How to complete the EU’s banking union (*)

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ABSTRACT

We argue that a solid and federal banking union is the most important basis for a stable eurozone. The current banking union remains unsatisfactory; the resolution mechanism needs a more federal decision making process and a fiscal backstop, while also a Single Deposit Guarantee Scheme is required. A further transfer of responsibilities to European institutions and more risk sharing are essential to sever the doomed loop of banks and sovereigns. Ideally, we need a treaty change to separate the monetary and supervisory functions of the ECB. However, a banking union is not enough, given that banks’ assets exceed the EU’s gross domestic product (GDP) threefold. The role of banks in financing the economy should be reduced and alternatives should be developed to arrive at a true European Capital Union, based on a further deepening of the single market. Bank’s exposure to the debt of their own sovereign needs to be eliminating the exemption of investments in sovereign debt from the large exposure rules and by applying a non-zero risk weight to sovereign debt in the capital ratios. Only when the EMU will be completed along these lines can the euro be permanently stabilized.

Keywords: Banking union – Capital Union – Treaty change – Systemic banking crisis.


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1 Introduction

Mid 2014, the EMU remains unfinished, but the Banking Union as agreed until now has strengthened it in important ways, although crucial pieces are still missing to achieve a truly European banking union. After the European elections of May 2014, one can hardly expect more progress due to political fatigue and a false sense of comfort as the financial markets are temporary tranquillised by the ECB’s impressive non-standard measures.

We develop an ideal model for a Banking Union, which aims at maximising welfare and financial stability in the EU and the Eurozone, while disregarding those national or industry interests that hinder true financial integration in Europe. A well functioning Banking Union requires a further transfer of important competences towards federal European institutions, focused on the Eurozone member states and the EU member states that have to adopt the euro when they are ready. It also requires sufficient risk sharing, but ideally bank restructuring and reducing the role of banks in financing the economy should prevent that systemic problems erupt again. Taking into account the radical political consequences of applying this model of a Banking Union and the fact that it requires a treaty change, which is an arduous and long process, we also propose a second best solution that is based on the current Treaty, while using its institutional and legal capacity to the maximum extent. The required shift of powers to the federal level will meet opposition from the banking industry and national authorities captured by their financial industry; hopefully the wish to protect taxpayers from having to pay for bank failures seem to counterbalance the latter effect in a number of member states.

It is remarkable to observe the lack of scientific work on Banking Union as compared to the vast amount of research done on monetary policy, although the Banking Union is probably of the same importance as the creation of the euro and the ECB. Therefore we tried to summarise the existing literature and to extend the theory of optimum currency areas to reflect the need for a banking union.
2 Economic consequences of a Eurozone without a Banking Union.

The economies of a well functioning Monetary Union benefit from a single interest rate, reflecting the monetary policy stance of their common central bank. During the first phase of the EMU, this was also the case in the Eurozone. Shortly after the financial crisis, in 2009-2010, investors started adopting a different and more critical view on the fiscal and competitiveness position of the member states. They realised that the Southern member states suffered from weaker economic fundamentals than most of the Northern member states, problems that could not be compensated anymore by currency depreciations and higher inflation rates. An important variable was also the solvency situation of the governments, itself related to the solvency of domestic banks. This was the case for Ireland, where the boost of a real estate bubble and the weak supervision lead to the collapse of major banks and a sudden increase of the sovereign by 30% GDP, because these banks were too big to fail. The dangerous embrace of banks and sovereigns in the Eurozone is the result of the fact that banks hold a large amount of domestic government debt on their books. Total sovereign bond holdings at the books of banks amounted to around 1200 billion euro at the end of 2007 and increased to 1720 billion euro of government securities mid 2013 (around 18% of the Eurozone GDP); thereafter it stabilised.

The share of domestic government bonds at the books of domestic banks went down after the introduction of the euro, illustrating the beneficial effect of the euro on financial sector integration. After the start of the crisis however, this trend was suddenly reversed. Banks from Northern member states stopped investing in sovereign debt of Southern member states, whereas domestic banks of the latter countries increased their exposure on debt of their own sovereigns: from 16 to 22% in Italy, from 26 to 33% in Spain, from 10 to 25% in Ireland and from 14 to 18% in Greece (even taking into account the debt restructuring of Greek sovereign debt in 2011). Spain, Italy, Portugal and Ireland now hold more than 700 billion of domestic sovereign debt on their books while in 2007 it was around half that amount. The reasons for “home bias” (the fact that banks hold a disproportionate share of debt of their own sovereign) are several. First is the “moral suasion” by national regulators; it is in the self-interest of banks to make domestic government financing more dependent on domestic banks, so as to have another argument to force the government to rescue domestic banks in case of banking problems. Another is “carry trades”, where banks are betting long on high-risk sovereign debt, a phenomenon seemingly more prevalent in the Southern member states. Funding such exposures was also made possible by the ample liquidity provided by the ECB starting end 2012, via the three years Long Term Refinancing Operations. Additional factors that could have amplified the home bias approach were recommendations from core country supervisors to domestic banks, which demanded risk reduction of their sovereign portfolios. And finally there is the systemic risk of an extreme scenario of a Eurozone break-up, when liabilities of banks would be re-denominated into local currency and so would the domestic sovereign debt,
hence domestic banks would be better prepared for redenomination of domestic sovereign debt than foreign banks. Battistini, Pagano and Simonelli confirm that “moral suasion” and “carry trade” trade hypothesis are particularly valid for peripheric countries’ banks, whereas systemic risk scenario of the euro break-up forces all banks to “turn back home” and even more those in core countries.

Ideally, a bank should be able to go bankrupt, as any private company. However, if a bank faces difficulties, it is sometimes hard for a government to let that private institution fails, as is the case for other non-financial companies. This is even more valid for large banks (and 85% of all assets in the Eurozone are held by some 130 banking groups). If such a bank would go bankrupt, a large share of families lose their savings, something politically hard to accept and disastrous for the economy as the loss in wealth would shock demand in the country and bring down growth. All banks are interrelated and one bank going broke brings down other banks, which have them lend money via the interbank market or other channels. This is the problem of “too big to fail”. In the absence of a European fiscal backstop (something we argue for in this paper) only the national governments can rescue their banks. This sets in motion the “vicious circle” or “doomed loop” between banks and sovereigns: weak banks are more likely to add to the public debt problems and countries with a high or even unsustainable public debt are considered too weak to back their banks, leading to vulnerable banks that are distrusted by other banks and loose access to cheap funding via the interbank market. The result is that markets start to link the fate of governments to the solvency of the banking system and the other way round. At least, that is the case in the Eurozone; in the USA there exist no such relationship. This is illustrated in Figure 1 where the CDS premia on sovereign and bank debt is correlated.

Figure 1: Relationship between banks and sovereigns (Daily observations since end 2010)
This is due to the fact that banks hold a much smaller part of total US federal sovereign debt and of the debt of the States (which are subject to strict debt rules), to the special investment status the USD enjoys as the first international reserve currency and to the fact that Eurozone banks rely more on volatile wholesale funding while US banks are more funded via equity and customers deposits (IMF, October 2013). However the main reason is probably the existence of a fiscal backstop in the USA that helps the FDIC to resolve smaller banks in a credible way via its 100 bn USD credit line to the Treasury. TARP (original 700 bn USD) can be considered as an ad hoc fiscal backstop to rescue or resolve systemic banks.

The close relationship between banks and sovereigns in Europe results in a kind of Berlin wall between banks in the South and those in the North. Banks of the South are considered to be weak as they are linked to a weak sovereign and concentrate their business in weak economies while the banks of the North are considered to be strong as they are related to a stronger sovereign. As a consequence, strong banks start to distrust weaker banks and financing via the interbank market becomes more difficult - if not impossible - for the Southern banks, leading to higher financing costs and higher lending rates.

The doomed loop between banks and sovereigns increases the costs of credits for business and households in the Southern member states leading to less investment. The fact that the economies of the eurozone are financed for around three quarters via banks (less than one fifth in the USA) increases the impact of this problem for investment and demand.

Table 1 illustrates that Vulnerable Euro Area Periphery Countries (VEAPs, a nice and better definition of what was called the G103 countries before: Cyprus, Greece, Ireland, Italy, Portugal, Slovenia and Spain) performed at the same level as the Euro-area, even a bit better than the North/core, prior to the outburst of the eurocrisis. During the period 2010-2014, the sudden capital withdrawal and the austerity needed to readjust their economies led to a negative growth rate (except for Ireland) and a skyrocketing unemployment rate.
An even more illustrative way to summarise the consequences of the eurocrisis for the VEAPs is the “Misery index”, developed by the American economist, Arthur Okun in the 1970s to monitor the consequences of the economic policy of the Carter administration. We apply a modified version including the unemployment rate, the long-term interest rate (reflecting both the inflation rate and the real long term interest rate) and deduct real GDP growth (Geeroms et al., 2014). The idea is that high levels of unemployment, of inflation and of real interest rates all contribute to the economic misery of a country while stronger GDP growth alleviates the misery and therefore is deducted.

We observe in Figure 2 that the misery index decreases in all countries prior to the introduction of the euro and continues to do so until around 2008. The financial crisis of 2008-2009 and even more the eurocrisis have reversed that trend in all VEAPs.

Figure 2: Misery Index (*)

(!) The Misery Index is the sum of the long-term nominal interest rates and the unemployment rates minus the year on year real GDP growth rate.
The Eurocrisis revealed the fundamental problem of the “vicious circle” or “doomed loop” between sovereigns and banks. It was reflected in the report “Towards a genuine Economic and Monetary Union”, prepared by the Four Presidents (of the Council, the EC, the Eurogroup and the ECB), who proposed the creation of an “integrated financial framework” or “banking union” as one of the four building blocks of a complete EMU. The report stresses the need to “break the link between banks and sovereigns”. We shall illustrate in the rest of this paper that even more is needed than the banking union proposed in the Four Presidents report (Single Supervisory mechanism, Single Resolution mechanism and Single Deposit Guarantee mechanism, the latter not even considered anymore): Europe needs a truly European Banking Union including an integrated capital market in the medium term for the survival of the euro itself. If it is not properly constructed and financial market defragmentation remains, there will be very limited restoration of economic activity in the peripheral countries and at best marginal improvements in labour markets, especially given the limited room for the ECB to stimulate demand and the absence of political will in surplus countries to increase demand in the eurozone. Given that economic and social welfare is the backbone of the European integration, the EU may become politically destabilised. The political backlash the EU is facing after the European elections already illustrates that danger. The rise of Eurosceptic parties itself hinders the much needed Treaty Change.
3 Theoretical foundations of a Banking Union

The Theory on Optimal Currency Areas (the oca) states that a monetary union will only survive if the benefits of more economic integration due to adopting a common currency are larger than the disadvantages caused by the loss of the exchange rate instrument. If that condition is not met and an economy is hit by an asymmetric shock, sufficient flexibility in factor markets can solve that problem. This flexibility has two aspects: across the board mobility and flexible prices.

