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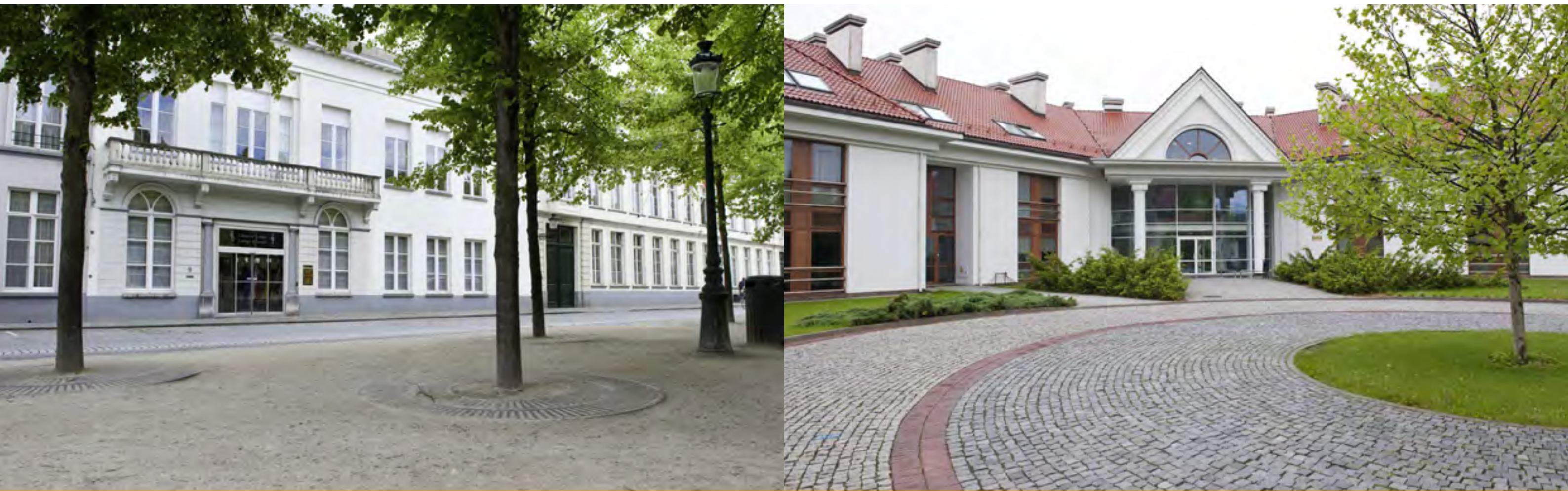
Towards a Banking Union: Open Issues

A report by Christian de Boissieu



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Towards a Banking Union: Open Issues

A report by Prof Christian de Boissieu*

Executive summary

The purpose of this paper is to give an account of the debates regarding the implementation of a banking union in Europe that took place in Bruges in April 2013 at a Conference co-organised by the College of Europe and the European Commission's Joint Research Centre (JRC). The benefits to be expected from the banking union are reviewed. Then its components are analysed and discussed with a special focus on supervision and resolution of banks. The challenges are both functional and institutional. They involve micro-and macro prudential considerations. As regards the ECB, will there be possible conflicts of objectives and conflicts of interest when it cumulates its monetary policy function with its new supervisory role? For banking supervision, how to combine the division of labour between the ECB and the national competent authorities with the necessary coordination between them?

The same kind of challenge applies to resolution and deposit insurance. The paper relates the transition to a banking union to other structural issues such as the separation of bank activities and the financing of the real economy in the new regulatory framework.

1. Background

On 18 April 2013 the College of Europe (Bruges) hosted the second Conference on the general theme " Scientific Support to Financial Stability", co-organised by the European Commission's Joint Research Centre (JRC) and the College of Europe. The first Conference took place in November 2012 in Brussels and was devoted to the scientific support for analysis of systemic risks and of policies dealing with them (most of the presentations are available on the websites of the JRC and the College of Europe). The April 2013 Bruges Conference was entitled "Towards a Banking Union: Open Issues". As with the Brussels Conference, it gathered high-ranking financial experts, EU policy makers, representatives from the ECB, the EIB, the EBA, the US Federal Reserve System, academics, bankers, as well as representatives of the European Banking Federation and of the European Consumers Organisation (BEUC). It was opened by Michel Barnier, Commissioner for Internal Market and Services, and co-chaired by Rector Paul Demaret (College of Europe) and Dominique Ristori (Director-General of the JRC).

Access to reliable, independent and comparable data is key to the banking union (hereafter BU), since transparency of bank data is a prerequisite for an effective supervision and resolution by the competent authorities. All the speakers acknowledged both the necessity and the difficulty in improving access to the relevant banking and financial data. For instance Francesca Campolongo (JRC) referred to the permanent "struggle" to find good data and to improve data disclosure in particular by banks. It is worth noting that "market discipline" is at the core of Pillar 3 of Basel II and Basel III and it implies more and better information disclosure by banks to all stakeholders. Monique Goyens (BEUC and member of the Liikanen Group) referred even to a "battle of data", questioning the role of financial industry-led research which is not independent enough. This was a view which was strongly opposed by Wim Mijs (European Banking Federation) who stressed the positive–sum game between the regulators, the bankers, the stakeholders and the public at large regarding the collection and treatment of the relevant data.

