism will be presented. In 3.2 a comparison with the American equivalent of the resolution legislation will be carried out. In 3.3 the fiscal backstop question associated with the inadequate resources of the resolution fund will be tackled; various possible options for the future set-up will be proposed. In the section 4, we conclude with some basic recommendations.

2. Single supervision

In November 2014, the European Central Bank (ECB) took on the direct supervision over the significant banks ("systemically important financial institutions" – SIFIs) in the Eurozone. As defined in the Single Supervisory Mechanism (SSM) Regulation (Article 6) and the SSM Framework Regulation, 129 banks are representing more than 85 % of the aggregate total banks' assets in the Eurozone.[2] At the same time there are more

2 That makes the ECB one of the world's biggest banking supervisors (Dombret 2015).

than three thousand of the less significant credit institutions ("less significant supervised entities" – LSSE) accounting for less than 15 % of the aggregate total assets that stay under the direct supervision of the national competent authorities. However, the banking sector as a whole is overseen by the ECB in matters of risk concentration, so it has the right to intervene with these small banks.

So what exactly can the ECB do now? The SSM regulation (1024/2013), Article 4 confers on the ECB the following tasks and powers:[3]

- the authorisation of banks and the withdrawal of authorisations (ultimate licencing authority)
- the assessment of notifications of the acquisition and disposal of holdings in banks
- ensuring compliance with regulatory requirements, such as own funds requirements or large exposure limits
- ensuring compliance with the requirements regarding the governance of banks
- supervisory reviews and stress tests
- the supervision of recovery plans and early intervention when a bank does not meet the regulatory requirements
- the possibility to make resolution recommendations to the Single Supervisory Board (see further)

Certainly, there are some clear benefits of the European banking supervision. Firstly, the ECB is having an overall, consolidated view over the cross-border banking activities. As the large banks usually operate in more than one country, the European level overview enables an earlier identification of problems and better crisis-management. Secondly, it prevents a possible lenience of national supervisors when dealing with domestic banks. A reluctance to intervene may appear so that their national champions did not get a competitive disadvantage compared to foreign banks. Thus, sub-optimal results stemming out of national interests should be effectively eliminated by removing the distinction between home and host supervisors and imposing an impartial European perspective. Thirdly, the more the ECB establishes itself as a common supervisor, the more financial integration should advance; *"the creditors of banks will increasingly look for European solutions to banking problems as they can rightly claim the ECB has been supervising the banks"* (Wolff, 2014). Finally, it is supposed that with the ECB in charge the banking supervision will exhibit a significant level of quality as its reputation and expertise is very rarely disputed.

As for the assessment of the functioning, indeed it was witnessed that the quality of supervision amounts to the high standards. However, there are some objections too. Generally, with more data reporting required the new system is considered intrusive (Schoenmaker and Véron, 2016). Moreover, there are some concerns of a more systemic nature. Firstly, it is often feared (Allen et al. 2011) (Ioannidou, 2012) that within the same institution the supervisory mandate and the monetary policy may get easily in conflict;

3 Summary listed according to: Demary and Bauer (2014).

when monetary policy objectives stand in opposition to financial stability.[4] Because, although a new Supervisory Board was established within the ECB, the Governing Council has the ultimate say even on the supervisory matters, so the trade-offs between the two may occur. Secondly, with taking up the influential role and performing new delicate powers, the ECB will become more politicized. Furthermore, the institution is getting much more powerful without too much scrutiny or accountability, for instance from the European Parliament (Beck and Gros, 2012). Another concern is that the part of banks exempted from the direct ECB supervision, i.e. the "less significant" banks – often dubiously managed and, with the largest portion of them concentrated in a limited number of countries, are creating an asymmetry with yet unknown consequences. Finally, another considerable segment exempted from the single supervision is the shadow banking, i.e. the financial institutions performing more or less the same activities as banks yet not considered and treated as banks, particularly in the sense of banking regulation, despite the fact that some are systemically important. *"This puts the regulator at a disadvantage as financial intermediaries shift risk towards outside of the regulatory perimeter"* (Beck, 2016).