Labour mobility is close to nil between North and South and low between West and East of the eu. Cross border mobility within eu15 in 2010 stood at just 0.35 %, which compares to interstate/province mobility in the us, Australia and Canada of 2.4, 1.5 and 1 %, respectively (oecd, 2012). Labour markets in the eu are much more regulated and wages display downward rigidity, while cultural/language differences also inhibit migration. Concerning the factor capital, before the eurocrisis, cross border capital mobility was high, as a result of the single financial market after the introduction of the euro; but after the eurocrisis, banks withdrew behind national borders and this condition for a successful monetary union is now weaker than before. This problem is in itself a strong reason for a Banking Union.

Conditions for an Optimal Currency Area

If an economy is adversely hit by a shock and the labour markets cannot absorb that shock, a monetary union is still viable, the oca concludes, if there is sufficient solidarity and shock absorbing capacity at the federal level. The eu budget amounts to 1 % of gdp, only about half of its spending can be considered as fiscal transfers from richer to poorer Member States, but this concerns mainly structural solidarity, not a shock absorbing capacity to amortise the impact of idiosyncratic shocks. The revenue side of the eu’s budget is largely based on the vat basis and gdp, but the implied transfer is more from richer to poorer member states than from booming member states to those suffering a recession and this solidarity is to a large extent also flattened via the uk rebate and the rebate on the rebate of other net payers. Moreover, the eu Treaty includes two “no bailout” clauses, meaning that fiscal transfers are limited to the eu budget.
or separate intergovernmental arrangements - European rescue funds: the temporary EFSF and the permanent ESM. Currently these instruments constitute additional funds of more than 5% of GDP that can be used to help mitigate imbalances within the EMU and support structural change. These funds can be deployed only in programme countries and have to be repaid, so they cannot serve as automatic stabilizers and shock absorbers for the whole EMU but rather as financial assistance instruments, which are used in times of real hardship. They include an element of solidarity because the sovereigns that back the rescue funds accept risks rejected or overpriced by the private financial markets.

It is interesting to note that the traditional 1960’s OCA theory does not provide any theoretical foundation for a banking union. This could probably be explained by the capital restrictions prevailing in these years; the dramatic surge in international capital flows was only triggered by the oil shock in 1973-1974, the growth of the Eurodollar market and the remarkable increase in bank lending during 1979-1981 (Kaminsky 2005). The OCA theory was developed well before that period and could not draw lessons from sudden reversals of capital flow that caused a Latin American debt crisis (early 1980’s), a Scandinavian debt crisis (early 1990’s), a South-east Asian debt crisis (1997-1998) and a Russian debt crisis (1998). The theory was also developed by international economists who may have been less focused on financial theory (Maes, 2002).

We can explain the role of a Banking Union in the framework of the OCA theory in two ways: 1) the absence of a Banking Union can be a reason for important asymmetric shocks due to sudden capital flow reversals, while 2) a well functioning Banking Union can be an important instrument to accommodate such shocks. The Banking Union has the unique feature of both increasing risk sharing through a private and a public insurance scheme. Private: it will increase financial integration by harmonising regulation (single rulebook, single supervisory mechanism, resolution plans). Public: it introduces a kind of fiscal federalism in the banking sector in Europe, at least when a banking crisis emerges. Therefore it fits into and complements the OCA-theory as it increases risk sharing and alleviates the impact of asymmetric shocks.

3.1 Destabilising capital flows in the absence of a banking union as the main reason for the Eurocrisis.

The volume of capital flows grew steadily from the mid 1990s to 2000 but then took a dip during the 2001-2002 recession before a near tripling in flows between 2002 and 2007. At the peak, gross capital flows exceeded 40 percent of the Eurozone GDP, far in excess of other advanced economies.

The common shock absorbers i.e. flexible labour and goods markets can never be sufficient to compensate for shocks of the magnitude caused by the vast volumes
of capital flows that have amplified the existing imbalances. The Euro area countries exchange goods and services equivalent to around 20% of euro area GDP per year, compared with 15% in 1999 (ECB 2013). The pre-crisis volume of capital flows within the Euro area was twice as much as the volume of intra Eurozone trade.

Paul De Grauwe (2011) outlined why the capital flow reversal provoked such an important asymmetric shock in the Eurozone. He proves that the very fact that a member of a currency union loses control of its own currency and central bank makes it more vulnerable to capital flow reversals and speculation against its sovereign debt than countries that keep their currency. The latter can still monetise their sovereign debt or the central bank can allow higher inflation to erode the domestic debt. Even more important is the fact that capital outflows in such countries lead to a currency depreciation or, if not exported, can only be reinvested in the same economy bringing the interest rate down again. In that sense, he explains why American and British sovereign debt was not attacked by the markets - although these countries have weaker economic fundamentals than the Eurozone. The sovereign debt of several VEAPs was suddenly dumped early 2010, but in their case, the capital outflow was in euro, a currency shared with other countries that benefitted from capital inflows, the mirror of the outflow from the VEAPs. Greece, Portugal and Ireland did not benefit from a drop in their currency nor had they the possibility to allow a higher inflation rate. The results are described above: they became disconnected from the financial markets and needed support from the other eurozone members.

One can add that a currency zone like the EMU offers more protection against such sudden capital reversals compared to a system of fixed exchange rates. Indeed the Target II system compensates the domestic banking sector from the weaker countries, at least partially, from deposit and funding withdrawal via the possibility to build up debts via Target II balances.

3.2 A Banking Union is needed in a monetary union.

Mundell himself (1973) added a new OCA property after developing his original approach of the early sixties. He showed that a common currency could better mitigate adverse shocks by reserve pooling and portfolio diversification. He argued that countries suffering from asymmetric shocks could still share a common currency while missing labour flexibility and a solidarity mechanism, if they can “insure” each other through financial markets. Financial integration permits to cushion asymmetric shocks through capital flows: deficit countries can borrow from surplus countries or can sell foreign assets if needed to finance their current account deficit. Under a common currency, a country suffering an adverse shock can better share the loss with a trading partner because both countries hold claims on each other’s output and “insure” one another through private financial markets.
Figure 3 illustrates that until around 2005, financial integration in the Eurozone increased (for corporate bonds even until 2008) but this tendency was reversed since then and banking sectors started to withdraw behind national borders, thereby making theEMU more vulnerable to shocks (see also de Sola Perea and Van Nieuwenhuyze, June 2014). The same tendency is observed for investment funds’ holdings of debt securities and equity (ECB, financial integration indicators). The collapse in capital flows in 2008-2009 was truly remarkable, falling to about 5 percent of GDP; global capital flows are now one third of the pre-crisis level (Lane, 2013).

In a well-functioning single market capital flows should lead to equalisation of the marginal product of capital across member states and that would be the only determinant of capital flows and domestic saving rates would be uncorrelated with domestic investment rates. Feldstein and Horioka (1980) observed that this is not the case in the world, due to differences in taxation and regulations, besides other reasons. We observe that since the eurocrisis, the fragmentation of the EU’s single market and the eurozone became very prevalent.
One of the reasons is probably that banks are still very much “national banks” in the EU (see Figure 5), supervised by national prudential regulators that impose rules on their banks resulting in restrictions on international capital flows.

Figure 4: Collapse of financial integration since financial crisis (Correlation between savings and investment in the member states of the Eurozone(*))

Figure 5: Foreign ownership of banks

(*) The higher the correlation, the lower the financial integration and risk sharing between member states.
Banks in the EU remain to a large extent national, if we look at the relevant parameters “number of foreign owned banks” and “assets owned by foreign banks”. The “nationalisation” of banks is more outspoken for the bigger member states, France, Germany, Spain and Italy (and the Netherlands) than for the smaller member states. The smaller member states have much more foreign banking activities and this is even more outspoken for the central European countries. It is therefore no surprise that France, Germany and Italy are among the most reluctant in transferring the responsibility for banking resolution to the EU level.

The policy reforms should aim at a new financial environment with less destabilising capital flows (such as excessive debt flows intermediated by non-diversified local banks) and increased stabilising capital flows (such as equity flows and debt flows inter-mediated through diversified banks that are embedded in an area-wide banking union). (Lane 2013)

A monetary union therefore needs a single financial market and a Banking Union. Schoenmaker (2013) reformulates this conclusion in the form of an “impossible trinity” of simultaneously having integrated banking markets, national supervision and financial stability. This impossible trinity can logically only be overcome in one of two ways: either, one returns to a world of segmented, national banking markets and forgoes the benefits of integration (an undesirable path we are following since the eurocrisis), or one moves towards supra-national structures for financial supervision and resolution. It is estimated that capital markets integration in the USA explains the absorption of two-thirds of shocks in the USA (Sørensen and Yosha, 1996). Gros (2012) illustrates, comparing the US State of Nevada with Ireland, that a banking union is more important as shock absorber than a fiscal union.
The EU and the Eurozone’s Banking Union

The Report of the Four Presidents (Towards a genuine Economic and Monetary Union) rightly suggests that the **EMU** requires an integrated financial framework or a Banking Union built on three pillars: a single supervisory mechanism, a single resolution mechanism and a single deposit guarantee scheme. One should also add the crucial need for the Single Rule Book, the harmonised application of the **EU** rules and the development of European capital markets. The Eurozone countries have to finalise the **EMU** architecture and financial sector fragmentation is a key obstacle for the smooth functioning of the common monetary policy and a major obstacle to investment, economic growth and prosperity. Therefore the creation of an integrated financial framework allowing for a proper **EMU** functioning via a centralised system of bank supervision, resolution and depositor protection is the only option. After monetary policy has been transferred to the central level, the same approach for bank supervision, bank resolution and a common deposit guarantee scheme is a logical consequence given that fiscal and economic policies cannot be centralised to the same extent. The goal of a mutual approach to the banking sector by the Eurozone not only derives from the Eurocrisis, but will also pave the way for more competition, sounder financial institutions and a safer environment for consumers, thereby contributing to higher growth for the Eurozone.

