

## THREE REFORMS TO STRENGTHEN THE BANKING UNION AND THE EURO AREA

Asymmetry between debtors and creditors, the fiction of riskless assets and the lack of a European deposit insurance scheme feed the woes of the euro area

The euro area is home to a € 10.8 trillion economy and brings 340 million people from 19 different countries into a single monetary area.

These numbers speak for themselves. Designing a well-functioning euro area is crucial if we want to enable the enterprises, the workers and the consumers of the euro area to live and prosper together.

There are three dimensions to reforming the euro area:

- **institutional:** *what governance and what decision-making process?*
- **economic:** *what economic policy with what level of coordination, what fiscal rules and what adjustment mechanisms?*
- **financial:** *what financial architecture and what mechanism to allocate capital inside the euro area?*

In the wake of the non-paper making proposals to complete the Banking Union released on 6 November by the German Federal Ministry of Finance, this technical brief concentrates on the financial dimension of the necessary improvement of the euro area, which to a large extent covers the field of Banking Union. The guiding thread of our approach is the analysis of the concept of market discipline at the heart of its functioning.

Two preliminary remarks: First, the fact that the euro is not a complete currency creates an intrinsic difficulty in building a coherent monetary area. The countries that have adopted the euro have given up the traditional prerogative of sovereign states to create money. Therefore, a debt issued by a euro area country is similar, from a credit risk standpoint, to a debt denominated in a foreign currency. As a consequence, the debt of a euro area country can under no circumstance be considered as riskless. Incidentally, this means that no such thing as a euro-denominated risk-free rate exists today.

Second, the architecture of a monetary zone can be based, at the two extremes, on market discipline or on the intervention of public authorities. Both ways of operating have their logic as well as their pros and cons. But beyond this debate, one thing is certain: in order to be effective, the design of a monetary zone must be in line with its underlying principle. Failing to do so creates a fundamental incoherence in the system.

This latter point is at the root of many of the euro area's problems: in theory, market discipline is its governing rule; in practice, market discipline is applied to debtors but much more reluctantly to creditors, which creates an unbalanced and structurally dysfunctional system.

## What is in the expression “market discipline”?

The following examples give an illustration of the asymmetrical application of market discipline in the euro area:

### A / Market discipline and banking

In the aftermath of the banking crisis of 2007-2008, EU member states extended collectively up to €450 bn (in the form of equity, loans, financial guarantees, etc...) to their respective banking systems to avoid imposing losses on banks' bondholders. Such a massive public support of private banking interests created a strong shock in public opinions and within the policy-makers community. It led, among others, to the adoption in 2014 of the Bank Recovery and Resolution Directive (BRRD), which introduced rules forcing bondholders to absorb the losses of ailing banks before public budgets can be called upon. Unfortunately, BRRD kept de facto the last word in resolution processes with political decision-makers instead of giving it to the Single Resolution Board, and it made exceptions for banks not considered as systemically important. The consequence of this choice has been continued taxpayer funded bailouts of failed banks. For instance, banks bailouts (Banca Popolare di Vicenza and Veneto Banca) and so-called “precautionary recapitalisations” (Monte dei Paschi di Siena) have cost at least € 23 bn to the Italian taxpayer since 2015. To this day, Banco Popular has been the only time when a bank resolution has worked according to plan since the adoption of BRRD.

### B / Market discipline and sovereign issuers

Throughout the various crises that have hit over the past ten years, euro area's leaders have almost systematically refused to consider the possibility of a write-off of the obligations of sovereign bond issuers in difficulty. In 2012, they did accept however - after considerable drama - a restructuring of Greek debt through a combination of maturity extension and interest capping, but they did not agree to write-offs despite what most economists consider as an unsustainable level of Greek debt. In all other cases, no restructuring of any kind took place, not to mention write-offs.

### C / Market discipline and the interaction between sovereign issuers and banks

The euro area financial architecture is built on the economic fiction that the bonds issued by euro area sovereigns are riskless, and it organises that fiction by attributing a zero-risk weight to sovereign bonds in the calculation of banks' capital requirements. This operates to the advantage of creditors and provides them with a reason to provide funding to euro area countries without analysing their credit quality and without charging the right price. We can see easily why this rule was adopted: by benefitting creditors, sovereign issuers who, through the Council, are also the co-legislators of EU regulation have secured for themselves a more abundant funding at a better price.

This situation, often referred to as the doom loop between sovereigns and banks, creates a nexus between sovereigns and banks: euro area banks fund their home country through bond purchases<sup>1</sup> as an assurance that their home country will bail them out, if need be, with the money provided. This is the economic equivalent of a circular reference. In the case of the relationship between banks and sovereign issuers in the euro area, it encourages a misallocation of capital by banks and feeds the unconditional support of too-big-to-fail banks by sovereigns at the expense of taxpayers. Both effects are perverse and, in any case, are a distortion to market discipline.

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<sup>1</sup> Euro area banks hold typically between 20% and 25% of a total euro area sovereign debt stock nearing today € 10 tn.