The obstacles to reliable and comparable data are manifold: excessive financial complexity (e.g., some exotic derivatives instruments), the difficult ex-ante assessment of risks, persistent divergence across Member States in the accounting and evaluation procedures despite their reliance on the same accounting rules (IFRS). Therefore it is not surprising that the ECB's comprehensive assessment of banks in the euro area which was scheduled to start in November 2013 and end in November 2014 emphasises more transparency for the purpose of "enhancing the quality of information available on the condition of banks".

The JRC in cooperation with DG MARKT has built the model SYMBOL (Systemic Model of Bank Originated Losses) which assesses the financial position of individual banks and the macro implications under exogenous shocks. This model is still in progress since the collection of detailed and reliable data is indispensable. However, it is already a useful tool for assessing the probability of default of each bank. It takes into account contagion effects on the inter-bank market in order to analyse the micro/macro links, in particular the channels of transmission from individual bank risks (credit risks, market risks, operational risks) to systemic risks and to simulate the impact of various shocks. In this respect such a modelisation could be very useful in the implementation of bank stress tests and in the assessment on an ex-ante basis of the conditions and implications of the transition to a BU.

2. Benefits of banking union

R.Goyal et al. (2013) presents a comprehensive survey of the economic foundations of the BU. The Bruges Conference was an occasion for revisiting the main arguments.

Without being exhaustive, it can be argued that the BU in Europe is a means towards the following goals:

(i) To deepen the single market for financial services and make it more effective. We are still far from an effective single market for banking and financial services and a true level playing field. One of the goals of BU is to make the single market a reality in particular through a "single rulebook". However there is a debate on the financial re-regulation process and the effectiveness of the single market. Commissioner Michel Barnier stressed that the single rulebook has been significantly enhanced by the final version of CRD IV (Basel III) which tightens the requirements for bank capital, liquidity and governance. Wim Mijs (European Banking Federation) regretted that even CRD IV leaves too much room to the competent national authorities to incorporate idiosyncratic measures in the transposition of the directive and in particular in its interpretation, in such a way that we could be very far from a real level playing field. Likewise Karel Lannoo (CEPS) underlined the fact that according to CRD IV the national authorities keep some discretionary power for the weights attached to real estate or for the implementation (or not) of the counter-cyclical buffer. This ongoing debate means that we will have to find the right balance between coordination and decentralisation as regards the concrete implementation of Basel III. The BU implies also such a search and clarification.

(ii) To overcome the current fragmentation of financial markets in Europe. This is another way to look at the single market puzzle. The euro zone crisis has generated diverging interest rates and increasing spreads over the whole yield curve. Banks in countries under pressure still pay a premium on their debt compared to banks in core countries. The crisis has also fuelled an augmented "domestic bias" for investors, a partial repatriation of financial assets, some form of "re-nationalisation" of private savings and the necessity to compensate the private capital flows from the South (Greece, Portugal, Spain) to the North of Europe by some public transfers from the North to the South. In this connection, Frank Smets (ECB) started from the basic objective to return to a globalised finance in the EU and not only in the euro area.

(iii) To overcome the "impossible trinity". D. Schoenmaker (2011), referring to the concept of "financial trilemma", underlined the fact that we cannot have the three sides together: financial integration, financial stability and national policies for crisis prevention and management. If we want to maintain financial integration and to reach financial stability, we must pass to some supra-national policies for the management of financial crises. This financial trilemma is as important for financial matters as the Mundell-Padoa-Schioppa impossibility triangle is for monetary policy in an open economy with perfect capital mobility.

(iv) To go out of the vicious loop between banks and sovereigns. Several speakers including Klaus Trömel (EIB) and Frank Smets emphasised the benefits to be had from a BU in this regard. The euro zone crisis has illustrated the manifold and bi-directional links between banks and sovereigns. In several cases the systemic banking crisis associated with private over-indebtedness has led to state intervention as an investor of last resort in the banking sector and to an outburst in the public debt ratio (Ireland, Spain). Among other examples, the Cypriot crisis illustrates the negative impact of non-performing sovereign debt on individual banks and on the banking system as a whole. In many cases, spreads are the main channel of transmission from the sovereign to corporate debt (including bank debt). What to expect and what not to expect from the BU regarding the bank/sovereign loop? Banks will continue to buy sovereign debt, induced to do so by the scale of weights embedded in Basel III. But an effective supervision at the European level means that the supervisors would be in a better position to contain on an ex-ante basis the accumulation of bad debts on bank balance-sheets. Moreover, a Spanish or an Irish scenario would be much less likely since the resolution of banks in the BU would rely on public funding as the last, not the first, solution. Compared to the pre-BU configuration, the probability for a bank crisis morphing into a sovereign debt crisis will significantly decrease, although it will not be zero.

(v) To internalise externalities. The presence of externalities – either positive or negative – leads to under - or over - utilisation of some instruments. Frank Smets pointed to the risk of under-capitalised banks if the decisions were mostly taken at the national level. Here we come back to the classical argument à la Tinbergen (1954): the presence of externalities pushes towards coordination or even centralisation (which represents the highest degree of coordination) of policy instruments. Cross-border banking and financial activities in the EU are still significant despite the recent fragmentation. The Cyprus crisis shows that spill-over effects fuelled by expectations and contagion could create a systemic problem from a configuration which was difficult to characterise as "systemic" on a purely ex-ante basis. Potential negative externalities for the rest of Europe came from the initial and counter–productive decision of the Eurogroup to tax all deposits. De facto the final decision to exonerate deposits up to EUR 100,000 limited the externalities for depositors in the rest of the EU. The Cyprus crisis shows that the transition from individual to systemic risks is much more complex than usually appreciated. It deserves more scientific and policy attention. The magnitude of externalities across Member States explains the creation of the three European regulatory and supervisory bodies (ESMA, EBA, EIOPA) according to the recommendations of the de Larosière report made before the euro zone crisis. This crisis means that we must go further regarding the internalisation of financial externalities.

