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European Banking Union

Fritz Breuss

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The ongoing Euro crisis and the worse economic development in Europe than in the USA 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 stabilised, even five years after Lehman Brothers. From the grand solution of a "European Banking Union" (EBU) only the first pillar, the European Bank Supervision with the single supervisory mechanism (SSM) will come into effect in 2014. The other necessary steps – the single resolution mechanism (SRM) and the single deposit guarantee mechanism (SDM) – will follow later. Until the "Europeanisation" will take place the bank recovery and resolution will be managed nationally based on EU law. A first evaluation indicates that the potential benefits of solving bank problems via the resolution mechanism of a new EBU would be distributed unequally between the member countries of the EU/Euro area. Germany would be the biggest loser, Spain and the Netherlands 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 EBU depend on the number and size of banks which are located in a country. It is, however, not yet clear whether the goal of macroeconomic stabilising of bank resolutions would be better achieved when executed via the SRM or with the ESM, both for the countries affected and for the Euro area as a whole.

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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 five years after Lehman Brothers. From the grand solution of a "European Banking Union" (EBU) only the first pillar, the European Bank Supervision with the single supervisory mechanism (SSM) will come into effect in 2014. The other necessary steps – the single resolution mechanism (SRM) and the single deposit guarantee mechanism (SDM) – will follow later. Until the "Europeanization" will take place the bank recovery and resolution will be managed nationally based on EU law. A first evaluation indicates that the potential benefits of solving bank problems via the resolution mechanism of a new 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 EBU depend on the number and size of banks which are located in a country. It is, however, not yet clear whether the goal of macroeconomic stabilizing of bank resolutions would be better achieved when executed via the SRM or with the ESM, both for the countries affected and for the Euro area as a whole.

Keywords: Economic and Monetary Union, Eurozone, European Integration, Banking Union.
JEL Classification: E42, E61, F15, F33, F41, F53

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A shorter version of this study has been published in German (*"Europäische Bankenunion"*) in Vierteljahreshefte zur Wirtschaftsforschung, DIW Berlin (82), 2/2013, pp. 127-147.

Contents

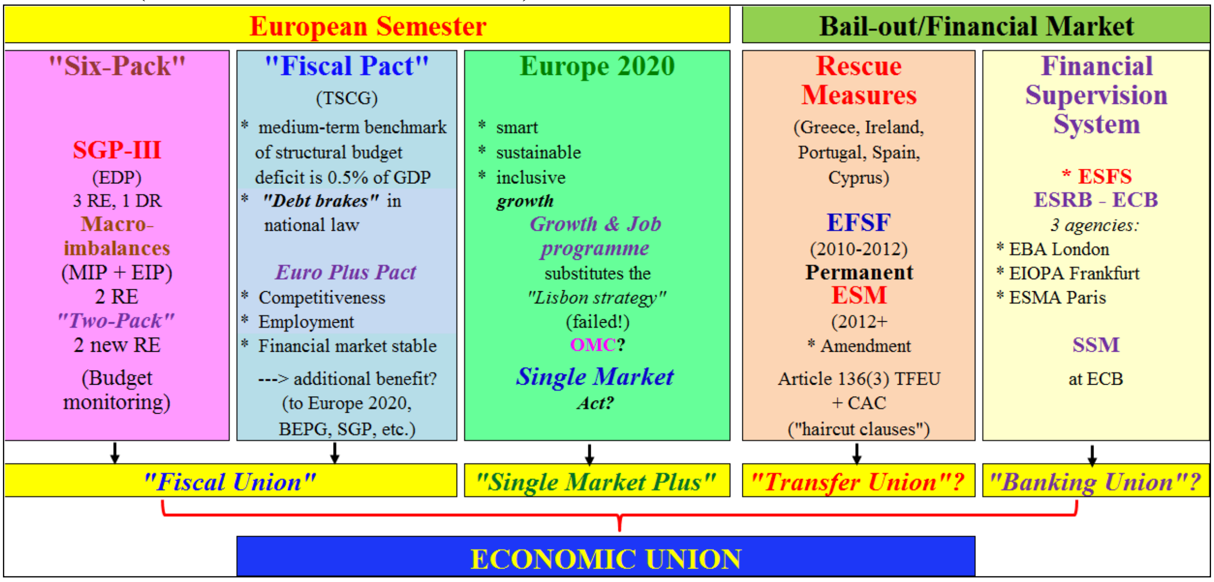
1. Introduction

The ongoing euro crisis is the result of at least three interacting factors: a current account crisis (different competitiveness of euro-zone 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 U.S., 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 euro zone increased (especially in the peripheral countries) after the GFC so strong that it in early 2010 sparked the so-called euro crisis (no crisis of the euro). Already five euro zone 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 the 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 euro zone (except Ireland) have the common problem that their competitiveness against the core of the euro zone 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 recover only slowly.

It is noteworthy that the United States that triggered the GFC, mastered both the "Great Recession" in 2009 (real GDP - 3.1%) and also the recovery since then better than Europe (-4.3% EU, euro zone -4.4%). While the euro zone in 2012 and 2013, slid again into a recession, the economy of the U.S. - albeit slowly – picked up. In contrast to the euro zone the U.S. have already a well-functioning monetary union. The U.S. obviously are able to solve better and more flexible economic crises which have their origin in the banking realm. In the EU, the crises have disclosed relentlessly the weaknesses of the economic structure of the Economic and Monetary Union (EMU). Since the outbreak of the euro crisis representatives of the EU are eagerly trying to close these gaps. With the new economic architecture (New Economic Governance; see *Figure 1*) 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 / euro zone 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.

Figure 1: New Economic Governance of EMU since 2010
("EU Economic Government")



BEPG = Broad Economic Policy Guidelines; SGP = Stability and Growth Pact; EDP = Excessive deficit procedure; RE = Regulation; DR = Directive; EIP = Excessive imbalance procedure; MIP = Macroeconomic imbalances procedure; OMC = Open method of coordination; EFSF = European Financial Stability Facility; ESM = European Stability Mechanism; CAC = Collective Action Clauses; ESFS = European System of Financial Supervisors; ESRB = European Systemic Risk Board; EBA = European Banking Authority; EIOP = European Insurance and Occupational Pension Authority; ESMA = European Securities and Markets Authority; SSM = Single Supervisory Mechanism; TSCG = Treaty on Stability, Coordination and Governance in the EMU; TFEU = Treaty on the Functioning of the European Union.
Source: Author's conception

2. Retarded reform of the international banking system

Shortly after the Lehman collapse, the G20 meeting in Washington on 15 November 2008 already indentified 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. To large, systemically important banks could practically blackmail the States.
2) *Universal banking system:* In response to the "Great Depression" in the thirties of the last century, the "Glass-Steagall Act" was introduced in 1933. It was a two-tier banking system: investment banking was separated from normal banking business. Only under

President Bill Clinton in 1999, in several sessions this scheme was lifted and the universal banking system, long been common in Europe.

Since that correct identification of the problems of the international financial sector, which contributed to triggering the GFC in 2008/09, five years have passed in which on the international level (G20, G7, OECD, BIS) always new approaches to stabilize the international financial sector have always suggested . However, the actual implementation has a "long line". All activities end in the intention to curb and smartly reregulate the financial sector, which has been increasingly deregulated up to the crisis, and thus led to "irresponsible practices" (Barroso 2012a).

2.1 Reforms outside the euro zone

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 subject already long-established rules. Additionally, by the so-called Volcker Rule in 2010 the Dood-Frank Act legally introduced again an attenuated form of the two-tier banking system, a kind of "Son of Glass-Steagall." Part of the Volcker Rule, banks prohibit trade on their own account and participation in hedge funds and private equity funds, will be adopted in late 2013 (Lanz 2013b).

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" 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 (equity as a percentage of total assets) at UBS and Credit Suisse was much lower than that of a comparison group.

Great Britain, although (still) an EU member, but outside the euro zone, 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 that of an interim report and in 2013 in a final report (Edmonds, 2013). They were implemented in the Financial Services Act of 2012. As in the U.S., a kind of "Son of Glass-Steagall" was introduced by a structural reform which proposed the end of the universal banking system. In the wake of the Libor scandal a high-profile parliamentary commission has proposed to make responsible bankers also criminally liable (see Neue Zürcher Zeitung, 20 June, 2013, p 27).

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 (see Neue Zürcher Zeitung of July 20, 2013, page 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".

2.2 Financial market reforms in the EU

In the EU the two problem areas "too big to fail" and "two-tier banking system" were addressed in the Liikanen Report (2012) which issued many recommendations to solve the banking crisis. Some of the suggestions of the Liikanen report will be implemented in several legislative initiatives of the European Commission (Internal Market and Services) regarding aspects of the reform of the banking services internal market (European Commission, 2013b), some (e.g. the problem of "too big to fail") is still waiting for implementation.