3. Bail-in and single resolution

It is important to point out that especially the big credit institutions are by no means ordinary market players that could be easily put in the standard insolvency proceedings. Their abrupt exit from the market would not be without serious consequences for the payment system, at least. From the regulator's perspective, it is often essential to preserve their critical functions and to evaluate the impact of the restructuring on the financial system as a whole. Nor it is often particularly responsible to put the bank into the lengthy national insolvency proceedings and keep the creditors in uncertainty for years. The resolution process thus also has to be swift and reassure depositors (Micossi, 2013). This is why "too big to fail" institutions need special treatment. In the recent crisis we have seen many ad hoc rescues orchestrated by the member states when trying to support their failing banks.[5] As the states were too often too small vis-à-vis their banking sectors which they were supposed to bailout, and as the use of public funds for "redeeming" banks' misbehaviour was quite unpopular among the public, it made sense to policy-makers to move the resolution authority to the European level and to set up a uniform framework to manage orderly bank resolutions in the future.

The Single Resolution Mechanism (SRM) provides for centralised decision-making and resolution financing for the Eurozone (and for voluntary non-Eurozone members

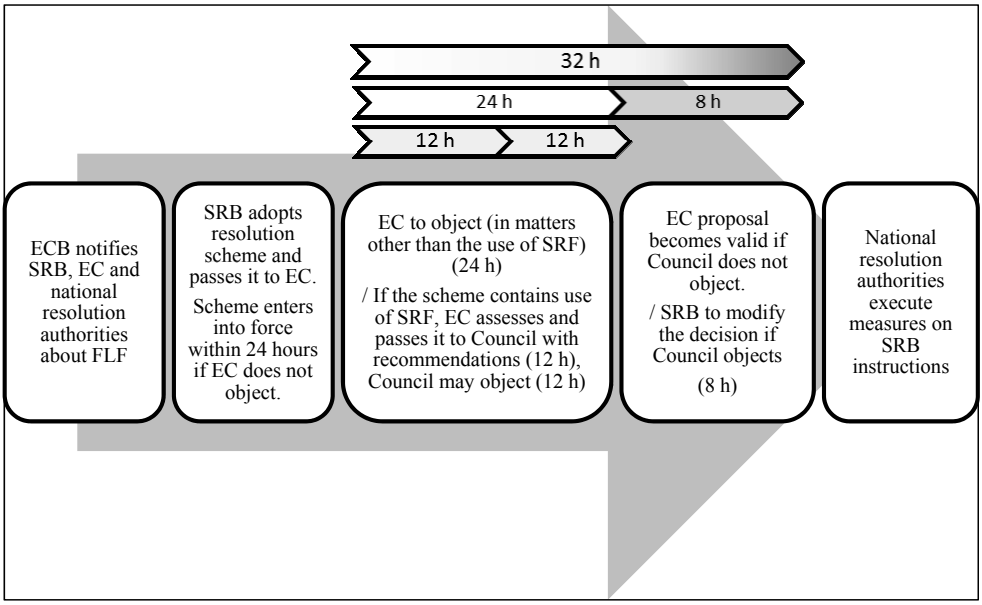
4 A situation may arise in which the Governing Council might be tempted, out of monetary policy concerns, to alter decision the Supervisory Board proposed from a supervisory perspective (Dombret 2015).

5 It led to many inconsistencies and emergence of a new phenomenon, *the doom loop* between the highly indebted countries and their banking sectors, creating a situation where the sovereign rescued the failing institutions only at the cost of increasing its own insolvency risk. This in turn reinforced the bank insolvency risk as they were loaded with the government bonds which were now becoming riskier, thus catalysing the debt crisis.

of the EBU) banks. It consists of the new established agency, the Single Resolution Board (SRB) and the Single Resolution Fund (SRF).

The decision-making process is rather complicated,[6] involving the ECB, SRB, European Commission (EC) and national finance ministers (Council). It is thus *"a mix of national and Eurozone-wide decision processes, especially when funding decisions are involved"* (Beck, 2016) and the question remains how effective will it be given the involvement of so many actors. Most questions revolve around the role of the SRF which will be closely examined below.

Figure 1 | The EBU resolution process, simplified



Source: Council of the EU, 2016; authors' own processing.

