The European Banking Union:
The Last Building Block towards a New EMU?

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Abstract

The ongoing Euro crisis and the worse economic development in Europe than in the United States are grounded, not the least in the delayed implementation of reforms of the banking sector. Whereas the leaks in economic governance of EMU have been fixed the banking sector is still not stabilized, even six years after Lehman Brothers. From the grand solution of a "European Banking Union" (EBU) only the first pillar, the European Bank Supervision with a Single Supervisory Mechanism (SSM) will come into effect in 2014. The other necessary steps – the Single Resolution Mechanism (SRM) and the Single Deposit Guarantee Scheme (SDGS) – will follow later. Until the "Europeanization" will take place the bank recovery and resolution will be managed nationally based on EU law in a ten years' transition period. First evaluations indicate that the net benefits of joining EBU would be distributed unequally between the Member States of the EU/Euro area. Germany would be the biggest loser , Spain and the Netherlands are the biggest winners. Of the non-euro countries, the UK and Sweden have the most to gain, but Poland would lose. The country-specific gains of joining the EBU depend on the number and size of banks which are located in a country. The resolution mechanism of EBU would beyond doubt have a strong stabilising effect in case of financial shocks. The outcome depends on the design. The best solution for all Euro area countries would be a backstop solution via ESM with transfers to failing banks. First estimates by the European Commission indicate that a genuine EBU – by avoiding a systemic banking crisis - would result in macroeconomic net benefits for the EU in the range of 0.7% to 1% of annual GDP.

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1. Introduction

The ongoing euro crisis is the result of at least three interacting factors: a current account crisis (different competitiveness of Eurozone members), a sovereign debt crisis and a banking crisis. The euro crisis was preceded by the global financial and economic crisis (GFC) in 2008-09, which in turn had its origin in the United States, as the housing bubble burst and many systemically important banks plunged into the abyss. The bankruptcy of the investment bank Lehman Brothers on 15 September 2008 sparked an international banking crisis, because the interbank market virtually collapsed and stopped lending to the real sector. In addition, the three causes of the crisis in the Eurozone increased (especially in the peripheral countries) after the GFC so strongly that in early 2010 it sparked the so-called euro crisis (no crisis of the euro). Already five Eurozone members – especially in the periphery – are in one way or another under the euro rescue umbrella. The causes vary. Greece would have gone bankrupt because of its indebtedness without euro rescue. In Ireland, the bursting of the housing bubble led to a crisis of the banking system and after the nationalization of banks to a sovereign debt crisis. In Portugal, the GFC led to a sovereign debt crisis. In Spain – as in Ireland – the real estate boom was fatal for the banking sector. In Cyprus, the banks pulled the country into crisis. All problem countries of the Eurozone (except Ireland) have the common feature that their competitiveness against the core of the Eurozone has fallen for years and thereby built up macroeconomic imbalances (especially in the current account). Since the strict recovery and reform requirements of the "troika" (experts of the EU Commission, ECB and IMF), these imbalances have decreased again, but the peripheral countries slipped into a deep recession (with sharply rising unemployment), from which they are recovering only slowly.

It is noteworthy that the United States, after triggering the GFC, mastered both the "Great Recession" in 2009 (real GDP – 3.1%) and the recovery since then better than Europe (-4.3% EU, Eurozone -4.4%). While the Eurozone, in 2012 and 2013, slid again into a (double-dip) recession, the economy of the US – albeit slowly – picked up. In contrast to the Eurozone the US has already a well-functioning monetary union. The US obviously is able to solve better and more flexibly economic crises which have their origin in the banking realm. In the EU, the crises have relentlessly disclosed the weaknesses of the economic structure of the Economic and Monetary Union (EMU). Since the outbreak of the euro crisis representatives of the EU have been eagerly trying to close these gaps. With the new economic architecture (New Economic Governance) by the "six-pack" (reform of the Stability and Growth Pact and the surveillance of macroeconomic imbalances; fiscal pact; Euro Plus Pact, "two-pack") the EU/Eurozone wants to get a grip at least on two of the causes of the crisis – debt and current account crisis (Breuss 2013). A stabilization of the banking sector, thus preventing future banking crises, is to be achieved through the creation of a European Banking Union (EBU). The latter would also be a further step closer to completing the internal market.

2. Problem areas of the European banking sector

2.1. The burden of non-performing loans.

Since the outbreak of the GFC in 2008-09 the number and volume of “bad” or “non-performing loans” (NPL) – especially in the peripheral countries (Greece, Ireland, Italy, Portugal and Spain) – greatly increased (German Council of Economic Experts 2012: 157; European Commission 2013c). A study by Ernst & Young (2012) also points in this direction. According to their estimates the volume of “bad loans” in the Eurozone has increased to 918 billion euros (an increase of 80 billion euros in one year) in 2013. This corresponds to 9.5% of GDP in the Eurozone. The share of “bad loans” to total assets is highest in Spain (15.5%), Italy (10.2%), and low in Germany (2.7%). On average, in the Eurozone it is 7.6%, according to data from “Bank Watch” (2013: 1). The share of NPLs in total loans was highest in non-euro area countries like Bulgaria (18%) and Hungary (16%). Then Greece follows with 15.8% and Cyprus with 14%. In the EU-27 on average this share was only 4% (Germany 2%, Austria and France each 4%). Also the Bank for International Settlement (BIS 2013: 12) stresses the problems of NPL in Europe. Whereas the share of non-performing loans trended up after 2008 in the euro area, it subsided after 2009 in the United States.

2.2. Overbanking in small Eurozone countries.

The Cyprus crisis has shown dramatically that some (small) euro area member states have a far too large banking sector (Allen *et al.* 2011; Beck 2012; European Commission 2013c; Liikanen Report 2012: 13). In addition, some of these countries had a business model limited only to the banking sector. And during the GFC in 2008-09 and the subsequent euro crisis this made them greatly vulnerable. According to ECB sources, in 2013, the share of bank assets to GDP in Luxembourg amounted to 2100%, 770% in Malta, 634% in Ireland and 614% in Cyprus. In comparison, 482% in Switzerland, 296% in Austria and 142% in Slovenia. In contrast, the corresponding proportion in large EU countries was rather modest. In the UK, 502%, 291% in Germany and in the US even only 91%.

2.3. Tight-mesh interbank network in Europe.

In European banking there are intensive linkages, with the risk of “spill-overs” and contagion in the case of banking crises. The cross-border banking (assets and liabilities) is characterized on the one hand by a “neighborhood effect” (i.e., German banks are trading higher with customers/banks in neighbouring countries such as in France and *vice versa*; banks in Belgium do business with banks in the Netherlands, etc.), but at the same time there is a strong “bias” towards Britain. Due to the prominent role of London as an international financial center, the cross-border banking businesses with Britain are stronger than the neighbourhood shops. Germany’s banking business with the UK accounts for 23.6%, with the closest neighbours in France only 7.8%, and 2.4% with Switzerland (24.7% with US banks). Similar magnitudes have the other Eurozone banks. Even the share of business of US banks with the UK amounts to 34% of their total cross-border bank transactions (Tonzer 2013: 39).

2.4. Eurozone periphery banks require manifold adaptation.

In their global financial stability report, the IMF (2013a: 17) has concluded that the peripheral countries of the euro area (Greece, Ireland, Italy, Portugal, Spain) have the worst scores in the ranking of the banking systems of the euro area and therefore need massive adjustment (see also Ferber 2013). This verdict is based on four bank balance sheet indicators – loss absorption capacity: bank buffers ratio (Basel III: 8%); asset quality: change in impaired loan ratio (share of NPLs); funding: loan-to-deposit ratio; profitability: return on assets.

At first glance the European banking sector is not as fit as those of the United States. According to Vítor Constâncio, the Vice-President of the European Central Bank (“Financial

Times", 1 October 2013), Europe's banks are just as strong as US rivals and are being unjustly undervalued by investors. Whereas the profitability of European banks – even six years after the "Subprime" crisis and the crash of Lehman Brothers – is still subdued, US banks seem to be in rude health. Three factors seem to distort the picture (Szalay 2013: 21): i) a different role of the banking sector in the real economy (in Europe bank assets amount to 270% of GDP, in the US only 70%; non-financial enterprises are financed by over 50% via bank credits in Europe, whereas this ratio is only 20% in the US); ii) shadow banking (hedge funds etc.) plays a much bigger role in the US than in Europe. The balance sheets are relieved primarily because of the prominent role of the major mortgage lenders Freddie Mac and Fannie Mae; iii) there are differences in the evaluation of balance sheets. Whereas the US banks only publish net positions according to the US-GAAP system, in Europe banks must evaluate according to a gross principle (IFRS).