The EU has already launched numerous partial reforms of the financial sector – on the one hand in implementing the requirements of G20 rules and on the other hand in the context of increasing the efficiency of the single market in financial services. However, the first major reform steps of the banking sector come into force only in 2014 (implementation of Basel III and the single supervisory mechanism).

- *Implementation of the new G20 rules for the global financial system into EU law* (a selection; European Commission 2013b):
  <u>April 2009</u>: Hedge Funds and Private Equity ("AIFMD")
  <u>July 2009:</u> Remuneration and prudential requirements for banks ("CRD III")
  <u>September 2010:</u> Derivatives ("EMIR")
  <u>November 2008-November 2011:</u> Credit Rating Agencies: Stricter rules for credit rating agencies took effect on 20 June 2013.
  <u>July 2011:</u> Single Rule Book of prudential requirements for banks: capital, liquidity and leverage and stricter rules on remuneration and improved tax transparency ("CRD IV" / "CRR")

January 2014: Entry into force of the implementation of *"Basel III"* (capital adequacy requirements and liquidity requirements[1]) into EU law. This is realized by:

(I) by a *banking package* (adopted by the European Parliament on 16 April 2013, adopted on 20 June, 2013 by the ECOFIN) 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

(II) a regulation of *"bankers' 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.

- *EU measures to increase the stability and efficiency of the* Single Market in financial services (a selection; European Commission 2013b):

July 2007: Risk-based prudential and solvency rules for insurers ("Solvency II")

September 2009: Establishment of the European Supervisory System (ESFS), comprising three European Supervisory Authorities (ESAs) - the European Banking Authority (EBA in London), the European Insurance and Occupational Pensions Authority (EIOPA) in Frankfurt and the European Securities and Markets Authority (ESMA in Paris) - as well as for the supervision at the macro level the European Systemic Risk Board (ESRB at the ECB). This financial market supervision system took effect on 1 January 2011.

August 2010: Strengthened supervision of financial conglomerates

September 2010: Short-Selling and Credit Default Swaps

December 2010: Creation of the Single Euro Payments Area ("SEPA") .

Many other schemes are still awaiting proposals from the Commission (e.g. structural reforms in banking; regulation of financial benchmarks (such as LIBOR or EURIBOR); innovative payment services (credit cards[2], etc.), creating long-term European investment fund.

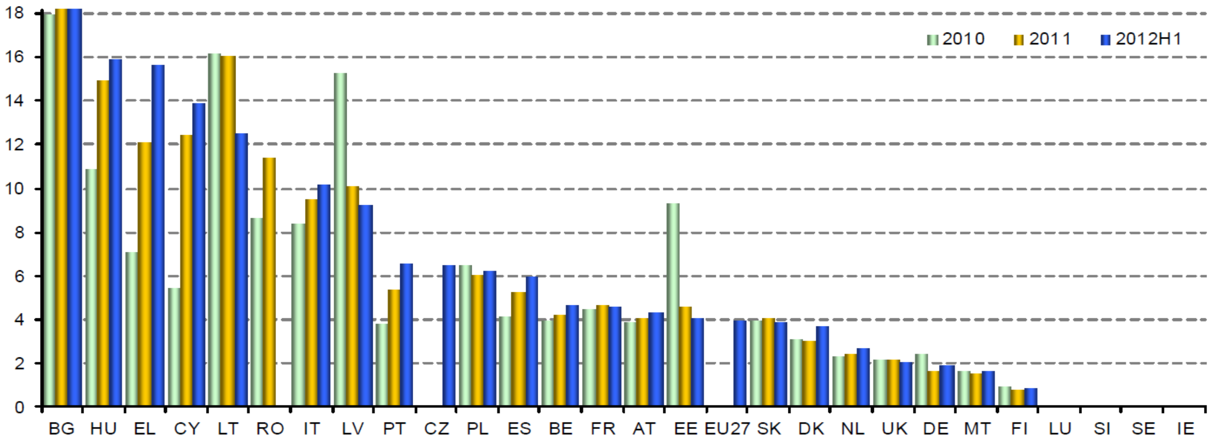
3. Problems of the European banking sector

- *Increase in non-performing loans of banks:* Since the outbreak of the GFC in 2008/09 the number 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; see *Figure 2*).

[1] 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

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

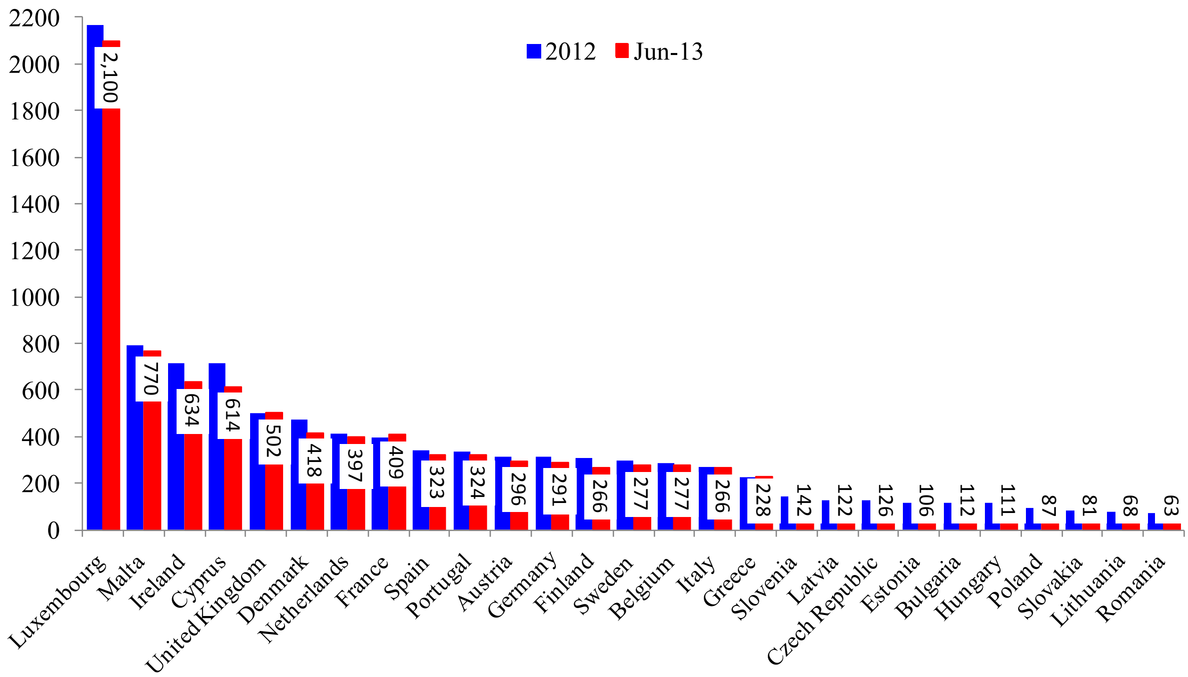
Figure 2: Non-performing loans (NPLs) to total loans (%)



Sources: ECB, Consolidated banking data; ECFIN E3: Bank Watch, No. 183, 10/06/2013, p. 1

A study by Ernst & Young (2012) also points in this direction. According to their forecasts the volume of "bad loans" in the euro zone is expected to increase to 918 billion euros (an increase of 80 billion euros in one year) in 2013. This corresponds to 9.5% of GDP in the euro zone. 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 euro zone it is 7.6%.

