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Policy Brief

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The EU must push ahead with banking union to boost confidence in its banking system

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#BankingUnion
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EU banks have so far weathered the storm caused by the pandemic, the war in Ukraine and sharp interest rate hikes. However, the failure of Credit Suisse and three US tech banks underlines how quickly investor and creditor trust can erode, prompting regulators to intervene and governments to provide public support. While swift and decisive action in the US and Switzerland prevented a systemic bank crisis, the EU will struggle to preserve financial stability if things go badly wrong. To boost confidence in its banking system, it is therefore high time for the EU to push ahead with banking union. To get its act together, the EU should 1) improve banks' resilience by adopting strict prudential regulation instead of creating new vulnerabilities, 2) make the crisis management framework more credible to ensure that banks can fail without using taxpayers' money, and 3) put in place European backstops to bank resolution and deposit insurance to withstand a systemic crisis.

The latest series of bank failures in Switzerland and the US reminds us of the inherent fragility of the financial system. Fifteen years after the collapse of Lehman Brothers, fears of a new systemic banking crisis are back in the headlines. Within two weeks, three regional banks in the US, Silvergate, Silicon Valley Bank, Signature Bank, and the second largest Swiss bank, Credit Suisse, collapsed. The problems leading to the failure of the four banks are quite different, but they all started to wobble when investors lost confidence and depositors suddenly withdrew their money. On financial markets, trust is obviously ephemeral in nature. Bank failures can always occur, but the crucial question is how to handle the aftermath.

Authorities contained contagion effects but at the price of violating the liability principle. After the global financial crisis, governments worldwide promised that never again would taxpayers be forced to bailout a private bank. Instead, private sector players should shoulder the cost of a bank failure by either letting it go into insolvency or putting it into resolution, triggering the bail-in of the bank's shareholders and debt investors. This promise has not been kept: to prevent the bank failures in the US and Switzerland from spreading to other banks, central banks and governments provided large guarantees and liquidity support. While this has so far prevented a systemic bank crisis, it's a fact that the agreed rules were not respected. For fear of putting financial stability at risk, authorities decided to rescue the banks with public money instead of letting shareholders, bondholders and uninsured depositors fully bear the entire costs.

The EU should learn from these overseas failures and put its own house in order. EU banks so far seem to be weathering the turmoil in financial markets. Still, these latest bank failures raise the question where the vulnerabilities in the EU banking system lie and whether EU authorities could better handle the collapse of a systemically important bank. To boost confidence in the EU banking system, policymakers should seize the occasion to push ahead with banking union. In concrete terms, this requires three things. First, within the ongoing negotiations on transposing the final set of Basel III reforms into EU law, European co-legislators should consider the negative consequences lighter regulation and laxer supervision may have on banks' resilience. Second, governments should put to one side national interests preventing the collective bank crisis management framework from making progress. And third, the EU should put in place European backstops to bank resolution and deposit insurance to ensure that the banking system can indeed withstand a systemic crisis.

1 Lessons of the bank failures in Switzerland and the US

1.1 Light regulation and lax supervision may have devastating consequences

In the US, neither bank management nor supervisors addressed the build-up of substantial risks. Two major problems led to the collapse of the three US banks Silvergate, Silicon Valley Bank (SVB), and Signature Bank. First, they were highly vulnerable to a bank run due to a very concentrated and largely uninsured depositor base. SVB, the biggest, focussed on the venture capital and start-up community. Silvergate and Signature Bank were the preferred banks of the crypto industry. All three saw a large deposit inflow between 2020 and 2021. But the downturn in tech and cryptocurrency prices led to a progressive outflow, causing serious liquidity problems. Second, the trio invested the cash they had received from their clients between 2020 and 2021 in high-quality securities, mostly safe government bonds. When the Federal Reserve Bank (Fed) started to increase interest rates in 2022 at an unprecedented level, these securities nosedived. SVB was particularly badly prepared for the rapidly changing interest rate environment. When the increasing deposit outflow eventually forced it to sell securities at a loss, investors suddenly lost confidence and depositors withdrew their money. Regulators also lost confidence in the banks' management and closed all three.