The same holds for those **EU** Members that have to join the common currency when they are ready and could be willing to enter the Banking Union before that time. Therefore they have secured themselves an opt-in clause in the first pillar of the Banking Union, namely the **SSM**, and now look for similar provisions in the second pillar, the **SRM**. The reason for that is not only that they will sooner or later join the euro but also that their financial markets are dominated by the Eurozone banks. In the case of Central European countries, foreign owned banks cover from above 50% to almost 100% of a given country banking sectors. Therefore one could say that these countries will be under the Banking Union umbrella even without being formally a part of it.
The Single Supervisory Mechanism - first pillar of the Banking Union

Due to the financial crisis, several member states entrusted their central banks with prudential supervision based on their credibility – which was lost by separate prudential supervisors – and reaping the synergies between monetary policy and prudential supervision (recently the UK). This is the so-called “Twin Peak” model. There is no convincing evidence that this model is superior to a model of separation of supervision and monetary policy (Whelan, 2012). Countries have used and still use different models; some even introduced the Twin Peak model and are now considering returning to the old model of separation. However, at this moment, the large majority of the Eurozone countries apply the Twin Peak Model. It is therefore surprising that so many protested when the ECB was asked to become responsible for prudential supervisions.

Central banks are probably the most trusted institutions in the financial-economic world, even more so after the financial crisis of 2007-2008, so the ECB was made responsible for the SSM. Based on the principle of subsidiarity, because the supervision of around 6000 banks in the Eurozone is a huge task for an institution without any experience in prudential supervision, and because national authorities prefer keeping an eye on their own banks, the ECB is assisted by the national competent authorities (NCA).

Entrusting the ECB with banking supervision was hindered by the TFEU: article 127(6) was the only solid legal basis possible within the current TFEU, but that article excludes supervision of insurance companies by the ECB, and, more important, it subordinates supervision to the ECB’s decision making bodies, creating a potential conflict of interest when the Governing Council is the ultimate responsible for monetary policy and for prudential supervision. It is a matter of debate to what extent monetary stability can be hampered by prudential considerations. Theoretically it might happen that the Governing Council needs to restrict liquidity in order to preserve its primary goal of price stability but, at the same time, is tempted to provide liquidity to a bank in order to rescue it. In order to circumvent this problem a new body was set up that is separate to the Governing Council, namely the Supervisory Board (SSM) of the SSM. It executes all decisions and is responsible for the whole supervisory business. However due to the limits of the TFEU, the Governing Council of the ECB remains the ultimate responsible for the decisions on prudential supervision and at least formally has to approve decisions of the SSM Supervisory Board. Safeguards are created as much as possible to ensure a clear separation between the monetary policy and supervisory functions of the ECB (see below), but the final answer to the separation of monetary policy and supervision and to the problem that insurance companies are not covered by the SSM requires a full Treaty Change.
The ssm is open to non-euro area member states via the establishment of “close cooperation”, a specific mechanism that includes provisions for those (non-euro) who are not members of the Governing Council and thereby balances their rights and obligations.

A single supervisor with the credibility of the ECB should be able to overcome the indolence observed from the side of national supervisors, also phrased as ‘light touch’ regulation, to apply the rules in a uniform way, disregarding the flexibility sometimes awarded to ‘national champions’, to overcome supervisory forbearance and other problems related to national supervisors captured by the interests of their national banks. This shall not only contribute to a more stable financial system, but also help to restore the monetary transmission mechanism and thereby reducing the problem of Target II balances (Thimann, 2013).

5.1 Scope of the Single Supervisory Mechanism

The ssm covers all ±6,000 credit institutions established in the euro area. The ssm is the ultimate responsible authority for all banks in the eurozone, but the actual conduct of supervision is delegated to the NCA’s, depending on the size of the banks. The EU argued that even smaller banks can pose systemic risks due to interlinkages and thus destabilise countries and regions; Spanish Caja’s are used as an example (Garicano, 2012).

The actual supervision is differentiated according to the systemic nature of the credit institutions. If a bank exceeds one of the following thresholds, it is considered to be ‘significant’ and is directly supervised by the ECB and the SB:

1) the total value of its assets exceeds €30 billion; or

2) the ratio of its total assets over the GDP of the participating Member State of the establishment exceeds 20 %, unless the total value of its assets is below €5 billion; or

3) following a notification by its NCA that it considers such an institution of significant relevance with regard to the domestic economy.

Furthermore, the ECB supervises the three most significant credit institutions in each of the participating Member States; this is to prevent that a eurozone country would have no bank under the ssm (imagine Cyprus or Estonia) and would just vote on other member state’s banks without being implicated itself. Banks that have requested or received public financial assistance directly from the EFSF or the ESM (not those that received national support) are also considered to be significant. The less significant credit institutions remain supervised by the NCA’s, with a light form of reporting to the SB, while the ECB remains legally
responsible and may always decide to exercise direct supervision of any bank any time, thereby securing full supervisory control. This can become a source of weakness, when it would turn out that the annual reporting is insufficient to warn the ECB of upcoming systemic problems in a group of smaller banks which remain under the radar.

5.2 Tasks and powers of the ECB

The ECB is responsible for an extensive set of tasks ranging from the authorisation of credit institutions to carrying out early interventions in the case of financial distress of a credit institution (ECB 2013). The ssm Regulation provides specific safeguards to mitigate potential conflicts of interest between the ECB’s monetary policy function and its supervisory function, among others:

1) A Supervisory Board (SB) is composed of the chairwoman and the vice chair (a member of the ECB’s Executive Board), four ECB representatives and a representative of the NCA of each participating country. That means that one quarter of the board consists of federal independent experts and three quarters of national representatives. This can be compared with the FDIC that supervises most financial institutions in the USA. The Board of the FDIC has 5 members, three appointed by the President and the Senate, one representative of the Consumer Financial Protection Bureau and one of the Office of the Comptroller of the Currency; there are no representatives of the 50 states. The same applies to the other supervisory bodies in the USA. It has to be seen to what extent the decisions of the SB will be based on European interests or become compromised by national interests. One can hope that the SB will evolve from a meeting of national supervisors to a meeting where everybody adopts a European view on all banks, irrespective of their nationality.

2) The decisions of the SB are deemed to be approved unless the GC objects; this is an important mechanism to prevent potential conflicts between the two roles of the ECB.

3) The deliberations of the ECB Governing Council on supervisory matters is strictly separated from its monetary policy work, including separate agendas and meetings.

4) A mediation panel resolves differences of views of competent authorities of participating Member States regarding an objection of the Governing Council to a draft decision by the SB.
The **ECB** has no experience in prudential supervision; it concerns a huge and complex task and there is a limited pool of experts at the market. It is therefore a challenge for the **ECB** to organise itself as soon and as effective as possible to take over prudential responsibilities from the **NCA’s** and to prevent remaining too long dependent on the **NCA’s**.

Also for its supervisory functions, the **ECB** is accountable to the European Parliament (the **EP**) and the Council. The Interinstitutional Agreement between the **EP** and the **ECB** provides in particular for strong parliamentary oversight of the **ECB**’s supervisory tasks through regular exchanges of views with Parliament’s responsible committee, confidential oral discussions with the Bureau of that committee and further access to information including to a record of proceedings of the Supervisory Board. The **EP** can veto the Chair of the Supervisory Board.

### 5.3 The legacy problem and the comprehensive assessment.

The **ECB** cannot afford to become responsible for banks that later on fail because they had hidden losses on their books; this could destroy the credibility of the **ECB** and of its monetary policy. For that reason, the **SSM** regulation includes the provision that the **ECB** must conduct a comprehensive assessment (**CA**) including:

1) a Risk Assessment exercise: an examination of all types of risk related to funding and liquidity, management, business models and so on; this less known aspect of the **CA** started third quarter of 2013 and is finished,

2) a Balance Sheet Assessment or **BSA** (including an assessment of the balance sheets and of a risk based selection of credit and market portfolios), including an Asset Quality Review (**AQR**) that is scheduled for the first half of 2014, based on the annual financial statements for the year 2013, will make a static assessment, and

3) a Stress test using the output of the **BSA** and jointly conducted by the **EBA** and the **ECB**, will make a dynamic diagnosis for three years ahead.

The **ECB** will assess the banks it will directly supervise. The **AQR** and the stress test will lead to one single figure on the capital needs of each bank. Banks will need to have at least 8% **CET1** (7% of **CRDIV** plus 1% because it concerns systemic institutions). Results of both the **AQR** and the stress test will be published at the same moment, in October 2014. It has to be seen how the responsible institutions will deal with the unavoidable leaks. It is also an open question how to reconcile the secrecy required for the partial results of the **AQR** a bank will be informed off end of June 2014 and the bank’s responsibility to make all market relevant information public due to company law.
All legacy assets, that means possible losses that originate from the time before the ECB takes over supervision, remain the responsibility of the national governments. Notice that this looks obvious, but in reality it is hard to distinguish the legacy from new losses; banks sometimes have claims that last for decades and losses can remain hidden for the ECB and appear later after the SSM has started. Under the CA, the legacy assets will by definition be equal to the capital shortfall detected and published begin November 2014.

The ECB has no other choice than to produce credible results and to withstand the pressure by national supervisors (who want to keep their own credibility intact), from banks (who want to continue their existing business models without raising extra capital) and from national fiscal authorities (which are anxious to avoid that capital shortfalls are detected they have to fund) to hide problems once more (as was the case for the previous unfortunate EBA stress tests). One should not underestimate the importance of the CA by an independent institution like the ECB that has to preserve its credibility also for reasons of monetary policy. Likewise, the ECB has insisted, but the EBA was fully on its side, on a credible stress test, which proved so important to return to solvent banks in the USA (IMF, August 2013). The CA seems to be able to restore confidence in the banking industry; banks already anticipated the outcome and raised close to 100 bn euro of new capital mid 2014. A credible CA will result in a proper functioning of the interbank market, will restore the monetary transmission mechanism and reduce, if not eliminate, the interest rate differentials which jeopardise investment and economic growth in the Southern member states. The Comprehensive Assessment has the potential to become a “game changer” in the Eurocrisis.