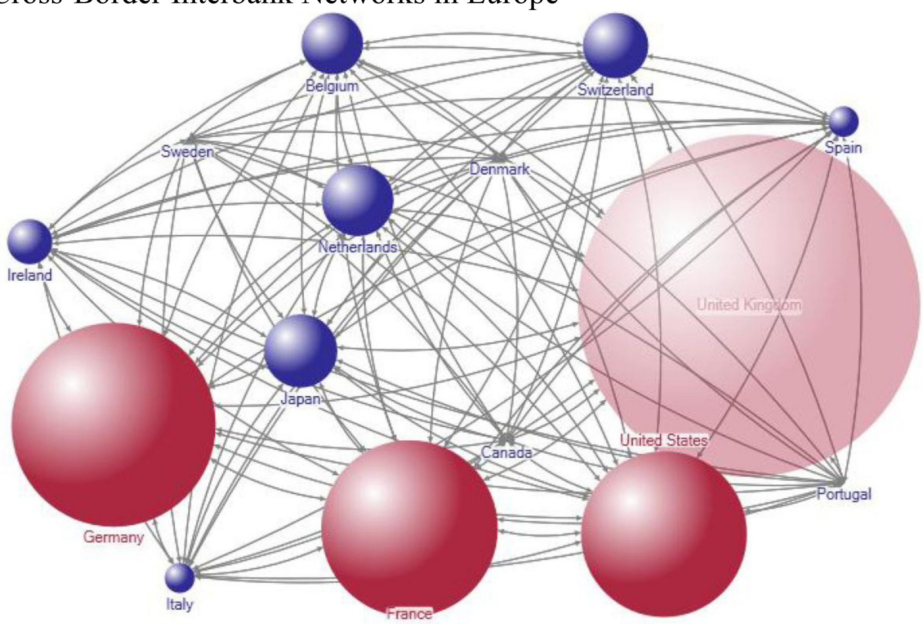
Figure 3: Sizable Assets – Overbanking in Small Euro area countries
(Bank Assets as a share of GDP in %)



Source: ECB

- *Too large banking sector in small euro-zone countries:* The Cyprus crisis has shown dramatically that some euro-zone Member States have a much 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, that during the GFC in 2008/09 and the subsequent euro-crisis made them greatly vulnerable (see *Figure 3*). In 2012, the share of bank deposits to GDP in Luxembourg amounted to 2174%, 792% in Malta, 718% in Ireland and 716% in Cyprus. In comparison, 482% in Switzerland, 380% in Austria and 143% in Slovenia 143%. In contrast, the corresponding proportion in large EU countries was rather modest. In the UK, 504%, 311% in Germany and in the U.S. even only 91%.
- *Great linkages in European banking, 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 neighboring 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 (see *Figure 4*).

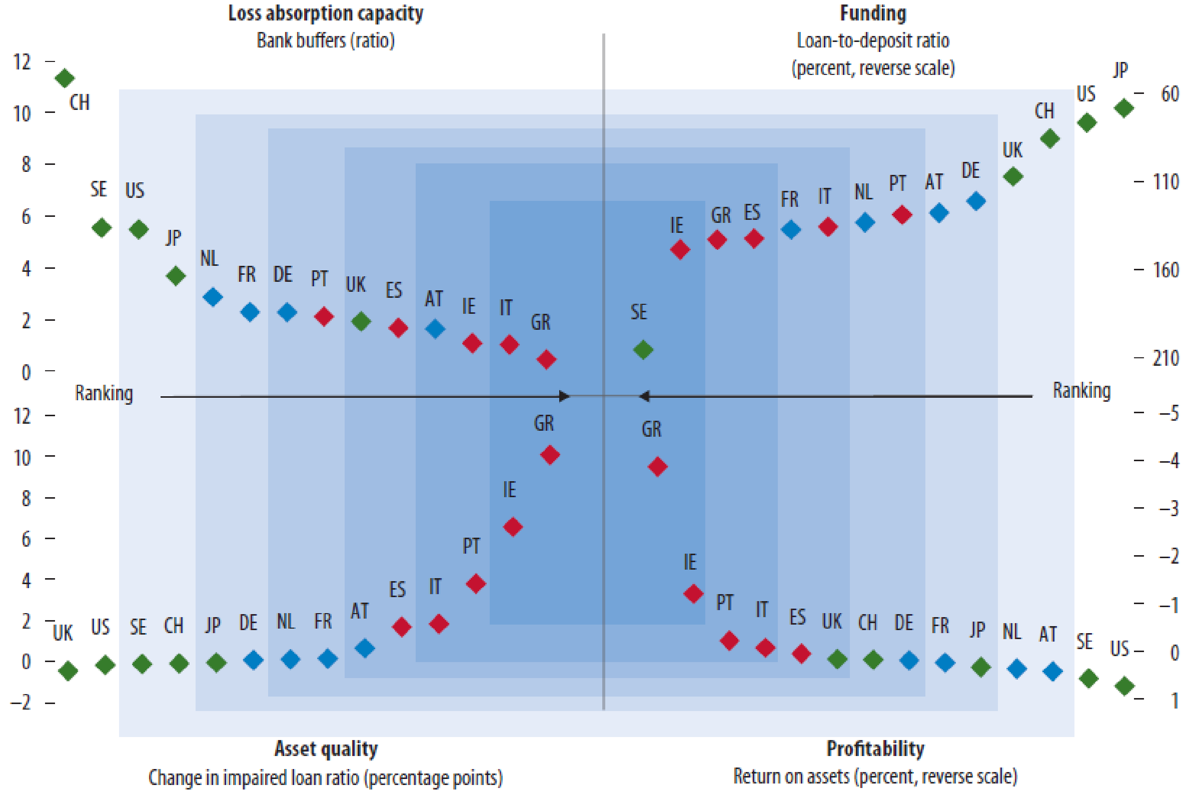
Figure 4: Cross-Border Interbank Networks in Europe



Source: Tonzer (2013), p. 20.

Due to the prominent role of London as an international financial center, the cross-border banking businesses with Britain are stronger than the neighborhood shops. Germany's banking business with the UK accounts for 47%, with the closest neighbors France only 12% and 10% with Switzerland. Similar magnitudes have the other euro-zone banks. Even the share of business of U.S. banks with the UK amounts to 53% of their total cross-border bank transactions (Tonzer 2013: 20).

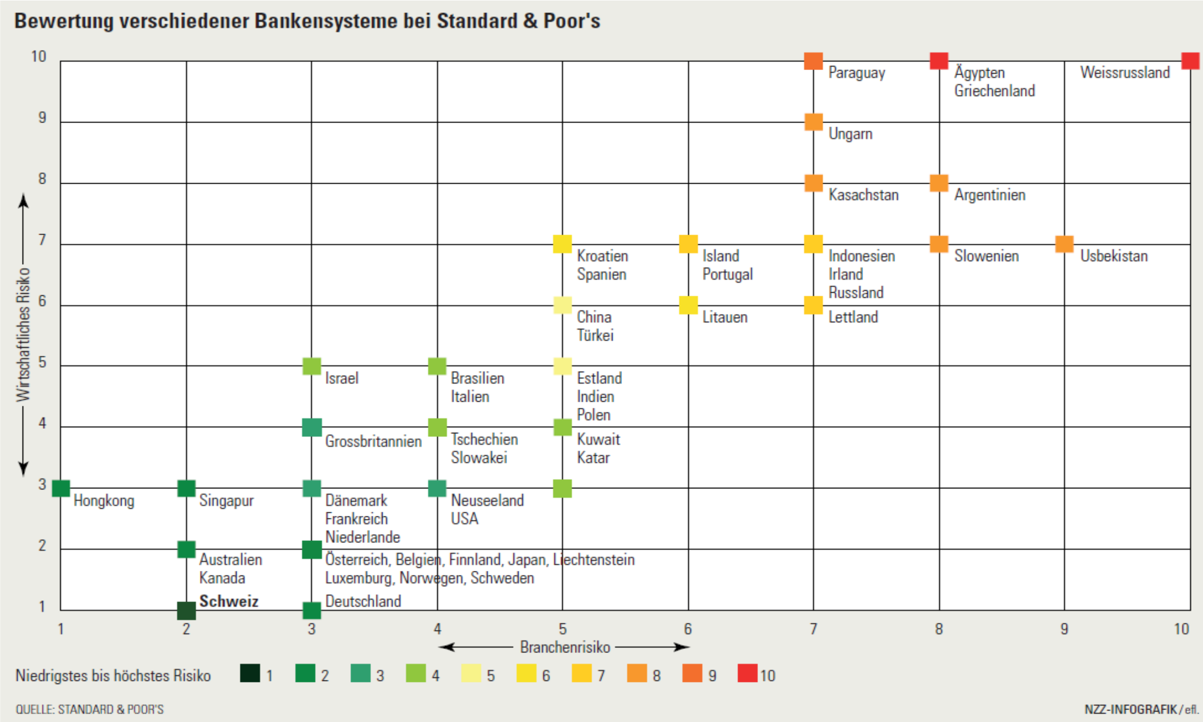
Figure 5: Ranking of Banking Systems – Fragmentation in the Euro area (Based on 4 Banks' Balance Sheet Indicators, 2012:Q3)



Source: IMF (2013a), p. 17

- *Banking sector in the euro periphery requiring adaptation:* In their recent global financial stability report, the IMF is (2013a: 17) concluded that the peripheral countries of the euro area (Greece, Ireland, Italy, Portugal, Spain) have the worst scores 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; see *Figure 5 and 6*).

Figure 6: Evaluation of Banking Systems according to Standard & Poor's
(Economic risks versus risks of branches)



Source: Ferber (2013), p. 21

- *High public debt through bank bailout (The State as "lender of last resort"):* The government interventions 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 programs (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 euro zone (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 the 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.