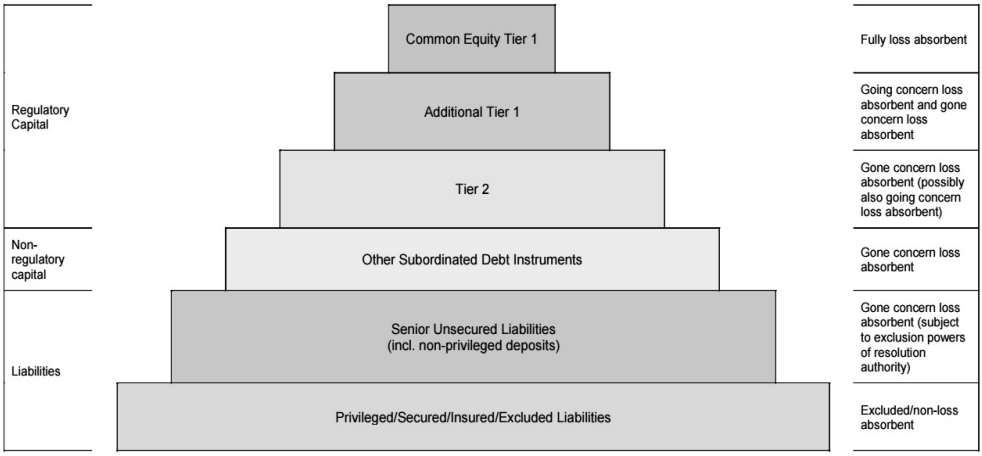
SRM is based on the Banking Resolution and Recovery Directive (BRRD) that is applied in all the EU member states and sets a common ground for member states to deal with the bank failures. Besides the new requirements for the banks such as to prepare

6 Based on Council of the EU (2016) the resolution process works as follows: The ECB notifies the SRB that a bank is failing or likely to fail (FLF). Such a decision can be made also by the SRB alone, if after having informed the ECB it receives no reaction for three days. The SRB then adopts a resolution scheme which determines the tools and the use of the SRF and transmits it to the European Commission (EC). If the EC does not object, the scheme enters into force within the 24 hours of its approval by the SRB. Of course the EC may object (regarding the discretionary aspects) or propose to the Council to object (regarding the necessity of the resolution or the amount to be used from the SRF). In that case it has to do so within 12 hours of the SRB's approval of the resolution scheme, enabling the Council to take a decision within the next 12 hours. If the Council objects to the placing of an institution under resolution, that institution is wound up in accordance to the applicable national law.

its own recovery plans, the main objective of the BRRD is to enable banks to fail in an orderly manner and without recourse to the use of public funds; it grants the resolution authorities the capacity to make credit institutions internalize the costs of their own failure. It is ensured by a new principle referred to as *bail-in*, as opposed to the classic public *bailout*.

So as of 1 January 2016, in the EU the bank shareholders are again the first to absorb the losses generated by the non-performing assets with their equity. But if the regulatory (and non-regulatory) capital is not enough, the unsecured bondholders are next in the row to write-off their claims, or converting them into equity. If needed, the pecking order could be extended until the insured deposits in the hierarchy of creditors are reached.

Figure 2 | Bail-in sequence under BRRD[7]



Source: Alonso and Jennings-Mares, 2015.

However, the resolution directive does not rule out the external rescue altogether. It leaves bailout an option to be applied in case of a systemic crisis and high contagion risk. But there is a condition that at minimum 8 % of total liabilities and equity capital are used in the bail-in before any other specific measures envisaged in the resolution plan, including the use of SRF take place. In addition, the SRF can only provide funds in the maximum amount of 5 % of the total liabilities and equity capital of the bank.

7 Tier 1 capital consists of the core capital (common stocks and disclosed reserves) and additional Tier 1 capital (preferred shares and high contingent convertible securities). Tier 2 is the supplementary capital; it consists of undisclosed reserves, revaluation reserves, general loan-loss reserves, hybrid capital instruments and subordinated debt. It is less reliable than the Tier 1 capital. These two types of regulatory capital are used to calculate the capital adequacy of the bank. Senior unsecured liabilities have a higher priority (seniority) in the bank's capital structure, so in case of a bail-in being applied they get hit only after the other subordinated debt. The secured liabilities have an asset pledged as collateral for the loan, therefore they are non-loss absorbent, lenders receive the asset.

3.1 Some of the main advantages and shortcomings of the bail-in

The bail-in principle has some incontestable advantages. It mitigates the destabilizing impact on public finances and sovereign debt associated with the public bailout (the so-called "doom loop"). It also reduces the moral hazard by making the bank owners and creditors responsible for the bank failure instead of the taxpayers. Moreover, even with the use of the resolution fund which is financed by industry levies, bail-in essentially replaces the public subsidy with private penalty, as explained by Avgouleas and Goodhart (2014).[8] Implicitly, it is believed that turning unsecured debt into bail-inable debt will incentivize creditors to take part in more vigilant monitoring of the owing institution (Avgouleas and Goodhart, 2014) and demand more prudent conduct, e.g. curbing excessive leverage which was and still is the main reason why the rescue of a SIFI is not an easy task for the regulator.

