

## **Between Discipline and Solidarity:**

### **How European Leaders Cope With Crisis and the Reallocation of Risk**

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**Abstract:** The austerity policies that EU policymakers adopted in response to the Eurozone crisis are often criticized as the product of neoliberal ideas institutionalized in the Maastricht Treaty. Yet this critique tends to overstate the programmatic coherence of Eurozone leaders' ideas, and prevents us from seeing Eurozone institutions as sites of contestation and change. This paper will trace the Eurozone's institutional evolution from a "no-bailout" to a new conditional bailout regime. We analyze in particular some key aspects of in the creation of the banking union. We highlight a shift away from the notion that fiscal indiscipline was the main problem, and market discipline the main solution to the crisis. Policymakers disagreed over the desirable balance between "discipline" and "solidarity", but all now explicitly accepted a certain measure of solidarity. Insofar as such solidarity involves risk-sharing among and across the member states, the Eurozone has departed from its previous model of fiscal discipline in favor of a new conditional bailout regime of last resort.

#### **I. The regime of EMU: neoliberal paradigm or ambiguous institution?**

In public debates and scholarly analyses, conventional wisdom holds that the Economic and Monetary Union created at Maastricht was predominantly "neoliberal". The creation of an inflation-fighting independent European Central Bank and the obligation of member governments to maintain fiscal discipline, as well as the prohibition of individual member state bailouts by other states or EU institutions, are often cited as evidence of the European desire to uphold stability and thus placate financial markets. In scholarly analyses as well, Europe's Economic and Monetary Union (EMU) is often characterized as the expression of a neoliberal paradigm (McNamara 1998; Dyson and Featherstone 1999; Hall 2010, 2012; Blyth 2013; Schmidt and Thatcher 2013; Stiglitz 2016). There is no question that such portrayals do capture one dimension of reality. Yet the "no bailout" regime of EMU that emerged from the 1990s was more complex and ambiguous than is often believed. As the crisis revealed most vividly, the existence of the European Central Bank as the apex of the system did not involve the espousal of a strictly neoliberal separation between monetary authority and the rest of economic policy. The ECB progressively became an activist central bank, and this evolution was overall in "continuity" with previous policies (Brunnermeier, James, & Landau 2016), rather than a radical break with the status quo ante. More generally, there was always a decidedly managerial set of motivations behind the creation of the euro, which never went away (Jabko 2010). These motivations came to the surface again in the course of the Eurozone crisis, alongside neoliberal motivations that were more widely expected and that were most visible with the EU's turn toward austerity (Blyth 2013).

The Banking Union is, in this sense, the latest episode in a long and complex tug of war between different conceivable visions of the Economic and Monetary Union. On the one hand, it looks fully consistent with the no-bailout provisions of the Treaty. It privileges bail-ins (of private investors) rather than bail-outs (with taxpayers' money) and it opens the possibility that undisciplined member states might default without taking down the entire economic and monetary union. The Single Supervisory Mechanism will be the essential piece of the new framework, whereas bank resolution

and common deposit insurance are relatively neglected. Thus, it seems stacked in favor of discipline and against solidarity. On the other hand, the Banking Union is clearly an extension of European solidarity, albeit limited and conditional, to yet another aspect of the Eurozone's political economy. Market discipline is no longer assumed to operate independently, without an active supervisor. Rather than being "global in life, but national in death" (King 2009), the EU-level supervision of Eurozone banks means that they will become increasingly European in both life and death. They will no longer be national liabilities that can pull down entire countries into a financial abyss when they fail. When and if that becomes the case, the interdependence between Eurozone member states and their economies will continue to increase, creating what Jean Monnet called "de facto solidarities", most famously in the Schuman Declaration; he viewed these manifestations of solidarity as the foundations of European federalism.

This paper argues that it makes sense to view the pre- and post-EMU institutional frameworks as ambiguous institutions (Mahoney and Thelen 2010), rather than as expressions of a well-defined neoliberal policy paradigm. The largely overlooked ambiguity of the pre-crisis EMU lay the foundation for crisis-time institutional innovations that typically did not conform to expectations of a strictly neoliberal Europe. In the build-up of the Banking Union, for example, many continued to insist on fiscal discipline as the main remedy against the risk of default. Yet even the most fervent advocates of discipline now explicitly recognized that fiscal indiscipline was not the main culprit for the banking crisis dimension of the Eurozone. By agreeing to build a banking union, they deliberately engaged in risk-sharing among and across member states. To be sure, such solidarity was limited and conditional in practice. European political leaders disagreed over what kind of banking union they wanted, and more specifically about the desirable balance within it between discipline and solidarity. In many ways, this disagreement was a transposition of earlier debates on the Economic and Monetary Union. But it is not simply the case that the focus on discipline crowded out any solidarity in the Banking Union – just as it is not the case that the Maastricht Treaty gave birth to a straightforwardly neoliberal Economic and Monetary Union.