(vi) To reduce the risk of capture of regulators by the financial industry. The argument is extensively discussed in the academic literature especially in light of the crisis and the growing focus on conflicts of interest. Supervision and resolution taken at the national level would entail a risk of regulatory forbearance. This argument validates more integration and centralisation. At the Bruges Conference it was only incidentally mentioned by Monique Goyens who questioned the data collected by the industry. The idea that a supervisory mechanism centralised at the European level would be less exposed to lobbies and pressures is based on the notion of "distance" from vested interests which are supposed to be more powerful at the national level than at the EU level. Here the word distance could have several meanings: for sure geographic, but also functional, political, institutional, etc.

The emphasis on the benefits to be had from BU does not mean that there are no costs. F. Campolongo reminded us that science must develop ex-ante assessment of the discounted cost-benefits of such a major economic and political project. The main challenge is to quantify so many qualitative changes and to value numerous externalities.

3. The Single Supervisory Mechanism(SSM)

3.1 The three pillars and their sequencing

BU rests on three pillars: A Single Supervisory Mechanism, a Single Resolution Mechanism and an integrated scheme of deposit insurance (the Report considers later the meaning of an "integrated" scheme since the debate is still very open). The fact that Basel II and III also rest on three pillars does not imply that "three" has become the golden figure of financial regulation. This convergence is purely coincidental.

The three pillars of BU form a consistent system. Many speakers including Commissioner Barnier, Frank Smets or Martin Merlin (European Commission, DG MARKT) underlined that the three pillars cannot be decoupled from each other. But, on the other hand, since BU relies not on shock therapy but rather gradualism, proper sequencing is both required and fundamental.

It should take place in the following order: supervision, then resolution of banks and, at the end, deposit guarantee. Not in the steady state but during the transition period which is expected to last at least a couple of years, the EU will face a dilemma: how to implement a credible and effective BU when it will be piecemeal during the transition phase, given the lags in effect between the respective integration of supervision, resolution and deposit insurance. The solution could be the following: extending the monetary policy debate to financial regulation. In order to be time-consistent, each stage of the BU must be set in such a way that it is perfectly consistent with and conducive to the later stages. From the functional viewpoint the three stages (one for each pillar) are not separable even if they will be implemented successively. This is what may be called the non-separability principle.

3.2. Who should be in charge of what?

The central role of the ECB

For several reasons, at the Bruges Conference no one, including the academics, really questioned the central role of the ECB in the SSM. First, the SSM will benefit from the global reputation and credibility of the ECB. Second, and this argument is closely connected with the preceding one, the independence and "distance" of the ECB from national authorities will be valuable features of the SSM. Third, the ECB has a comparative advantage in collecting micro-economic information about bank condition and risks, and this advantage has been rather increasing with the implementation of unconventional monetary policy which requires more transparency about bank balance-sheets. F. Smets reminds us that out of the 17 national central banks of the Eurosystem (before the entry of Latvia in the euro area as of January 2014), 15 are already deeply involved in bank supervision. Fourth, other scenarios are not fully credible. For instance, the EBA is fulfilling a useful function when it prepares and publishes bank stress tests. To put it at the core of the SSM would raise a whole bunch of operational, legal and governance issues. The accepted idea is to give the leadership to the ECB but to benefit from more coordination between the ECB, the EBA and other existing institutions.

Given the fact that there are about 8200 banks in the EU and 6000 in the euro area as recalled by Commissioner Barnier, the ECB will start its supervisory activity as of November 2014 by directly supervising the most "significant" banks of the eurozone, namely around 130, which taken together represent a market share of 80% to 85% of bank assets in the euro area. Given the list of SIFIs published each November by the FSB which includes 28 banks at world level (as of November 2012) of which 16 are European banks, it means that the ECB will directly supervise many non-SIFI but "significant" banks. For a bank to be qualified "systemic" or "significant" the relevant criteria are: the size, the density of connexions with other banks and the extent of externalities, etc. The difference between the two concepts is more a question of degree than of substance.

In order to fulfil its supervisory function the ECB needs to recruit staff. It has to hire between 800 and 1000 supervisors coming from national supervisory bodies, banks, the private sector at large, and universities. The staffing implication of the BU for the ECB must not be underestimated. As regards the recruitment of experts in bank supervision, a zero-sum game between the ECB and the national competent authorities (NCAs) must be avoided. The way to do so is to hire qualified people well beyond the circle of central bankers.

The review of banks' balance sheets

In November 2013 the ECB just started an assessment exercise which will be carried out through to November 2014 just at the time when the ECB will be taking over its supervisory role. As put forward by the ECB itself, the review of banks' balance sheets has three (three again!) goals. 1) Transparency: to enhance the available information on banks. Therefore this objective could be related to pillar 2 of Basel II and III which has to do with "market discipline". Mario Draghi spoke of the need to "dispel the fog" around bank balance sheets in the euro area. In light of the eurozone crisis, this is the number one goal. 2) Repair: to identify and implement prompt corrective actions if necessary. 3) Confidence building: all bank stakeholders are potential targets of this confidence-building exercise.