Nonetheless, it is worth paying more attention to the hidden downsides of the bail-in. First of all, perhaps obvious point is that the bail-in does not mean the losses somehow disappear; they are only shifted to other entities, consequently individuals; besides owners and creditors, through worsened terms also to bank managers, bank staff, and borrowers (Avgouleas and Goodhart, 2014).[9] The whole bottom-line is only to impose losses upon those who can bear the burden "the best". And as the recent Italian development shows, the idea of bail-in as a tool of private penalty does not work always as expected and thus raise questions whether the bail-in is universally applicable. There are specifics, often of political nature, in EU member states that hinder the smooth application of this principle; home resolution authorities can be reluctant to use the bail-in tool because of its adverse impact on specific groups of creditors.

The Italian example is illustrative: the country's banking sector has been for years suffering from hoards of bad loans, weak profits and poor corporate governance which could potentially threaten a wider Eurozone banking system stability. Recently the problem has worsened. The non-performing loans (NPLs) have amounted to about one fifth of the country's GDP (Banca d'Italia, 2016)[10] and many banks are finding themselves in bad need of new capital. Since a direct bailout is almost ruled out under the new European rules,[11] the bail-in should have kicked in. Yet there is a catch. In Italy, imposing losses on bondholders means hitting the retail depositors, i.e. households and small businesses, which is politically very problematic. So, a third way must have been invented. To avert a banking crisis, a government-led private banks coalition has put together a fund with the aim to recapitalize the troubled banks by buying their shares and to clean their balance sheets by buying the NPLs in securitised form.[12]

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8 Avgouleas and Goodhart (2014) are citing Huertas (2013) when relating to this concept.

9 Essentially, bail-in is "only" *"a radical rethinking of who bears the ultimate costs of the operation of fractional reserve banking"* (Avgouleas and Goodhart, 2014).

10 The sum of bad debts for households and firms is €348 467 million according to the April 2016 Bank of Italia's Financial Stability Report (Banca d'Italia, 2016).

11 And the already high indebtedness of the government would probably make this option impossible anyway.

12 More on the matter in Financial Times (Hale et al., 2016) or in The Economist (2016).

Secondly, it should be stressed again that the bail-in will not remove the need to inject public funds, especially in the event of a systemic crisis or a large cross-border institution. And even if the bailout was avoided, *"simply being able to resolve a bank without taxpayer's money does not necessarily reduce the economic cost of the resolution, since a failure of a systemic bank can impact GDP, unemployment and hence tax revenues and welfare expenditures"* (Mayes, 2014a). Moreover, at times of shock and with the herd behaviour in the market, it is very likely that the generalised adoption of the bail-in across the EU would trigger contagious consequences that would have destabilizing effects (Avgouleas and Goodhart, 2014). As demonstrated by Paolo and Paris (2016), the smaller and safer a bank is, the larger the advantage (in terms of less default probabilities in the banking system derived from contagion effects) of choosing the bailout option instead of the bail-in option. And *"while the debate between bailing in and bailing out banks has swung strongly in favour of bailing in, governments are finding that some of their "investments" through bailing out are turning out to be beneficial for the taxpayer"* (Mayes, 2014b, p. 1).

Figure 3 | Strengths and weaknesses of the bail-in and bailout mechanisms

	Strengths	Weaknesses
Bail-in	Fairness. The investors bear the cost of the recapitalisation, restructuring or resolution of troubled banks.	Contagion; a generalised adoption of bail-in across the EU would trigger contagious consequences with destabilizing effects.
	Mitigation of the destabilizing impact on public finances and sovereign debt (the „doom loop") associated with the public bailout.	Distributional consequences; an adverse impact on specific groups of creditors with political implications; universal application is questioned.
	Reduction of the moral hazard by making the bank owners and creditors responsible for the bank failure instead of the taxpayers.	No removal of the need to inject public funds, especially in the event of a systemic crisis or of a large cross-border bank.
	Incentivization of creditors to take part in more vigilant monitoring of the bank; potentially curbing excessive leverage.	No automatic reduction of the economic cost of the resolution.
		Necessity for a bank of having sufficient amount of the eligible liabilities. E.g. Czech banks have only a few bail-inable instruments.
		Increased risk reflected in worsened terms for the bank by the investors.
Bailout	Often effective and safer solution especially in case of systemic crises. The smaller and safer a bank is, the larger the advantage of bailing it out.	Unfairness. The taxpayers have to pay for the bank's failure.
	Potentially a cheap solution, Governments' "investments" can turn out to be beneficial for the taxpayer.	Potential destabilizing impact on public finances and sovereign debt (the „doom loop").