Ultimately, the Eurozone has now implicitly departed from its previous "no bailout" model narrowly focused on fiscal discipline. Building on past ambiguities, European political leaders moved in the direction of a conditional bailout model, wherein bailouts are permissible if they fulfill certain conditions. To the extent that this is the case, the EMU is clearly no longer in the paradigmatic universe of disciplinary, self-help neoliberalism. In fact, the EMU arguably never was firmly in that universe in the first place. Market actors, as well as many political leaders, did not place much stock in the blanket promise of "no bailout" that the signers of the Maastricht Treaty made in 1991. They assumed – correctly, as it turned out – that, if and when a crisis hit, strict discipline would have to give way to pragmatic crisis management. When actors had to cope with crisis, they could hardly afford to be overly wedded to a single paradigm. In that sense, the Banking Union simply made visible and explicit a subterranean managerial dimension to the Eurozone that was left implicit until the crisis.

While our paper speaks to the contestation over euro area governance more broadly, we focus on two reforms related to the banking union to analyze the institutional evolution from a "no-bailout" to a new conditional bailout regime. Do the conditions indicate the coherence and path-dependence of a neoliberal paradigm or is the new regime characterized by the same tension between discipline and solidarity that, in our view, characterized the old regime? If the latter, how new is the new conditional bailout regime?

## **II. The banking union between discipline and solidarity**

Our first case concerns the bail-in rule: from 2016 onward, any European rescue program must contain a significant absorption of losses by private bank debtholders. It was intended to restore discipline and reduce the need for contrived solidarity of European taxpayers. But it was also the admission of a fundamental change: financial institutions, not governments, were the targets of the disciplinarian thrust. This amounts to a damning verdict on the notion of market discipline that is the hallmark of the neoliberal paradigm. The bailout package for Cyprus in 2013 exercised the rule, inflicting considerable losses on shareholders and savers (Schäfer et al 2016: 19-20; Henning 2017: 194-196). However, Cyprus did not establish an institutional precedent that could from now on run its course: the lingering banking crisis in Italy indicated the dangers of limiting solidarity, namely devastating losses for individuals and the potential for contagion. If private bail-in is not possible in every case, conditional forms of public bailouts need to fill the gap.

The second reform we look at is the resolution regime for banks, notably the debate about a fiscal backstop for such a regime. In the short run, it is possibly the most crucial element of the banking union but this backstop touches on the fiscal taboo of euro area governance. Without a viable resolution regime, member state governments are reluctant to close down insolvent banks, for fear that the inevitable fiscal costs expose them to a bond market attack and a diabolic loop of failing banks and overstretched public finances. As long as the problem of non-performing assets on banks' balance sheets remains unresolved, the financial system is constrained in its lending business and the ECB must keep up its extraordinary monetary policies. The creation of a Direct Resolution Instrument inside the European Stability Mechanism admits as much, although it is small and highly conditional, "designed not to be used" as a senior official of the ECB noted, disapprovingly. The risk of a bond market attack on particular sovereigns would be drastically reduced if government bonds were not exclusively a national liability but also a joint liability of all euro area members. However, the safe haven countries of the euro area do not want to incur this joint liability for what can be portrayed as legacy debt of the pre-crisis era. They insist on fiscal discipline that would give each government the means to compensate savers and tide viable parts of banks over difficult times; solidarity would create incentives to shift the costs of national bank resolution on other member states. Yet, with the creation of a Single Supervisory Mechanism, assets and liabilities of banks in the euro area are no longer national in the sense of the supervisory and regulatory responsibility of national authorities. If, in the future, a big bank fails, the doctrine of discipline for bank resolution will be tested to breaking point.

Our two case studies are biased in favor of the hypothesis that the reforms continue to institutionalize the neoliberal thrust of disciplining governments through policy devolution and market competition. If we find evidence for our preferred interpretation, it should hold even more strongly for other innovations, such as the European Stability Mechanism: in their own long-term self-interest, member states have to exercise a modicum of solidarity. The idea of risk-sharing provides them with a coherent term that builds a bridge between the old and the new repertoire of permissible actions.

### **II.a Private sector bail-ins as the way out?**

The bail-in rules of interest here try to shift the risk of permanent losses to a more or less broad base of private shareholders and creditors of a bankrupt bank, away from taxpayers (Schäfer et al 2016: 6). A narrow or small base would only include holders of junior claims, namely hybrid capital (eg

bonds that must be converted into equity) and subordinated debt (e.g., unsecured credit). A broad or large base for bail-ins would include senior claims against a bank, such as secured credit or savings deposits. Bail-ins can precede or follow government bailouts. In the latter case, legislation allows the government to impose losses on claimants after the worst of a crisis is over which forced it to step in immediately. The latter procedure is what critics of strict bail-in rules such as Goodhart and Avgouleas (2014) propose. They see the immediate imposition of losses on private investors as a sure way of precipitating a crisis because the prospect of losses will encourage every investor to get out before everybody else does.