5.4 Who cares about macroprudential supervision?

The SSM awards certain responsibilities concerning macroprudential supervision to the ECB (article 5 of the Regulation). Microprudential supervision looks at individual financial institutions in isolation and aims preventing the costly failure of these individual financial institutions in order to protect investors and deposit holders. This was the traditional form of prudential supervision. Starting begin of this millennium, the BIS introduced the idea of macroprudential policy, based on the observation that there can also be risks to the financial system as a whole even when individual supervised institutions are deemed safe. The 2007-2008 crisis brought this viewpoint to the forefront; the crisis was systemic in nature and resulted also from the globalisation of the financial sector, its interlinkages and the adoption of similar strategies and positions.

Macroprudential supervision recognises the importance of the interlinkages between the financial firms and adopts a macroeconomic view, in order to safeguard the financial system as a whole and to reduce the risk and the macroeconomic costs of financial instability. Macroprudential policy uses
diverse instruments, including supervisory tools like countercyclical capital buffers, sectoral capital requirements, caps on loan-to-value (ltv) and debt-to-income (dti) ratios, taxation policy and structural (competition) policy.

In a monetary union and a single market, these instruments become even more important because the exchange rate instrument and the instruments of capital controls cannot be used anymore, although article 65.1b tfeu allows for certain exceptions to the principle of free movement of capital, including prudential measures. Some macroprudential tools can be used in a monetary union to compensate for the handicap of a single monetary policy stance applied to 18 different economies. Macroprudential policy is important to prevent financial shocks and can also help steering the economy after a financial shock, while in normal times, monetary policy seems to be sufficient. The banking and fiscal problems of Ireland and Spain were to a large extent the result of macroprudential failures whereby the monetary and fiscal authorities reacted too late or not at all to prevent a real estate bubble.

The field of macroprudential policy is new and there is limited experience. It is therefore no surprise that the viewpoints on the relationship between monetary and financial stability differ (Yellen, July 2014). The old viewpoint, from before the financial crisis, was that financial stability and monetary policy had little to do with each other. After the experience with the 2007-2008 financial crisis, it was realised that macroprudential and monetary policy could reinforce each other or could, sometimes, oppose each other, in which case a choice has to be made concerning these objectives. As far as the ecb is concerned, if macroprudential actions would run counter to the monetary policy objectives of stable prices, the latter would prevail (Mersch, September 2013); financial stability is a secondary objective and “would lead to a lengthening of the policy horizon of the monetary authority as the financial cycle is longer than the business cycle” (Smets 2013). One could argue that financial stability proved to be a more important concern than inflation risk since 2007-2008. Paul De Grauwe (2007) underlined that the financial crisis had “unveiled the fallacy” of the consensus view in favour of inflation targeting. Axel Leijonhufvud (2008) adopts the same approach while Giavazzi and Giovannini (2010) claim that inflation targeting “can... increase the likelihood of a financial crisis.” Alan Blinder argues that financial stability should come first in the ranking of objectives because “there is no price stability without financial stability”. In 2014, the risk of deflation is more relevant than the risk for inflation. The question arises to what extent the goal of financial stability is an argument for accepting a higher deflation risk.

The European Systemic Risk Board, hosted by the ecb, is responsible for macroprudential oversight at the eu level; it has to prevent and mitigate systemic risks that might undermine the financial stability of the eu. The esrb collects information, identifies systemic risks, issues warnings and recommends measures to national authorities, the eu or other esfs bodies. The esrb has disappointed until now, due to its heavy structure but mostly because it has soft power and can only issue recommendations to other institutions and member states who rarely take action based on these recommendations.
Under the SSM regulation, the ECB will indeed play an important macroprudential policy role. The ECB will be able, in addition to the national authorities, to apply certain measures addressing systemic or macro-prudential risks. These measures include higher requirements for capital buffers, in particular counter-cyclical buffers. Other macro-prudential instruments, such as loan-to-income and loan-to-value ratios, remain the sole responsibility of national authorities. While a Supervisory Board was created for microprudential supervision, no such institution was set up for macroprudential supervision, therefore these tasks will lie within the SSB.

The ESRB should be strengthened, both in terms of resources and in terms of powers, because financial markets in the EU are integrated (and should even become more integrated as we argue in this paper) and the ESRB is the only institution to coordinate the national macroprudential policies of the Out’s with those of the participating member states of the SSM.

There remains a case for reviewing the objectives of the ECB (article 127) and change the TFEU so that the ECB can decide which objectives have to prevail at a certain moment. The ECB should play a bigger role in macroprudential policy (i.e. loan-to-income and loan-to-value ratios could also fall into the competence of the ECB if it judged that national authorities set these ratios too low) and decision making should be simplified. The ECB should dispose of the appropriate set of instruments, some are now the monopoly of member states, and be accountable towards the European Parliament and national parliaments. National fiscal authorities will in any case continue to play a role as they dispose of relevant instruments and are responsible for political decisions such as income and wealth redistribution related to macro prudential policy.
The Single Resolution Mechanism

The second pillar of the Banking Union is the Single Resolution Mechanism (SRM). It builds further upon the Bank Recovery and Resolution Directive (BRRD), adopted by the Council end of June 2013 and planned to come into force begin 2015; it will apply to banks and investment firms.

6.1 Actual situation: critics of the BRRD and the SRM

6.1.1 The Banking Recovery and Resolution Directive for the EU28

The BRRD tackles potential bank crises at three stages (EU, June 2013):

1) Banks have to set up recovery plans, a list of measures to restore their financial position in case of problems. Resolution authorities have to prepare resolution plans, defining actions needed if an institution were to be resolved (the “testament” of the bank).

2) Resolution authorities have the power to “take over the bank”.

3) The main resolution measures include: sale of (part of) a business, establishment of a bridge institution (the temporary transfer of good bank assets to a publicly controlled entity or “bad bank”), asset separation (the transfer of impaired assets to an asset management vehicle) and bail-in measures. The latter are the most controversial.

The bail-in instrument enables resolution authorities to write down or convert into equity the claims of the shareholders and creditors of institutions which are failing or likely to fail (so-called “going concern” as compared to “gone concern” or failed bank). The ranking order of bail-in is crucial: first of all ordinary unsecured, non-preferred creditors are bailed in, like shareholders, bondholders and deposits from large corporations. If that is insufficient, the resolution authority can bail-in deposits from natural persons and sme’s; these have preference over the claims of the previous creditors. Deposits up to 100,000 euro are protected by the Deposit Guarantee Scheme (see below) and are never bailed in; these are called “covered deposits”. Certain types of other liabilities are also permanently excluded, such as covered bonds, liabilities to employees, liabilities arising from a participation in payment systems and certain interbank liabilities. In order to prevent that banks would base their funding too heavily on deposits, rules on the Minimum Required Eligible Liabilities (MREL) will be imposed on the banks (to be developed by EBA), so as to prevent the Cyprus scenario, where also deposits had to be bailed in due to a lack of liabilities in the form of bonds.
To solve cases when the bail-in is insufficient, member states have to set up ex-ante resolution funds, which need to reach within 10 years at least 1% of covered deposits of all the credit institutions in the country. Financial institutions have to pay into these funds via contributions based on their liabilities, excluding own funds and covered deposits, and adjusted for risk. A country can choose to merge this fund or to keep it separate from the pre-financed fund foreseen under the deposit guarantee scheme.

Before any state intervention is possible, at least 8% of the balance sheet of a bank has to be bailed in, although exceptions are possible in certain circumstances, including financial stress.

The EC’s new State aid rules applicable to support measures for banks in the context of the financial crisis (August 2013) mirror the provisions in the BRRD; they stipulate that equity and subordinated bondholders must definitively be wiped out before any state assistance can be considered. EU state aid control thus effectively constitute the basis for bank resolution well before the BRRD and the SRM take effect in 2016 (Deutsche Bank, 2013).

There is a heated debate about the bail-in with arguments for and against but looking at the Cyprus case, where it resulted in capital controls, one needs to treat this instrument cautiously. The BRRD rules also allow for state support in certain cases and this leaves the door open for a differential treatment of banks, whereby strong governments can support their banks, while weak governments can not afford it. This can again lead to financial fragmentation.

It is important to facilitate other resolution instruments that have already been tested (sale of a business, established of a bridge institution, asset separation) also when it comes to cross-border mergers and acquisitions. The American FDIC (see later) resolved some 490 banks since 2007, but most of them were acquired by other banks, mainly from other States; in the Eurozone this is, most of the time, not the case, Fortis being one of the few exceptions. The Single Market Acquis should be enforced and it should be avoided that national authorities continue imposing a strong home bias when it comes to rescuing banks.

6.1.2 The Single Resolution Mechanism for the EZ 18 and the willing


1) The Single Resolution Authority (SRA) is based on article 114 TFEU. The decision making process is complex and involves several institutions. The Board consists of an executive director, four full-time appointed members and the representatives of the national resolution authorities of all the participating countries. It can meet in executive session, including
only the director, the four full-time members and the representatives of member states concerned by a particular resolution decision. The ECB starts the resolution process via a notification to the Board that a bank is failing or likely to fail or the Board can decide itself placing a bank into resolution. It then decides the application of resolution tools and the use of the single resolution fund. Decisions by the Board will enter into force within 24 hours of their adoption, unless the Council objects. Most draft resolution decisions are prepared in the executive session. The plenary session is responsible for decisions that involve liquidity support exceeding 20% of the capital paid into the fund, or other forms of support, such as bank recapitalisations. If the European Commission disagrees with the Board, it has to go to the Council. We agree with those arguing that the decision-making process is cumbersome and involves too many bodies (Lorenzo Bin Smaghi, December 2013). It is also the case that the role of the ECB will be marginal as it can only change a decision by the Board via the Council. As a last point, we think that the decision to put a bank in resolution should be taken by the supervisor; mixing this role with the SRA can only water down the resolution process.