We can see through those different examples that the euro area has systematically applied market discipline to debtors but only marginally to creditors and, in the latter case, with much reluctance when it has.

This has many negative consequences and comes to the detriment of the economic efficiency of the zone, of citizens and of taxpayers. Market discipline has to apply to both debtors and creditors if a coherent euro area is to be built and if it is to channel capital towards issuers at the right price and, thereby, produce positive economic effects for the benefit of society. Absent a symmetrical treatment of debtors and creditors, market discipline becomes a buzz word hiding a “rapport de force” in favour of creditors, a situation leading to an inefficient allocation of capital, financial crises and the build-up of a populism too happy to have discovered a proof of collusion between financiers and political decision makers.

There is a general fear within the euro area that applying market discipline to creditors will upset markets and create financial chaos. This fear is to be found with many policy-makers, country leaders and within the economists’ community alike<sup>2</sup>, but it is misguided. What is the coherence of placing financial markets at the centre of the financing of the euro area economy and sovereign issuers without the belief that markets are able to accept discipline for themselves? The function of financial markets is to allocate capital and, as long as there are given the right information in a clear and transparent manner sufficiently ahead of time, they are able to adapt. If we do not believe in this premise, we should question the very validity of having financial markets altogether. In order to operate, financial markets do not need the moral hazard provided by the public safety net protecting them from issuers’ default.

### Three reforms to strengthen the Banking Union and the euro area

The three following reforms should be implemented if euro area policy-makers want to make the rules governing the area coherent.

1. Put in place a European deposit insurance scheme (EDIS). This much-debated topic is essential for the Banking Union as it is the only way to ensure that banks depositors benefit from the same guarantees regardless of where they are located. In other words, EDIS is a condition to build citizens’ confidence in the resilience of the banking system and to avoid bank runs and their destabilising effects.
2. Give the Single Resolution Board (SRB) direct and full authority for the execution of bank resolutions, including in the case of non-systemically important banks. This is essential in a context where the current system has shown its limits when it comes to putting an end to the socialisation of banks’ extreme losses, even in cases when the banks to be resolved are of small size.
3. Reform the rules and apply non-zero risk weights to sovereign risk in the calculation of banks capital requirements. The current zero risk weight fiction is the source of a major economic distortion in the functioning of euro area financial markets as the doom loop it creates between banks and sovereigns feeds financial instability. Contrary to what many voices say, if announced sufficiently ahead of implementation time, such a reform would not trigger a financial market panic: the market would simply do its job of putting a price on sovereign bonds without a regulation creating unwelcome distortions. Alternatively, if policy-makers believe collectively that markets could not cope with a banking regulation reflecting economic reality, they should question the wisdom of continuing to finance their deficits through market mechanisms (namely by issuing tradable bonds).

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2 See, for instance, Centre for Economic Policy Research (CEPR) Policy Insight 91 “*Reconciling risk sharing with market discipline: A constructive approach to euro area reform*” – January 2018;  
URL: [https://cepr.org/sites/default/files/policy\\_insights/PolicyInsight91.pdf](https://cepr.org/sites/default/files/policy_insights/PolicyInsight91.pdf)

## German proposal on completing the Banking Union

The proposals made on 6 November by the German Ministry of Finance to complete the Banking Union<sup>3</sup> link, among others, the adoption of EDIS to a reform of sovereign debt capital charges through the implementation of so-called concentration charges. This proposal comes in the wake of the work done on the subject by Bruegel<sup>4</sup> and CEPR<sup>5</sup>. The idea is to force capital charges on banks holding exposures to a euro area country in excess of a certain threshold. This idea is economically coherent as it aims at breaking the doom loop between sovereign issuers and banks, but it is only a substitute to getting rid altogether (i.e. without a threshold and with a risk weight not related to the concentration level) of the sovereign risk-free fiction at the heart of the fragility of the euro area. As such, concentration charges should be seen as a second best solution attempting to be more acceptable to euro area countries opposed to getting rid of the zero-risk weight fiction. It can also be noticed that the BMF non-paper section on this topic starts by affirming rightly that “sovereign bonds are not risk-free investment” and finishes, in an obvious contradiction, by saying that “in this way (i.e. after concentration charges have been applied), banks in all countries would build up a “safe portfolio” of sovereign bonds over time”. But, beyond this contradiction in the narrative, the direction of travel contained in the proposed measure is the right one, even if it does not provide the complete solution.

### Sovereign Bond-Backed Securities as a safe asset: a flawed concept

The idea of developing for the euro area a synthetic security called by some “Sovereign Bond-Backed Securities” (SBBS)<sup>6</sup> and others “safe asset”<sup>7</sup> is gaining momentum in some circles and keeps coming back in public policy debates.

The so-called “safe asset” discussed would effectively be a basket of euro area sovereign bonds issued by intermediaries who would have purchased beforehand the very same bonds in the market. The economic idea behind is the well-known principle that diversification of an investment portfolio spreads the risk and makes it more manageable. In the mind of its promoters, the safe asset would “reduce the impact of shifts in market sentiment against vulnerable euro area members to maintain market access and avoid sharp spikes in borrowing costs”<sup>8</sup>. It would also, supposedly, be a solution to avoid too high a concentration of sovereign risk on the books of banks purchasing those assets and, therefore, end the doom loop.