Renewed market panic is exactly what occurred when the bail-in rules for the euro area were first proposed in October 2010. The announcement of these rules was part of the infamous Deauville declaration by Chancellor Merkel and President Sarkozy. Issued at the margins of a G8 Summit, the Declaration triggered a new round of panic in government bond markets of vulnerable countries, especially Ireland and Portugal and to a lesser extent Spain and Italy. Henning (2017: 65) suggests that the Declaration drove Ireland and Portugal into troika programs and was a “serious mistake”. This violent market reaction made any more official statements on this matter subside until the negotiations of a Single Resolution Mechanism and the bailout of Cyprus two years later.

The Deauville Declaration was an opportunity for the French and German leaders to demonstrate conspicuous consensus after a series of disagreements over the specifics of the Greek bailout in May 2010, the extent of the ECB’s extraordinary measures and the need for coordinated crisis management generally (Schelkle 2012). They could agree on bail-in rules for very different ideological reasons: for the French President, it was a way of signaling to markets that he was willing to use the Visible Hand of government to stop excessive risk-taking by financial investors; for the same moral hazard rationale, the German Chancellor was keen to send the signal that private investors had to take responsibility for themselves once the systemic threat was contained. At the time, both the French and the German government were immersed in botched attempts at rescuing too-big-to-fail banks, Dexia in the case of France (together with Belgium and Luxemburg), Hypo Real Estate and its Irish subsidiary Depfa in the case of Germany (Dübel 2013: iv-v; 12-15; 32-35). The Deauville Declaration thus came at a time when the two (and other) governments were not only concerned about the European response to the financial crisis but were struggling with the domestic politics of bank rescues. How difficult they found the latter is indicated by the fact that both the French and the German government missed every opportunity for bail-ins in the winding down of Dexia and Hypo Real Estate, respectively, before and after the Deauville Declaration.

The problem of overstretched public finances and the need for a conspicuous political response to banks’ reckless behavior did not go away, however. Even though the Deauville doctrine was suspended for the time being, at least three governments bailed-in private investors when a big national bank failed (Dübel 2013; Schäfer et al 2016):

- In February 2011, the Danish government bailed-in even senior debtholders and large deposit savers when Amagerbanken failed. This was done in steps, especially the extension to senior unsecured bondholders came relatively late. Unsecured deposit savers were eventually rescued when the recovery of assets was more successful than initially thought.<sup>1</sup> The case is significant in that it shows that a small open economy that is fiscally strong could exercise bail-ins in a way

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<sup>1</sup> See Woll (2014: ch.6) for a more detailed analysis of the Danish bank rescues. She compares them favourably with the Irish bailouts that came at an exorbitant cost to national taxpayers.

that did not lead to flight out of its financial markets. Amagerbanken was, however, a retail mortgage lender that was not systemically important and located in a country that was not part of the euro area.

- In April 2013, the Spanish government had to bail-in junior debtholders of Bankia, Spain's largest mortgage lender at the epicenter of its real estate bust. Bankia was already the result of a timid attempt at restructuring the Spanish banking system: it was a merger of seven Cajas, with modest debt write-downs at the time of its creation in 2010. The bail-in of junior debtholders was a highly contested condition of the €100b bank rescue program financed by the European Stability Mechanism (ESM), agreed in mid-2012 when the crash in house prices finally materialized. The prolonged procedures led foreign investors pull out of unsecured debt and covered bonds while small retail investors were misled to invest in supposedly safe banks (Dübel 2013: 30). The bail-in was preceded by national resolution legislation in late 2012 that could inflict bail-ins after the first phase of state guarantees.
- After several attempts at rescuing SNS Reaal bank, the Dutch government nationalized the mortgage lender in February 2013. Shareholders and junior creditors had their claims written down to zero, a new law allowed to expropriate holders of subordinated debt without compensation. The Dutch bail-in was highly significant for two reasons: the Netherlands was the country with the highest mortgage debt-to-GDP ratio in Europe (Dübel 2013: 37) and the bail-ins happened under the watch of finance minister Dijsselbloem who had just been appointed as President of the Eurogroup (Schäfer et al 2016: 8). Both were strong signals of the line that the Council of euro area finance ministers was likely to take, even in situations where a banking system could be considered to be too big to fail.

None of these three bank bail-ins led to disconcerting market reactions (Schäfer et al 2016: 16-19). There was hardly any market response to the bailing in of senior debtholders in Denmark. Nor was there an adverse response to the forced write-down of junior debt by Bankia which could have been seen as foreshadowing the treatment of private claims on Southern European banks generally. But most foreign debtholders – mostly other European banks – had left by the time the Spanish bail-in was executed. Only the Dutch bail-in of junior debt led to some abnormal rise of CDS spreads<sup>2</sup> and a fall in stock market returns. They were primarily driven by higher perceived risk of credit to Southern European and Irish banks (the so-called GIIPS). Market expectations that these banks would be bailed out in the future were clearly dashed, given the political cue that the Dutch nationalization entailed regarding the Eurogroup's stance on the matter.