Source: authors' own processing, based on Avgouleas and Goodhart, 2014; Mayes, 2014a; Paolo and Paris, 2016.

3.2 Dodd-Frank legislation: comparative analysis and early assessment

Having stated several bottlenecks of the new bail-in regime, it is important to look at how the same principle is being treated in the American *Dodd-Frank Wall Street Reform and Consumer Protection Act* of 2010 comparing to the European BRRD.

To start with, there is a distinction in the US and EU bail-in's purpose. The European resolution authorities, unlike Federal Deposit Insurance Corporation (FDIC), can apply two approaches. Either the bail-in is triggered to effect bank recapitalization to restore it to health (going concern), or it treats the bank as bankrupt (gone concern) and provides with sufficient capital the entities that will emerge following the liquidation of the resolved parent institution (Avgouleas and Goodhart, 2014). In the US, only the latter approach is used. Anyhow, the underlying reality determining the choice of one of these two approaches can be rather opaque.

The Dodd-Frank Act's orderly liquidation authority (OLA), the equivalent to the European resolution procedure, gives FDIC the possibility to treat similarly situated creditors differently, FDIC can favour certain unsecured creditors over others. In the BRRD this is possible only in limited number of circumstances. However, both legislations contain the safeguard which provides that no creditor incurs greater losses than it would have incurred if the institution had been wound up under normal insolvency proceedings in accordance with the no creditor worse off principle.[13]

Unlike in BRRD, in Dodd-Frank Act, the costs of resolution is borne by the shareholders and unsecured creditors of parent top-tier holding company. This is called the Single Point of Entry approach. *"The FDIC would then form a bridge holding company ('NewCo') and transfers the failed holding company's ownership of healthy operating subsidiaries into it, leaving the holding company shareholders and creditors behind in the estate of the failed holding company. Operating subsidiaries that face no solvency problem will be transferred to the new solvent entity or entities (NewCo)"* (Avgouleas and Goodhart, 2014, p. 4).

Having presented the main distinctions between the American and European versions of the bail-in legislation, should there be any straightforward inspiration for the European resolution procedure? The answer is still not clear.

Bail-in has distributional consequences and potentially clear losers. Strong disagreements might arise as to which subsidiary is bailed-in and which is not. *"Where there are subsidiaries in non-EBU European countries such disagreements could even go as far as creating serious problems in the relationship of the EBU with non-EBU European countries, serious problems in the relationship of the EBU and non-EBU countries, especially where losses are bound to fall unevenly"* (Avgouleas and Goodhart, 2014, p. 10). Group-based solution in accordance with the American model would be the obvious solution for this issue, but on the other hand it might reinforce the subsidiarisation, which would go against the principles of the European single market (Avgouleas and Goodhart, 2014).

13 Thus specified by the BRRD.

3.3 Resolution fund and fiscal backstop

After a part of the creditors was bailed-in, the SRF, financed by the banking sector itself, could be called to the rescue by the SRB. There are several downsides relating to the SRF's use; the first one is the time needed to complete the process of progressive mutualisation of the originally national funds – the target size shall be built gradually over the coming decade. The second one is the size which is rather unimpressive; the 1 % of covered deposits equals to approximately €55 billion. One may argue that the fund of such size would be able to make a difference only in case of a relatively modest medium-size bank failure. For instance, almost €80bn of federal guarantees were required to wind-down the Franco-Belgian Dexia Group (Dierks, 2015). But back then the effective tools including the powerful bail-in principle were missing. Gros and de Groen (2015) computed that the targeted fund might have been enough to solve the bank failures during the recent global financial and Eurozone crises if the new rules were in effect. Thus SRF might be indeed sufficient but certainly not for a major crisis of a systemic nature. In fact, no resolution fund would handle such crisis alone (Gros and De Groen, 2015). But the only thing that matters for markets is who bears the ultimate, catastrophic risk, i.e. shouldering the cost of a banking system rescue (Pisani-Ferry, 2016). Therefore, a sort of fiscal backstop is needed, should the resolution mechanism have credibility, strengthen market confidence and thus help promote financial stability.