A Silicon Valley Bank scenario is unlikely to occur in the EU thanks to regulatory differences. The Trump administration exempted medium-sized banks from the Basel requirement to manage liquidity and interest rate risks and from strict stress tests of their risk management. This light touch regulation and lax supervision allowed the three US tech banks to build up substantial risks. Banks in the EU are less vulnerable to such risks for four reasons. First, all banks, big and small, are subject to Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) requirements. Second, banks' deposits have grown far less rapidly and are likely to be more stable than those in the US, not least because EU banks have more insured depositors. Third, banks' sovereign bond holdings are lower and cash at central banks occupies a bigger slice of banks' balance sheets, making EU banks less vulnerable to interest-rate risk and liquidity problems than US banks. Fourth, scrutiny of smaller banks is higher. So, supervisors are more likely to detect and act against risks such as interest rate threats, wider governance problems, and excessive risk concentration such as a very narrow community of clients. But, while scrutiny over medium-sized banks is stricter than in the US, the EU has created other vulnerabilities as witnessed by the insufficient implementation of the prudential rules adopted by the Basel committee for banking supervision.

1.2 Trust is of the essence

Even a global and systemically important bank can get into trouble. Unlike the US tech banks, Switzerland's second largest bank Credit Suisse (CS) was subject to strict prudential requirements and closely supervised by the Swiss Financial Market Supervisory Authority (FINMA). There were no large unrealised securities losses that would have pointed to elevated asset liability management risks as in the American cases. Although CS had been making losses for years and lacked a viable business model, the bank displayed solid capital and liquidity metrics. What brought Credit Suisse down was a lack of confidence among investors and depositors. For years, the bank had presided over a series of missteps and scandals and failed to establish a new business model with a sound corporate culture. Following the fresh US failures, concerns about possible spill-over effects intensified investor doubts in CS viability and resulted in renewed deposit outflows. Tapping the Swiss National Bank's (SNB) CHF 50 billion liquidity facility as a pre-emptive measure failed to shore up market confidence. As sustained deposit outflows risked the bank becoming illiquid, the Swiss regulator urged UBS to purchase its old rival at a knock-down price in order to prevent a full-blown collapse that could have seriously endangered financial stability worldwide.

For a bank, a loss of confidence is a fatal blow. The CS example underlines that large banks can also fail when subjected to a sudden deposit outflow. As long ago as 1983, Diamond and Dybvig pointed out banks' usual business model with funding from liquid, low-cost deposits and investing in illiquid, high-return assets works as long as everybody has confidence in the system. However, if people start to believe others will withdraw their funds, they will want their own money back too, making banks that cannot easily liquidate their investments collapse. In an era of online banking, the threat of a bank run is even greater as clients do not need to queue up in front of a bank branch and depositor flight can happen within minutes. The inherent risk of sudden deposit outflows creates a role for public policy. Governments and central banks can prevent self-fulfilling panics by requiring banks to pay into deposit guarantee schemes and by acting as lenders of last resort. To avoid this public safety net creating moral hazard, all financial intermediaries that engage in liquidity transformation must be subject to prudential regulations and be aware that any costs will ultimately be borne by the private sector. The latest series of bank rescues, however, shows that market participants had no trust that their money was safe and that private burden-sharing can be difficult to enforce.

