5

The Banking Union Revisited

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The main purpose of this chapter is to give an account of the implementation of banking union in Europe. The benefits one may expect from a banking union are reviewed. Its components are analysed and discussed with a special focus on the supervision and resolution of banks. The challenges are both functional and institutional. They involve micro- and macroprudential considerations. As regards the European Central Bank (ECB), will there be possible conflicts of objectives when it cumulates its monetary policy function with its new supervisory role? For banking supervision, how is it possible to combine the division of labour between the ECB and the national competent authorities (NCAs) with the necessary coordination between them?

The same kind of challenge applies to resolution and deposit insurance. The chapter also relates the launching of banking union to other structural issues, such as the separation of bank activities and the financing of the real economy (investment and growth) in the new regulatory framework. At the end it touches upon the Capital Markets Union (CMU) project.

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R. Douady et al. (eds.), *Financial Regulation in the EU*,
DOI 10.1007/978-3-319-44287-7_5

5.1 Background

Access to reliable, independent and comparable data is key to the banking union (hereafter BU), since transparency of bank data is a prerequisite for effective supervision and resolution by the competent authorities. Everyone acknowledges both the necessity and the difficulty of improving access to the relevant banking and financial data. It is worth noting that "market discipline" is at the core of Pillar 3 of Basel II and Basel III, and it implies more and better information disclosure by banks to all stakeholders. Some analysts even refer to a "battle of data," questioning the role of financial industry-led research which is not independent enough. This is a view which is strongly opposed by others, who stress the positive sum game between the regulators, the bankers, the stakeholders and the public at large regarding the collection and treatment of the relevant data. In their assessment of the first 18 months of BU, Dirk Schoenmaker and Nicolas Véron (2016) underline the persistent challenge of access to relevant and reliable data.

The obstacles to reliable and comparable data are manifold: excessive financial complexity (e.g. some exotic derivatives instruments), the difficult *ex ante* assessment of risks, persistent divergence across member states in the accounting and evaluation procedures despite their reliance on the same accounting rules (IFRS). As regards listed banks, IFRS are mandatory in the European Union (EU) but this harmonization does not apply to unlisted banks. There is still a high degree of heterogeneity in accounting and auditing rules and practices even within the euro area. Therefore it is not surprising that the ECB's comprehensive assessment of banks in the euro area implemented from November 2013 to November 2014 has emphasized more transparency for the purpose of "enhancing the quality of information available on the condition of banks" (JC 2014).

The Joint Research Centre of the European Commission, in cooperation with DG MARKT, has built the model SYMBOL (Systemic Model of Bank Originated Losses), which assesses the financial position of individual banks and the macro implications under exogenous shocks (Pagano et al. 2012). This model is still in progress since the collection of detailed and reliable data is indispensable. However, it is already a useful tool for assessing the probability of default of each bank. It takes into account contagion effects on the interbank market in order to analyse the micro/macro links, in particular the channels of transmission from individual bank risks (credit risks, market risks, operational risks, liquidity risks) to systemic risks and to simulate the impact of various shocks. In this respect such a modelization could be very useful in the implementation of future bank stress tests.

5.2 Benefits of Banking Union

R.Goyal et al. (2013) have presented a comprehensive survey of the economic foundations of BU. Without being exhaustive, it can be argued that BU in Europe is a means towards the following goals:

1) To deepen the single market for financial services and make it more effective. We are still far from an effective single market for banking and financial services and a true level playing field. One of the goals of BU is to make the single market a reality, in particular through the "single rulebook." However there is a debate on the financial reregulation process and the effectiveness of the single market. In many respects we are still far from a real single rulebook. Some analysts have regretted that even CRD IV and CRR leave too much room to the competent national authorities to incorporate idiosyncratic measures in the transposition of the directive and in particular in its interpretation, in such a way that we could be very far from a real level playing field. For instance, according to CRD IV the national authorities keep some discretionary power for the weights attached to real estate or for the implementation (or not) of the countercyclical buffer. This ongoing debate means that we will have to find the right balance between coordination and decentralization as regards the concrete implementation of Basel III. BU also implies such a search and clarification.
2) To overcome the current fragmentation of financial markets in Europe. This is another way to look at the single market puzzle. The Eurozone crisis has generated diverging interest rates and increasing spreads over the whole yield curve. Banks in countries under pressure still pay a premium on their debt compared to banks in core countries. The crisis has also fuelled an augmented "home bias" for investors which is well documented, a partial repatriation of financial assets, some form of "renationalization" of private savings and the necessity to compensate private capital flows from the south (Greece, Portugal, Spain) to the north of Europe by some public transfers from the north to the south.
3) To overcome the "impossible trinity." D. Schoenmaker (2011), referring to the concept of "financial trilemma," underlined the fact that we cannot have the three sides together: financial integration, financial stability and national policies for crisis prevention and management. If we want to maintain financial integration and to reach financial stability, we must pass to some supranational policies for the management of financial crises. This financial trilemma is as important for financial matters as the Mundell–

Padoa–Schioppa impossibility triangle is for monetary policy in an open economy with perfect capital mobility.