- *Hesitant banking reform main reason for renewed recession in the euro zone:* According to the IMF (2013b, 2013b) the still slow implementation of the reform of the financial sector is one of the main reasons for the recent drift of the euro zone (and the EU) into a recession. While the economy (real GDP) of the United States in 2012 (+2.2%), 2013 (+1.7%) and 2014 (+2.7%) is growing, the euro zone is in recession (-0.6%, -0.6% and +0.9%). Similarly, the forecasts of the European Commission (2013a) and the OECD (2013) for the year 2013 for the euro area (-0.4% and -0.6%).

4. European Banking Union

The GFC 2008/09 and especially the various rescue measures in the euro zone since the start of the euro crisis - often caused by banking crises - has prompted calls for a creation of a banking union can (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).

Coeuré (2012) still finds a further justification for 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 euro zone, 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 is - especially in the peripheral countries of the euro zone - 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 U.S., 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!

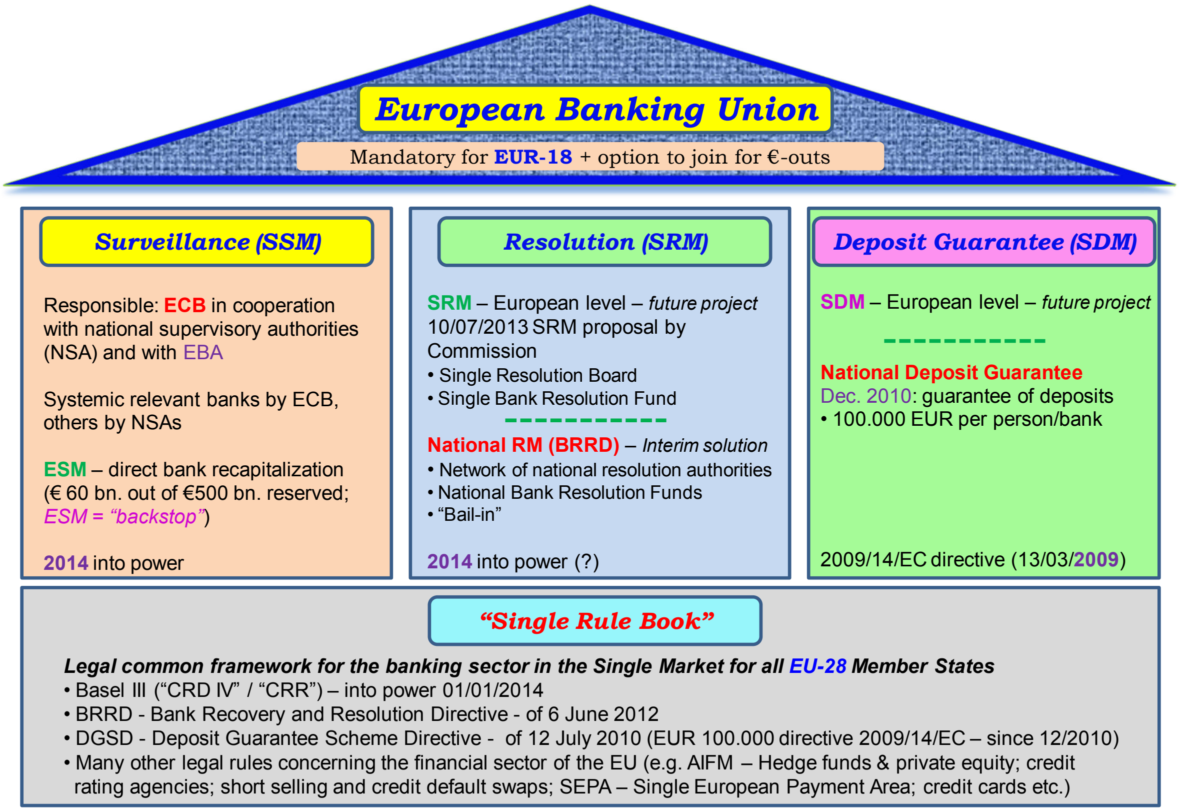
On the basis of the first report of the President of the European Council, Van Rompuy (2012a), submitted on 26 June 2012 - in close cooperation with the Presidents of the Commission and the ECB - the Heads of State or Government of the euro area (Euro area 2012) and the European Council (2012a) on 29 June 2012 requested from the European Commission to prepare a proposal for a common banking supervision. On 12 September 2012, 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; and
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) stipulates that the "Integrated Financial Framework" (Banking Union) will be built in three stages. First, in 2014 a "single supervisory mechanism” will 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 have agreed upon these proposals already at their meetings of the European Council (2012a, 2012b) on 29 June 2012 and on 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 - a disastrous combination of sovereign and banking debt crises, the EU aims 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 EMU would thereby be created. This should be possible in three steps[3] (see *Figure 7*).

Figure 7: The blueprint of the European Banking Union



SSM = Single Supervisory Mechanism; SRM = Single Resolution Mechanism; SDM = Single Deposit Guarantee Mechanism; ESM = European Stability Mechanism;

Source: Own representation

4.2.1 European Banking Supervision at the ECB

The first key element in establishing a European Banking Union, the European Banking Supervision is legally brought on track. Starting in March 2014 the most significant credit institutions of European systemic importance shall be subject to European Central Bank (ECB) supervision. At least 150 banks in the euro zone shall be directly monitored by the (ECB). The common supervision

[3] 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) an 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.

mechanism for banks (*Single Supervisory Mechanism* - SSM) under the leadership of the ECB is only a first step on the road to a banking union in the euro zone. The direct bank aid (recapitalization) from the euro rescue fund ESM is linked to the SSM and should originally be possible already in 2013. The Heads of state and government on 19 October 2012 and the EU finance ministers on 13 December 2012 agreed upon this matter. Realistically, however, this is not possible before autumn of 2014, because firstly, the European Banking Supervision must be functional.

According to a preliminary agreement by the European Parliament (EP) with the EU Member States under the Irish Presidency ("Trialogue" agreement) on 19 March 2013 and after the EP has reached an agreement with the ECB about the ECB's accountability to the Parliament, it has approved the SSM on 12 September 2013. By the end of 2013 the SSM package will be put into force.

The legislative package to the first stage of the banking union (SSM) consists of *two regulations*. The first rules the future competences of the ECB and the second those of the European Banking Authority (EBA) in the future common banking supervision.

Legal basis, tasks of the ECB and the role of national supervisors:

The Council Regulation (COM(2012) 511 final, 2012/0242 (CNS) to "Conferring specific tasks on the European Central Bank concerning policies relating ot the prudential supervision of credit institutions", i.e. the creation of a single supervisory mechanism (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.

<u>Tasks of the ECB (Article 4):</u> The ECB is entrusted with certain tasks relating to the prudential supervision of credit institutions established in Member States of the euro area ("participating Member States"). The ECB shall exclusively be competent to carry out, for prudential supervisory purposes, the tasks listed in Article 4 in relation to all credit institutions established in the participating Member States:

Among other things, the ECB will be the competent authority for the licensing and authorization of credit institutions; assessing acquisitions and disposals of holdings in credit institutions; ensuring compliance with the capital requirements and the adequacy of internal capital relative to the risk profile of the credit institution (liquidity and leverage); supervision of financial conglomerates in relation to the credit institutions.

Furthermore, the ECB will also ensure compliance with provisions on leverage and liquidity, apply capital buffers and carry out, in coordination with resolution authorities, early intervention measures when a bank is in breach of, or is about to breach, regulatory capital requirements. The ECB will also carry out stress tests for banks - previously the exclusive competence of the EBA – in the framework of capital aid out of the ESM. Additional powers of the ECB (on-site inspections) are regulated in Articles 9 to 11, and sanctions (fines of up to 10% of total annual turnover) in Article 15.

<u>Role of national supervisors (Article 5):</u> National supervisors will continue to play an important role with the creation of a Single Supervisory Mechanism. First, all tasks not conferred on the ECB will remain with national supervisors. For example, national supervisors will remain in charge of consumer protection and the fight against money laundering, and of the supervision of third country credit institutions establishing branches or providing cross-border services within a Member State.

In Germany, the Federal Cabinet on 8 May 2013 decided on a draft law for the transfer of powers of national banking supervision to the European Central Bank (SSM Regulation). Key questions remain unanswered in the bill. The federal government can currently not conclusively confirm which German banks will be subordinated to the ECB supervision and with which additional work the German supervisory authority (BaFin) will be confronted within the SSM. Furthermore, it is not quite clear how ECB and BaFIn will work together (EurActiv 2013).