2) A Single Bank Resolution Fund (SRF) is set up under the control of the SRA to ensure the availability of medium-term funding support while the bank is restructured. It needed to be based on an Intergovernmental Agreement, because Germany was afraid that such fund could impact on its budgetary sovereignty. During the first eight years, a network of national resolution funds will operate including the possibility to lend from each other on a voluntary basis and from the capital markets, up to certain limits; there will be no real common fund, but rather a mechanism whereby the national resolution funds are gradually merged. All bail-in tools of the BRRD first need to be exhausted before the SRF can be tapped; it is the last but one line of defence before the ESM is used as a fiscal backstop but via the national budgets. The very last line of defence is the possibility for the ESM to invest directly in a bank (so called ‘direct bank recap’) but up to a total amount of 60 bn euro, a cap decided to prevent that the ESM would risk losing its AAA-status. After eight years, a common SRF will be in place. During this eight-years transition period, the Council will discuss the possibility of a fiscal backstop.

The SRF is based on an Intergovernmental Agreement (IGA), although three legal services (of the EC, the Council and the ECB) argued that article 114 TFUE was sufficient legal basis, but Germany vetoed this legal approach. An IGA runs counter to the Community method, it adds to the complexity of EU decision making and it sidelines the European Parliament.

This complex system of decision making, based until 2024 on a future network of national resolution funds and without fiscal backstop cannot be called the key stone of the Banking Union. Before we develop a blueprint of a real single resolution mechanism, it is useful to look at how this is organised in a monetary union of the same size as the EZ, namely the USA.
6.2 Bank resolution in the USA

It is worth comparing with the US model of FDIC (Federal Deposit Insurance Corporation) that has been established in 1934 as a consequence of the Great Depression and which is responsible for resolution of banks but also insures deposits of up to 250,000$. FDIC was the outcome of a political alliance generated during the great depression. Crises present opportunities for the creation of bold new institutions, when in the name of preserving the benefits of an existing system new institutions are needed to prevent the system’s collapse. Crucially, the ultimate credibility of the FDIC rests on its ability to change the risk assessment to replenish losses, to engage in effective supervision and liquidation, and by its unique status, being backstopped by the federal treasury and the Federal Reserve. The Deposit Insurance Fund of the FDIC is funded by its member institutions through premiums and assessments paid on deposits, according to the risk a bank poses and different for smaller (below 10 bn USD assets) than for larger banks. The Dodd-Frank Act includes that the size of the DIF should be minimum 1.35% in 2020 of the insured deposits and increase to 2% later on, but does not set a maximum. This would amount to more than 80 bn USD or some 0.6% of total assets of US banks. If needed the FDIC can draw on a credit line of 100 bn USD with the US Treasury. FDIC deposit insurance is backed by the full faith and credit of the United States government. This means that the resources of the United States government stand behind FDIC-insured depositors (Aizenman 2012).

Since the financial crisis the FDIC resolved 484 ailing institutions (situation end October 2013), but the average balance size was 1.4 bn USD, with very few banks larger than 3 bn USD balance size, so it concerned smaller banks. The systemic crisis of 2007-2008 was indeed much too large for the resources of the FDIC. The Emergency Economic Stabilization Act of 3 October 2008 created the Troubled Asset Relief Program or TARP in order to purchase or insure troubled assets up to an amount of 700 bn USD, later reviewed to 431 bn USD. TARP played the role of an ad hoc resolution fund, financed by the federal treasury. Besides that, the originate-and-distribute model applied to mortgage backed securities, lead the two Government Sponsored Enterprises, Fannie Mae and Freddie Mac to take over 16 percent of the non-financial sector debt. In September 2008, the federal government took control of both GSE’s.

6.3 A real Single Resolution mechanism: scope

While we would ideally argue in favour of a real pan European banking union that is directly responsible for all banks in the eurozone, political realism forces us to look into the direction of the subsidiarity principle for a pragmatic yet effective SRM. We think that a useful distinction can indeed be made between significant and non-significant banks or between European and national banks. We argue in favour of covering only the systemically important banks or
“European banks”. The scope of srm and ssm should not be the same and the srm should have a certain degree of discretionary power to include certain banks within the parameter of the srm. Because we opt for a real European Resolution Authority instead of a Board with all member states (see below), there is no need to include at least three banks of each member state as is the case in the ssm where it is needed to implicate all member states in supervision, an argument that does not apply if we go for a federal resolution authority. This distinction allows to have at the same time more Europe and less Europe: member states will be more responsible for the non-significant banks and there will be more Europe when it comes to stabilising the financial system. This would also address the problem that the same rules for small and big banks give privilege to big banks who have more instruments (manpower, experience, legal expertise) than small banks to influence regulators, not to mention that sifis, posing systemic risks, are treated differently by governments. Therefore treating them similarly when it comes to resolution is logical.

6.4 A real Federal Resolution Authority

The Single Resolution Authority (sra) should be “able to act timely and efficient, if necessary, within a very short time, such as a few days or, where necessary, a few hours” (ecb, 2013). The srm builds further upon the brrd, which is the first “line of defence”. The European level is of crucial importance however; it guarantees better financial stability in the eu and is more effective in resolving banks than a network of national resolution authorities. We share the viewpoint of Yves Mersch (2013) that government interventions to prevent their banks collapsing have resulted in these countries themselves ultimately needing help in the form of an eu/imf programme. It is also the case, as argued by Benoît Cœuré (2013), that a European resolution mechanism, further removed from national banking interests, is more likely to resolve a bank than national authorities, something that would lead to a decrease in the moral hazard problem resulting from the “too big to fail” problem.

Within the current Treaty, the best solution is awarding the European Commission with the task of Resolution Authority: it is an existing body, with vast experience in banking resolution and, via dg comp, it has expertise in the field of state support awarded to banks after the financial crisis. The ec is in principle independent from national interests, it is supposed to act in the Community interest and, what is important, it is accountable to the European Parliament. The lack of credibility of the current Commission in the eyes of Paris or Berlin is not a solid longer-term argument to deny the ec the role of sra.

In order to establish a kind of Chinese Wall between the resolution function of the ec and the role of dg comp, we propose to split the current dg Market in two: one dg for financial markets and banking resolution and one for the other aspects of the Single Market. Both dg’s will be more important in terms of
responsibilities and staff than many other DG’s, some of which can be merged and/or restructured. As a consequence a “Commissioner for the Single Financial Market” should be appointed who would not only facilitate the well-functioning but would also be a guardian of the EU financial market. The nature of the decisions will be similar to those already taken by the EC in the case of mergers and acquisitions and state aid.

Ideal would be an ad hoc resolution authority, but this can only be done after a Treaty Change. Such ideal SRA should be based on the model of a small board of independent experts that would be impartial and take all decisions, appointed for a fixed time period by the European Council, that can decide quickly, after consulting national and European stakeholders (such as DG COMP). This is in fact the model of the Board of the ECB. It is stronger and more effective than the EC, because it would be more independent from political influences. The more federal decisions are, the more flexibility can also be awarded to the decision makers. If national authorities decide, one has to define strict and rigid rules for bail-in and state support in order to prevent a fragmented banking sector. We are afraid that the more power is left with the member states, the less likely it is that institutions will indeed be resolved: decisions will be biased towards concerns of purely domestic financial stability and history has shown that the political influence of banks, although rather invisible, is tremendously big. It is rational for national authorities to support their own banks, even more so if competing member states do the same. However, 28 individually rational approaches lead, in the case of a more or less integrated financial market, to a collectively suboptimal solution. Therefore a federal institution is needed to overcome these spillover effects of individual decisions.

It makes sense that the involved member states participate in decisions on resolution but their role should be limited to assist the Board as described above. In order to allow this decision making process to be open for a constructive contribution from national resolution authorities, one could envisage that concerned national authorities reach a consensual decision on resolution in a given very short timeframe, thereby limiting the role of the Board to assisting during the preparation of this decision. This model would create incentives for national resolution authorities to reach a consensus and, if not, would pave the way for a quick and efficient decision by the permanent members of the Board. One has to acknowledge the special case when the Board would affect national budgetary competences. In such circumstances the affected national resolution authority should be given a voice and in an event of non-acceptance the resolution would be halted and regular insolvency would apply.
6.5 A real Single Resolution Fund: risk sharing

All bail-in tools of the brrd first need to be exhausted before the srf can be tapped; it is the last line of defence, before the esm is used for direct bank recap. This two-tier approach is to be preferred as Wagner (2012) proves.

One has to take into account that the Deposit Guarantee Scheme includes also a pre-financed fund of 0.8 % of covered deposits. National authorities will therefore dispose of 1.8 % of covered deposits in steady state, after ten years, or around 100 bn Euro, based on the size of covered deposits in 2012. In the usa, the Deposit Insurance Fund of the fdic also serves both purposes of deposit guarantee and resolution of banks. A similar model is being implemented in Poland, where the Deposit Guarantee Fund acquired some 2 % of deposits during its 20 years functioning and now is also tasked with resolution.

6.5.1 The size of the Single Resolution Fund

▸ In order to assess the appropriate size of both funds (srf and dgs), we compare with several benchmarks.

▸ The ec (Impact assessment of June 2012) estimates that the appropriate target size of the dgs and the srf together should be between 1 % and 4 % of the eu bank’s covered deposits. If one adds the margin offered by the bail-in tools, the optimal size would be 1 % of covered deposits.

▸ The imf (2013) estimates that a common fund of 1-2 % of total liabilities (excluding equity) would be sufficient in large systems (like the usa and the eu) as an effective safety net. In the imf’s reasoning, the fund is only meant to cover individual banks failures, not systemic crises. This would come close to 300 bn euro (if 1 % of liabilities) or 600 bn euro (in case of 2 %). The imf calculates that the common fund should be 4-5 % in smaller systems; this illustrates the benefits of pooling the national resolution funds and of the srf.

▸ The Dodd-Frank Act requires a minimum contribution of 1.35 % of covered deposits to be increased to 2 percent in the longer term. Currently, the reserve ratio is only 0.63 percent (Ellis 2013).