Unfortunately, this apparently attractive concept suffers from technical difficulties that raise serious doubts as to its usefulness, not to mention its very feasibility, in the real world.

First, regardless of the diversification of the basket, there can be no such thing as a safe asset made of sovereign bonds issued by member states of the euro area. The reason for this situation is simple to understand: if no single euro area sovereign bond can be considered as risk-free, as previously stated, there is no reason why a basket of such bonds would become risk-free. “Safe asset” is therefore a misnomer.

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3 Bundesfinanzministerium (BMF), *Non-paper on proposals to complete the Banking Union*;  
URL: <http://prod-upp-image-read.ft.com/b750c7e4-ffba-11e9-b7bc-f3fa4e77dd47>

4 Nicolas Véron – Bruegel and Peterson Institute for International Economics : «Sovereign concentration charges : A new regime for banks’ sovereign exposures » – November 2017;  
URL: [http://bruegel.org/wp-content/uploads/2017/11/IPOL\\_STU2017602111\\_EN.pdf](http://bruegel.org/wp-content/uploads/2017/11/IPOL_STU2017602111_EN.pdf)

5 CEPR, January 2018 (see above)

6 European Systemic Risk Board (ESRB) High-Level Task Force on Safe Assets: “Sovereign bond-backed securities: a feasibility study” - January 2018; URL: [https://www.esrb.europa.eu/pub/task\\_force\\_safe\\_assets/shared/pdf/esrb.report290118\\_sbbs\\_volume\\_1\\_mainfindings.en.pdf](https://www.esrb.europa.eu/pub/task_force_safe_assets/shared/pdf/esrb.report290118_sbbs_volume_1_mainfindings.en.pdf)

7 CEPR, January 2018 (see above)

8 CEPR, January 2018 (see above), Point 4.2.4, page 17

Second, the assertion that the safe asset would “reduce the impact of shifts in market sentiment against vulnerable euro area members to maintain market access and avoid sharp spikes in borrowing costs” is altogether wrong: by definition, the market price of the safe asset would have to reflect the market prices of the different individual bonds it would consist of. If it were not to be the case, an arbitrage would emerge that would enable market participants to lock-in risk-free profits by buying the underlying single bonds in the right proportion and selling the safe asset, but this is a technical impossibility. As for the doom loop argument, if banks concentrate their purchases of sovereign bonds on their home country today, it is not because they cannot diversify their holdings (buying a diversified portfolio of bonds is trivial for a market professional), but because they operate in a system where concentrating their holdings on their home country debt is the best assurance they can get to be bailed-out in case of trouble. This is a rational decision on their part in a context where they are encouraged to do so by the absence of risk weight imposed by regulation on such holdings.

Third, the concomitant assertions that “creating a safe asset in the euro area would create a source of demand for euro area sovereign debt that is not “skittish” in the face of changes in market sentiment”<sup>9</sup> and that “bonds of countries that lose market access should no longer be eligible for purchase by safe asset issuers”<sup>10</sup> seem contradictory: what is the logic of a mechanism which has an objective to keep the market open to issuers of lesser quality regardless of market sentiment and, at the same time, limits the use of the safe asset vehicle to issuers in bad times?

Fourth, if the safe asset is constituted on the primary market, national debt management offices would have to coordinate their issuance programmes, which seems highly unrealistic given the different agendas and funding constraints different countries have to deal with. And if it is constituted on the secondary market, the transaction and carry costs incurred by intermediaries would, without any doubt, make it economically unadvantageous compared to the direct purchase of its individual components by institutional investors, investment funds or banks.

Fifth, in the current regulatory environment, the capital treatment of the safe asset would be less advantageous than the treatment of sovereign bonds, which is an obvious obstacle to its development. Developing the safe asset concept would therefore require to amend capital requirements regulation to create a new category of assets that, even if not riskless as we have seen, would bear a zero risk-weight. This is highly undesirable, as it would add yet another distortion to economic reality in the euro area.

## Conclusion

The euro area must choose between a full implementation and a rejection of market discipline, as its asymmetrical implementation between debtors and creditors makes for an incoherent system. In the current environment where financial markets are at the heart of the functioning of the euro area, policy-makers must assume that a market-based system operates, by construction, by impacting market prices. Running a market system and avoiding price movements are two mutually exclusive objectives. Alternatively, if the belief is that financial markets are not able to perform the task of allocating capital at the right price as needed, a completely different way of organizing the euro area without them should be contemplated, but this option is clearly not on the table today even if theoretically possible.

Lastly, financial engineering, as in the pursuit of a structured “safe asset”, can never hide fundamental economic realities. This is why the energy of policy-makers should not be spent searching for solutions in that direction: there is no such thing as a free lunch and no form of window dressing will ever change this reality.

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9 CEPR, January 2018 (see above), , Point 4.2.4, page 17

10 CEPR, January 2018 (see above), Point 4.2.4, page 18



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