Cooperation ECB and EBA:

The Regulation of the European Parliament and of the Council (COM (2012) 512 final, 2012/0244 (COD) "amending Regulation (EU) No 1093/2010 establishing European Supervisory Authority (European Banking Authority - EBA) as regards its interaction with Council Regulation (EU) COM(2012 511 final, 2012/0242 (CNS) conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions" (SSM Regulation) shall ensure a balance between Member States of the euro zone and those outside the euro zone in the decision-making structures of EBA. The legal basis is - as in Regulation (EU) No 1093/2010 - Article 114 TFEU.

The new EBA Regulation regulates mainly the supervisory cooperation with the ECB. In preparation for the practical implementation of the SSM the bank stress test, foreseen for the year 2013, which is usually done by the EBA (and delivered not always praiseworthy results in the past) has been postponed to 2014 (see FAZ-Net, 16 May, 2013). First of all, the ECB kill undertake a thorough analysis of the bank balance sheets of all banks in the euro zone.

Affected banks:

Within the framework of the SSM at least 150 banks in the euro zone should be supervised

directly by the ECB. Banks or corporations with total assets of over 30 billion euros or more than 20 percent of the GDP of a Member State are in principle as "significant". Regardless of these criteria the ECB oversees at least the three largest banks in each participating Member State directly. At the first sign of problems the SSM should also intervene in smaller banks. The ECB is also responsible for the direct supervision of banks, which are saved by EU funds (from the ESM or EFSF) from bankruptcy.
In the case of Germany, so far, it is assumed that all large commercial banks like the Deutsche Bank and Commerzbank, DZ Bank, the large state banks, a credit union (Apo-bank), and a savings bank (Hamburger Sparkasse) will be supervised directly by the ECB. The 1500 small German banks remain under national supervision (EurActiv 2013).

Participating countries in the euro zone versus non-euro countries:

In view of the narrow cross-border links between Member States, which introduced the euro, the banking union should first apply to all members of the euro zone. For the purpose of deepening the internal market ("Single rule book" for financial services) the banking union should the also be open to other EU Member States. Thus, the "European Banking Union" initially applies only to the euro zone, which will plant another divisive element in the EU.

Conflict of interest between ECB's monetary policy and banking supervision:

To avoid conflicts of interest between monetary policy goals and those related to bank supervision of the ECB (see the criticism of the German Council of Economic Experts 2012: 186) the SSM Regulation provides a clear separation between monetary policy and supervision (Article 18). There is a supervisory board (Article 19), which 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. The German Bundesbank has even proposed a voting system according to the shares of capital which hold the euro are Member States in the ECB, so that the large countries would have more weight and voting power.

Rules for the direct recapitalization of banks by the ESM:

On 20 June 2013 the finance ministers of the euro group achieved a political agreement on guidelines for the direct recapitalization of distressed banks by the ESM (see Euro Group, 2013). Current bank aid from the European Stability Mechanism (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 euro zone on 29 June 2012 decided that the ESM can directly recapitalize euro-area banks under certain conditions. This will hardly be possible before the autumn of 2014, because first the uniform Banking Supervision (SSM) has to become operational. 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. If these EU laws are implemented, 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). This is in line with the the principles of the regulations of the common resolution mechanism (Single Resolution Mechanism - SRM) or in accordance with the ECOFIN compromise on national bank resolution of 27 June 2013.
3) Of the total lending capacity of the ESM of EUR 500 billion EUR 60 billion will 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 is 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.

4.2.2 European Resolution Mechanism

4.2.2.1 „Europeanization“ of the Bank Resolution – dreams of the future

The SSM is supported by all EU institutions and EU Member States. It has also a clear legal basis and is sure to come into force during the year 2014. In contrast, the second step of the EBU, the common resolution mechanism at EU level (single resolution Mechanism - SRM) with a European restructuring fund seems to be still a dream of the future (see also European Commission, 2012a: 9 and 11). The major reason might be that this step would probably necessitate a change in the EU treaties.

Nevertheless, the project of an "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 the German Chancellor Angela Merkel and French President Francois 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 based on the existing EU treaties.

On 10 July 2013, the European Commission presented a legislative proposal for SRM (SRM Regulation, European Commission 2013d). The SRM is intended to complement the central bank supervision (common supervisory mechanism, SSM), based at the European Central Bank (ECB) and which work will begin by the end of 2014. All states participating in the SSM (the euro-zone countries plus any volunteers from the rest of the EU), will also take part in SRM, so that supervision and management are located on the same level. All banks of these countries would be subject to the SRM.

The central element is the "Bail-in" (as in the proposed national bank resolution, see chapter 4.2.2.2) 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. The new proposal is about the "Europeanization" of the resolution of banks. The lead in the closing of banks would be transferred from the national to the European level. According to EU Internal Market Commissioner Michel

Barnier, given the interdependence of the banks in the euro area one must put an end to the fragmentation of the authorities (see Höltschi 2013a, 2013b). The cases Dexia and Fortis have shown that the EU is urgently missing a rapid decision-making mechanism.

The SRM proposal suggest the following institutions (and governance) at European level:
a) Single Resolution Board;
b) Single Bank Resolution Fund.

The Single Resolution Mechanism (SRM) would work as follows (see European Commission, 2013d, 2013e):

- The *ECB*, as the supervisor, would signal when a bank in the euro area or established in a Member State participating in the Banking Union was in severe financial difficulties and needed to be resolved.
- A *Single Resolution Board*[4] (it shall be a special European Union agency; see European Commission 2013d: 64[5]) consisting of representatives from the ECB, the European Commission and the relevant national authorities (those where the bank has its headquarters as well as branches and/or subsidiaries), would prepare the resolution of a bank. It would have broad powers to analyse and define the approach for resolving a bank: which tools to use, and how the European Resolution Fund should be involved. National resolution authorities would be closely involved in this work.
- On the basis of the Single Resolution Board's recommendation, or on its own initiative, the *European Commission* would decide whether and when to place a bank into resolution and would set out a framework for the use of resolution tools and the fund. For legal reasons, the final say could not be with the Board (EU agency[6]).
- Under the supervision of the Single Resolution Board, *national resolution authorities* would be in charge of the execution of the resolution plan.
- The *Single Resolution Board* would oversee the resolution. It would monitor the execution at national level by the national resolution authorities and, should a national resolution

[4] 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.
[5] The German Council of Economic Experts (2012) even wanted a resolution authority which is totally independent of the ECB and the Commission. According to Van Rompuy (2012b: 7) a SRM would have the advantage to ensure a speedy and impartial decision-making process in which the European dimension is central. In this way, many of the current obstacles (such as national bias) would be reduced.
[6] This has a legal background (see Höltschi 2013a): According to the "Meroni doctrine" (European Court of Justice, which began with the Meroni judgment of 1958) only democratically elected EU institutions should make legally binding discretionary decisions. The transfer of such powers to agencies and other institutions is limited.

authority not comply with its decision, it could directly address executive orders to the troubled banks.

- A *Single (European) Bank Resolution Fund* would be set up under the control of the Single Resolution Board to ensure the availability of medium-term funding support while the bank was restructured. It would be funded by contributions from the banking sector (it is expected to reach a volume of 1% of insured deposits of all banks within 10 years, what would currently amount ot EUR 55 billion), replacing the national resolution funds of the euro area Member States and of Member States participating in the Banking Union, as set up by the draft Bank Recovery and Resolution Directive (BRRD, see chapter 4.2.2.2).
  For countries that have already established a national resolution fund (such as Germany), a special rule should be applicable in order not to raise an unfair burden: This would imply that not the banks pay into the European funds, but the national fund would pass over their already paid-up shares to the European level. The German Council of Economic Experts (2012: 186) additionally proposes a fiscal hedge via the ESM.

The *Commission's role* would be limited to the decision to trigger the resolution of a bank and the decision on the resolution framework, thereby ensuring its consistency with the Single Market and with EU rules on state aid, and safeguarding the independence and accountability of the overall mechanism.

Legal pitfalls

According to the European Commission (2013d: 6 and 19) the legal basis for the SRM proposal is Article 114 of the TFEU, which allows the adoption of measures for the approximation of national provisions aiming at the establishment and functioning of the internal market.

The proposal aims to preserve the integrity and enhance the functioning of the internal market. Uniform application of a *single set of resolution rules*, together with access to a single European resolution fund by a central authority will restore the orderly functioning of the Union banking markets, will remove obstacles to the exercise of fundamental freedoms and will avoid significant distortion of competition at least in those Member States which share the supervision of credit institutions at the European level (via the SSM).