2.5. Vicious circle between banks and sovereigns.

During the "Great Recession" and in the following "euro crisis" the European states played the role of the "lender of last resort" causing high public debt through bank bailouts. Government intervention to repair the banking sector since the onset of the GFC in 2008-09 has reached dramatic proportions according to recent data from Eurostat (Baciulis 2013). Government stimulus measures had different forms (direct aid with participation capital, monetary policy operations, overall fiscal support measures and the nationalization of banks). The net cost of the bank bailout programmes (the state played the role of a "lender of last resort") are reflected in a cumulative increase in the national debt by 2012 to 690 billion euros in EU-27 (or 5.2% of GDP) and around 520 billion euro in the Eurozone (or 5.5% of GDP). They increased the budget deficit of the EU-27 by 0.5% of GDP in 2010 (peak) and amounted in 2012 still 0.4% (0.7% in the euro area and 0.6% respectively). In Ireland the share of the deficit increase was greatest in 2010, due to the nationalization of banks: the overall deficit was 30%, including 20% of GDP by the bank nationalization. In Portugal, the budget deficit in 2010 rose to 10% of GDP, the share of bank rescue was relatively low at 1%. In 2012, the contribution of the bank bailout in Greece (thereby an increase of the budget deficit) with 4 percentage points of GDP was particularly large, followed by Spain with 3.6 percentage points. In other EU countries (Belgium, Latvia, Austria, Portugal and Cyprus – not counting the bailout of March 2013), the cost of the bank bailout increased the budget deficit by 0.2 percentage points. These capital injections were treated by Eurostat as deficit-increasing capital transfers (government expenditure) and not as financial transactions (acquisition of equity), since they were assessed to be covering losses. Nevertheless, all capital injections, whether they are treated as government expenditure or as acquisition of equity, generally affect government debt, as governments need to finance them.

2.6. Delayed bank reform dims growth prospects of the Eurozone.

According to the IMF (2013b) the still slow implementation of the reform of the financial sector is one of the main reasons for the much weaker recovery from the "Great Recession" in 2009 compared to the United States. Whereas the EU/Eurozone drifted in a "double-dip" recession in 2013 the US economy has been on a continuing recovery path since 2009 (see the forecasts by the European Commission 2013a; and the OECD 2013). Also in the medium term the growth prospects are much weaker for Europe than for the United States (IMF 2013b).

3. Time for reregulation after the financial crisis

3.1. International reform efforts of the G20.

Shortly after the Lehman collapse, the G20 meeting in Washington on 15 November 2008 already identified the main problems of the international banking system: (1) "Too Big to Fail": The states (taxpayers) had to act as a "lender of last resort" to stand straight to avoid further bank failures. This inevitably led banks to sovereign debt crises. Too large, systemically important banks could practically blackmail the states. (2) Universal banking system: In 1933, in response to the "Great Depression", the "Glass-Steagall Act" was introduced. It was a two-tier banking system: investment banking was separated from normal banking business. Only under President Bill Clinton, in 1999, this scheme was lifted in several sessions and yielded to the universal banking system, which had long been common in Europe.

Since that correct identification of the problems of the international financial sector, which contributed to trigger the GFC in 2008-09, seven years have elapsed in which new approaches to stabilize the international financial sector have been suggested on the international level (G20, G7, OECD, BIS). However, the actual implementation has a "long line" and the necessary reform steps are not completely implemented yet. The reason for the retarded reforms may lie in the fact that the whole system must change: the philosophy of a totally unregulated banking sector up to the GFC in 2008-09 needs to be reversed. According to EU Commission's President Barroso (2012a) the unregulated financial sector led to "irresponsible practices" and hence to the global financial crisis.

3.2. Reform steps in major financial centres.

In the United States, the reorganization and reform of the banking sector was faster than in Europe. On the one hand, both the resolution of insolvent banks and the banking supervision are already subject to long-established rules. Additionally, by the so-called Volcker Rule, announced in 2010, the US government legally intended to introduce again an attenuated form of the two-tier banking system, a kind of "Son of Glass-Steagall". The Volcker Rule prohibits banks to trade on their own account and to participate in hedge funds and private equity funds (Lanz 2013b). The complicated and comprehensive provisions of the Volcker Rule were scheduled to be implemented as a part of the Dodd-Frank Act on 21 July 2012, with preceding ramifications, but were delayed. The necessary agencies have approved regulations implementing the rule, which went into effect on 1 April 2014.

Great Britain, although (still) an EU member, but outside the Eurozone, has attempted to regulate its extensive banking sector itself after the bankruptcy and nationalization of Northern Rock in September 2007. The starting point was the Vickers Commission recommendations, first in 2011 with an interim report and in 2013 in a final report (Edmonds 2013). They were implemented in the Financial Services (Banking Reform) Act of 2013[1]. As in the US, a kind of "Son of Glass-Steagall" was introduced by a structural reform which proposed the end of the universal banking system[2]. In July 2013 HM Treasury invited comments on the document "Banking Reform: Draft Secondary Legislation" proposing four statutory instruments under the Banking Reform Act – ring-fenced bodies and core activities order; excluded activities and prohibition order; banking reform (loss absorbency

[1] See the UK Parliament website: http://services.parliament.uk/bills/2013-14/financialservicesbankingreform.html.

[2] In France, the banking reform was approved by both legislative chambers in July 2013. It stipulates that from 2015 on risky investment activities must be separated from normal customer business ("Neue Zürcher Zeitung", 20 July 2013: 26). Also in Germany, the German Bundestag on 17 May 2013 has decided on a weak form of the two-tier banking system in the context of the decision on the "Law for the protection against risks and to plan the recovery and resolution of credit institutions and financial groups".

requirements) order; and fees and prescribed international organisations regulations (HM Treasury 2013). In the wake of the Libor scandal a high-profile parliamentary commission proposed to make responsible bankers also criminally liable ("Neue Zürcher Zeitung", 20 June 2013: 27) [3].

In Switzerland, the banking crisis was also relatively well mastered and for the two major banks (UBS and Credit Swiss), which were classified as "too big to fail", one introduced stricter capital adequacy requirements than the normal rules of Basel III. The IMF praised in its latest country report (IMF 2013c; Lanz 2013a) the Swiss bank insolvency order, the introduction of "Basel III" and the "Too big to fail" (TBTF) legislation. However, the big banks were criticized. The relatively high risk-weighted capital ratios would stand against a high absolute level of indebtedness. The leverage ratio[4] (Tier 1 – own – capital divided by the bank's average total consolidated assets) at UBS and Credit Suisse is much lower than that of a comparison group of large banks (UBS 2.9%; average of US large banks 4.3%; but Deutsche Bank only 1.93%; see Lanz 2013c). The TBTF legislation requires that Swiss large banks (UBS, CS) must have a risk-weighted equity ratio of 19% and an unweighted equity ratio (leverage ratio of 4.6% by 2018 – Land 2014c).

3.3. A robust financial framework for EU's Single Market.

The global financial and economic crisis (GFC) in 2008-09 has highlighted the need for better regulation and supervision of the financial sector, also in the EU. Since 2010 the European Commission has proposed nearly 30 sets of rules to ensure all financial actors, products and markets are appropriately regulated and efficiently supervised. These rules are the basic framework for all 28 member states of the EU and underpin a properly functioning single market for financial services (European Commission 2013f). The ensuing euro crisis added an extra dimension, highlighting the need for a better governed and deeper economic and monetary union for a single currency to work in the long run (Breuss 2013). In 2011 the crisis took a new turn with the Eurozone debt crisis: it highlighted the potentially vicious circle between banks and sovereigns. For that circle to be broken, a European Banking Union (EBU) should be the answer. This is why EU Heads of State and Government committed to a banking union in June 2012 (European Council 2012a). The vision was further developed in the European Commission's blueprint for a deep and genuine economic and monetary union (the "Barroso plan") in November 2012 (Barroso 2012b). The Heads of State and Government agreed the legislative work underpinning the EBU should be completed before the end of the legislature (Spring 2014). The necessary legal underpinning (regulations and directives) for the 28 EU member states had to be agreed upon in a "trialogue" agreement between the Commission, the Council and the European Parliament.

Part of the legal measures to reregulate the financial sector in the EU/euro area are linked to the G20 commitments, including two very significant packages on prudential requirements

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[3] On 4 December 2013 the European Commission (http://ec.europa.eu/competition/publications/weekly_news_summary/2013_12_06.html) has fined 8 international financial institutions a total of EUR 1.71 billion for participating in illegal cartels (LIBOR and EURIBOR scandals) in markets for financial derivatives covering the European Economic Area (EEA) and the Yen market. The penalty consists of EUR 465 million euros for participating in euro-derivatives and of EUR 260 million for derivatives in Japanese Yen. The fines of the 8 involved banks are: Deutsche Bank (EUR 725 million); Société Générale (EUR 446 million); Royal Bank of Scotland (EUR 391 million); JP Morgan; RP Martin and the Citigroup. The British Barclays and the Swiss UBS are free of sanctions because they acted as chief witnesses.