The ECB will carry out its assessment review with the support of NCAs and the expertise of Oliver Wyman, a consulting firm. The sample consists of 130 "significant" banks, namely the banks which are going to be directly supervised by the ECB, from 18 countries (for the exercise, Latvia is already in the eurozone): 24 banks from Germany, 16 from Spain, 15 from Italy, 13 from France and fewer where the banking concentration ratio is much higher (5 banks from Ireland, 4 from Cyprus, 4 from Greece). The overall assessment will bear on standard items such as the bank's "own" funds, liquidity, risks, the quality of bank management and governance, etc. In close cooperation with the NCAs and Oliver Wyman, the ECB wants to develop its own rating methodology which is not to be a pure replication of the ratings applied by US supervisors.

The necessity of coordination

At the Bruges Conference, much attention was devoted to the coordination problem: i) the cooperation between the ECB and the NCAs as regards the concrete functioning of the SSM; ii) the relationships between the ECB and other existing bodies also in charge of prudential policy.

The first aspect raises a difficult but relevant issue. What will be for the SSM, both during the transition phase and in the steady-state regime, the balance between centralisation forces giving a growing role to the ECB, and decentralisation forces maintaining a very significant role for NCAs because of their privileged access to local information, of the valuable argument of "proximity" (which is a multidimensional concept: geographic, cultural, political)? The answer, which is quite impossible to provide on an ex-ante basis, will lie in the combination of two necessities: The fruitful division of labour between the ECB and the NCAs (in many cases the national central banks or institutions which are closely related to them), and the necessary cooperation between them. In one way or another, the question was raised by Charles Goodhart (LSE), Frank Smets, Wim Mijs and Karel Lannoo. The basic split between large banks directly supervised by the ECB and the small and medium-sized banks directly supervised by the national authorities is useful and apparently clear-cut. But even the size criterion will pave the way for some overlapping and competition between the "centre" and the "periphery". This wording is not intended to be pejorative in view of the fact that the NCAs will continue to care for their "significant" banks whereas the ECB cannot neglect small and medium-sized banks in light of the Cyprus crisis and some other banking crises.

To be more concrete, let us consider two examples which raise the issue of the optimum degree of centralisation (or decentralisation) within the SSM.

With Basel II and Basel III, the supervisors have to assess the quality of internal models used by banks (in particular the A-IRB models for "advanced internal rating based") to compute their risk-weighted assets (RWA). This referee function is crucial for comparing and rating bank internal models and therefore creating a level playing field. In the SSM, the ECB and the NCAs will have to cooperate to fulfil this function. De facto, the ECB will be more involved in the rating of large banks' internal models while the NCAs will focus more on small and medium-sized banks (by the way those banks mostly rely on the standard model or on the Foundation-IRB). But the two levels of decision have to be fully consistent since any significant discrepancy between them could generate competitive distortions.

A second example relates to the implementation of pillar 2 of Basel II and III, i.e. the competence of supervisors to tighten up the solvency ratios required from a bank above the regulatory thresholds given the specific risk profile of this bank. The concrete exercise of such a discretionary power in the SSM will also imply a high degree of consistency and coordination between the "centre" and the "periphery".

The other aspect of the coordination puzzle concerns the relationships between the ECB and other existing institutions at the European level. Charles Goodhart questioned the role and the very existence of the ESRB (European Systemic Risk Board) which is too a large group (about 60 people around the table) without any executive power and with no impact on the decision-making process. It has not issued any recommendation to any authority (Cyprus, Slovenia, etc). On the contrary Karel Lannoo pointed out to the usefulness of the ESRB when it made some strong recommendations concerning money market funds at the end of 2012 and when it published scoreboards concerning systemic risks.

What will be the role of the EBA when a full BU is in place? No one really questioned the very existence of EBA. But it will have to adjust to the new institutional framework. Piers Habens (EBA) underlined the fact that the EBA could contribute to many aspects of the BU except that it cannot provide liquidity in case of a need for it. Philippe Herzog (Confrontations Europe) pointed out the fundamental limits of EBA due to the fact that it is not a regulator. Charles Goodhart came back to the relationship between the EBA and the ESRB. What can be considered fairly certain, in view of the many uncertainties, is that EBA will continue to be deeply involved in bank stress tests in cooperation with the ECB and the NCAs. The participation of EBA in the current assessment of banks by the ECB is a positive token of the prevailing spirit of cooperation (rather than competition) between the various stakeholders of the BU. As put forward by Frank Smets, we are here also confronted with the question of what is the best incentive structure to fulfil the objectives defined by the European and national policy-makers. The question of the optimal incentives structure was mentioned but not really studied at the Conference.

3.3 Conflicts of objectives? Conflicts of interest?

Micro-and macro prudential measures

Banking supervision is mostly micro-prudential. It is a continuous policy applied to all relevant financial institutions. Charles Goodhart underlined the unavoidable “granularity” of macro-prudential measures, namely the necessity to index them on the economic cycle in order to limit their pro-cyclicality and if possible to make them contra-cyclical: “…macro-prudential measures are meant to be varied, and perhaps subsequently relaxed, over the course of the cycle…”

At present, this principle is widely accepted, whereas its concrete implementation is much more problematic. It suffices to refer to the status of the counter-cyclical buffer in Basel III, left to the discretionary appreciation of each national competent authority, or the on-going debate since the London 2009 G20 summit about bank dynamic (or ex-ante) provisioning. The concept of granularity is more complex, since, as underlined by Goodhart, it refers also to the optimal aggregation level for macro-prudential policy. Here the optimum is not necessarily the most aggregated level, and I would support the suggestion that prudential policy must also be "meso" oriented by looking at intermediate–level patterns (e.g., prices on local or regional real estate markets). This is a form of geographic selectivity and fine-tuning.