Whilst the SSM Directive brings a high level of harmonisation, it still allows flexibility to Member States which means that a certain fragmentation in the internal market could remain. The SRM provides instead for an integrated decision-making structure aligning resolution under the SRM with supervision under the SSM to eliminate the competitive disadvantage that banks in the participating Member States in the SSM have compared to banks in the non-participating Member States because of the lack of a centralized system to deal with failing banks.

However, the proposal must pass the Council of Ministers and must be approved by the European Parliament. The outcome of the debate is therefore uncertain.

For Germany, the SRM proposal is a strong challenge (Höltschi 2013a), both legally and politically. According to the German Federal Government - and Finance Minister Wolfgang Schaeuble has this repeatedly stressed, even earlier (see Der Standard, online 14 May 2013) - the SRM proposal would give the EU Commission competences which they cannot have according to the EU Treaties (primary legislation). As long as the Treaties are not changed (and a Treaty change can take a long time), according to Schäuble, only a "network" (cooperation) of national resolution authorities can take over the tasks described. Similar criticisms are expressed by German banks, which also reject a "collectivization" of money of the German Restructuring Fund. Also the informal finance minister meeting in Vilnius, Lithuania on 13-14 September 2013 came to no agreement so far about the SRM.

Political hurdles

In addition to the legal barriers to the SRM (Germany sees the need for a Treaty change; the Commission - Internal Market Commissioner Michel Barnier – opposes this view), there are political concerns financing related to the "Europeanization" of banking resolution via the SRM. Both a European restructuring fund as well as a "bail-in" solution based one on a "cascade of responsibility" as in the case of the bank rescue in Cyprus implies that banks in countries with a relatively sound banking structure (e.g. in Germany) would be liable for those in countries with poor banking structure[7].

This could create "mental" hurdles at the German banks and also in the German government as in the case of the demand for euro bonds or a debt redemption fund (joint liability for government debts) as is proposed in the plan by Barroso (2012b) which picked up earlier suggestions by the German Council of Economic Experts. A cautionary example is the dilution of proposal of the 11 EU Member States in the framework of enhanced cooperation to introduce a financial transaction tax by the zealous lobbying of (mainly) German banks.

[7] According to Schoenmaker-Siegman (2013) Germany would be the biggest loser of a European Banking Union, 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.

Banks will know how to prevent a new bank levy to finance a European bank restructuring fund.

4.2.2.2 National Bank Resolution with common rules as an interim solution

As an immediate solution with a real European Resolution Mechanism (EU authority and EU fund) seemed not feasible because of the possible need to change the EU Treaties, the European Commission already on 6 June 2012 made a proposal for a "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) [8]).

On 27 June 2013, the EU finance ministers in ECOFIN (2013) have agreed on a common position on the resolution of banks, i.e. dealing with ailing banks. Now, negotiations on the final version of the new regulation (Directive) can start with the European Parliament. The goal is - under the Lithuanian Presidency of the EU - to bring under roof the legislative process until the end of 2013. The proposed Directive on the restructuring and resolution of banks will apply - in contrast to the regulation on the European Banking Supervision (SSM) - to all EU Member States and is the European answer to the "too big to fail" problem. The policy needs, based on Article 116 TFEU, a qualified majority in the Council and the consent of the European Parliament.

Before making the big move to the second stage of the EBU, the 'Europeanization' of the banking resolution with a Single Resolution Mechanism (SRM), the EU makes first an intermediate step through the unification of the rules of the bank resolution at national level in all EU Member States. In this "two-step" model to a "network" of national resolution authorities - in cooperation with the European Banking Authority (EBA) in London – should solve the banking problem. Legally, this amounts to intergovernmental cooperation. According to Internal Market Commissioner Michel Barnier (2013), the ECOFIN agreement of 27 June 2013 paved the way for progression to stage two of the EBU, the SRM.

With the establishment of an EU-wide resolution framework based on the cooperation of national authorities, the EU follows international developments to address the "too big to fail"

[8] 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

problem, i.e. the rescue of banks by the state. As mentioned earlier, the G20 summit in Washington in November 2008 has already pleaded for reviewing the mechanisms for bank resolution and bank insolvency law to reduce the risk of contagion from cross-border banking activities. Also the following G20 summits pleaded repeatedly for an improvement of the regime for handling banks (see European Commission, 2012a: 3).
In the U.S., a resolution regime for systemically important banks was established by the Dodd-Frank Act in 2010. Endangered big banks are either converted or closed by a bankruptcy administrator of the Federal Deposit Insurance Corporation (FDIC). The envisaged solution in the EU should also allow the national resolution authorities to orderly unwind, the core services are to be retained, parts are sold to third parties and a bridge bank is set up. Banks that have failed shall be closed (see European Commission, 2012b: 4).

The resolution rules approved upon in the ECOFIN compromise as of 27 June 2013 should protect the taxpayers in the future - breaking the vicious circle of bank bailouts and rising government debt - and be a European answer to the "too big to fail" problem. The new rules will allow authorities more influence before the outbreak of a crisis and an orderly liquidation of a systemically important bank.
In the future, the rescue and resolution of crisis banks will be executed in phases (ECOFIN, 2013). Two new institutions (*resolution authority* and *resolution fund*) are provided. The worse the situation becomes, the stronger the national authorities can intervene. *Three stages* of crisis management (prevention, early intervention and resolution) are envisaged. The key elements are:

1) *Prevention and preparation:* In future, the banks will have to prepare preventive contingency or resolution plans ("last wills"), in which they outline on how to deal with financial stress or failure at group level but also for the individual entities in the group (ensure viability). In the Commission's proposed Directive a close cooperation between national resolution authorities and the European Banking Authority (EBA) in London is foreseen. This should avoid duplication between Member States in the case of prevention and avoidance.
2) *Early intervention:* Besides the banks, also the *national resolution* authorities will be required to draw up recovery and resolution plans. The powers of authorities will be expanded in order to intervene at an early stage (before the problems become critical and its financial situation deteriorates irreparably) when a bank is in breach of, or is about to breach, regulatory capital requirements. These powers will include the possibility of

dismissing the management and appointing a special manager even before a bank is failing, as well as convening a meeting of shareholders to adopt urgent reforms, and requiring the bank to draw up a plan for the restructuring of debt with its creditors.

3) *Settlement in the event of insolvency:* If the insolvency can no longer be averted, the resolution authority takes control. It can set the following actions:
   - A small bank may be closed quickly.
   - A large bank (*systemically relevant institution*) whose bankruptcy may hurt the economy would be split and partially restored. The healthy part can be sold on a *"bridge bank"*.
   - The bad assets of a bank are outsourced to a special purpose entity *("bad bank")*. In order to finance this national resolution funds should be established and on the other hand a "bail-in" system should be applied.

"Bail-in"

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, the 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 incur still greater losses, 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. Germany is pushing for an earlier date.

National resolution funds

If all this is not enough to finance a resolution, a *"national resolution fund"* will help out. Each EU Member State must establish such a fund. In Germany there is already such a fund. By the end of 2012, it was filled with EUR 1.3 billion (Der Standard, online: June 27, 2013). Ex-ante and ex-post it should be financed by bank levies. Originally, the European Commission had proposed, that this must achieve at least a sum of 1% of the insured deposits of all local banks in each state within 10 years. According to estimates by the European Commission (2012a: 8) 1% would represent around EUR 80 billion for the EU-27 and EUR 65 billion for the euro zone. The ECOFIN compromise sets the goal now at 0.8% of covered deposits of all the credit institutions authorized in their country.

National scope through more flexibility

Individual EU Member States wanted more flexibility in the implementation of the rules. France and Sweden asked for more leeway, however, were Germany and Austria voted against. According the ECOFIN compromise the national authorities will get more leeway. Under certain conditions (to prevent infection) and within certain limits countries may exclude certain types of liabilities from the "bail-in" (covered deposits; secured liabilities including covered bonds; liabilities to employees of failing institutions, such as fixed salary and pension benefits; commercial claims relating to goods and services critical for the daily functioning of institutions; etc.). They can use the resolution fund for the absorption of losses or for the recapitalization of a bank. Britain wants to maintain its current path of channeling via the national budget. However, then the goal of solving the "too big to fail" problem and to avoid the bank bailout by the state, will be thwarted again. One sees in these special request of some EU Member States already, that the solution with national resolution mechanisms can only be a precursor to an "Europeanization" and hence a full harmonization of the rules for the resolutions of banks.

4.2.3 European Deposit Guarantee System

Similar arguments and objections as in the case of the SRM apply also in the case of the European deposit protection scheme (*Single Deposit Guarantee Mechanism - SDM*). A common (single) deposit insurance at the EU / euro zone level is seen more skeptical and more or less rejected in the core countries of the euro zone (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. Meanwhile, since December 2010, there exists at EU level already a harmonized uniform - implemented by national law - deposit guarantee of 100.000 euro per saver and bank.