The EU has a wide-meshed safety net for its banks. In the wake of the global financial crisis, member states agreed to establish a three-pillar banking union to increase the resilience of the EU banking system. The Single Supervisory Mechanism (SSM) as the first pillar has been put in place and is functioning well. The second pillar dealing with bank failures is unfinished. Where it is in the public interest not to put a failing bank into normal insolvency and opt instead for resolution, the Single Resolution Board (SRB) restructures the bank to safeguard the continuity of its critical functions, overall financial stability and minimal costs to taxpayers. To facilitate a bank resolution, the SRB can draw on the industry-financed Single Resolution Fund (SRF). However, with just EUR 66 billion in the pot, SRF firepower is limited and reforming the European Stability Mechanism (ESM) to provide the SRF with a fiscal backstop remains on hold. What's more, there is no common backstop in the eurozone that could guarantee the provision of liquidity to ensure a successful bank resolution. In principle, the European Central Bank (ECB) can provide unlimited liquidity, but it does so only against adequate collateral that a bank coming out of resolution does not necessarily have. Last but not least, a European Deposit Insurance (EDIS) as the third pillar is missing completely. EU member states have put in place their own schemes but there is no solidarity at the EU level. As a result, an individual country hit by a severe banking crisis continues to be vulnerable to bank runs and deposit flight. All in all, the safety net created by the banking union appears inadequate to ensure EU banking system resilience.

1.3 Protecting financial stability and taxpayers requires contingency plans that work in practice

Governments drew on the public purse to shore up confidence in the banking sector. Following the distress of Silvergate, Silicon Valley Bank and Signature Bank, the US Federal Deposit Insurance Corporation (FDIC) promised to fully reimburse all SVB depositors, effectively eliminating the limit on statutory deposit insurance of USD 250,000. What's more, the Federal Reserve Bank (Fed) protected banks from the need to sell securities at a loss by establishing a new Bank Term Funding Program (BTFP) which gives banks access to central bank liquidity without applying the usual haircut to the long-term securities used as collateral. In Switzerland, the FINMA nulled the claims of the holders of Credit Suisse's most risky Additional Tier 1 (AT1) debt and the government provided a CHF 9 billion guarantee to shield Credit Suisse's purchaser UBS from future losses. Furthermore, the Swiss National Bank (SNB) supported both banks with additional liquidity worth CHF 200 billion in total. With their whatever-is-needed approach, authorities on both sides of the Atlantic managed to steady the ship. However, they destroyed any hopes that the regulatory changes post-global financial crisis would allow banks to fail without drawing on the public purse.

Public support was the only option to prevent these bank collapses from spreading to other lenders. Governments felt prompted to prevent these bank failures from plunging the wider financial system into chaos. In the US, the government provided public guarantees as it did not want to saddle its tech industry with big losses and feared that the triple-headed bank runs could spread to other regional lenders. In Switzerland, Credit Suisse had drawn a living will describing its strategy for rapid and orderly resolution. However, following concerns expressed by SNB Chair Thomas Jordan that resolution could trigger a bigger financial crisis, the government preferred to facilitate the UBS merger and surprised AT1 debt holders with nullifying their claims while refusing to bail-in all shareholders.

The EU is also home to impediments to resolution. The smooth resolution of failing banks in Europe is far from guaranteed. First, SRB banks are EUR 32 billion short of bail-in capital (MREL) that can absorb losses and provide fresh equity in any resolution. Second, banks need to remove remaining impediments preventing a smooth resolution such as difficulties in mobilising liquidity and collateral. And third, resolution may have unintended consequences. Before tapping the SRF that could help stabilise a stumbling bank, shareholders and bondholders worth 8% of the failing bank's balance sheet must take losses. However, this 8% bail-in requirement is hard to enforce in practice as there is a lack of transparency about the holders of bank debt and this makes predicting the consequences of a bail-in as regards financial stability a highly uncertain exercise. Fears of causing a systemic crisis are particularly pronounced among banks that have a large number of uninsured depositors or whose debt is held mostly by other financial institutions.