Goodhart pointed out also to an empirical asymmetry. It is much easier to tighten up banking and financial regulation in a boom than it is to relax it in a bust. Some empirical evidence of this asymmetry comes from a background IMF paper on macro-prudential policy. Moreover micro and macro-prudential policies could work in opposite directions. Whereas during the boom both micro-and macro policies converge to tightening (higher capital and liquidity requirements), they diverge during the bust with micro-policy pushing towards tougher measures and macro-policy trying to "lean against the wind" (i.e. to be contra-cyclical by lowering relevant ratios). Here there is a clear conflict of objectives within the overall prudential policy and the need for more instruments to reach the various objectives attached to financial stability. This is another application of the Tinbergen rule, but we have also to consider the Mundell rule. That is, how to assign the different prudential measures to the various goals of financial stability? We would need here more research and academic analysis.

How to encourage banks to lend more during a bust? Goodhart gave the example of the UK Funding for Lending Scheme as a vehicle for such a contra-cyclical policy. New loans granted during the bust phase would have a lower weight than the stock of "old" credits. With this proposal, we come back to an issue which will remain open for long. Could we assess and implement the optimal degree of granularity and selectiveness as regards geographic and temporal criteria? The split between micro and macro-measures is necessary but not sufficient, and in many respects we have to go beyond.

Potential conflicts within the ECB

Possible trade-offs between monetary and prudential polices are well-known and documented. At the Bruges Conference, the topic was raised but was not examined at length. It is known that such a trade-off could occur when monetary policy has to be tightened. The higher interest rate warranted from the monetary policy viewpoint could enhance the fragility of some banks whose assets are indexed on market rates. The impact could therefore challenge the supervisory function of the central bank.

There exists another potential conflict which is both functional and institutional. It relates to the links between the Governing Council and the Supervisory Board of the ECB. Several speakers addressed this issue during the Bruges Conference. One option would have been the full separation between the two bodies, the Governing Council being no more than an observer at the Supervisory Board (and vice-versa). There will be some overlapping as regards the membership of the two Boards. A huge dose of pragmatism is required. It seems more prudent to adapt the composition of the Supervisory Board after a couple of years of experience.

4. The Single Resolution Mechanism (SRM)

From the viewpoint of sequencing, the SRM is the second pillar of the BU. The problem of bank resolution was alluded to at the Washington DC G20 Summit in November 2008 which called for a review of resolution regimes and bankruptcy laws "to ensure that they permit an orderly wind-down of large complex cross-border financial institutions". Due to the impact of the euro zone crisis on banks the challenge of resolution has become still more topical. A sense of emergency has developed in particular after the Cyprus crisis. The draft directive for "establishing a framework for the recovery and resolution of credit institutions and investment firms" was adopted by the Council of the EU last June. As of November 2013, it is still going through a trilogue (Council, Commission and European Parliament). On 8 November 2013 the ECB published its opinion on the SRM, which is examined in more detail below.

At the Bruges Conference, Martin Merlin (DG MARKT) presented a comprehensive overview of the main debates and options concerning bank resolution. I draw extensively on his presentation at the Conference.

4.1 The legal basis for bank resolution

At the time of the Bruges Conference the debate about the legal basis for bank resolution was still lively. For sure there was and there is a consensus not to change the Treaties for this purpose. This is a sound position given the general mood in Europe and the economic and social circumstances. But as explained by M. Merlin there was a possible choice between Article 352 of the EU Treaty [Treaty on the Functioning of the European Union] which is not specific at all and requires Council unanimity, and Article 114 TFEU which is more precise since it is the traditional legal basis for the single market. Moreover, Article 114 requires only qualified majority for adoption by the Council and fits well with the general objectives of resolution. After all, the SRM will facilitate the orderly resolution of cross-border banking groups and this is a single market issue.

Here the cross-border dimension of bank activity is underlined, but the SRM will be applicable to any credit institution "failing or likely to fail" whatever the respective weights of purely domestic and cross-border operations in its net product. The legal debate is over, at least for now (but we cannot discard completely the scenario of legal and judiciary disputes). Both the Council in June and the ECB in November 2013 explicitly referred to Article 114 and the strengthening of the single market: "This would make the establishment of the SRM possible without the need for a Treaty change" (ECB press release, 8 November 2013). A comprehensive analysis of the legal basis for resolution and an option in favour of combining articles 114 and 352 are proposed by S. Micossi et al. (November 2013).

4.2 The basic ingredients of bank resolution

The general idea is to set up a Single Resolution Board (SRB) which will work in close cooperation with the NCAs. As for supervision, the debate concerning the balance between centralisation versus decentralisation forces exists also for resolution. However Martin Merlin pointed out that the size criterion which is relevant to assign responsibilities between the ECB and national supervisors applies less to resolution. The SRM will cover all banks whatever their size and "significance". In this respect the ECB's view is at odds with that of the German authorities. Mr W. Schäuble, the German Minister of Finance, has repeatedly said that the SRM must work as a network of the NCAs rather than as a centralised authority. This is not the view of the Commission, the ECB, the Council, and many other member countries. There is even no place for a two-tier resolution system based on a size criterion as it could be for supervision. Nevertheless there could be no real decoupling between supervision and resolution. First, there exists a logical sequencing. The SSM (either the ECB or the NCAs) should be solely responsible for assessing whether a credit institution is failing or likely to fail. The supervisory assessment will therefore be a necessary precondition for putting an institution into resolution. Second, the relevant geographic areas for the SSM and the SRM have to coincide. A country cannot be part of one without participating to the other. As already mentioned, this is what the non-separability principle dictates.