[4] On 12 January 2014 the Basel Committee issued the full text of Basel III's leverage ratio framework and disclosure requirements (BIS 2014) following endorsement by its governing body, the Group of Central Bank Governors and Heads of Supervision (GHOS). Basel III's leverage ratio is defined as the "capital measure" (the numerator) divided by the "exposure measure" (the denominator) and is expressed as a percentage. The capital measure is currently defined as Tier 1 capital and the minimum leverage ratio is 3%. This somewhat softened criteria of 3% should apply only as of 2018.

for banks and the regulation of capital markets (Single Rule Book of prudential requirements for banks: capital, liquidity & leverage and stricter rules on remuneration and improved tax transparency – "CRD IV"/"CRR"). Europe has also been working to improve the stability and efficiency of the Single Market in financial services. This is essential to ensure the financial sector supports the real economy (European Commission 2013b).

When the financial crisis spread to Europe in 2008, creating a "Great Recession" in 2009, the EU had 27 different regulatory systems for banks in place, largely based on national rules and national rescue measures. So the pre-crisis framework was incapable of responding to the financial crisis, in particular its systemic nature. Since 2008 the European Commission has tabled around 30 proposals to create piece-by-piece a sounder and more effective financial sector and hence further completing the Single Market (European Commission 2013b). The following steps to improve the financial sector in the EU/Eurozone were already implemented or are on the agenda for future completion (European Commission 2013f).

3.3.1. Better supervision of the financial system.

Three European supervisory authorities (ESAs) were established on 1 January 2011 to introduce a supervisory architecture: the European Banking Authority (EBA) in London, which deals with bank supervision, including the supervision of the recapitalisation of banks (it also carried out bank stress tests); the European Securities and Markets Authority (ESMA) in Paris, which deals with the supervision of capital markets and carries out direct supervision with regard to credit rating agencies and trade repositories; and the European Insurance and Occupational Pensions Authority (EIOPA) in Frankfurt, which deals with insurance supervision.

The 28 national supervisors are represented in all three supervising authorities. Their role is to contribute to the development of a single rulebook for financial regulation in Europe, solve cross-border problems, prevent the build-up of risks, and help restore confidence.

A European Systemic Risk Board (ESRB) settled at the ECB was established to monitor and assess potential threats to financial stability that arise from macro-economic developments and from developments within the financial system as a whole ("macro-prudential supervision"). To this end, the ESRB provides an early warning of system-wide risks that may be building up and, where necessary, issue recommendations for action to deal with these risks.

3.3.2. A Single Rulebook for all banks in the EU.

The European Council of June 2009 unanimously recommended establishing a "Single Rulebook" applicable to all financial institutions in the single market (8,300 banks). The rulebook, applicable to all 28 member states of the EU is a corpus of legislative texts covering all financial actors and products: banks have to comply with one single set of rules across the single market. This is crucial to ensure that there are no loopholes and good regulation everywhere in order to guarantee a level playing field for banks and a real single market for financial services.

3.3.2.1. Stronger prudential requirements – Basel III implementation.

The package on capital requirements for banks, the so called "CRD IV", which transposes via a Regulation and a Directive the new global standards on bank capital (commonly known as the Basel III agreement) into the EU legal framework, was published in the "EU Official Journal" on 27 June and entered into force on 16 July 2013[5].

[5] The implementation of "Basel III" (capital adequacy requirements and liquidity requirements[5]) into EU law is realized by: (1) a banking package (adopted by the European Parliament on 16 April 2013 and by the ECOFIN on 20 June) consisting of a) an equity-Regulation (CRR) and b) of the 4th Edition of the Capital Requirements Directive (CRD IV, replacing the previous Directives 2006/48 and 2006/49); and (2) a regulation of "bankers'

The new rules tackle some of the vulnerabilities shown by the banking institutions during the crisis, namely the insufficient level of capital, both in quantity and in quality, resulting in the need for unprecedented support from national authorities. The timely implementation of the Basel III agreement[6] features among the commitments taken by the EU in the G20.

3.3.2.2. Recast deposit guarantee schemes.

A second strand of a more robust financial sector is ensuring bank deposits in all member states are guaranteed up to EUR 100,000 per depositor per bank if a bank fails. From a financial stability perspective, this guarantee prevents depositors from making brutal withdrawals from their banks ("bank run"), thereby preventing severe economic consequences.

On 17 December 2013 a political agreement was reached between the European Parliament and EU member states on the new rules on Deposit Guarantee Schemes (DGS; see European Commission 2013g). The DGS Directive[7] will strengthen the existing system of national DGS to respond to the weaknesses that the financial crisis revealed. Depositors will continue to benefit from a guaranteed coverage of € 100,000 (EU law since December 2010) in case of bankruptcy, but access to the guaranteed amount will be easier and faster. Repayment deadlines will be gradually reduced from the current 20 working days to 7 working days in 2024 (15 working days as from 1 January 2019; 10 working days as from 1 January 2021, and eventually 7 working days as from 1 January 2024). For the first time since the introduction of DGS in 1994, there are financing requirements for DGS in the Directive. In principle, the target level for *ex ante* funds of DGS is 0.8% of covered deposits to be collected from banks over a 10-year period.

3.3.2.3. A framework for bank recovery and resolution – from "bail-out" to "bail-in"

Repeated bailouts of banks have created a situation of deep unfairness, increased public debt and imposed a heavy burden on taxpayers (European Commission 2013f). To ensure that the taxpayer will not have to end up bailing out banks repeatedly, the European Commission proposed a common framework of rules and powers already on 6 June 2012 to help EU countries intervene to manage banks in difficulty[8]. After the agreement by the EU finance ministers in ECOFIN (2013a; see also Barnier 2013) on a common position on the resolution of banks, i.e. dealing with ailing banks on 27 June 2013, the European Parliament and the member states reached a ("Trilogue") agreement on this framework (Bank Recovery and Resolution Directive – BRRD) on 11 December 2013, subject to technical finalisation and formal approval by both institutions.

The new rules provide authorities with the means to intervene decisively both before problems occur (for instance by ensuring that all banks have recovery and resolution plans in place) and early on in the process if they do (for instance the power to appoint a temporary

bonuses" with a 1:1 rule – i.e. bonuses may only be as high as the level of a normal salary. Exceptions (1:2) must be approved by the Board, either, if 66% of shareholders who own half of the shares agree or if there is a 75% majority.

[6] Details on the "International regulatory framework for banks (Basel III)" can be found on the website of the Bank for International Settlements (BIS), Basel: http://www.bis.org/bcbs/basel3.htm.

[7] The legal basis of the national DGS is the Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay (Text with EEA relevance), "Official Journal of the European Union" (OJ), L 68/3, 13 March 2009. It says that by 31 December 2010 the coverage for the aggregate deposits of each depositor should be set at EUR 100,000.

[8] "Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms (BRRD), Brussels, COM (2012) 280 final, 2012/0150 (COD)". Details concerning the topic of "recovery and resolution of financial institutions" can be found on the website of the European Commission (The EU Single Market – Crisis Management): http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm#maincontentSec1.

administrator in a bank for a limited period to deal with problems). If, despite these preventive measures, the financial situation of a bank deteriorates beyond repair, the new law ensures through a "bail-in" mechanism (modelled after the bank bailout in Cyprus on 25 March 2013) that shareholders and creditors of the banks have to pay their share. If additional resources are needed, these will be taken from the national, prefunded resolution fund that each member state will have to establish and build up so it reaches a level of 1% of covered deposits within 10 years. All banks will have to pay in to these funds but contributions will be higher for banks taking more risks. The BRRD is a law, which applies to all 28 EU member states and builds a fundamental step towards the completion of the Banking Union.

The "bail-in" mechanism in short (European Commission 2013f: 5):

If a bank needs to resort to bail-in, authorities will first bail-in all shareholders and will then follow a pre-determined order ("cascade of shareholders"). Shareholders and other creditors who invest in bank capital (such as holders of convertible bonds and junior bonds) will bear losses first. Deposits under EUR 100,000 will never be touched: they are entirely protected at all times via the recast DGS directive. Deposits of natural persons and SMEs above EUR 100,000 will (1) benefit from a preferential treatment ("depositor preference") ensuring that they do not suffer any loss before other unsecured creditors (so they are at the very bottom of the bail-in hierarchy) and (2) member states can choose to use certain flexibilities to exclude them fully.