Although the need for such common backstop is widely recognized, its concrete shape remains unclear. An inspiration could be drawn from the agreement between the Eurogroup ministers on the provisional set-up of a system of bridge financing agreements which is to ensure the SRF will have sufficient funding during the transitional period (Council of the EU, 2015).While the fund is being gradually built-up (collected from the banking sector levies), member states agreed to provide credit lines to the SRB to back their national compartments in the SRF in case of possible funding shortfalls. This emergency national funding will be recovered via ex-post contributions of the banking sector. Yet in the case of connecting SRF to the national budgets, *"the link between banks and their sovereign would not be weakened and different member states position could still lead to potentially very large heterogeneity in the approach to financial sector problems"* (Bruegel, 2014, p. 2). Also, as long as the mechanism has the national fiscal resources on line, the SRM decision making process is likely to remain complex, specifically involving the Council of the EU, and without granting the exclusive resolution authority to a single agency, i.e. the SRB or the Commission (Bruegel, 2014).

Another option would be to allow the SRB to borrow on markets while using guarantees granted by the member states. As explained by the European Political Strategy Centre (2015), this could be done in two ways. The guarantees may be granted by each member state individually for resolution operations on its territory, or they may be provided on pro-rata basis where in case of a shortfall, they would be called in proportion to a specific key from each member state. The former variation of this option is least favourable as the sovereign-banking link is not weakened. The latter on the contrary follows the mutualisation principle and thus is more effective in weakening the link. A combination of these two variations is also conceivable.

Finally, the obvious and also politically feasible long-term solution is involving the European Stability Mechanism (ESM) in the process. In fact, the ESM was already

considered as a backstop for the transition period by the Ecofin ministers in 2013 (Council of the EU, 2013) but was eventually abandoned. The ESM's main advantages as a backstop should make this option return to the serious discussion. It is already in place (although a Treaty change would be necessary), its size would be sufficient and credible, and thus warding off doubts the markets might have about the resilience of the European banking system in times of crisis. Should there still be any doubts about the sufficient capacity represented by the ESM, a credit line from the ECB to the ESM could be established. For now this additional backup option is however far from politically acceptable. But with or without the credit line from the ECB, the ESM as a common backstop still represents a better risk sharing mechanism than the options involving national budgets.

Figure 4 | Strengths and weaknesses of the various backstop options for the SRF

	Strengths	Weaknesses
Public credit lines from member states (MS)	Existing framework Possible mutualisation principle solution	Sovereign-banking link not weakened MS-level approval needed
Intercompartmental MS lending	Existing framework	Limited additional resources
Market borrowing + public individual guarantees	No (immediate) increase in public debt	Coordination questions MS-level approval needed Limited credibility Sovereign-banking link not weakened
Market borrowing + public pro-rata guarantees	No (immediate) increase in public debt	MS-level approval needed
Public credit lines from ESM	Potentially significant amount of resources available Mutualisation principle solution Breaking of the sovereign-banking link	ESM Treaty change needed MS-level approval needed

Source: authors' own processing, based on European Political Strategy Centre, 2015.

4. Conclusions and recommendations

This paper was to summarize and evaluate the key features of the current shape of the EBU. Its two main pillars which are already in operation were outlined; the single supervisory mechanism and the single resolution mechanism; and their main advantages as well as downsides and potential risks were examined. Most of the possible shortcomings of the supervisory mechanism are more of a hypothetic nature than of an actual immediate threat. Although there is a strong rationale for the establishment of the supervision at the European level and its performance is yet rated positively, there are hidden risks in the interaction between the supervisory and monetary policy mandates within the one institution. Also, a delicate segment of the banking sector, the small banks, is exempted from this central supervision. The single resolution mechanism based on the new bail-in

principle is even more contentious. The main concern revolves around the fact the resolution process is rather complicated, involving many actors, thus it may prove cumbersome when a swift action is needed. The bail-in mechanism has been assessed taking into account all the clear benefits and all the main downsides. Among the benefits we can highlight the reduction of the moral hazard or the mitigation of destabilizing impact on public finances. The downsides include mainly the contagion risks to the financail system or the adverse impact on specific groups of creditors which raises concerns about the universal applicability of the mechanism. The reality, especially the recent Italian example shows that some amendments in terms of greater flexibility of this instrument might be needed. We compared the BRRD to the US "Dodd-Frank solution" but concluded there is no straight forward inspiration for the European scheme. Finally, the risk of the resolution fund's insufficiency in the event of a systemic crisis should be tackled better sooner than later. We outlined four possible backstop arrangements and concluded that the ESM would serve the backstop purpose better than the options involving national budgets. In any case, for any convincing backstop arrangement and therefore for the completion of the current state of the EBU, there is a need for member states to reach consensus on this critical issue.

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