Who should be the institution for the SRM? In theory several options were available and Martin Merlin identified various candidates: a European institution such as the Commission, the Council, the ECB; some agency such as the EBA or a new agency to be put in place; the European Stability Mechanism (ESM) which has become the fiscal backstop of rescue programmes. For many reasons, namely the search for an independent authority and the need to avoid conflicts of interest, the second solution has been selected. The institution for the SRM should not be the EBA but a new and specialised agency fully distinct from the ECB and the Commission. Officially the SRM must start operations as of 1 January 2015, a few months after the start of the SSM. Andrea Enria, who chairs the EBA, has been recently advocating more integration against the network of national authorities approach: "You need European decision mechanisms rather than having always a committee-type of decision in a crisis" (*Financial Times*, 18 November 2013). According to him, it is vital to give more power to EU institutions especially for bank resolution. Ex post most speakers at the Bruges Conference would have endorsed such a position.

4.3 Organising bail-in procedures

The main objective of the new procedure is to count on private rather than on public money whenever a bank in the euro area is failing or likely to fail. Bail-in must be the rule, bail-out the exception. States and taxpayers will become payers of last resort, not of first resort as they were in 2007-2010 and more recently with the Irish, Spanish and Cypriot crises due to the systemic nature of those crises and the prevalence of the "too big to fail" argument. Before coming to resolution, everything must be done to avoid such a situation through the adoption of preventive measures, early intervention with the power given to the Authorities (European and national) to appoint a new management in case of a significant deterioration in the bank's financial situation or of serious violations of the law. Resolution itself is a multidimensional procedure since it could involve several steps such as partial sale of bank business, defeasance operations (transfer of impaired assets to a special vehicle) and bail-in measures. Indeed a concise definition of bail-in has been put forward by the EU: "…the imposition of losses, with an order of seniority, on shareholders and unsecured creditors".

The directive on recovery and resolution introduces a strong hierarchy in the means to resolve a bank. The hierarchy embedded in the procedure is so strong that it is comparable to what is called a lexicographic order in decision theory. First, shareholders are solicited for a recapitalisation. Second in order are creditors, in particular the ordinary, unsecured, non-preferred creditors. In any case creditors cannot suffer greater losses than they would have under the ordinary national insolvency procedure. Third, we have uninsured depositors. There is a long list of creditors and liabilities not eligible for bail-in procedures. For example, covered deposits (i.e. up to 100,000 euros) are excluded from bail-in. Fourth, states (including the ESM at the European level) and taxpayers will be last resort contributors. This ranking is reasonable. It has to be consistent with the company law of Member States, which could still vary across countries despite the adoption of several EU directives in this field. In some cases national company law for bankruptcy will have to be adjusted to the new configuration created by the resolution directive. In practice, in light of past experiences, it is not evident that appeal to public money will become an exception and a last resort solution. In order to avoid a gap between the desired objectives and reality, a strong political commitment from both the national and European decision-makers is needed.

4.4 Governance and funding

At the Bruges Conference there was much convergence of opinion on governance. The Board of the European Resolution Authority must be fully independent from the ECB in order to avoid conflicts of interest between supervision and resolution. The ECB has been very clear in its opinion on the SRM. "The ECB seeks representation in all plenary and executive meetings of the Single Resolution Board as an observer", an observer deprived of any voting right, possibly in order to have direct and timely access to valuable information. The exact composition of this Board remains unknown. It seems advisable to include some independent non-executive members of the Board.

The allocation of voting rights within the Board remains a sensitive matter as it is very often in European settings. There is an on-going discussion on this issue. At the end (but not too late) a compromise is expected and the time-table of the SRM could be respected.

As far as funding is concerned there was also much convergence of views. The system has to be funded on an ex-ante basis through premia paid by banks. This is very similar to most deposit insurance schemes which are also "funded", i.e. financed on an ex-ante basis. The premium paid by each bank has to be an increasing function of three factors: i) a scale variable such as the level of bank liabilities eligible for a bail-in; ii) the global bank risk, computed in aggregating credit, market and operational risks: a risk-based pricing is the way to deal with moral hazard; iii) the rate of global economic growth, taken as a proxy for the cycle. The positive relationship between premium and growth makes the system contra-cyclical since banks pay more during the boom, less during the bust.

We have exactly the same questions and answers for premia for resolution and deposit insurance. For instance, who is actually paying the quasi- taxes and premia? Under certain competition circumstances, banks could transfer a part of or the entire bill to their customers, with higher lending rates and/or lower deposit rates. The similarity between the funding of resolution and the financing of deposit guarantee means that it is not surprising that some experts and policy-makers advocate their merger. However, it is preferable to start the BU with a distinct and transparent Resolution Fund.

Several important questions concerning the governance and financing of resolution must be settled in the course of 2014 if we want to start the SRM at the beginning of 2015. Martin Merlin articulated some of these questions. Will the Commission be involved at some point in the resolution process? Here we need cost-benefit analysis which considers economic and political arguments. What should be the relationship between the European and the national resolution funds? Must the ESM, already involved in bank recapitalisation, be a backstop for the Resolution Fund? This last question illustrates the fact that the border between bail-in and bail-out, between private and public money is tenuous and has to be removed whenever the banking crisis reaches a certain threshold of intensity.