▸ The fdic can collect additional revenues by requesting banks to contribute special fees. In 2009 the fdic has collected 10.2 bn usd in regular assessment revenues but additional 5.6 bn usd in special assessment and at the end of the year it required insured institutions to pre pay three years worth of insurance premiums that raised another 46 bn usd.
When comparing European and American data, one has to take into account that the balance size of the banks of the Eurozone is around 320% GDP, but only 90% GDP in the USA; bank deposits account for 183% GDP in the EZ and for 59% GDP in the USA.

The EC’s Impact assessment for the BRRD (2012) includes wide ranging estimates, depending on the crisis scenario, the level of contagion and other parameters. If bail-in should be sufficient to absorb losses and recapitalise banks, then the minimum size of the total liabilities that should be eligible for bail-in ranges from 3% to 17% if these liabilities include unsecured debt, uncovered deposits and unsecured interbank exposures above one month maturity.

It is also hard to predict to what extent bail-in will be really used when it comes to a financial crisis of systemic nature and resolution authorities have, for instance, to take into account, that bailing in other banks can result in more problems. The EC’s impact assessment estimates that, without bail-in, the size of the pre-financed fund would need to range between 0.31% of GDP to 27.96% GDP or between 30 and 2 681 bn euro. Such wide range already points to the difficulty of estimating the appropriate size of the SRF.

Because bail-in of shareholders and creditors comes prior to national and European resolution funds it is important that the SRA has an important voice in determining the size of the MREL.

### 6.5.2 The contributions to the Single Resolution Fund

The SRF will be financed by bank levies raised at national level. Ex post contributions can be imposed when the available financial means are not sufficient. The SRF will have access to borrowing from third parties. The following questions need to be addressed: who pays, on what basis, how much, when.

It makes good economic sense to ask the sector to contribute to bank resolution and deposit protection. On top of that, there is the strong political will to let banks pay for the externalities they generate and it is a matter of fairness. The Dodd-Frank Act includes that provision and existing funds in the EU (Belgium, Germany, Poland and others) are also financed by the sector.

Economists consider such bank levies as “Pigouvian” taxes, taxes to compensate for negative external effects (think about environmental taxes). One can argue that the external effects caused by banks are the risk of failure and the required intervention by governments. Because systemic banks (“too big to fail”) create higher external effects, their systemic nature should be taken into account. It is
also the case that larger banks – due to the fact that they are considered to be systemic and therefore benefit from an implicit government guarantee – have access to more and cheaper funding and this artificial (government created) benefit should be taxed for 100 %. Steinbach (2013) estimates that this benefit can range between 3 basis points to 250 basis points, depending on the rating of the bank. Schich and Lindh (2012) found that the 17 largest German banks could save more than 20 bn euro in interest per year because of the implicit government guarantee. Xin Huang (2010) finds that “bank’s contribution to the systemic risk is roughly linear in its default probability, but highly nonlinear with respect to institution size and asset correlation”.

Therefore, the levies best take into account the systemic risk of the institutions, so as to internalise the external effects of socially unwanted risk behaviour. The “Financial Stability Contribution” as proposed by the IMF is an example of a Pigouvian tax that contains systemic risk (IMF, 2010 and Doluca et. al., 2010). Such system is also applied by the FDIC. The higher the projected failure of the bank, the greater the amount it should pay into the SRF; the contribution should compensate the benefits a bank gets from being considered as systemic by the markets. Given that governments spend most money on bank recapitalisation to biggest banks (mainly small and medium-sized banks are resolved, in the USA as well as in the EU), such progressive levy seems fair and based on sound market principles. Research (among others IMF, 2013 and OECD 2013) point to the problem that traditional indicators of systemic risk have failed to predict previous financial crisis and that alternatives are needed.

Levies solely or mainly based on the size of the bank’s assets are not the optimal way to let the financial industry contribute to the SRF. The risks exist that an agreement will be hard to reach about a uniform way to let banks contribute to a possible European Fund, as each member state will calculate the ‘juste retour’ and member states like France, with a large share of systemic banks, will resist such systemic taxes.

These levies will be partially shifted to deposit holders (in terms of lower interest rates), to creditors (in terms of higher interest rates to be paid on credits) and to shareholders and other stakeholders in the bank (in terms of lower profits, lower bonuses and so on). The tax wedge will increase the spread between net and gross interest rates and, together with the lower net profitability, lead to a smaller intermediation role for banks, a role to be taken over by other markets (such as securities) or instruments that might be more or less efficient. But taxing unwanted behaviour exactly aims reducing that behaviour as with environmental taxes.
6.6 The need for a credible backstop

It is always possible that the rescue of a bank is so expensive that neither bail-in instruments, nor the national resolution funds suffice to recapitalise the banks or to resolve them in an orderly way.

▸ Honohan and Klingebiel (2003) estimate that governments spent on average 13 pct. of GDP on resolving banks during a period covering 40 banking crises.

▸ The EU’s impact assessment (2012) summarises the state support to banks between October 2008 and October 2011: “The Commission approved €4.5 trillion (equivalent to 37 % of EU GDP) in state aid measures to financial institutions, of which €1.6 trillion (equivalent to 13 % of EU GDP) was used in 2008-2010. Guarantees and liquidity measures account for €1.2 trillion, or roughly 9.8 % of EU GDP. The remainder went towards recapitalisation and impaired assets measures amounting to €409 billion (3.3 % of EU GDP).”

It is clear that a pre-financed SRF plus bail-in can never cope with the financial consequences of a systemic financial crisis as observed after 2007. This kind of “tail risks” can and should not be insured via pre-financed contributions and constraints on the balance sheet of the banks; the very nature of a systemic crisis makes it unpredictable and all laws of probability that govern an insurance system fall apart. The USA also had to resolve its major banks after the 2007 crisis via TARP, as the Deposit Insurance Fund of the FDIC was much too small. Only drawing rights on the fiscal authorities and the lender of last resort can be effective to deal with tail risks. The concept of “Tail risk” is an argument typically used when it comes to rescuing banks with tax payers money. For other industries, tail risks also exist, but do not offer reasons to rescue them with public funds; the nuclear industry might be an exception. It is the tail risk that a systemic crisis erupts which makes up for the argument of public support.

One important policy line to be adopted is preventing that the final backstop leads to moral hazard. In order to avoid this it should be explained that, at the same time, this backstop will be always available, but will most likely never be used (Verhelst, 2013).

The SRF (and the SDCS) should therefore have a credible public backstop, in the same way as the FDIC has a credit line to the Treasury. This would be an argument to argue for a budget for the Eurozone and own resources (paid by all member states of the eurozone, not by a few, like those that go for the FTT), but in the absence of such common Eurozone budget, the closest substitute is the ESM. Borrowing from the ESM does not suffer from the risk of a downgrading (as is the case for Direct bank recapitalisation by the ESM) as it concerns loans, to be repaid by the sector. The ESM could have a credit line to the ECB for the purpose of bank recapitalisation.
The risk exists that in the absence of a credible fiscal backstop, the Comprehensive Assessment will be flawed (so as not to discover more capital needs than can be afforded by national and European fiscal backstops) and the credibility of the ECB and the whole eurozone can be at stake. We are in principle opposed to direct bank recap out of the ESM (based on the principle that no taxpayers’ money should be used to rescue banks), but in case there is no credible European backstop in place, we defend that the conclusions of the European Council of October 2013 on direct bank recap were made operational by a Council decision of June 2014.

The available lending margin of the ESM (€440bn euro) can be used to support governments in case they have to recapitalise banks and are not able to do so. However, this approach does not cut the “doomed loop” between banks and sovereigns, because the ESM provides for loans and these are added to the sovereign debt; it is irrelevant in this respect whether Eurostat excludes these from the Maastricht debt or not as the financial markets will always consider it as government debt in the economic sense. We would therefore rather argue to give the SRF a credit line to the ESM. Defining the conditions for access to direct bank recap in such a stringent way so as to make the ESM direct recap an instrument for “ultima ratio” intervention weakens the Banking Union and brings it again to the lower level of coordinating national regimes as is the case under the BRRD.

### 6.7 The current SRM compared to the required SRM

We compare below the ideal model of an SRM with the one that has been decided.

<table>
<thead>
<tr>
<th></th>
<th>Ideal model</th>
<th>Current SRM</th>
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</thead>
<tbody>
<tr>
<td><strong>Trigger for resolution</strong></td>
<td>Automaticity plus discretionary action</td>
<td>Discretionary action only - risk of forbearance by national authorities at SRB</td>
</tr>
<tr>
<td><strong>Quick resolution</strong></td>
<td>Able to resolve bank during the weekend</td>
<td>If lack of agreement at executive board, then delays possible</td>
</tr>
<tr>
<td><strong>Effective</strong></td>
<td>Small group of independent experts decide</td>
<td>Dominance of member states and complex decision making procedure</td>
</tr>
<tr>
<td><strong>Resolution Fund</strong></td>
<td>Common Resolution Fund of 1-2 % of balance sheet</td>
<td>Build up of network of funds over 8 years and gradual merging</td>
</tr>
<tr>
<td><strong>Backstop to fiscal authorities</strong></td>
<td>SRF credit line from the ESM - ultimately backstopped by governments</td>
<td>None. The direct recap with a maximum of €60bn is no substitute.</td>
</tr>
<tr>
<td><strong>Credit line to monetary authorities</strong></td>
<td>ESM credit line with the ECB</td>
<td>No</td>
</tr>
</tbody>
</table>
The role of the future Eurozone member states

The Banking Union (the ssm and the weak srm until now) is mainly conceived for the eurozone, to “break the vicious circle between banks and sovereigns”. We explained that this problem results in a fragmentation of financial markets. Paul De Grauwe (2012) has proven that the weakness of the sovereign is the result of the loss of control on its own currency (see above). Therefore the outs have less reason to join the Banking Union than the members of the eurozone. There are several reasons however for the outs to join the Banking Union.

First of all, benefitting from a strong and credible supervision and from a common backstopping mechanism can strengthen the own banks (even if they are small and the local capital markets are still underdeveloped), which is not only good for that sector of the economy, but also for the rest of the economy. On the other hand supervision in those Member States has proved to be conservative and efficient and therefore it would require strong evidence that switching to a new system will be at least equally beneficial.