Crunch time for bail-in rules came with the troika program for Cyprus. The Cypriot government had tested the patience of other EU member states in the run-up to the program by positioning itself as a tax haven and money launderer, making every effort to attract investments and deposits from dubious sources. It also negotiated with the Russian government a credit in order to avoid a troika program. When all these manoeuvres failed to ease the financing problems of Cypriot banks and the government, the Eurogroup asked the Cypriot government for a high co-payment to the sums provided under the ESM but left it to the Cypriot government of how to finance this contribution to

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<sup>2</sup> CDS or Credit Default Swaps are a form of wholesale credit insurance that even third parties can take out on credit contracts between two other parties. Since the providers of these instruments have rarely paid out on these insurance contracts, they should be seen as a vehicle of speculation on market risk. CDS spreads have become a widely used measure of risk in economic studies because they react very sensitively to events, more so than stock market returns.

the rescue program.<sup>3</sup> The Cypriot government proposed bailing-in senior debt holders, along the lines of the Danish bail-in, but also a “tax” (aka a write-down) of 9.9% on large and 6.75% on small deposit savings. The Eurogroup (and IMF director Lagarde) first accepted this proposal even though, under the EU Deposit Guarantee Directive, deposits of up to €100,000 were supposedly insured and should take losses only when all shareholders and large deposit savings are wiped out. Wolfgang Schäuble apparently criticized the bail-in of small deposit holders but came round to accept the portrayal of the measure as a “tax”; he was also not sure to secure a majority in the Bundestag without a large co-payment by the Cypriot government (Henning 2017: 196-198). A public outcry, not only in Cyprus, led to a revision of the proposal in March 2013 that bailed-in senior debtors and large deposit savers only.

The Cypriot bailout program could have been portrayed as a successful pushback against a nepotistic government. Western intelligence sources suggested that the Cypriot government had succumbed to pressures from Russia when it tried to limit the haircuts on large depositors (Henning 2017: 198). Instead, it turned out to be a public relations disaster for EA crisis management. The incident cast a shadow on bail-in rules, in media reporting and in Southern European countries. Market response was also very strong, both to the initial proposal and the final deal (Schäfer et 2016: 19-20). It was again the risk premia on credit to so-called GIIPS banks that shot up most. Markets clearly took it as a signal that the euro area was getting tough on bail-in since even senior claims had to take losses. That this did not translate to rising risk-premia in non-GIIPS countries is interpreted by Schäfer et al (2016: 20-22) as a sign that bail-in is not credible in fiscally more robust member states.

At the time that the Spanish and Dutch government performed the bail-ins for Bankia and SNS Reaal bank, respectively, a Single Resolution Mechanism (SRM) for the euro area was discussed. It is, apart from the Single Rulebook and a Single Supervisory Mechanism, the third pillar of the banking union which was decided in June 2012 and came into force in January 2014. The SRM involves the legislation of the bail-in rules because a resolution regime must establish a hierarchy of claims that have to be written down in the case of bankruptcy and systemic failure.

Member states preferred different models for bail-in rules (Barker 2016): Denmark, Sweden and Finland preferred a harmonized approach with the broadest possible bail-in base; savers with deposits below €100,000 would be compensated out of deposit insurance. At the other end of the spectrum was an unlikely alliance of France and the UK who argued for a flexible approach that allowed for discretion and could allow for exemption of deposits until all shareholders are wiped out. The latter is the so-called “depositor preference” approach, prevalent in the US, which was also preferred by the ECB. Spain was in favor of a large bail-in base like the Nordic countries but to exclude deposits permanently.

The Commission used its powers under the EU’s state aid regulation and insisted on bail-in since mid-2013 whenever banks were restructured and resolved before public finances were spent on rescues (Dixon 2016). The Bank Recovery and Resolution Directive 2014/59/EU (BRRD) has formalized and strengthened these bail-in rules, which apply to all EU countries as a matter of Single Market legislation.<sup>4</sup> The rules came into force in January 2016 and require “a contribution to loss

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<sup>3</sup> The troika estimated that Cyprus would need €17.7b to recapitalize its banks and meet its fiscal needs but offered to cover €10b only. It asked the Cypriot government to cover the rest (Henning 2017: 196).