The EU framework for failing banks is incoherent. The SRB is not responsible for all distressed banks but deals only with the resolution of banks that are too large to enter normal insolvency. Smaller banks in distress are liquidated by national resolution authorities. In making resolution decision, the SRB relies on the European Commission and the respective member states. As a result of this complicated institutional setup, there are serious doubts whether resolution decisions can be taken within the tight deadline of maximum 24 hours. Lacking any fiscal backstop, the SRB‘s firepower is limited and there is no clear commitment from the ECB to provide liquidity in resolution. What’s more, as the national laws for liquidating banks are very heterogenous across the EU, it is cumbersome for the SRB to ensure the No-Creditor-Worse-Off (NCWO) principle in a cross-border resolution case. Furthermore, the varying insolvency laws may produce very different results for creditors depending on the member state where the failing bank is located.

Lacking credibility, the EU bank crisis management framework puts member states in the line of fire. The European rules for handling bank failures have been in place for eight years now. But in the light of the aforementioned shortcomings, distressed banks were rarely placed in insolvency or in resolution. Instead of letting shareholders and bondholders foot the bill, EU governments continued to provide state aid to ailing banks to minimise the risk of financial turmoil. However, the capacity of individual countries to deal with the failure of a systemically important bank has its limits. In Switzerland, the newly created heavy-weight UBS now has a balance sheet double the size of Swiss GDP. The threat that banks may well be too big to be bailed-out is even more pronounced in euro countries that gave up monetary sovereignty and cannot ask the ECB to print more money. The EU would therefore do well to learn the lessons from the latest series of bank failures and get its own house in order without recourse to taxpayer funds.

2 How the EU can get its act together

EU banks have so far weathered the storm. However, to preserve confidence in its banking system, the EU should strengthen its prudential rulebook, improve its framework for dealing with failing banks, and eventually put in place European backstops to bank resolution and deposit insurance so as to withstand any systemic crisis.

2.1 Preserve confidence in the EU single rulebook

Scrutiny over medium-sized banks is stricter than in the US, but the EU can still do better. At the moment, EU banks seem to be better capitalised, have more cash in hand and be able to count on sluggish depositors who will not withdraw their money overnight. Irrespective of their size, all EU banks must abide by the EU single rulebook largely mirroring the internationally agreed standards set by the Basel Committee on Banking Supervision (BCBS). However, with each round of transposing Basel reforms into European law, the EU adds further deviations from the rules, undermining their effectiveness. European “specificities” so far include an SME supporting factor, an infrastructure supporting factor, special treatment of credit valuation adjustment (CVA) risk, and weaker calibration of certain factors in the calculation of the Net Stable Funding Ratio (NSFR).

Faithful transposition of the Basel standards is required to improve banks’ resilience. The devastating consequences of light touch regulation and lax supervision witnessed in the collapse of U.S. tech banks should make EU policymakers rethink their approach to banking regulation. Lower regulatory standards risk making EU banks more vulnerable and ultimately threaten the resilience of the entire banking system. Despite warnings issued by EU top regulators on the dilution of the Basel accord, the European Parliament and EU member states have been vying with each other to suggest new exemptions during the continuing negotiations on transposing the final set of Basel III reforms into EU law. What's more, banks are pushing for regulatory relief, in particular when off-loading credit risk on capital markets via securitisation. However, if policymakers want investors and depositors to trust in the resilience of banks, they need to faithfully transpose these Basel standards into EU law and not roll back prudential regulation. Instead of pursuing deregulation politics, the EU would be well-advised to reduce current vulnerabilities such as the home bias in banks' sovereign bond portfolios that leaves banks overly exposed to the fiscal distress of their home government.

2.2 Strengthen confidence in the EU bank crisis management framework

A stalemate among EU member states is blocking progress on the resolution framework. Learning from the lesson that preserving financial stability could well require swift action by public authorities and we need contingency plans that work in practice, the EU would do well to get its crisis management framework in gear. With the aim of addressing shortcomings and reducing the risk of drawing on public funds, the European Commission has been working on a review of the EU framework for "crisis management and deposit insurance" (CMDI). However, it has not presented its proposals yet due to a stalemate among EU member states that prevented an agreement on joint deposit insurance being reached last summer. While some countries would like to see more risk-sharing at EU level, including EDIS and a greater role for the SRB in handling bank failures, others insist on reducing risks in bank balance sheets first, especially concentrated exposure to sovereign debt.