Second, the large majority of banks in the future euro Member States are controlled by Eurozone banks (Figure 5). Therefore these banks will be under a strong, indirect regulatory pressure from the Banking Union that would limit their scope of action (dilemma of being outside the Banking Union while having banks in the Banking Union). Given that additional prudential responsibilities as stipulated by the ssm Regulation will stay at the national supervisory level, it would be even more difficult to justify their hesitation.

Third, by refraining from joining the Banking Union, those non-euro Member States will allow for the creation of new institutions without their presence. As was the case with the eu institutions, the experience of newcomers is that it takes years to be able to influence the system according to its weight. Joining the ssm and srm helps preventing financial market fragmentation between ins and outs and benefits the single financial market.

Above all, a strong banking union that offers risk sharing and ensures least-cost bank resolution could be an attractive proposition for the euro outs. Moving supervision to the ecb could improve supervisory quality in some countries, reduce compliance costs for cross-border banks, limit the scope for regulatory arbitrage, eliminate host-home coordination issues and increase the congruence between the market for financial services and the underlying prudential framework. A single resolution authority and common safety net, with backstops, would provide further benefits in terms of risk sharing, when these are in place (imf 2013). This would require equal footing for the euro outs as regards resolution and backstopping banks from euro-outs. For backstopping and direct bank recap, one needs to either review the esm Treaty so that euro-out’s willing to join would be entitled to do so under the condition that they
finance the Banking Union backstop part of the ESM, respecting the attribution key. The other option would be to allow the Balance of Payments Facility play the role of a backstop for euro-outs but this would create a different treatment from the one that benefits eurozone members. For the resolution there also seems to be no Treaty limit in granting the same rights to the euro and non-euro members.

But there are also drawbacks and complications, including the interaction of multiple central banks (with implications for the lender of last resort function and the conduct of macroprudential policies), difficulties in ensuring adequate participation of the opt-ins in SSM decisions, a loss of sovereignty and potentially less flexibility to deal with country specificities. These costs are likely to be small, especially for those whose currencies are pegged to the euro, have high levels of foreign currency liabilities or a sizable presence of euro-area banks in their financial system (IMF 2013).

From the viewpoint of the outs, before joining the Banking Union one needs to be sure that credible structures for the SSM are in place and the backstopping is available for them. If that is the case and if the ECB deals credibly with CA, then the way to the Banking Union for the outs will be open. Joining the Banking Union could be justified as described above and would be easier than joining the Eurozone, whose architecture has changed dramatically during the crisis and is still uncertain. Therefore membership of the banking union could constitute a first step on their way to the Eurozone.
The need for a Treaty Change

Some argue that without a Treaty change one cannot create a true banking union. On the other hand a Treaty change is impossible in the short run because the historically low public support for EU integration – including in founding members like France and The Netherlands - could result in dismantling the European Union, instead of strengthening it. Therefore we argue that the current legal framework, although imperfect, constitutes a sufficient minimum to establish a real banking union. In order to achieve this, one should disregard national and industry interests and use the current Treaty to its maximum by creating a centrally managed banking union for European banks. This was possible with the SSM, where even the non-euro member states did not ask for a Treaty change but found a way of safeguarding their presence in the Banking Union (despite the lack of presence at the Governing Council). As argued above there is a solid framework that can be delivered and it constitutes the medium term actions that need to be taken by the end of 2014 and the longer term.

In the short and medium term, the following actions are indispensible:

1) Establishment of the strong Single Supervisory Mechanism that will be well anchored within the ECB; it will be possible only after the bold and credible Asset Quality Review and stress test by the ECB and the EBA are concluded; this seems to be on track.

2) Improve the unsatisfactory SRM, including maximum centralisation power at the EC level and a Single Resolution Fund, entitled to borrow directly from the ESM that should have access to an ECB liquidity line; this seems difficult.

3) For that reason the ESM Treaty needs to be revised and this could also pave the way to accommodate non-euro Members in the banking backstop part of the ESM.

The longer term horizon would entail decisions to establish a Single DGS (the third and essential pillar of the Banking Union) that would be pre-financed by the sector, including risk sharing and a fiscal backstop, and a SRM based on more solid legal ground than article 114 of the TFEU. The further development of the Banking Union requires in the end a Treaty Change for several reasons:

1) article 127.6 of the TFEU is insufficient to fully separate the monetary policy function of the ECB from its role in the SSM;

2) article 114 is insufficient legal base for a fully fledged single resolution fund –something different from the current SRF - as there is a link with fiscal sovereignty; the same applies to a Single deposit insurance scheme;
a new Intergovernmental Treaty is no good substitute for a Treaty Change as it risks further fragmentation of the EU, sidelines the European Parliament, increases the complexity of the institutions, makes it very difficult to involve the EC and has other disadvantages;

4) the objectives of the ECB need to be updated in order to allow more flexibility to achieve the goal of financial stability.

Véron (2013) also argues that

5) Banking resolution requires a new legal basis as insolvency procedures belong currently to the national competences and need to be harmonised at the EU level.

What are the options for a sound legal basis?

1) Limited Treaty Change, based on article 48.6 teu, but this requires that the competences of the EU are not extended;

2) normal Treaty Change, based on article 48. 2-5 teu, which is a lengthy procedure requiring a Convention and risky referenda in member states such as France, Ireland or the Netherlands.

Only option 2) is the way forward solving all legal problems. A political constraint is that it is a long term horizon planning and the need for a banking union is real today, otherwise there will be no severance of the vicious debt-circle of banks and sovereigns without which the Eurozone crisis can again erupt. However, the EU has to convince the financial markets of a credible time path for such treaty change as well as for the creation of a fully fledged resolution mechanism.
Unfinished business: the fourth pillar of the Banking Union or how to solve “too big to fail” in the EU?

The political energy invested in the Banking Union and the short memory of politicians, helped by the fact that the ecb has temporarily calmed down the financial markets with its omts, vltro and other unconventional actions, explains that the lessons of the financial crisis are already forgotten and the required actions to finish the “unfinished business”, namely stabilise the emu to save the euro, are not even mentioned anymore.

The logic of a monetary union cannot be overruled by domestic political constraints. However, if we want to continue with the euro, we face the following trade-off (Figure 6).

If we deepen the Banking Union, we better meet the conditions for an optimal currency zone and we need less a fiscal union; without a Banking Union, we need the shock absorber of a Fiscal Union. At this moment, the Eurozone is at point C: we have only a partial Banking Union and an embryonic Fiscal Union (the eSM). The underdevelopment of financial markets in the Eurozone and the overreliance on banks to finance the economy, many still being too big to fail and undercapitalised, has increased the risk and size of a new asymmetric shock; it has shifted the trade-off line from A to B.
If the Eurozone would face a new idiosyncratic shock, such as an uncontrolled default of a member state due to a prolonged recession, disagreement about the Greek debt restructuring, a new downgrade of the French sovereign paper, stalled political reforms in Italy, legal doubts about OMT, deflation or others, we are in for a new round of ad hoc decisions as was the case with the creation of the EFSF/ESM. Such muddling through process comes at important economic and political costs.

One can therefore be concerned that new problems of unsustainable public and private debt can again become a threat for the survival of the euro, as it was the case (and still is the case to a certain extent) in 2010 with the Greek crisis.

A debt crisis has two sides: there is the side of the real economy, where we have, unfortunately, to observe that the new European rules preventing public and private debt problems are hardly more binding than the Stability and Growth Pact. But there is also the financial side that can be used to prevent that new debt problems spill over to the rest of the eurozone and become a risk for the survival of the euro. The Banking Union is contributive in that sense as it helps absorbing the consequences of economic shocks. Still missing is the following:

▸ solving the “doomed loop between sovereigns and banks” by preventing that banks become too much exposed to their own sovereign;

▸ create truly European banks;

▸ funding the economy less via (vulnerable) banks but more via alternative channels, such as securities and alternative institutions, including private equity funds.

Ideally, the financial industry should be restructured and/or its role in financing the economy reduced to such an extent that it can insure itself against failures, without risking systemic crisis that has to be solved via fiscal backstops and taxpayers support.

9.1 Preventing that banks become too much exposed to the debt of their own sovereign.

CRDIV can be considered as a lost opportunity to limit banks exposure to the debt of their own sovereign, even worse, this new directive and regulation might increase the problem. Indeed, CRDIV includes the risk that the new liquidity requirements stimulate banks holding even more sovereign debt as this asset class is more liquid (Nouy, 2012).
CRDIV continues the practice of attaching zero risk weight to holdings of sovereign debt for the capital requirements of banks. Some argue that such zero risk weighting could be defended prior to the adoption of the euro because the sovereign never goes bankrupt as it has access to monetary financing. But even that was wrong as history proves that sovereigns frequently prefer default rather than to raise taxes or raise inflation (Greece was in a state of default during more than half of its existence). The default of Greece and the need to bail out other peripheral member states proved again that a zero risk weight does not correspond to reality. We therefore think that a non-zero risk weight should be attached to the sovereign debt to calculate the rwa or limits could be introduced on sovereign debt holdings. Bundesbank President Jens Weidmann argued in favour of non-zero-risk weight (Weidmann, 2013) and other Central Bank Governors followed, as did the Chairwoman of the Supervisory Board, Nouy before the European Parliament (27th of November 2013). The USA applies a 20% risk weight on investments in the debt of its 50 States. Only common Eurobonds (or a variant) can be considered as safe in the sense that they are backed by the governments of the whole eurozone and by the ECB as a lender of last resort. Banks need such a risk free and liquid asset, in the USA these are the federal treasury bills and bonds, and this offers an extra argument in favour of a common eurozonedebt.

CRDIV includes the possibility to prevent large exposures or too high concentration of the investment of a bank into the debt of one client (25% of capital), but this rule is not applied to sovereign debt and left to the discretion of the national supervisors. This will not work as national supervisors, national banks and the sovereign are too narrowly intertwined to impose this kind of discipline. We therefore defend the idea that the ECB (SSM) should enforce this rule.

Applying a non-zero risk weight and large exposure rules should be introduced in a gradual way, so as not to disturb the financing of the sovereign debt of member states.
9.2 Development of equity and corporate bond markets

Compared to the USA, bank financing of the real economy is dominant in the Euro Area (Figure 7).