A common deposit insurance at the EU / euro-zone level would again raise the issue of the funding by a Single Deposit Guarantee Fund.

5. Winners and losers of joining EBU

To recap the rational for creating a European Banking Union (EB) and, hence, the a truly integrated European-level banking system, two major targets stand out (see also Schoenmaker-Siegmann, 2013a: 2):

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 Schoenmaker-Siegmann (2013a) calculate the benefits of switching from a national bail-out to a European-level bail-out mechanism and compare this improvements with the costs to join EBU (the cost to finance the European Resolution Fund). A decision must be made whether a failed bank will be bailed out (recapitalized by resolution) or whether it is closed.

Under efficient resolution, a bailout takes place when the aggregate (world-wide) benefits (B) exceed the total costs (C), so that the line that separates (gives the threshold level of) bailout from no-bailout is characterized by $B = C$, i.e., a slope of 1 (see Schoenmaker-Siegmann, 2013a: 6). Under a supranational authority in the EBU (*Single (European) Bank Resolution Fund - SEBRF)*[9], bailouts take place when EBU-specific benefits exceed total costs, i.e.,

[9] Instead of a "Single Resolution Board" and a "Single Resolution Fund" as foreseen in the Commission's proposal for a future SRM, Schoenmaker-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).

α_{EBU}.B > C; α_{EBU} = fraction of benefits in EBU resolution approach), so that the slope is 1/ α_{EBU}. Under the home country approach, the equilibrium outcome is that the burden falls completely on the home country, which only takes the home share α_h into account (i.e. α_h.B > C; α_h = fraction of benefits in the home country approach). The difference between the slope of EBU resolution and that of home country resolution indicates the improvement of efficiency of bank resolutions.

Based on data of top 25 European banks in 2011, Schoenmaker-Siegmann (2013a: 11) focus on the large banks, as small- and medium-sized banks are largely domestically oriented and do not trigger-off cross-border problems. The top 25 banks have average assets of €985 billion and capital of €40 billion. The European assets of the 25 banks amount to about half of total EU banking assets and the European cross-border assets of this top 25 counts for 71 percent of overall cross-border assets within the EU. Firstly the authors calculate the costs and benefits for the top 25 banks, and then they aggregate the results to receive country-specific effects.

The *cost-benefit analysis* of bank recapitalizations is done under the following assumptions (see Schoenmaker-Siegmann, 2013a: 7-8). Banks' equity is used as unit of calculation. Firstly, it is considered that the loss (L_j) for each bank (j) is 2 times equity E_j: $L_j = 2. E_j$. This makes a bank insolvent. If the bank is recapitalized to its original (required) equity capital, 100% of equity becomes the new value of the bank. The total net costs of the bailout are 100% of the initial (pre-shock) equity of the bank: $C_j = 1. E_j$. The book value of equity (Tier 1 capital) is also in the Basel capital regulation seen as a robust indicator on the relative magnitude of bank risk. Furthermore this cost-benefit analysis of joining EBU has a long-term perspective and therefore the authors assume that the probability of failure is equal among the banks (alternatively, one could also derive a bank's probability of failure from its current stand-alone credit rating).

The total *benefits* B_j of keeping the bank j open are θ times equity: $B_j = \theta. E_j$ (where θ is the benefit parameter). Bailout benefits can be thought of as preventing a temporary reduction of credit availability (credit crunch) through shortening of balance sheets by a forced liquidation of the loan book in a particular country. Another source of benefits is the safeguarding of financial stability of the total banking system.

The efficiency of the resolution mechanisms (home versus EBU) are calculated by assuming that the efficiency benchmark is characterized by $\theta = 1$, where the net benefits are non-negative. Against this benchmark the different resolution setups are assessed.

The distance of the *home rule resolution* for bank *j* is the difference between the home threshold and the efficient benchmark threshold (see Schoenmaker-Siegmann, 2013a: 10):

$$D_j^{home} = \frac{1}{\alpha_{h,j}} - 1$$

This index is zero for domestic banks ($\alpha_h = 1$), indicating that the resolution is efficient in the single country setting. The index is very large for banks with a very shmall home fraction. Similarly, the distance of the supranational rule for bank *j* is as follows:

$$D_j^{supra} = \frac{1}{\alpha_{EBU,j}} - 1$$

The index will be zero fo banks with all its business within the Banking Union ($\alpha_{EBU} = 1$), indicating that supranational resolution is efficient in EBU. The index is large for banks with a small fraction within Europe but sizeable business interests in the rest of the world.
In a final step the *efficiency improvement ("benefits of EBU")* moving from the home rule to the supranational rule (SRM) is calculated. The relative efficiency improvement of (*EI*) of ban *j* from country *i* is measured in percentage:

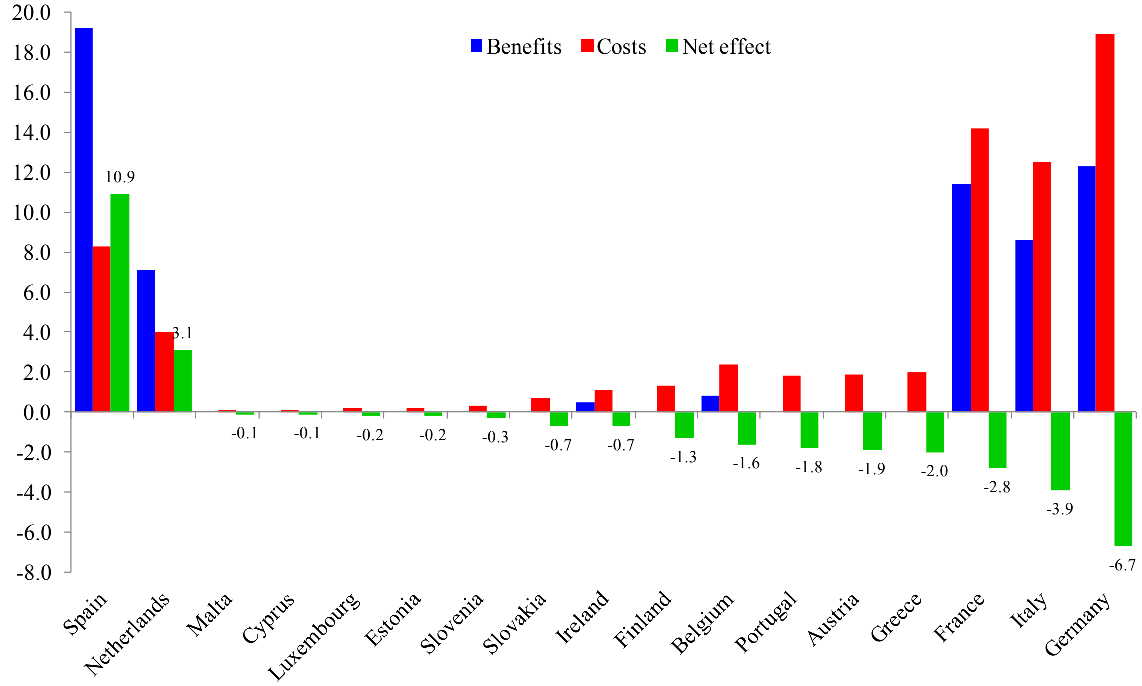
$$DE_{i,j}^{Rel} = \frac{D_j^{home} - D_j^{supra}}{D_j^{home}}$$

For domestic banks the improvement is zero as the home country rule is already fully efficient. Also for international banks without any other business in the rest of Europe, the improvement is zero (This concerns 10 countries in the euro area in which none of the top 25 European banks are located). The other extreme are European banks with only business in the rest of Europe. For this group of banks, the supranational approach under EBU is fully efficient, producing a relative improvement of 100 percent.
Total *costs* (C_j): The cost sharing of joining the resolution mechanism of EBU is 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)* which corresponds to the capital input into the ECB (e.g., the shares of Germany is 18.9%, that of Austria 1.9%).

After assigning and aggregating the results of EBU benefits of the top 25 European banks to the EU/euro area countries, Schoenmaker-Siegmann (2013a: 22) reach the following *results* of their *cost-benefit analysis* of joining the European resolution mechanism of EBU.

Results for *Euro area countries* (see *Figure 8*): 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. Therefore Schoenmaker-Siegman (2013a) can calculated “benenfits” of joining the EBU only for these 7 euro area countries For the other 10 euro area countries with no own big bank joining the EBU results only in “costs” according to the capital key of the ECB are considered in the calculation of the net effects. 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%).