Within the upcoming CMDI review, the EU has the chance to make its EU bank crisis management framework ready for full deployment. There are four measures that policymakers should envisage:

1) **Ensure full transparency about the holders of bank debt and introduce upper limits for bank debt crossholdings**. Insolvency and resolution affect, by design, other financial institutions and investors that hold securities of a failing bank that can be bailed-in. Losses incurred by other banks, insurance companies or pension funds may in turn impair their own viability and could therefore have destabilising consequences for the wider financial system. The risk of financial contagion would be particularly high in a systemic crisis where several lenders simultaneously fail because they are interconnected. To allow for the orderly wind-down of a failing bank, there should be full transparency about who would bear the losses. What's more, to prevent holdings of bank debt from becoming an impediment to resolution, there should be upper limits for bank debt crossholdings. At the moment, globally systemic important institutions (G-SII) are not allowed to use bail-inable debt issued by another G-SII for meeting own bail-in capital requirements (TLAC). This prohibition should be applied also to insurance companies, pension funds and smaller banks.

2) **Harmonise national insolvency laws and the possible uses of deposit insurance funds**. To ensure a level playing field for bank liquidation in the EU and to facilitate the SRB's mission to ensure that in resolution no creditor is worse off than in insolvency, the national rules governing the liquidation of banks should be harmonised. In addition, all EU member states should allow the use of national deposit insurance funds for "alternative measures" to prevent bank failures in the first instance, not just to compensate savers after a bank has collapsed. To avoid regulatory arbitrage, those alternative measures should follow a harmonised least

cost test that ensures that stabilising a bank with money from the national Deposit Guarantee Scheme (DGS) is less costly than putting it into insolvency and paying out insured depositors.

3) **Introduce a general depositor preference**. To reduce the impact of bail-in on the real economy, all deposits, whether insured or not, should be equally treated within resolution. At the moment, deposits up to EUR 100,000 are covered by the statutory deposit insurance and these depositors benefit from a super-priority of their claims. With a general depositor preference, deposit liabilities are given a more senior (or higher) position than other senior unsecured creditor claims. As such, they must be paid in full before other general unsecured claims can be met, increasing the prospects of recoveries from a failed bank's assets. A handful of EU member states already confer special protection on the deposits of large corporations. However, to facilitate bail-in and restore depositors' trust that their money is safe, a general depositor preference should become a binding requirement throughout the EU.

4) **Enable the use of deposit insurance funds in resolution**. Since the bail-in rules are currently so strict that in reality no one wants to apply them, bank rescues continue to be paid for with taxpayers' money. It therefore seems warranted to enable the SRB to reduce the strict 8% bail-in requirement and bridge the gap with money from the national deposit guarantee schemes (DGS). By removing the super-priority of the DGS, the SRB would be allowed to combine the funds available in the SRF (1% of covered deposits) and in the DGS (0.8% of covered deposits). This would bring the firepower to be used in an EU bank resolution close to the 2% of covered deposits in the US. As a reminder, both SRF and DGS are financial resources collected from the banks, so private money. Reducing the number of bailed-in creditors by making DGS funds available could limit the economic and political costs of resolution and thus reduce the need to bail out banks to safeguard financial stability. Empowering the SRB to use DGS funds in resolution would, however, need to come with strings attached as – in the absence of EDIS – it is money collected at national level.

Taken together, these measures would make the European crisis management framework more credible and thus increase confidence in the system. EU governments would therefore do well to give up some national interests and free the way for urgently needed reforms of the CMDI framework.