Figure 7: Bank credit to the private sector (bank credit as percentage of total credit to the private non-bank sector, Q1, 2013)

(*) Data on non-consolidated basis and therefore include a large share of loans between related non-financial companies in BE and LU. On a consolidated basis, the percentage is above 40%.

This can to a certain extent be explained by the prevalence of relatively more SME’s in the European economy than in the USA; SME’s rely more on bank financing as they have less access to the securities markets. The reverse side is of course, that securities markets are rather underdeveloped in the Euro Area, something which is even more prevalent concerning private equity financing.
The difference in size and depth of equity and corporate bond markets between the EU and the USA is also due to the heavy reliance of most of the EU member states on pay-as-you-go pension systems and the relative underdevelopment of funded second and third pillar pension systems compared to Anglo-Saxon countries.
On the other hand, the financial and the eurocrisis have offered a new argument to the long list of arguments used by the 
ECB to promote alternatives to traditional bank financing. A higher share of non-bank financing of the economy would 
make the member states of the eurozone more resilient to economic shocks; this would even more be the case, if it would concern long-term cross-border holdings. Insurance companies and occupational pension funds have some 8 trillion of assets that can be invested in long term projects, while the money market funds and investment funds have another 8tn euro, in total some 16 trillion euro of assets, or only one trillion less than total bank deposits in the eurozone. Therefore the 
EU should continue harmonising the obstacles that hinder the development of a pan-European capital market; these obstacles are of a legal and tax nature and are also related to different solvency procedures.

The 
ECB has developed a set of non-standard measures to restore its monetary transmission mechanism; all these measures work via banks. At this moment, the 
ECB undershoots its inflation target; core inflation as well as inflation expectations based on surveys and implicit in market prices point to a medium term and even a longer term inflation rate significantly below 2 %. Never before have the various components of the inflation index reached their minima all together (Praet, 213). However, article 127 TFEU states: “The primary objective of the 
ECB shall be to maintain price stability. Without prejudice to the objective of price stability, the 
ECB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union. The 
ECB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 119". While respecting its mandate, the 
ECB should therefore also aim at restoring credit supply to SME’s, as major drivers for growth and employment in the 
EU (see also ECB, 2013b). This can be achieved via securitisation of SME loans, among others via the EIB (EIF) and other non-bank channels. We do not have to repeat the other proposals of the 
ECB’s Green paper on long-term financing of the European economy (2013) and the reports of the high-level group on long-term financing, including the role that can be played by project bonds for financing long term investments in the 
EU.

9.3 Making banks more solvent.

Considering the traditional Basel rule for bank solvency, the Core Tier I ratios, Euro area banks are better capitalised than US banks. It has been widely illustrated however (among others by the OECD) that the degree of discretion banks have to attach risks to their assets leads to unacceptably high divergences of Core Tier I ratios, even between banks with a very similar balance sheet. Looking at the leverage ratio (ECB November 2013c) reveals that Deutsche Bank has a leverage ratio of close to 1.5 %, while the Basel Committee recommends 3 % as a minimum; also the other major banks of the eurozone, Crédit Agricole, Société Générale, Santander and 
BNP Paribas stay below this minimal threshold. This serious undercapitalisation is also observed by the FDIC (Bair 2013). It is therefore needed that the SSM and the SRM consider the leverage ratio, besides
the capital ratio based on RWA when deciding prudential measures. It would be advisable as well if the EU raises the leverage ratio above 3%, as some national supervisors suggest.

### 9.4 Bank restructuring.

The Liikanen report is also part of the second approach, an approach adopted in the USA and the UK. In the USA, former Fed Chairman, Paul Volcker proposed in 2010 his ideas on bank reform focusing on splitting investment banking from retail banking, while in the UK, the recommendations of Vickers are the basis for extra capital requirements for investment banking.

The basic idea is to make traditional retail banking—whereby a bank concentrates on its traditional intermediation function—safer, by splitting investment banking from that function or imposing higher capital buffers on that part of the bank. Only the traditional bank benefits from state guarantees and bail out mechanisms. In that sense, the restructuring constraints on banks addresses the too big to fail problem by reducing the risk that these institutions will fail and by simplifying their resolution if they do fail.

Due to the absence of a common political viewpoint in the EU, a High-level Expert Group was set up, under chairmanship of Erkki Liikanen, former Commissioner and Finnish central bank president. The so-called Liikanen Group presented its final report in October 2012. The EC agreed its proposal begin 2014. This included a ‘carve out’ for the UK, allowing the UK to continue its own Vickers model, which is super equivalent compared to the EC’s model according to some, but much weaker in its implementation according to others. The legal service of the EC later declared this carve out as illegal, based on single market law. We are not against the coexistence of different banking models in the eurozone and the non-eurozone member states of the EU. Competition will prove which banking model is most trusted by the markets and if the UK, to take that example, prefers a lax legislation resulting in a feeble banking system to attract more savings, it is their problem if it fails and the British taxpayers have to fuel the bill. In the eurozone, we need a stable banking system in each member state however, because all tax payers have to rescue systemic banks of the eurozone as has proven recent history.

The protest of some member states, especially France, against the Commission proposal was outrageous and political support seems absent to make progress with banking restructuring. It is remarkable that the Eurozone, which is so much dependent on bank financing, hesitates to restructure its banking industry; however the USA is also struggling in the process of implementing the Volcker proposals. This only confirms the high influence that banks have on political systems in Europe and the USA.
One can observe lack of support for the Liikanen report in most member states of the EU. The UK prefers its own approach and the other member states are in the process of deciding a watered down form of bank restructuring. France goes for a subsidiarisation model, but allows the deposit-taking institution to carry out more activities than in the Liikanen report, including market-making within limits. Germany considers separation of retail banking if assets devoted to proprietary or high frequency trading and hedge fund financing operations are relatively large in relation to the banks’ balance sheet. Like in France, the enthusiasm of some political parties in Belgium on a radical split of the traditional retail banking and all other activities, encountered the practical difficulties posed by the need to finance the economy and the limits of a small open economy in the centre of the single financial market. The compromise agreement reached resulted in the new Belgian Banking Law of end 2013; a law that reached a good equilibrium between safer banks and financing international trade, so important for a small open economy (Geens, 2014).

It is important that the EC makes a reasonable but ambitious proposal on bank restructuring before the European elections of May 2014 to better shape the financial landscape of the EU.
Conclusions

The Euro is an unfinished project, the new economic governance structure remains ineffective and the fiscal union is a far dream. We therefore need in the short to medium term a true banking union to strengthen the unfinished EMU and provide effective stabilisers for shocks via the financial system, which normally absorbs 2/3 of all shocks in a well-functioning currency union. This is even more important in the Euro area which is hit by financial shocks resulting from bank renationalisation and too much reliance on bank funding and which is handicapped by the immobility of labour, rigid product and factor markets and the absence of a Eurozone budget. In other words, the banking union is the last resort when it comes to preventing new unsustainable debt evolutions and imbalances, given that the application of the new economic governance structure decided after the eurocrisis seem unable to prevent this. The Banking Union is the only instrument we have at this moment to release the ECB from the handicap that it has to focus its non-standard measures on restoring the monetary transmission mechanism so that it can use these and other measures to restart the economy via accessible financing, also for SMEs.

Therefore we have argued for a complete European banking union, whereby, based on the principle of subsidiarity, European banks are put under a three pillar Union including a single supervisory mechanism (that will be finished by November 2014), a Single Resolution Mechanism (the current model needs significant improvement) and a Single Deposit Guarantee Scheme (the EC did not even make a proposal). The role of banks in financing the economy should be reduced, they should raise further capital to meet minimal solvency thresholds and investing in national sovereign bonds should not receive special treatment. Liquidity requirements should be sufficient. This could be realised based on the current TFEU, but in the longer run, a Treaty change is needed. Creating this truly European Banking Union would be the biggest integration move and the most important shift of power from national to the European level since the establishment of the euro.
## List of Abbreviations

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<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>AQR</td>
<td>Asset Quality Review</td>
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<tr>
<td>BRRD</td>
<td>Banking Resolution and Recovery Directive</td>
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<td>BSA</td>
<td>Balance Sheet Assessment</td>
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<td>CA</td>
<td>Comprehensive assessment</td>
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<tr>
<td>CDS</td>
<td>Credit Default Swap</td>
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<td>CET1</td>
<td>Core Equity Tier 1</td>
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<tr>
<td>DGS</td>
<td>Deposit Guarantee Scheme</td>
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<td>EBA</td>
<td>European Banking Authority</td>
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<td>EC</td>
<td>European Commission</td>
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<td>ECB</td>
<td>European Central Bank</td>
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<td>ESCB</td>
<td>European System of Central Banks</td>
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<td>EFSF</td>
<td>European financial Stability Facility</td>
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<td>EIB</td>
<td>European Investment Bank</td>
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<td>EIF</td>
<td>European Investment Fund</td>
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<td>ESM</td>
<td>European Stability Mechanism</td>
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<td>EZ</td>
<td>Eurozone</td>
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<td>EIOPA</td>
<td>European Insurance and Occupational Pensions Agency</td>
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<td>ESFS</td>
<td>European System of Financial Supervisors</td>
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<td>ESMA</td>
<td>European Supervisor for financial markets</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<tr>
<td>FDIC</td>
<td>Federal Deposit Insurance Corporation</td>
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<td>FRFA</td>
<td>Fixed Rate Full Allotment</td>
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<td>FTT</td>
<td>Financial Transactions Tax</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>Acronym</td>
<td>Full Form</td>
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<tr>
<td>LTRO</td>
<td>Long Term Refinancing Operations</td>
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<tr>
<td>MREL</td>
<td>Minimal Required Eligible Assets</td>
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<tr>
<td>OCA</td>
<td>Optimum Currency Area</td>
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<tr>
<td>OMT</td>
<td>Outright Monetary Transactions</td>
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<tr>
<td>RWA</td>
<td>Risk Weighted Assets</td>
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<td>SB</td>
<td>Supervisory Board</td>
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<td>SDGS</td>
<td>Single Deposit Guarantee Scheme</td>
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<td>SRA</td>
<td>Single Resolution Authority</td>
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<td>SRF</td>
<td>Single Resolution Fund</td>
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<td>SRM</td>
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