<sup>4</sup> Article 37 lists the “bail-in tool” as one of four means of bank resolution. The other resolution tools listed in Article 37 BRRD are: the sale of business, a bridge institution and asset separation.

absorption and recapitalization equal to an amount not less than 8% of the total liabilities including own funds of the institution under resolution” (Art. 44(5) BRRD). Article 44 defines a clear hierarchy of liabilities that can be written down or converted into shares (the conversion rate of debt into shares does not have to be 1:1 and can involve a write-down). The bail-in basis includes every liability, including senior debt, unless it is excluded; such permanent exclusion concerns deposits below the €100,000 threshold but also hedge instruments like covered bonds. Some discretion is possible in exempting certain liabilities from this hierarchy of loss-taking under certain conditions, eg if it is seen as likely to trigger contagion. This takes on board the concerns that critics of bail-in rules expressed. The missing bail-in would then have to be compensated by the resolution fund that the financial industry has to build up although it cannot cover more than 5% of these exemptions. In short, the BRRD’s bail-in rules are close to the Spanish position as regards the bail-in base but the legislation left room for the Franco-British request for flexibility.

This flexibility would soon be tested by the Italian banking crisis. It is the consequence of two recessions in the wake of the financial crisis that led to a sharp rise in non-performing loans (Notarpietro and Rodano 2016: 9). Four regional banks failed in 2015. What made the headlines is the suicide of an Italian pensioner (BBC [2015](#)). Like so many Italian households, he held his lifetime savings in the form of subordinated debt that were wiped out in the insolvency of Banca Etruria; his suicide note indicated that this was the reason for his fateful decision. Then prime minister Renzi put €4 billion into the rescue of these banks, facilitating the rescue financed by a private consortium of three big banks.

EU bail-in rules were due to come into force only two months later, so could not be blamed for the pensioner’s suicide. But the connection was made (Münchau 2015). The ‘bank supervisor Carmelo Barbagallo [was] quoted by Reuters news agency, [that] letting the four banks fail under those new EU rules next year would have meant "sacrificing the money of one million savers and the jobs of nearly 6,000 people".' (BBC 2015) EU state aid rules played a role but so did domestic institutions. After complaints by thousands of bank customer, local bank supervisors soon investigated Banca Etruria for mis-selling these financial instruments to retail clients who were not aware of their junior status in the case of an insolvency (Ognibene [2015](#)). Italian banks in turn are weighed down by lengthy insolvency procedures in the case of non-performing secured loans that they have extended to their customers and the Italian government has started to address that problem with legal reforms (IMF [2016](#): 22).

The bank supervisors also foreshadowed the Italian government’s battle against bail-in. This has come to the fore in the bankruptcy of the world’s oldest bank, Monte dei Paschi di Siena in December 2016. The saga started to unravel after the Italian bank performed worst in the ECB’s stress tests and was asked to shore up its capital base which it failed to achieve. In December 2016, another multi-billion government bailout was required. EU bail-in rules were complied with by converting junior bonds into shares (Treanor and Kirchgaessner [2016](#)). The IMF (2016: 25) estimated that a large amount of bail-inable debt is held by retail investors, half of all subordinated debt of Italian banks and a third of their senior debt. This means: “Staff calculations based on publicly available data [...] show that, for the majority of the 15 largest Italian banks, the 8 percent minimum requirement would currently imply bail-in of retail investors of subordinated debt. For about two-thirds of the number of banks in the sample, losses would also be imposed on some senior debt holders.” (IMF 2016: 25) In the transposition of the BRRD, Italian legislators decided to implement full depositor preference; it will come into force in 2019 (IMF 2016: 25). In other words, deposits will

become the most privileged form of claims in an insolvency although not completely exempt. It remains to be seen whether Italian savers trust the promise of protection; funding costs for Italian banks are likely to rise.

In sum, the bail-in rules have shifted risks away from taxpayers to debtholders of banks. While this was the intended effect and should be a no-brainer, the rules are contested in practice. For good reason: taxpayers and debtholders are often the same people, so shifting the risk from one to the other hardly makes a difference and leaves them too exposed. The bail-in rules were meant to impose discipline on banks and their professional investors. But they invariably also hit less savvy retail investors in search for a slightly higher yield for their savings. Solidarity with them requires some flexibility of the rules and high hurdles for their bailing-in. Where the bail-in base is to a large extent made up by such debtholders in need of protection, bail-in is not the way out that EU finance ministers had hoped for. Solidarity then requires that there is some fiscal back-stop for the banking union which exists in principle but is highly conditional.

## **II.b Bank resolution without a common fiscal backstop?**

The main rationale for a common fiscal backstop is, in the short term, to act as a resolution fund for failing banks while the Single Resolution Fund is being progressively accrued by bank levies and, in the longer term, to maintain confidence even through the worst crisis scenarios, in which the future resolution fund and bail-in rules may not suffice. From the perspective of its advocates, it is a necessary form of solidarity in exchange for the new common discipline that the Banking Union and its stricter supervision at the EU level will impose on banks and, indirectly, on their sovereigns.