2.3 Build confidence in the European system dealing with systemic crises

Learning the lesson that trust is of the essence and that the mere existence of a solid safety net may mean it will never be needed, the EU should put in place strong safeguards that can convincingly withstand a systemic crisis. There are three long-standing elements for completing banking union that policymakers should home in on:

1) **Ratify the ESM reform to provide the SRF with a backstop**. The reform of the European Stability Mechanism, which has been ratified by all euro area countries but Italy, would provide the SRF with a backstop to increase its firepower. The ESM backstop is a credit line that the SRB could draw on if needed. While the funds available in the ESM are public money, the loan to the SRB would need to be repaid and any loss would be recouped from all banks via an extra levy. Making the ESM the central fiscal backstop for the banking union would soften concerns that the EU resolution regime may prove inadequate to ensure financial stability. It would increase confidence that the failure of a major bank will not spread to healthy ones and potentially overburden the fiscal capacity of a euro area sovereign. As

last resort, its mere existence would make it less likely that the backstop would be called upon in the first place.

2) **Secure the provision of liquidity in resolution**. To ensure a bank's operability after resolution, one must also replenish its liquidity buffers. Since resolution might eat up a bank's available collateral, it might not be able to hand any securities to the ECB in exchange for central bank money. This is why the guarantee for ECB liquidity might need to come from somebody else. One option comes from the former SRB Chair Elke König who proposed that the SRB could provide a first-loss guarantee to the ECB so that the latter supports the resolved bank with liquidity. Since it is the banks that fund the SRF, this solution would ultimately make the banking system liable without imposing possible losses on the public purse.

3) **Protect depositors at European level**. Any national deposit guarantee scheme would collapse if several large banks failed at the same time. Since deposit guarantee schemes work like a form of insurance, they can only withstand an idiosyncratic bank failure. In a systemic crisis, their funds would not suffice to compensate all insured depositors. This is why the European Commission in 2015 submitted a draft law to establish a joint European deposit insurance fund. Several attempts to agree on a way forward have failed. However, the fragility of the financial system witnessed these days is a stark reminder that governments should not simply hope for the best but actively prepare for the worst.

3 Conclusion

The EU should use the recent banking turmoil as an opportunity to put its own house in order. Although EU banks look resilient at the moment, the EU would be well-advised to avoid business as usual. Instead, policymakers should draw lessons from the latest series of bank failures and take measures that boost confidence in the European banking system. The ongoing negotiations on the EU banking package provide the opportunity to strengthen the prudential rulebook. And the upcoming CMDI review allows for removing the most pressing shortcomings of the European resolution framework.

Agreeing on the lowest common denominator will not do the trick. Ordinary citizens will trust that their money is safe only if they have every reason to believe in the robustness of the safety net. Therefore, the outcome of the EU banking package and the CMDI review must substantially reduce the risk of bank failures and make it less likely that taxpayers have to foot the bill. The collapse of Credit Suisse and the three US tech banks highlighted the fact that banking relies on everybody's confidence in the system. Policymakers should acknowledge this and strive for ambitious results on the two files now on the table. But that alone will not be enough.

Policymakers should not lose sight of the banking union's long-term agenda. The important work on addressing the most pressing shortcomings in banking supervision and resolution must not obscure a crucial - and missing - element for boosting citizens' confidence: European deposit insurance. While finding an agreement on the CMDI review within this legislative term is highly ambitious, the final deal must include a clear political commitment to establishing the third pillar of the banking union under the next European Commission. The CMDI review must build a bridge towards European deposit insurance and not lead to nowhere.

This time must be different. Several attempts to find an agreement on a European deposit insurance failed because of member states' entrenched positions on the balance between risk-reduction and risk-sharing. On the risk-reduction side, banks and supervisors have gone a long way to successfully address legacy problems. Further risk reduction will be easier to achieve with a credible commitment towards risk-sharing in the medium-term. There needs to be trust on all sides to pave the way for an integrated banking union that truly deserves the name. We now have a window of opportunity for really pushing ahead with banking union and EU governments should seize it.

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