3.3.3. Other measures of the Single Rulebook.

To complement the key pillars of the single rulebook set out above, the Commission has tabled legislation on other aspects to make the financial sector as a whole more robust (European Commission 2013b, 2013f):

The following rules are now in force (a selection of measures taken): risk-based prudential and solvency rules for insurers ("Solvency II"); strengthened supervision of financial conglomerates; remuneration and prudential requirements for banks ("CRD III"); stricter rules on hedge funds and private equity ("AIFMD"); stricter rules on short selling and credit default swaps; a comprehensive set of rule for derivatives ("EMIR"); a framework for reliable high quality credit ratings; creation of the Single Euro Payments Area ("SEPA") as of 2014; markets in financial instruments (MiFID II; Trilogue agreement on 14 January 2014).

Other proposals included: reform of the audit sector; reform of the framework for market abuse; revision of current rules on markets in financial instruments and investment funds; shadow banking including Money Market funds and Securities law (proposal made in September 2013); revision of the governance of market benchmarks such as "Libor" and "Euribor" (proposal made in September 2013); innovative payment services (credit cards[9], etc.); creation of long-term European investment funds; review of the reform of the structure of the banking sector through the work of the high-level expert group headed by Erkki Liikanen.

The Liikanen Report (2012) addressed two problem areas in the EU financial sector: "too big to fail" and "two-tier banking system". Based on proposals in the Liikanen report, but not so far-reaching, are attempts by the European Commission to ban proprietary trading ("prop trading" or PPT). The Commission's proposal is only a light version of a "two-tier banking system" ("Son of Glass-Steagall"), but it should be the last piece to solve the puzzle of the "too big to fail" problem in the EU. The proposal would cover only the largest banks, some 30 large (globally system relevant – G-SIIs) banks in the EU plus some US and Japanese banks with subsidiaries in the EU ("Neue Zürcher Zeitung", 7 January 2014: 19).

[9] On 24 July 2013 the European Commission presented a proposal for a regulation of the capping of interbank fees (for credit and debit cards).

4. European Banking Union

The GFC in 2008-09 and especially the various rescue measures in the euro area since the start of the Euro crisis – often caused by banking crises – have prompted calls for the creation of a banking union (European Commission 2012b; German Council of Economic Experts 2012; CESifo Forum 2012; Breuss 2012).

4.1. Rationale and vision

The need for a greater integration of the European banking sector in a "banking union" can already be deduced from the previously identified "problems in the European banking sector". Above all, it applies to "break the link between sovereign debt and bank debt and the vicious circle which has led to over € 4,5 trillion (or 37% of EU GDP) of taxpayers money being used to rescue banks in the EU" (European Commission 2012b: 3).

Cœuré (2012) still finds a further justification for the EBU. Since the start of the euro crisis, there is a close relationship of banks to sovereign debt and the view of the rating agencies (see also Gros 2013; Mayer 2013). The sovereign debt crisis has also led to a fragmentation of the credit markets in the Eurozone, which – in addition to the fragmentation of government bond markets (increase in interest spreads after the Greek crisis) – covered both banks and the non-bank private sector. Since the outbreak of the euro crisis in early 2010, there has been – especially in the peripheral countries of the Eurozone – a tight link between the sovereign and bank creditworthiness which is clearly visible in the high degree of correlation between sovereign CDS premia and bank CDS premia within the same jurisdiction. In the US, with a well integrated fiscal and banking union, absorbing shock mechanisms (fiscal federalism) at the federal level, credible discipline on the state level (effective "no bail-out") and a central regulatory mechanism for the monitoring and resolution of banks (bank insolvency law), there is no correlation between CDS spreads for banks and governments. By the way, not even in Germany!

On the basis of the first report of the President of the European Council, Van Rompuy (2012a), submitted on 26 June 2012 – in close cooperation with the Presidents of the Commission and the ECB – the Heads of State or Government of the euro area (Euro Area 2012) and the European Council (2012a) on 29 June 2012 requested from the European Commission to prepare a proposal for a common banking supervision. On 12 September the European Commission (2012b) presented *A Roadmap towards a Banking Union*.

The Commission's proposals are based on the vision of establishing a banking union in three stages as envisaged in the report by Van Rompuy (2012a) and then modified and refined on 6 December 2012 (Van Rompuy 2012b). Van Rompuy's plan for a stable and prosperous EMU is based on four building blocks: 1) integrated financial framework; 2) integrated budgetary framework; 3) integrated economic policy framework to ensure growth, employment and competitiveness; 4) ensuring democratic legitimacy and accountability in decision-making in the EMU.

The "Van Rompuy plan" to create a new EMU as of December 2012 (similar to the plan by Barroso 2012b) stipulated that the "Integrated Financial Framework" (Banking Union) would be built in three stages. First, in 2014 a "single supervisory mechanism" would be implemented, later a "single resolution mechanism" should follow and in the end a "single deposit guarantee mechanism" would complete the European Banking Union. The Heads of State or Government agreed upon these proposals at their meetings of the European Council (2012a, 2012b) on 29 June and 14 December 2012. They commissioned the legislators of the EU (the Commission and the European Parliament) to prepare appropriate legal action.

4.2. Realisation in three steps

After the euro crisis – for taxpayers – showed a disastrous combination of sovereign and banking debt crises, the EU aimed towards a great solution, i.e. a stronger monitoring and harmonization of the European banking sector at EU level. Ultimately the internal market should be completed by those in financial services and an "integrated financial framework" for the EMU would thereby be created.

Building on the strong regulatory framework common to the 28 members of the Single Market (single rulebook), the European Commission therefore took an inclusive approach and proposed a roadmap for the Banking Union with different steps, potentially open to all member states but in any case, for the 18 member states within the euro area (6,000 banks).

The European Banking Union (EBU) should be created in three steps[10] (see Figure 1): surveillance with a Single Supervisory Mechanism (SSM); resolution with a Single Resolution Mechanism (SRM); deposit guarantee with a Single Deposit Guarantee Mechanism (SDM).

As basement for this EBU house (mandatory participants are all euro area countries; EBU is also open to all EU member states) is the "Single Rulebook" with EU law applicable to all EU member states (primarily the implementation of Basel III rules and the EU rules for bank resolution in the BRRD). The SRM and the SDM will have a long transitional phase (10 years) during which a national mechanism will be in place.

4.2.1. Single Supervisory Mechanism

On 4 November 2013, about one year after the Commission had proposed to set up a single banking supervision mechanism in the euro area, the SSM Regulation[11] entered into force (European Commission 2013f; see also ECOFIN 2013b). The ECB actively began to take up its new role of supervisor[12] carrying out a comprehensive assessment of all banks which would be under its direct supervision and the balance sheets of those banks[13]. In parallel it planned to recruit high-quality supervisory staff and build up a new supervisory structure to integrate national supervisors before the start of its activities.

4.2.1.1. The ECB assessment

The assessment of 128 large euro area banks began in November 2013 and took a year to complete. It was carried out in collaboration with the national competent authorities (NCAs) of the member states that participate in the SSM, and was supported by independent third parties at all levels at the ECB and at the national competent authorities.

The exercise had three main goals: transparency – to enhance the quality of information available on the condition of banks; repair – to identify and implement necessary corrective

[10] The European Commission (2012a: 2) even speaks of four pillars of a future EBU: 1) a single EU deposit guarantee scheme covering all EU banks; 2) a common resolution authority and a common resolution fund for the resolution of, at least, systemic and cross-border banks; 3) a single EU supervisor with ultimate decision-making powers, in relation to systemic and cross-border-banks; and 4) a uniform "single rule book" for the prudential supervision of all banks.