Yet the problem with a fiscal backstop is that presenting the bill of bank failures to taxpayers is politically the least popular remedy to bank runs – both in the short run and in the long run. After the very unpopular bank rescue operations of 2008-9 in response to the global financial crisis, there was no appetite among EU political leaders for creating a banking union that would involve fiscal, and therefore taxpayers' resources. Thus, it is no wonder that, when banking union was first being seriously discussed at the UE level in 2012, promises were made early on that taxpayers' money would never be used again. For example, the Commission issued a press release in September 2012 assuring that a primary goal of the Banking Union was "to make sure that supervisory authorities have all the tools they need to deal with bank failures without taxpayers' money." (European Commission 2012). Such statements are reminiscent of the promises that were made at the time of the Maastricht Treaty, when many politicians peddled the EMU by assuring their constituents that the "no-bailout" treaty provisions protected them against any danger from undisciplined foreign governments.

In addition to the universal distaste for bailouts funded by taxpayers, it was also unclear which taxpayers should be solicited in cases where national banks hold wide pan-European assets. In such cases, there is a clear temptation to shift the burden to other member states as much as possible. As Merkel reportedly told Sarkozy when he first floated the idea of creating a common European backstop in 2008: "To each his own shit" (Irwin 2013). In abstract terms, it might make sense at some point in the future that pan-European and homogeneously regulated banks would cease to be considered as national champions. Yet some national banking sectors will in the foreseeable future remain more internationalized than others. For example most the German banking sector is made

up of small banks and much more focused on local customers than, say, the French banking sector (Howarth and Quaglia 2014: 130-131). To this day, therefore, there is considerable reluctance in many member states to assume the debts of “other countries” and of their banks. When framed in these stark terms, solidarity among member states is clearly not popular – even though national banks are increasingly pan-European and regulated by the European Central Bank’s Single Supervisory Mechanism.

These problems were not clearly articulated in June 2012 when a late-night Eurozone summit statement declared – to the surprise of most observers – that it was necessary to “break the link between banks and sovereigns” between governments and banks (Euro summit 2012). Only later did government leaders, with the help of their economic advisors, parse this idea of banking union in greater detail. By December 2013, the president of the European Council announced the creation of a banking union with a single supervisor (housed within the ECB), a common guarantee of deposits, and a bank resolution mechanism (Van Rompuy 2013). These were the three missing elements of a banking union, given that the Single Rulebook had been implemented already in 2010.

As it turned out, Van Rompuy’s announcement was very optimistic. Germany in particular moved to oppose a common fiscal backstop to back up the Single Supervisory Mechanism. By late 2013, many governments, led by Germany, had backtracked from their initial support to deposit insurance, in particular. Part of the problem was that the specific aspects of the banking union were not couched on paper in June 2012, so it was possible for member states to backtrack on common understandings (Véron 2015). The opponents of a backstop now declared that they supported the single supervisor, within the European Central Bank, but not the other two components, as long as “legacy” debts held by national banks were not resolved. In other words, they wanted to tip the balance in favor of discipline rather than solidarity.

The way in which the promise of solidarity was hollowed out is instructive. Part of the agreement reached by the Euro summit in June 2012 was to allow direct bank recapitalization through the European Stability Mechanism. In order to “break the link between banks and sovereigns”, ESM money would serve for the recapitalization of a failing bank, rather than be extended in the form of a loan to the member state government for that purpose. This was never done, however, despite subsequent bank failures and recapitalization needs in several member states. The ESM was created by a separate treaty as an intergovernmental institution, not as an EU institution. This means that member governments hold the ESM’s purse and that unanimity was initially the rule for any major ESM programs or disbursements. Initially, there was always German opposition to any bank recapitalization after the June 2012 agreement. In June 2014, an agreement was finally reached to define the conditions under which bank recapitalization would take place (Eurogroup 2014). The ESM was now only allowed to intervene for “systemically important” banks; before the ESM intervenes, the bail-in must have already taken place under the terms of the BRRD; and the member state must participate on par with the ESM in the bank recapitalization. Effectively, these conditions are so stringent that bank recapitalization by the ESM is almost ruled out in practice.

The argument that German policymakers and other Northern European governments levelled most often against a common fiscal backstop as well as against a common deposit insurance at the EU level went hand in hand with their argument against debt mutualisation. The risk of “moral hazard” was paramount if a large common backstop became available to states or banks that engaged in risky behavior (Howarth and Quaglia 2013). In other words, discipline must prevail, or else solidarity

will be abused. In addition, taxpayers should not be required to mop up non-performing “legacy assets” of banks that were not properly regulated by national regulators before the advent of the SSM. Under the terms of an agreement reached in December 2013, the Single Resolution Fund financed by industry would only become progressively available in full for any single resolution operation. Solidarity will thus kick in only when discipline over banks is durably ensured by the SSM. Until then, resolution costs would continue to be borne by the “national compartments” where failing banks were located. And even when the fund does become fully integrated, solidarity will mostly intervene in the form of the private insurance fund, in conjunction with bail-ins, and will be limited by the size of the resolution fund (€60b).