5. Deposit insurance

So far deposit insurance, which is the third pillar of the BU, has drawn much less attention than the other pillars. There are at least two main reasons for the relative lack of attention. The time-table for pillar 3 is not very clear yet and in any case far delayed compared to the SSM and the SRM. Moreover the topic could be more sensitive from the viewpoint of national sovereignty than supervision and resolution which are already touchy issues.

Before 2007-2008 there was a significant heterogeneity across EU countries with respect to deposit insurance. The crisis has precipitated some convergence, in particular for the ceiling of insured deposits (EUR 100,000).

The Bruges Conference did not deal with deposit insurance as such. However, it should be expected that coordination between the national deposit insurance authorities and any European funds will become necessary. Moreover, cooperation will be necessary but not sufficient. In the medium and long-run, the EU will have to develop a more centralised system such as a FDIC-like European Insurance Fund. The main reason is the non-separability principle mentioned earlier. In the steady-state regime, the three pillars of the BU are not separable from each other. A subsequent question will be whether to keep the Resolution Fund and the Deposit Insurance Fund totally apart in order to avoid overlapping and possible conflicts of interest or to merge them for the sake of coordination and potential economies of scale. In the US which is more of an example than of a model, the FDIC is also deeply involved in the resolution of banks by addressing bank failures through mergers and acquisitions.

6. Other structural issues

6.1 The ins and the outs

It has been very clearly said that the BU is open to Member States which are not in the eurozone. Some Member States such as Poland seem to be interested in joining whereas the UK and Sweden are very likely to stay outside. In a recent speech (5 November 2013), Jörg Asmussen, member of the Executive Board of the ECB, pointed out that the BU is "essential for the ins and desirable for the outs". If they join, the outs would participate on equal terms as euro countries to ensure a level playing field between the ins and the outs. They would also participate in the governance of the banking union in a way which yet remains to be determined. Conversely, due to the non-separability principle, the BU is a "package". It is not possible to be a member of one or two pillars without accepting the other(s).

6.2 The separation of bank activities

The crisis has opened a contentious debate on banking activities and whether it is necessary for the supervisory authorities to implement some "Chinese walls" between some of them. In the US the Dodd-Frank Act and in particular the Volcker rule (2010) took the option of a "soft" separation between banks and hedge funds. It is "soft" since this re-regulation of banking activities in the US is much less ambitious than the Glass-Steagall Act (1933). In Europe, the Vickers report in the UK and the Liikanen Group mandated by the Commission went further in their recommendations by advocating a strong separation between commercial banking and trading activities. This regulatory requirement is parallel to the transition to a BU, but they are not independent from each other and they will interact since the structure of the banking industry conditions the way supervision, resolution and deposit insurance could be implemented.

At the Bruges Conference, Jan Pieter Krahnen (Goethe University and member of the Liikanen Group) opened the debate about the cost-benefits of separation and the way to implement it concretely. The objective is clear. It is to bring back market discipline into the system.

However, its justification is open for debate. Goodhart recalls that, at the start, the subprime crisis was very classical: the outburst of a real estate bubble. It had nothing to do with proprietary trading. Implementing the separation will be complex. On the one hand, separation between commercial banking and trading addresses two major challenges. i) Time-inconsistency: banking is long-term while trading is short-term. ii) The distribution of risks, which raises several problems such as transparency, traceability, risk shifting.

On the other hand, however, banking and trading are so intimately connected that a full separation is not warranted. As J.P. Krahnen put it, "…up to a certain level, trading and banking go well together". Trading is much larger than proprietary trading.

But it is not always easy to separate market making from proprietary trading. Professor Krahnen pointed out to the Liikanen recommendation concerning mandatory issues of junior bank debt. Given the development of new forms of investment banking, he insisted on the necessity of being very pragmatic when implementing some separation of bank activities. Monique Goyens, also member of the Liikanen Group, observed that "…the risks that are being taken in the financial area should be borne by those who take them or who allow them to be taken." She added: "… recommendations of the Liikanen Group are good for civil society or for people". Klaus Trömel was especially concerned about the distribution of risks and the inherent difficulty to trace them. With one form or another of separation, where will the risks be allocated? What is the best place to manage them? To ask those questions is not a way to condemn separation but it is an appeal for more academic research and more empirical (and historical) studies.

The debate about separation is still not over in Europe. Some Member States (e.g. France) have taken regulatory initiatives even before the Liikanen report was out. We have to avoid any significant discrepancies across countries in the implementation of the proposals in the Liikanen report. Otherwise, there will be no level playing field which is a core objective of the single market and one of the goals of the BU.

6.3 The financing of the real economy

The main challenge of the on-going re-regulation process is the following. How to strengthen the banking and financial sector and to contain systemic risks without jeopardising the financing of the real economy, growth and employment? An application of this general consideration is the transition from Basel II to Basel III and its implications for investment and growth. What is at stake is the good calibration of the new prudential rules. The problem was alluded to at Bruges but not further elaborated. Commissioner Barnier mentioned that the European Commission was instrumental in inducing the Basel Supervision Committee early 2013 to adjust the definition of the LCR (liquidity coverage ratio) in a direction more favourable to bank financing. Possible adjustments in the long-term liquidity ratio (NSFR for net stable funding ratio) could occur in the short term. In any case the business model of banks is likely to change with the capping of bank maturity mismatch generated by the conjunction of the two liquidity ratios. Klaus Trömel questioned the financing of SMEs in the new regulatory environment whilst Charles Goodhart drew attention to the usual tendency of regulation to be pro-cyclical, and the necessity to make it more contra-cyclical and to induce more bank financing during a bust or a recession.