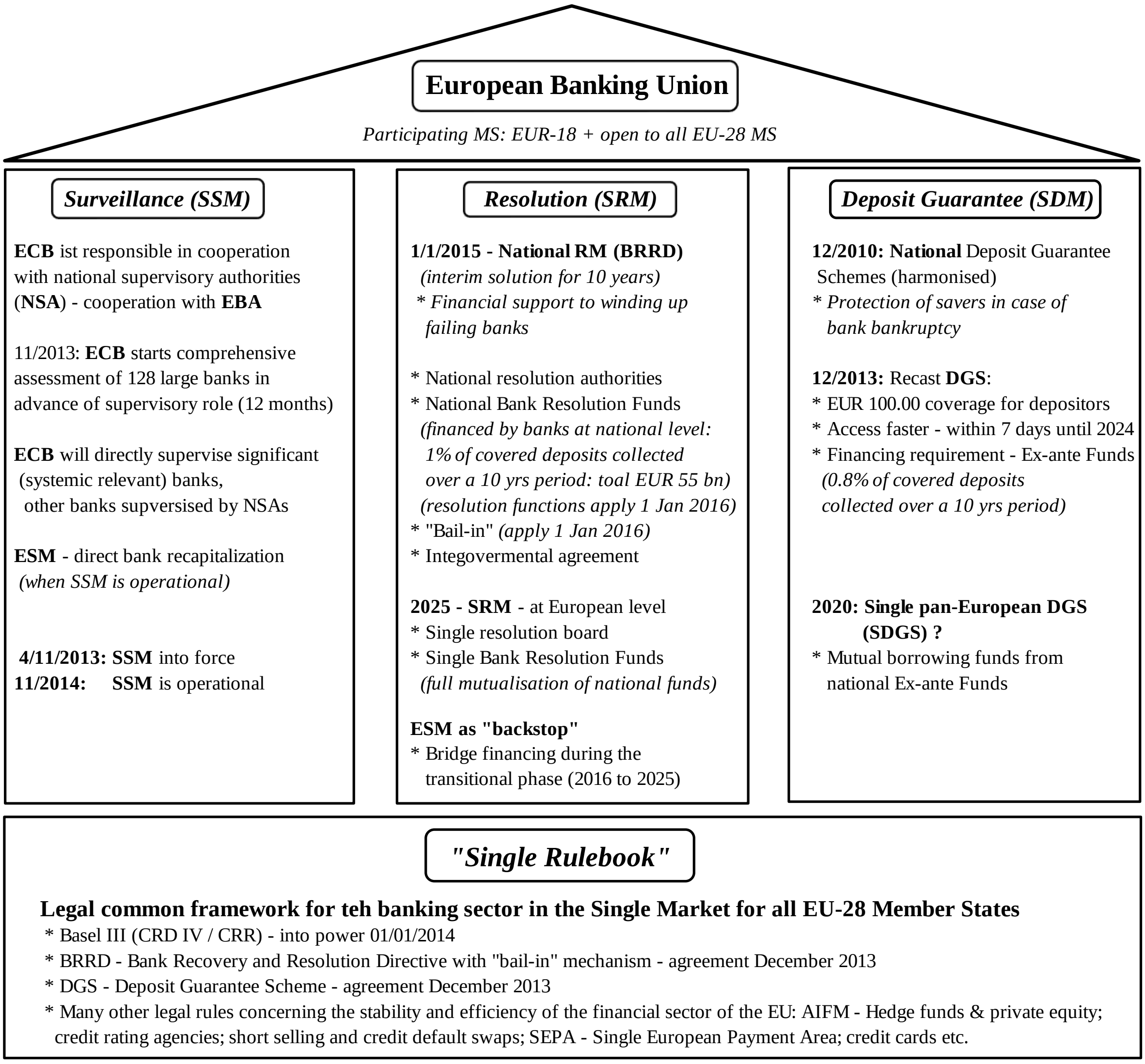
[11] The legislative package of the SSM consists of two regulations. The first rules the future competences of the ECB and the second those of the cooperation with the European Banking Authority (EBA): (1) ECB as Supervisor*:* The Council Regulation (EU) no. 1024/2013 of 15 October 2013, "Conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions", OJ, L 287/63, 29 October 2013 (SSM Regulation), i.e. the SSM is based on Article 127 (6) of the Treaty on the Functioning of the European Union (TFEU), which provides a legal basis for conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions and other institutions with the exception of insurance undertakings. (2) ECB cooperation with the EBA*:* The Regulation (EU) no. 1022/2013 of the European Parliament and of the Council of 22 October 2013, "Amending Regulation (EU) no. 1093/2010 establishing a European Supervisory Authority (European Banking Authority – EBA) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) no. 1024/2013", OJ, L 287/5, 29 October 2013. The legal basis is Article 114 TFEU.

[12] See the ECB website for the description of its new "banking supervision" tasks as part of the SSM: http://www.ecb.europa.eu/ssm/html/index.en.html.

[13] See ECB website: http://www.ecb.europa.eu/press/pr/date/2013/html/pr131023.en.html; and ECB 2013.

actions, if and where needed; and confidence building – to assure all stakeholders that banks are fundamentally sound and trustworthy.

Figure 1: The first blueprint of the European Banking Union



DGS = Deposit Guarantee Scheme; EBA = European Banking Authority; ESM = European Stability Mechanism; SDGS = Singe Deposit Guarantee Scheme; SDM = Single Deposit Guarantee Mechanism; SRM = Single Resolution Mechanism; SSM = Single Supervisory Mechanism.
Source: Own representation.

The assessment consisted of three elements: i) a supervisory risk assessment to review, quantitatively and qualitatively, key risks, including liquidity, leverage and funding; ii) an asset quality review (AQR) to enhance the transparency of bank exposures by reviewing the quality of banks' assets, including the adequacy of asset and collateral valuation and related provisions; and iii) a stress test to examine the resilience of banks' balance sheet to stress scenarios. These three elements are closely interlinked. The assessment was based on a capital benchmark of 8% Common Equity Tier 1, drawing on the definition of the Capital Requirements Directive IV/Capital Requirements Regulation, including transitional arrangements, for both the AQR and the baseline stress test scenario.

The comprehensive assessment concluded with an aggregate disclosure of the outcomes, at country and bank level, together with recommendations for supervisory measures. This comprehensive outcome was published in October 2014 prior to the ECB assuming its supervisory role, and included the findings of the three pillars of the comprehensive assessment.

4.2.1.2. Main features of the SSM[14].

- It confers new supervision powers on the ECB for the banks of the euro area: the authorisation of all banks in Europe and the coherent and consistent application of the single rulebook in the euro area, the direct supervision of significant banks, including all banks having assets of more than EUR 30 billion or constituting at least 20% of their home country's GDP (around 130 banks), the monitoring of the supervision exerted by national supervisors on less significant banks. The ECB may at any moment decide to directly supervise one or more of these credit institutions to ensure consistent application of high supervisory standards.
- The ECB shall ensure the coherent and consistent application of the Single Rulebook in the euro area.
- The SSM is open to all non-euro area member states.
- For cross-border banks active both within and outside member states participating in the SSM, existing home/host supervisor coordination procedures will continue to exist as they do today.
- The governance structure of the ECB will consist of a separate Supervisory Board supported by a steering committee, the ECB governing Council with the right to object to Supervisory Decisions from the Board, and a mediation panel. On 16 December 2013 the EU Council appointed Danièle Nouy as first Chair of the SSM at the European Central Bank.
- The ECB's monetary tasks will be strictly separated from its new supervisory tasks (Article 18 of the SSM Regulation), in order to eliminate potential conflicts of interest between the objectives of monetary policy and prudential supervision (see the criticism of the German Council of Economic Experts 2012: 186). To this end, a supervisory board (Article 19; it is composed of four representatives of the ECB appointed by the Executive Board of the ECB and one representative of the national authority competent for the supervision of credit institutions in each participating member) responsible for the preparation of supervisory tasks will be set up within the ECB. The board's draft decisions will be deemed adopted unless rejected by the ECB's governing council.

4.2.2. Single Resolution Mechanism

The second building block for a fully-fledged banking union is the creation of the Single Resolution Mechanism (SRM). The reinforced regulatory and supervisory framework of the SSM and enhanced prudential requirements will bolster the safety of banks[15]. However, the risk of a bank experiencing a severe liquidity or solvency problem can never be totally excluded. In the EBU bank supervision and resolution need to be exercised by the same level of authority and be backed by adequate funding arrangements. Otherwise tensions between the supervisor (ECB) and national resolution authorities may emerge over how to deal with ailing banks, while market expectations about member states' ability to deal with bank failure nationally could continue, reinforcing feedback loops between sovereigns and banks and fragmentation and competitive distortions across the Single Market. Swift and decisive actions at the central level, backed by EU-level funding arrangements, are also needed to avoid nationally conducted bank resolution from having disproportionate impacts on the real economy, and in order to curb uncertainty and prevent bank runs and contagion to other parts of the euro area.

Therefore, on 10 July 2013, the European Commission presented a legislative proposal for the SRM (SRM Regulation, European Commission 2013d) at EU level. The SRM is intended

[14] See European Commission 2013f.
[15] Ibid.

to complement the ECB supervision as part of the SSM. The SRM Regulation basically applies the substantive rules of the Bank Recovery and Resolution Directive (BRRD) in a coherent and centralised way ensuring consistent decisions for the resolution of banks thanks to a Single Resolution Board and it will include common resolution financing arrangements (including a Single Resolution Fund).