The “legacy assets” issue raises the question of whether and when national banks will be truly considered European and separate from their sovereigns in the banking union (since they will be regulated homogeneously by the SSM). If that is/becomes the case, then presumably the resolution mechanism and the backstop (if any) should be fully European rather than national. This is not the case right now, but at some indefinite point in the future it will become impossible to argue about legacy assets. In the meantime, there is a certain legitimacy to this argument, even though it is notoriously hard to separate what can be attributed to bad national supervision from what happens when a bank finds itself in a liquidity crisis due to sudden investor defiance. Another problem is that “legacy” arguments can indefinitely postpone the establishment of a common fiscal backstop, even though such a backstop would make more economic sense – by making national banks less vulnerable to adverse shocks, and by spreading risks and costs of bankruptcies more widely and over a much larger capital pool.

The question of who will be providing the fiscal backstop remains a Pandora's box that nobody wants to open right away, however. It is clearly on the radar of policymakers, for example in the “Five presidents’ report” (European Commission 2015). On the one hand, the report proposes a “European Deposit Insurance Scheme (EDIS)” as “the third pillar of a fully-fledged Banking Union alongside bank supervision and resolution”, which should be “privately funded” (11). On the other hand, the report explicitly called for a “credible common backstop” (p. 11) for the banking union, as well as “in the longer term a euro area-wide fiscal stabilization function” (p. 14). Despite initial claims that EU banking union would be strictly a private insurance mechanism, EU policymakers thus cautiously recognized the necessity of new fiscal instruments. Nothing is yet set in stone, and neither common deposit insurance nor a fiscal backstop have gone beyond the stage of Commission proposals. But the fact that such steps were placed on the horizon and are squarely objects of EU debate was already significant.

The question then becomes, can a banking union survive without a fiscal backstop in the short to medium term? And the answer to this question is, probably so, as long as the limits of the system are not tested. The Single Supervisory Mechanism (SSM) will have to prove itself in the emerging “half a banking union” – without centralized debt resolution and deposit insurance (Posen and Véron 2014).

The viability of a banking union without a fiscal backstop is, in a sense, similar to that of an Economic and Monetary Union without backstops. The EMU could survive, even prosper, until a major crisis hit and the fragility of the system was revealed. When crisis hit, however, it became obvious that the EMU needed to be reformed. The EFSF and then the ESM were created, and the ECB started lending money indirectly to struggling governments. But those reforms could probably not have

been carried out in the absence of a crisis, and an Economic and Monetary Union primarily focused on the monetary dimension was all that governments could agree on at Maastricht.

Likewise, a banking union limited to pan-European bank supervision is a more feasible option in the short term than a full-fledged banking union leaning against a true fiscal union. The financial consequences of a banking union might later necessitate the buildup of common fiscal instruments – i.e., more solidarity, in addition to the already visible discipline that the SSM will impose. But the beauty of the banking union that has emerged so far is that such steps do not have to be taken immediately, and that the framework is built incrementally over time.

For now, there are already signs that the banking community is taking the SSM seriously (Schoenmaker and Veron 2016). The SSM started operating in August 2014, and the ECB massively recruited new staff for its day-to-day operations. The Single Resolution Mechanism is also up and running as of January 2015. It is much more complex than the SSM in its decision-making process, however (Howarth and Quaglia 2014). It now is only able to spell out a resolution process without fully providing necessary funding for it, but this will change over time. By 2024, it will have a fully-funded Single Resolution Fund at its disposal as a resolution instrument, with a target figure of 1% of deposits of all banks in the system. The Single Resolution Fund will collect bank levies and will be drawn from in order to finance the resolution of assets of failing banks. Even though this fund will remain insufficient to resolve major bank failures and cannot be used for recapitalization, it will facilitate and lend credibility to future recapitalization operations. It will also allow the ECB to avoid having to provide emergency financing to insolvent banks, as opposed to its normal role of lender of last resort to banks that face a liquidity crisis (yet are generally solvent).

It is also quite possible that the sturdiness of the banking union will not be tested as quickly as that of the Economic and Monetary Union, precisely because it considerably strengthens banking supervision and adds a layer of insurance against a Eurozone crisis, thus making a crisis less likely. The banking union, albeit incomplete, could therefore be enough to forestall the kind of confidence crises that repeatedly engulfed the EU in 2010-12.

### **III. The reallocation of risk in the new EMU regime**

Our case studies looked at two significant reforms that are related to the banking union. The first tries to allocate risk explicitly to the private sector when banks go bust; the other also forces European banks to form a risk pool if one of them needs resolution, without a joint fiscal backstop by member states. The common theme is to give responsibility for financial failure back to market actors, investors and bank owners. One may see in these reforms a persistent neoliberal thrust in that market mechanisms are strengthened and state-building at the EU level is kept at a minimum.