The impact of Basel III on the quantity and quality of bank financing is critical for European economies which are mostly “bank-based” (the UK being a “market-based” financial system, which is an exception in Europe). Since we cannot assume that market financing or private equity will automatically substitute for bank financing if it becomes one way or another more selective and scarce, the capability of Europe to rebound in terms of investment and growth is at stake. We must not forget either that the implementation of the new prudential rules at the world level could generate a non-cooperative game (some countries staying apart from the new rules), which could lead us very far from the ideal configuration of the level playing field.

7. Concluding remarks

At present, Europe is the "low pressure" zone in the world economy, posting low growth, and high global and youth unemployment. By itself the BU will not solve the challenges of the real economy. But it is an opportunity not only to improve the resilience of European finance but also to think and to act together for the long term, in a period of quasi-general myopia. The BU is much more than a purely technical project, much more than the addition of integrated supervision, resolution and deposit insurance. It is one of the few political economy perspectives that we have in common today. It deserves a strong commitment, discipline and continuity from policy makers at the European and national level notwithstanding essential electoral cycles. Since the BU project requires both research and support, the College of Europe at Bruges and the JRC (European Commission) intend to maintain and extend their cooperation in order to deepen and exchange views and knowledge on the evolution of financial regulation in light of the crisis. As Dominique Ristori (JRC) said in Bruges in April 2013, "in order to succeed in the implementation of the banking union, we need strong political decisions. But science has a lot to contribute too."

References

This paper is based on the written contributions and the debates at the Bruges Conference (18 April 2013). Many contributions are accessible on the websites of the College of Europe and the JRC. I just add some specific references.

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Acronyms

A-IRB model	Advanced Internal Rating Based
BEUC	European Consumers Organisation
BU	Banking Union
CEPS	Centre for European Policy Studies
CRD IV (Basel III)	Capital Requirements Directive
DG Markt	Directorate General Internal Market and Services
EBA	European Banking Authority
ECB	European Central Bank
EIB	European Investment Bank
EIOPA	European Insurance and Occupational Pensions Authority
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
FDIC	Federal Deposit Insurance Corporation
FSB	Financial Stability Board
IFRS	International Financial Reporting Standard
IMF	International Monetary Fund
JRC	European Commission's Joint Research Centre
LCR	Liquidity Coverage Ratio
LSE	London School of Economics
NCA	National Competent Authority
NSFR	Net Stable Funding Ratio
RWA	Risk-Weighted Assets
SIFI	Systemically Important Financial Institution
SRB	Single Resolution Board
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
SYMBOL	Systemic Model of Bank Originated Losses

European Commission

Scientific Support to

Financial Stability

Towards Banking Union: Open Issues

Bruges
18 April 2013

Programme

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09:30 – 10:00	Registration and welcome coffee

10:00 – 10:15 **Opening session**

Introductory remarks by **Paul Demaret**, Rector of the College of Europe and **Dominique Ristori**, Director-General of the Joint Research Centre, European Commission

Michel Barnier, Commissioner for Internal Market and Services, European Commission

10:15 – 11:30 **Session I - Towards a separation of deposit and investment banking activities**

Moderator: **Christian de Boissieu**, Professor of Economics, Paris I Panthéon Sorbonne University and College of Europe

Keynote speaker: **Jan Pieter Krahnen**, Member of the High-level Expert Group on reforming the structure of the EU banking sector, Director of the Center for Financial Studies and of the new Center of Excellence SAFE

Discussants:

Monique Goyens, Director-General, European Consumers' Organisation (BEUC) and Member of the High-level Expert Group on reforming the structure of the EU banking sector

Susan L. Baker, Treasury Attaché, U.S. Mission to the European Union

Discussion between the participants

11:30 – 12:45 **Session II - The Single Supervisory Mechanism: practicalities and issues at stake**

Moderator: **Eric de Souza**, Professor of Economics, College of Europe

Keynote speaker: **Frank Smets**, Director-General, Directorate-General Research, European Central Bank

Discussants:

Francesca Campolongo, Head of Scientific Support to Financial Analysis Unit, Joint Research Centre, European Commission

Wim Mijs, Chairman of the Executive Committee of the European Banking Federation, Chief Executive Officer of the Dutch Banking Association

Discussion between the participants

12:45 – 14:15 Buffet lunch

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14:15 – 15:30 **Session III - The organisation of Macro-Prudential Policies in Europe**

***Moderator*: Eric de Souza**, Professor of Economics, College of Europe

***Keynote speaker:* Charles Goodhart,** Professor Emeritus, London School of Economics

Discussants:

Karel Lannoo, Chief Executive Officer, Centre for European Policy Studies

Christian de Boissieu, Professor of Economics, Paris I Panthéon Sorbonne University and College of Europe

Discussion between the participants

15:30 – 16:45 **Session IV - The Single Resolution Mechanism: state of play and next steps**

***Moderator*: Christian de Boissieu**, Professor of Economics, Paris I Panthéon Sorbonne University and College of Europe

***Keynote speaker:* Martin Merlin,** Head of Financial Services Policy Unit, Internal Market and Services Directorate-General, European Commission

Discussants:

Klaus Trömel, Director-General, Risk Management Directorate, European Investment Bank

Piers Haben, Director Oversight, European Banking Authority

Discussion between the participants

16:45 **Conclusions**

Dominique Ristori, Director-General, Joint Research Centre, European Commission