The SRM should ensure that – notwithstanding stronger supervision – if a bank subject to the Single Supervisory Mechanism faces serious difficulties, its resolution can be managed efficiently. In case of cross-border failures, it would be much more efficient than a "network of national resolution authorities" and avoid risks of contagion. The SRM will take over when the ECB, as the supervisor, would flag a bank, which needs to be resolved in the euro area or established in a member state participating in the EBU. As the SRM is corollary to the SSM, member states outside the Eurozone which join the SSM will also join the SRM.

4.2.2.1. Ten-year national transition before the SRM is operational

There are different legal interpretations of the TFEU concerning a SRM at European level between the European Commission and the member states (in particular Germany). In some countries (e.g. in Germany) there are also political hurdles for a "Europeanization" of the resolution mechanism and the "collectivization" of money of the already existing – e.g. the German Restructuring Fund. Germany fears that banks in countries with a relatively sound banking structure, such as those in Germany, would be liable for those in countries with a poor banking structure. Whereas the European Commission (the Internal Market Commissioner, Michel Barnier) sees the SRM backed by Article 114 of the TFEU, Germany (Finance Minister Wolfgang Schäuble; see also Höltschi 2013a) calls for Treaty change[16]. As a compromise, it was agreed that one starts with an interim solution to begin first with a network of national resolution mechanisms, which should then gradually merge after ten years into the SRM at EU/euro area level. On 18 December 2013 the Council (ECOFIN 2013c) set out its position on the establishment of a single resolution board and a single fund for the resolution of banks[17].

The ECOFIN called on the presidency to start negotiations with the European Parliament with the aim of agreeing the regulation on the SRM at first reading before the end of the Parliament's legislature in May 2014.

The compromise reached within the ECOFIN Council consists of a draft regulation on the SRM, and a decision by euro area member states committing them to negotiate, by 1 March 2014, an intergovernmental agreement on the functioning of the single resolution fund. This agreement, in line with terms of reference also approved, would include arrangements for the transfer of national contributions to the fund and their progressive mutualisation over a ten-year transitional phase (10 years national funds, then a European fund). It would endorse the bail-in rules established in the bank recovery and resolution directive (BRRD) as applicable to the use of the single fund.

Single Bank Resolution Fund (SRF): The SRF would be financed by bank levies raised at national level. According to the BRRD Directive each EU member state must establish

[16] However, the project of a "Europeanization" of the bank resolution is demanded from all institutions (European Commission, European Council, EMU reform plans of Van Rompuy and Barroso). Even the Franco-German paper on the reform of the monetary union, which German Chancellor Angela Merkel and French President François Hollande presented on 30 May 2013 (France-Germany 2013), calls for a "uniform resolution body that integrates the national resolution authorities" and can be created on the basis of the existing EU treaties. According to EU Internal Market Commissioner Michel Barnier, given the interdependence of banks in the euro area one should put an end to the fragmentation of the authorities (Höltschi 2013a, 2013b).

[17] The European Council (2013) welcomed – besides the final agreement reached by the legislators on the Deposit Guarantee Scheme Directive (DGSD) and the Bank Recovery and Resolution Directive (BRRD) – the general approach and the specific conclusions reached by the Council (ECOFIN) on the Single Resolution Mechanism (SRM) as a crucial step towards the completion of the Banking Union.

National Bank Resolution Funds[18]. On the basis of 2011 data on banks and an estimated amount of covered deposits held in banks in the euro area, the 1% target level for the Single Resolution Fund would correspond to around EUR 55 billion (based on more recent data the target value could be higher, EUR 80 billion for EU-27 and EUR 60 billion for the euro area). The target size of the Fund in absolute amounts (euros) will remain dynamic and will increase automatically if the banking industry grows. A transitional period of 10 years is foreseen before the Fund reaches its full target level. The SRF would initially consist of national compartments that would be gradually merged over ten years. During this ten-year period, mutualisation between national compartments would progressively increase. So while during the first year the cost of resolving banks (after bail-in) would mainly come from the compartments of the member states where the banks are located, the share would gradually decrease as the contribution from other countries' compartments increases.

The creation of a SRM will ensure that supervision and resolution are exercised at the same level for countries that share the supervision of banks within the SSM. This will prevent the emergence of tensions between supervision at EU level and national resolution regimes. The SRM will cover all countries participating in the SSM, namely the euro area member states and those non-Eurozone countries that decide to join the SSM via close cooperation agreements.

Single Resolution Board: The draft regulation agreed by the Council provides for a Single Resolution Board[19] with broad powers in cases of bank resolution. Upon notification by the ECB that a bank is failing or likely to fail, or on its own initiative, the board would adopt a resolution scheme placing the bank into resolution. It would determine the application of resolution tools and the use of the single resolution fund. Decisions by the board would enter into force within 24 hours after their adoption, unless the Council, acting by simple majority on a proposal by the Commission, objects or calls for changes.

The board would consist of an executive director, four full-time appointed members and the representatives of the national resolution authorities of all the participating countries. It would exercise its tasks in either a plenary or executive format. Most draft resolution decisions would be prepared in the executive session, composed of the executive director and the appointed members, with the representatives of member states concerned by a particular resolution decision involved in a first stage.

Plenary Session: The plenary session would be responsible for decisions that involve liquidity support exceeding 20% of capital paid into the fund, or other forms of support, such as bank recapitalisations, exceeding 10% of funds, as well as all decisions requiring access to the fund once a total of EUR 5 billion has been used in a given calendar year. In these cases, decisions would be taken by a two-thirds majority of the board members representing at least 50% of contributions.

The plenary session, voting by simple majority, would also have the right to oppose decisions by the executive session that authorise the fund to borrow, and decisions on the mutualisation of financing arrangements in the event of the resolution of a group with institutions in both SRM participating and non-participating EU countries.

To guarantee the budgetary sovereignty of the member states, the draft regulation prohibits decisions that would require a member state to provide extraordinary public support without its prior approval under national budgetary procedures.

[18] In Germany there is already such a fund (amounting to EUR 1.3 billion by the end of 2012; "Der Standard", online: 27 June 2013).

[19] Schoenemaker and Gros (2012) suggest that a new "European Deposit Insurance and Resolution Authority" (EDIRA) should start simultaneously with the ECB's supervisory power via the SSM. The President of the European Parliament, Martin Schulz, threatened to burst the ECOFIN compromise on the SRM because of its pitfalls concerning the speed of resolution of banks and the "multiplicity" of national institutions instead of one at European level (e.g. the European Commission; see "Die Welt", 19 December 2013).

The SRM would cover all banks in the participating member states. The board would be responsible for the planning and resolution phases of cross-border banks and those directly supervised by the ECB, while national resolution authorities would be responsible for all other banks. However, the board would always be responsible if the resolution of a bank requires accessing the single resolution fund.

National resolution authorities would be responsible for executing bank resolution plans under the control of the single resolution board. Should a national authority not comply with its decision, the board could directly address executive orders to the troubled bank.

The SRM Regulation, based on article 114 of the Treaty on the Functioning of the European Union (TFEU), requires a *qualified majority for adoption by the Council* in agreement with the *European Parliament*. The *intergovernmental agreement* would *enter into force* once *ratified by member states participating in the SSM/SRM* that represent 80% of contributions to the single resolution fund.

State aid and bank resolution: In any case the *state aid rules* on burden-sharing will apply if resolution actions involve government support ("bail-out"). In order to implement the burden-sharing by shareholders and junior creditors, the SRM would be able to apply as of the entry into application of this Regulation, rules allowing the write down of shares and subordinated debt to the extent necessary in order to apply the state aid rules.

Only after a ten-year transition period the fully-fledged SRM should become operational at EU level according to the proposals of the European Commission (2013d, 2013e, 2013f).

"Bail-in": The central element of the bank resolution according to the BRRD and the SRM is the "Bail-in" procedure with its clear pecking order (burden-sharing) according to that the shareholders, creditors and possibly unsecured deposits are used first to cover losses and to finance the resolution in order to protect the taxpayer. This instrument – modeled after the bank bailout in Cyprus – will be central. "Bail-in" would potentially apply to any liabilities of the institution not backed by assets or collateral, and not to deposits protected by a deposit guarantee scheme, short-term (e.g. inter-bank) lending, client assets, or liabilities such as salaries, pensions, or taxes.