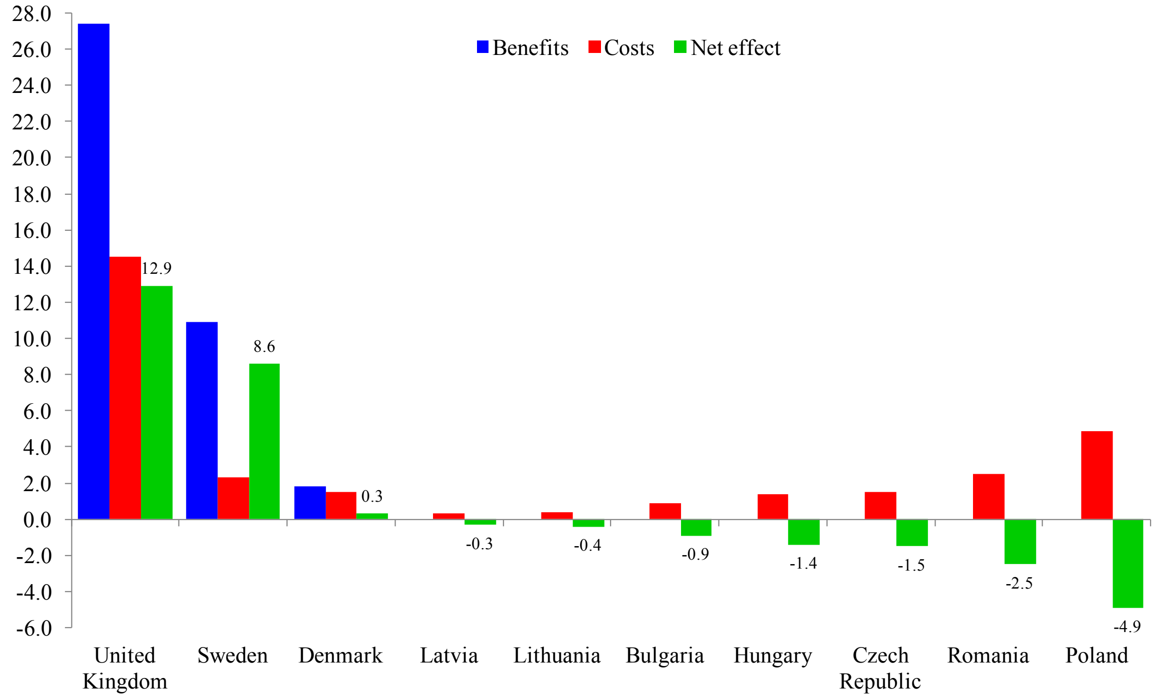
Figure 8: Net effect (benefits minus costs) for Eurozone countries of joining banking union



Sources: Schoenmaker-Siegmann (2013a), p. 22 and Schoenmaker-Siegmann (2013b).

Results for *Non-euro area countries* (see *Figure 9*): 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, Schoenmaker-Siegman (2013a: 22) calculate also hypothetically the costs and benefits of the non-euro area countries joining the EBU. Out of the chosen list of 25 top European banks only 3 large banks are located in non-euro countries: Denmark, Sweden and Untied Kingdom. Therefore Schoenmaker-Siegman (2013a) can calculated “benenfits” of joining the EBU only for these 3 non-euro area countries For the other 7 non-euro area countries with no own big bank joining the EBU would result only in “costs” according to the capital key of the ECB. The biggest “net effects” would go to the United Kingdom (12.9%) and Sweden (8.6%). The biggest loser would be Poland (-4.9%). Interestingly, the main non-euro area countries that do not wish to join the Banking Union for poltiical reasons (ie.e. the UK and Sweden) would be the largest beneficiaries from the EBU.

Figure 9: Net effect (benefits minus costs) for non-Eurozone countries of joining banking union



Sources: Schoenmaker-Siegmann (2013a), p. 22 and Schoenmaker-Siegmann (2013b).

6. Macroeconomic impact of EBU

The cost-benefits analysis by Schoenmaker-Siegman (2013a, 2013b) calculates in a bottom-up approach the net effects of countries joining the European resolution mechanism for banks in the context of a future complete EBU. Starting with the evaluation of the improvements of efficiency in case of resolution at the level of 25 top European banks, the authors aggregate the bank results in order to get country results. A clear pattern emerges: countries with large domestic banks are winners; countries with no such banks are losers.

What their cost-benefit analysis does not render is the macroeconomic impact of joining the EBU. The macroeconomic questions is which mechanism – *home rule* mechanisms by national governments or *supranational rule* mechanisms via EBU's SRM – can better a stabilize a country's economy which run into recession because of problems with failing banks (e.g. the cases in the Euro area periphery, Cyprus and Spain). A further question concerns the possible repercussions to the economy of the other member states of the Euro area (the core countries). Before having a consistent macro model representing the future EBU with all interactions of banks, ECB, private real sector and public sector, we can only theorize about the possible macroeconomic impact of bank resolution with different resolution mechanisms.

1) *Home rule bank rescue:* It is plausible that a rescue (resolution) of a national bank via *home rule measures* by the national government ("lender of last resort") – this was the way banking problems were solved so far (with the exception of the Cyprus case) - would be the least efficient one. Bank rescue via the government reinforces the diabolic link between bank failures (debts) and sovereign debts (would increase) with negative consequences for the economic performance in general.
2) *SRM rescue within the EBU:* This would be the favoured alternative to home rule rescue. In this case (as Schoenmaker-Siegman, 2013a, 2013b have demonstrated in their cost-benefit analysis) the burden of the bank rescue in one country (say in the periphery) would be shared by all members of EBU (the Euro area). Hence, the stabilization of a country (e.g. in the periphery) with the failing bank can succeed better; but the impact in the remaining Euro area (the core) would be worse than in the case of a national rescue operation in the periphery alone. The reason is that in case of the EBU all countries (banks) must contribute to the *Single (European) Bank Resolution Fund (SEBRF).* However, a SRM rescue operation would break the diabolic link between banks (debt) and national governments (sovereign debts).
3) *Direct recapitalization via ESM:* In the first stage of EBU when the SSM will be installed in 2014, it is possible to recapitalize failing banks via loans of the ESM (EUR 60 billion are reserved for this purpose) directly. Again this option would help to break partially the diabolic link between bank failures and national budget burdens. However, in the ESM solution the capital owners (the Member States of the Euro area) and not the banks would bear the burden of the bank rescue operation and would also share the losses in case of closing a failing bank. It is an open question whether a pure *"ESM bank rescue" solution* would be better to stabilize the economies in the periphery (with the failing bank) and/or in the core of the Euro area than the pure *"SRM bank rescue" solution*.
4) *Mixed resolution mechanism with "bail-in" approaches:* As was discussed in the previous chapters the SRM and also the interim nationally coordinated resolution mechanism (BRRD) will work with a mixed strategy. Not all the rescue funds will come from either the ESM or the SEBRF but in the first place some kind of "bail-in" measures will take hold. Such solutions would shift the losses from the EBU member states more to the deposit holders of the failed bank in a periphery country and would therefore reduce the stabilization effect of "pure" ESM or SRM solutions.

In any case an EBU is an urgently needed instrument to stabilize the Euro crisis and will help to pace the road towards a genuine new EMU. It would complete the tool kit developed only after the outbreak of the Euro crisis in early 2010 (see the overview of all new instruments of the "New Economic Governance" of EMU in *Figure 1*).

7. Conclusions

The ongoing euro crisis, which is reflected in a significantly worse economic situation and development in the euro zone than in the United States, not least has its cause in the still sluggish implementation of the reform of the financial sector. While the gaps in the economic architecture of EMU (New Economic Governance) were largely closed by profound changes, the reform and thus stabilization of the banking sector is still in its infancy implementation, even five years after Lehman Brothers. While numerous individual reform measures have been put in place at EU level, the major reforms (Basel III and Banking Union) will only enter into force in 2014.

From the grand design of the three-stage "European Banking Union" only the first stage, the European Banking Supervision (SSM) – and this only for the banks of the euro zone – will be implemented in 2014. If only a subset of EU banks is regularly supervised by the ECB, this feeds new divisive tendencies in the EU. 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. Many questions also remain open, especially how to handle "shadow banks".

A first evaluation indicates that the potential benefits of solving bank problems via the resolution mechanism of a new 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 EBU depend on the number and size of banks which are located in a country.

However, even if also the other two building blocks of a complete European Banking Union (the European resolution mechanism – SRM and the single deposit insurance - SDM) should be achieved it is not clear whether the macroeconomic impact (the stabilizing overall effect) of bank resolutions is better when executed via the SRM or with the ESM alone. The effects may be different in the country affected but also the implications of contagion and macroeconomic spill-overs to other EU/Euro area Member States are not quite clear.

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