We argue instead that these two reforms can be seen as elements of a new departure. We could have chosen easier examples, such as the ECB's activist monetary policy and the sizeable capacity for emergency lending that outstrips the IMF by far. But even bail-in rules and the SRM concede that underregulated financial markets, not fiscal authorities, were the source of instability and that some risk-sharing is required when a common shock hits member states or market panic spreads across the EA. We considered to what extent this forced governments to exercise solidarity, ie deliberate or consciously accepted risk-sharing through public mechanisms, when all else fails.

Bail-in rules in the case of bank failure have been formulated with some room for discretion for public authorities. Both the Direct Refinancing Instrument of the ESM and the SRM were designed to relieve beleaguered national fiscal authorities from these liabilities that would drag them into a negative feedback loop with failing banks. Protracted negotiations and the absence of clear rules about resolution and the hierarchy of loss-taking meant that risk was reallocated from European taxpayers to domestic savers and retail investors in the crisis-stricken country concerned. Even a hard-nosed economic assessment would suggest that this is inefficient as these actors are too weak to bear the risk; their impoverishment is likely to lead to protracted recession and to wipe out permanently valuable businesses. Despite initial resistance by the lucky Nordic countries, this was an indefensible state of affairs and they had to yield. But it remains to be seen how much solidarity will be exercised if, for instance, the Italian banking system implodes under the weight of non-performing loans and the highly indebted national government is unable to shoulder its recapitalization. While the explicit commitment is to let market actors take losses first, the experience of almost a decade of crisis management suggests that decision-makers will not stick to a neoliberal rule-book.

This uncertainty is what makes bail-in rules and resolution capacities at the EU level “ambiguous institutions” in the sense of Thelen (2009: 491): “[I]nstitutions and rules are often ambiguous from the beginning, almost *by design*, as a consequence of the particular (often conflicting) coalition of interests that presides over their founding. [...] [T]hese arrangements embody and institutionalize different, often conflicting, goals—which can of course also get balanced out rather differently over time.” Rather than a design flaw, ambiguity must be understood in political-economy terms, as a *flaw by design*. It provides what economists call a “second-best” solution to functional problems because it keeps, in a union of democratic and diverse member states, legitimate contestation open until and when an institutional equilibrium emerges (which is not guaranteed).

Thelen’s statement points to two elements of ambiguity: first, it serves to accommodate conflicting interests and, second, the original compromise may evolve considerably over time. Our paper documented the conflicting interests over bail-in rules and fiscal backstops for bank resolution above. The conflicts are real:

- The Deauville Declaration illustrated that one may favor bail-in rules for very different ideological reasons. There is no consensus among economists what constitutes the best solution in functional terms. The principle of risk diversification, preferred by some Nordic countries, suggests as broad a bail-in base as possible but this can lead to more financial instability as everyone tries to escape at the earliest sign of bankruptcy. Hence, if one is very concerned about financial stability, as the UK and the French governments are, one would want to keep the bail-in base narrow and exercise it with discretion; but this procedure is open to political pressures and taxpayers may end up with the largest share of the bill.
- Bank bailouts are extremely unpopular and hence the SRM, paid for by the financial industry, was politically a foregone conclusion. And yet, it took the EA quite a while to agree on the modalities of the SRM. One reason are dubious “legacy assets”: bank balance sheets are still full of assets contracted when they were under national supervision that may have been too lax and are now non-performing. By the time the resolution fund is fully paid up, this may be less of an issue but are banks that fail and quickly exhaust the €60b fund then a matter for a European fund, say the ESM? Taxpayers in the member states concerned will remember that they are also savers and vehemently demand their politicians to rescue their

savings, while those in other member states will not see this as a matter of common concern.

- More generally, the perception of a tension between discipline and solidarity conforms the mainstream economist's framing of a tradeoff between insurance and moral hazard. The more comprehensive insurance is, be it a joint fiscal backstop or a larger privately financed resolution fund, the more likely it is that financial institutions take more risks. It also works the other way round: too little insurance may make banks overly cautious, contributing to prolonged stagnation, while every individual bank's problem can spark market panic. The choice of the tradeoff that the EA has agreed on can be exemplified with the DRI: it is extremely small and hard to access, thus errs on the side of discipline. This then requires the massive "firewall" of the ESM, much bigger than the resources of the IMF, to shield other members from the fallout of crises in another member state.

We see in these newly created ambiguous institutions the evolution from a no-bailout to a conditional bailout regime: at every step in this evolutionary process, reforms assert discipline to prevent moral hazard (of fellow member states but also markets), supposedly in line with the austerity delusion and the neoliberal paradigm. Yet, the story does not end here. Market panic which is supposed to act as a disciplinary threat has a tendency to spill over and escalate, which the reforms explicitly concede. This will predictably force the hands of governments to show some solidarity in the sense of 'generalized and reciprocal self-interest. Not ethics, but politics explain it.' (Baldwin 1990: 299)

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