- A *"cascade of burden-sharing*" will apply: There will be a clear pecking order. In the first place, according to the compromise of the ECOFIN, the owners (shareholders) would have to pay, followed by the holders of hybrid capital and subordinated debt (junior bonds). In third place senior bonds (senior bonds) and deposits of about EUR 100,000 by large companies would follow, ranked fourth deposits of about EUR 100,000 from individuals and SMEs. Liabilities to the *European Investment Bank (EIB)* would have preference over the claims of ordinary unsecured, non-preferred creditors and depositors from large corporations. Customer deposits up to EUR 100,000 remained untouched. A number of liabilities (e.g. deposits covered, secured debt, fixed salary and pension claims, interbank liabilities with a maturity of less than 7 days, etc.) are permanently excluded from liability.
- *Liability*: In order to have available enough absorption capacity in the event of a crisis, banks should hold a minimum (minimum requirements for own funds and eligible liabilities – MREL) of 8% of their total assets, i.e. shareholders and creditors of the banks are liable first with an amount of at least 8% of the total liabilities. Should still greater losses incur, additional 5% will be covered by the national resolution funds or the ESM. If the financial needs exceed the threshold of 13%, bank investors (large investors above EUR 100,000) will be asked to pay again. In 2016, a review clause will allow the European Commission, based on recommendations of the European Banking Authority (EBA), to introduce a harmonized MREL rule for all banks. When the liability rule should apply, is still open. This is planned for 2018.

4.2.2.2. Backstop before the EBU is in place

Eurogroup and ECOFIN ministers (Eurogroup 2013b) also adopted a statement on the design of a backstop to the single resolution fund. The statement specifies that during the initial build-up phase of the fund (over a 10 years transition period), bridge financing will be available from national sources, backed by bank levies, or from the European Stability Mechanism (ESM), according to existing procedures. Lending between national compartments would also be possible. During this *transitional phase*, a common backstop will be developed, which would become *fully operational at the latest after ten years.* The backstop would facilitate borrowings by the fund. It would ultimately be reimbursed by the banking sector through levies, including ex-post.

This statement reiterates the political agreement achieved by the Eurogroup and ECOFIN ministers (Eurogroup 2013a) already on 20 June 2013 on guidelines for the direct recapitalization of distressed banks by the ESM. Current bank aid from the ESM (e.g. in the case of Spain) were executed via the member states: they received loans from the ESM, which were used to recapitalize banks. However, this operation increased the national sovereign debt.

To break the vicious circle between bank and sovereign debt crises, the Heads of State or Government of the Eurozone on 29 June 2012 decided that the ESM can directly recapitalize euro-area banks under certain conditions. Between the individual components of the legislation of the Banking Union, there are close relationships, especially with the directive on bank recovery and resolution (Bank Recovery and Resolution Directive – BRRD) of 6 June 2012, and the directive for a deposit insurance system (Deposit Guarantee Scheme Directive – DGSD) of 12 July 2010.

With the implementation of these EU laws, guidelines for the new task of the ESM will be developed. The ESM will take the direct recapitalization of banks as a new task under Article 19 of the ESM Treaty. The ESM may – on the request of an ESM Member and in accordance with the provisions of the ESM Treaty – conduct direct recapitalisations of an institution only if the following criteria are met:

1) The institution has a systemic relevance or poses a serious threat to the financial stability of the euro area as a whole or the requesting ESM member (risk of infection, according to Article 3 ESM Treaty).
2) “Bail-in”: There will be a clear pecking order (burden-sharing) for recapitalisation operations: private capital resources will be explored as a first solution, including sufficient contributions from existing shareholders and creditors of the beneficiary institution(s).
3) Of the total lending capacity of the ESM of EUR 500 billion, EUR 60 billion will be reserved for direct bank recapitalization. In addition, a burden-sharing scheme will determine the contributions of the requesting ESM Member and the ESM, respectively. This scheme will comprise two parts: (i) If the beneficiary institution(s) has insufficient equity to reach the legal minimum Common Equity Tier 1 (CET1) ratio of 4.5%, as established in the Basel III framework/CRD IV/CRR, under a sufficiently prudent scenario of a stress test, the requesting ESM member will be required to make a capital injection to reach this level before the ESM enters into the capital of the institution. (ii) If (one of) the institution(s) already meets the above-mentioned capital ratio, the requesting ESM member will be required to make a capital contribution alongside the ESM, equivalent to 20% of the total amount of the public contribution in the first two years after the entry into force of the instrument and to 10% afterwards. If the contribution in this first part were lower than would have been required in the second part, the requesting ESM member would be asked to inject an additional amount alongside the ESM to cover the difference.
4) Legacy of past bank rescue operations: How far the ESM will be able to take over retroactively ongoing bank support, will be decided uniformly from case to case. Possible candidates would be Greece or Ireland. Spain has no interest.

4.2.3. Single Deposit Guarantee Scheme

In the early discussion about a European Banking Union the European Commission (2012a) when presenting the four-pillar concept of a EBU also reflected about the need of a “Single Pan-European Deposit Guarantee Scheme” (SDGS). But this idea has been refused because of low chances to be politically implementable. Similar arguments and objections as in the case of the SRM at EU level apply also in the case of a SDGS. A common (single) deposit insurance at the EU/Eurozone level is seen more sceptically and more or less rejected in the core countries of the Eurozone (especially Germany), but it is advocated in the peripheral countries, as in the case of the rescue operations via the ESM. The transfer donors are more opponents, the transfer recipients advocates.

At an early stage, the European Commission (2010) speculated about a SDGS and argued that a single pan-European scheme would have two main advantages: first, the impact assessment estimates that € 40 million administrative costs per year could be saved; second, it could better deal with bank failures. The impact of a single bank failure on a large scheme is lower than on a scheme only covering the banking sector of one member state.

However, there are complicated legal issues which would need to be examined. The idea of a pan-EU Deposit Guarantee Scheme remains a potential longer-term project. Later the European Commission (2013f) declared that it is not envisaged to equip the banking union with a single supranational DGS at this stage. The priority is to reach an agreement on a common network of national deposit guarantee schemes. The proposal on DGS once agreed will ensure that every member state has a deposit guarantee fund which is properly funded, *ex ante*. The text also opens the way to a voluntary mechanism of mutual borrowing between the DGSs from different EU countries. This is the only form of mutualisation foreseen at this stage.

As described in section 3.3.2.2, on 17 December 2013 a political agreement has been reached between the European Parliament and EU member states on the new rules on Deposit Guarantee Schemes (European Commission 2013g). The DGS Directive will strengthen the existing system of national DGS to respond to the weaknesses revealed by the financial crisis. Depositors will continue to benefit from a guaranteed coverage of € 100,000 (EU law since December 2010) in case of bankruptcy, but access to the guaranteed amount will be easier and faster. Repayment deadlines will be gradually reduced from the current 20 working days to 7 in 2024.

4.3. Winners and losers of EBU

4.3.1. Cost-benefit analysis of joining EBU

To recap the rational for creating a European Banking Union (EBU) and, hence, a truly integrated European-level banking system, two major targets stand out: (1) EBU can foster financial stability in Europe, in particular in the Euro area by breaking the diabolic loop between national governments (sovereign debts) and banks (bank debt); (2) EBU would take into account the cross-border externalities of large banks; normally, national governments concentrate only on the domestic effects of bank failures and ignore cross-border effects.

In a cost-benefit analysis Schoenemaker and Siegman (2013a, 2013b) calculate the net benefits of switching from a national bail-out to a European-level bail-out mechanism. The *benefits* of joining the EBU result from the efficiency gains moving from the home rule to a supranational rule (SRM at EU/euro area level). This is calculated by aggregating the efficiency gains of joining the EBU of 25 largest European banks (located in 10 euro area countries; 2011 balance sheet data) to receive the country-specific effects. Total *costs* of joining the resolution mechanism of the EBU are based on the ECB capital key. Each euro area country would have to pay the same amount into a *Single (European) Bank Resolution*

Fund (SEBRF)[20] which corresponds to the capital input into the ECB. By comparing benefits and costs Schoenemaker and Siegman (2013a, 2013b) get the net benefits for euro area and non-euro area countries. Out of the chosen list of 25 top European banks only 7 of these large banks are located in euro area countries – Belgium, France, Germany, Ireland, Italy, Netherlands and Spain – and only three in non-euro area countries (Denmark, Sweden and the United Kingdom). For the other countries with no own big banks joining the EBU results only in "costs" according to the capital key of the ECB.

In the *euro area* the biggest "net effects" would go to Spain (10.9%) and the Netherlands (3.1%). The biggest losers ("net payers") would be Germany (-6.7%), Italy (-3.9%) and France (-2.8%). Then follow small euro area countries with only small banks and therefore the "net costs" are only the result of "costs": Austria (-1.9%), then Portugal (-1.8%), Belgium (-1.6%), Finland (-1.3%), Ireland and Slovakia (each -0.7%), Slovenia (-0.3%), Estonia and Luxembourg (each -0.2%) and Malta and Cyprus (each -0.1%).

Non-euro area countries: Whereas EBU membership is mandarory for euro area (EA) countries, non-euro area countries (also called "outs") have the option to join the Banking Union. The United Kingdom and Sweden have declined to join the EBU. Nevertheless, Schoenemaker and Siegman (2013a: 22) calculate also hypothetically the costs and benefits of the non-euro area countries joining the EBU. The biggest "net effects" would go to the United Kingdom (12.9%) and Sweden (8.6%); Denmark (0.3%). All other countries are losers – the biggest would be Poland (-4.9%), followed by Romania (-2.5%), the Czech Republic (-1.5%) and Hungary (-1.4%). The losses of the others are below 1%: Bulgaria (-0.9%), Lithuania (-0.4%) and Latvia (-0.3%). The cost-benefit analysis again underlines the asymmetry in the distribution of bank risks. The largest banks (with the exception of Spain) are located in the core of the EU/euro area.

4.3.2. Macroeconomic stabilization properties of the EBU

Applying the two-region euro area QUEST model with a banking sector (the euro area is partitioned in the "periphery" – with Greece, Ireland, Italy, Portugal and Spain – and the "core", with the remaining euro area countries) Breuss, Roeger and in't Veld (2015) simulate the stabilization effects of alternative bank resolution options in case of a financial shock in the periphery. In the baseline scenario (whereby the government of the euro area periphery does not intervene after a financial shock comparable to those of the GFC in 2008-09) the periphery would suffer a drop in GDP of 6% and of the core of 0.4% (see Table 1).

The EBU solution with the SRM at EU/euro area level is best from the perspective of the periphery (drop of GDP by only 2.2%) since it constitutes a transfer from the core banks to the periphery banks) but is worse for the core (drop of GDP by 1%). The backstop solution via ESM loans to the periphery banks is also costly for the periphery (GDP -3.2%). The least costly solution turns out to be an EBU based on a "bail-in" of national depositors. This solution effectively overcomes the national financial market inefficiency by making all households/savers share the risk/losses.

[20] Instead of a "Single Resolution Board" and a "Single Resolution Fund" as foreseen in the Commission's proposal for a future SRM, Schoenemaker and Gros (2012) propose an authority which would cover the 2nd (SRM) and 3rd (SDM) pillar of the planned EBU. They call this institution "European Deposit Insurance and Resolution Authority" (EDIRA) which would manage a "European Deposit Insurances and Resolution Fund" (EDIRF).

Table 1: First year GDP effects of alternative bank resolution options

Scenarios	GDP periphery	GDP core	GDP euro area
1. No intervention: baseline	-5.99	-0.44	-1.85
National measures:			
2. National "bail-out": periphery government rescue	-4.54	-0.33	-1.40
3. National "bail-in"	-2.73	-0.21	-0.85
European Banking Union:			
4. EBU: SRM at EU/Euro area level	-2.21	-1.00	-1.31
5a. ESM: backstop with loans	-3.22	-0.19	-0.82
5b. ESM: backstop with transfer	-2.06	-0.18	-0.66

Source: Breuss, Roeger and in't Veld (2015).

Within the logic of this model there is one solution which would minimise aggregate, core and periphery losses: this would be a backstop arrangement where the ESM is providing transfers to periphery banks (GDP drop in the periphery by 2%; in the core by 0.2% and in the euro area by 0.7%). This solution would come close to overcoming both national and intra EA risk sharing deficiencies by spreading losses to all households (equity owners/workers) in the EA. This analysis has shown that an EBU in the euro area can overcome to a large extent limited financial market integration.

4.3.3 Macroeconomic net benefits of the EBU

The European Commission (2012a: 16-17), in an economic impact study, has analyzed the costs and benefits of the proposed SRM. The costs of the framework are taken to derive notably from the potential increase in the funding cost of banks due to the removal of the implicit state support and from the costs of setting up resolution funds (first national and then a single bank resolution fund). Such increases in banks' costs might have negative effects for GDP. On the other hand, the improved stability of the financial sector, and reduced likelihood of systemic crises and risks for taxpayers' money to recapitalise failing banks, would have a positive effect on GDP. New costs for banks should be minimal while the framework should work in a variety of crises of different magnitude (losses by EU banks during the recent crisis from 2008 to 2010 are taken as a key reference point).

Table 2: Economic impact of Basel III, DGS/RF and Bail-in tool (debt write down)
Costs and benefits as % of annual GDP

	Basel III	DGS/RF	Bail-in	Sum
Costs	0.16	0.04	0.14-0.42	0.34-0.62
Benefits	0.30	0.32	0.76	1.38
Net Benefits	0.14	0.28	0.34-0.62	0.76-1.04

Basel III, transformed into EU law by CRD IV; RF = Single (European) Bank Resolution Fund; Bail-in tool according to the rules of BRRD and SRM.
Source: European Commission 2012a: 17.

The efficiency and effectiveness of the proposed framework of an EBU is to be seen in the context of a joint calibration of Basel III rules, funding available under Deposit Guarantee Schemes (DGS) and the bail-in tool (BRRD and SRM). The new capital requirements under the Basel III accord (which reduces the probability of bank failures) are – according to Commission's estimates (European Commission 2012a: 17) expected to generate net benefits equal to 0.14% of the EU's GDP annually (see Table 2). The necessary funding of DGS or specific resolution funds (RF) are expected to bring positive net benefits equal to 0.2-0.3% of the EU’s GDP annually. The “bail-in tool” could produce economic net benefits equal to 0.3-0.6% of the EU’s GDP annually. Overall, these measures are expected to generate a cumulative net benefit equal to 0.7-1.0% of the EU’s GDP annually.

The *costs* (in terms GDP, investment, volume of loans, etc.) are estimated by the European Commission (2012a: 17) through a simple methodology also used by the Bank of England, and validated by the estimations of a dynamic general equilibrium macroeconomic model (QUEST III) that has been extended to incorporate financial intermediation by the banking sector. The *benefits* are estimated using the SYMBOL model, developed by the European Commission.

5. Conclusions

The euro crisis is due in good part to the unresolved banking problems in Europe. On the one hand the European financial sector is highly fragmented because of national rulings. On the other hand cross-border externalities disturb the functioning of the Single Market. Out of the three main causes of the Euro crisis (fragmented competitiveness, sovereign debt and banking crises) the latter two are intermingled in a vicious circle of sovereign debts and bank debt. A European Banking Union (EBU) should first break the diabolic link between sovereign debts (national governments) and bank debt and the vicious circle which lead to rescue banks by taxpayer’s money (States as “lender of last resort”). And second, the EBU would take into account the cross-border externalities of large banks. Normally, national governments concentrated only on the domestic effects of bank failures and ignore cross-border effects.

The state of play of the EBU is characterized by the mismatch of ideal of the “roadmap towards a Banking Union” proposed by the European Commission in September 2012 and the agreements reached so far. From the three-pillar solution (SSM, SRM and SDM) based on the fundament of the “Single Rulebook” the Banking Union started in autumn 2014 with the SSM at the ECB. The SRM at EU/euro area level is postponed. In a 10-years transitional phase a network of national resolution mechanisms will manage bank failures. Gradually the national resolution funds will merge towards a mutualized Single Resolution Fund at EU/euro area level. The Single Deposit (Guarantee) Mechanism has been only recast at national level (DGS). As always with EU projects they are work in progress. And the EBU project is one of the most important projects to complete the Single Market for financial services.

There are many problems connected with the EBU project. If only a subset of EU banks (only those of the euro area) is regularly supervised by the ECB, this promotes the EU cleavage. This is especially true in the case of the increasing risks of banking in the new EU member states in Eastern Europe. Moreover, it is questionable whether a European banking supervision can better assess *ex ante* the risks of banks than national supervisory authorities, which also were not always able to do this job properly. Although shadow banks are already targeted by the European Commission, they pose a great danger to the stability of the European financial sector. Many questions also remain open, especially how to handle “shadow banks”.

First evaluations indicate that the net benefits of joining the EBU would be distributed unequally between the member states of the EU/euro area. Germany would be the biggest loser, Spain and the Netherlands are the biggest winners. Of the non-euro countries, the UK and Sweden have the most to gain, but Poland would lose. The country-specific gains of joining the EBU depend on the number and size of banks located in a country. The resolution mechanism of the EBU would beyond doubt have a strong stabilising effect in case of financial shocks. The outcome depends on the design. The best solution for all euro area countries would be a backstop solution via ESM with transfers to failing banks. First estimates by the European Commission indicate that a genuine EBU – by avoiding a systemic banking crisis – would result in macroeconomic net benefits for the EU in the range of 0.7% to 1% of annual GDP.

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