4) To get out of the vicious loop between banks and sovereigns. The Eurozone crisis has illustrated the manifold and bi-directional links between banks and sovereigns. In several cases the systemic banking crisis associated with private overindebtedness has led to state intervention as an investor of last resort in the banking sector and to an outburst in the public debt ratio (Ireland, Spain). Among other examples, the Cypriot crisis has illustrated the negative impact of non-performing sovereign debt on individual banks and on the banking system as a whole. In many cases spreads are the main channel of transmission from the sovereign to corporate debt (including bank debt). What to expect and what not to expect from the BU regarding the bank/sovereign loop? Banks will continue to buy sovereign debt, induced to do so by the scale of weights embedded in Basel III. But effective supervision at European level means that the supervisors are in a better position to contain on an *ex ante* basis the accumulation of bad debts on bank balance sheets. Moreover, a Spanish or an Irish scenario comparable to the one we had a few years ago would be much less likely in the future since the resolution of banks in BU relies on public funding as the last, not the first, solution. Compared to the pre-BU configuration, the probability for a bank crisis morphing into a sovereign debt crisis will significantly decrease, although it will not be zero.
5) To internalize externalities. The presence of externalities—either positive or negative—leads to under- or overutilization of some instruments. Here we come back to the classical argument à la Tinbergen (1954): the presence of externalities pushes towards coordination or even centralization (which represents the highest degree of coordination) of policy instruments. Cross-border banking and financial activities in the EU are still significant despite the recent fragmentation. The Cyprus crisis has shown that spillover effects fuelled by expectations and contagion could create a systemic problem from a configuration which was difficult to characterize as "systemic" on a purely *ex ante* basis. Potential negative externalities for the rest of Europe came from the initial and counterproductive decision of the Eurogroup to tax all deposits. The final decision to exonerate deposits up to €100,000 limited the externalities for depositors in the rest of the EU. The Cyprus case suggests that the transition from individual to systemic risks is much more complex than usually appreciated. It deserves more scientific and policy attention. The magnitude of externalities across member states explains the creation of the three European regulatory and supervisory bodies (ESMA, EBA, EIOPA) according to the recommenda-

tions of the de Larosière report made before the Eurozone crisis. This crisis means that we must go further regarding the internalization of financial externalities.

6) To reduce the risk of capture of regulators by the financial industry. The arguments are extensively discussed in the academic literature especially in light of the crisis and the growing focus on conflicts of interest. Supervision and resolution taken at national level would entail a risk of regulatory forbearance. This argument validates more integration and centralization. The idea that a supervisory mechanism centralized at European level would be less exposed to lobbies and pressures is based on the notion of "distance" from vested interests which are supposed to be more powerful at the national level than at EU or euro area level. Here the word distance could have several meanings: for sure geographical, but also functional, political, institutional and so on.

The emphasis on the benefits to be had from BU does not mean that there are no costs. The operational costs are difficult to estimate. The ECB had to recruit extensively (about 1,000 additional staff) in order to fulfil its new role as the main supervisor of banks. But a part of this recruitment came from a substitution effect: some experts left their NCA in order to work with the ECB on prudential issues. Likewise, how to measure the loss of national sovereignty through BU and the centralization of banking supervision and its costs for any member country? For the sake of transparency and accountability it would be useful to develop an *ex ante* assessment of the discounted costs/benefits of such a major economic and political change. The main challenge is to quantify so many qualitative changes and to value numerous externalities.

5.3 The Single Supervisory Mechanism

5.3.1 The Three Pillars and Their Sequencing

BU rests on three pillars: a Single Supervisory Mechanism (SSM), a Single Resolution Mechanism (SRM) and an integrated scheme of deposit insurance. The fact that Basel II and III also rest on three pillars does not imply that three has become the golden figure of financial regulation. This convergence is purely coincidental.

The three pillars of BU form a consistent system. They cannot be decoupled from each other. But, on the other hand, since BU relies not on shock therapy but rather on gradualism, proper sequencing is both required and fundamental.

It should take place in the following order: supervision, then resolution of banks and, at the end, deposit guarantee. Not in the steady state but during the transition period, which is expected to last at least a couple of years, the EU will face a dilemma: how to implement a credible and effective BU when it will be piecemeal during the transition phase, given the lags in effect between the respective integration of supervision, resolution and deposit insurance? The solution could be the following: to extend the monetary policy debate to financial regulation. In order to be time-consistent, each stage of the BU must be set in such a way that it is perfectly consistent with and conducive to the later stages. From the functional viewpoint the three stages (one for each pillar) are not separable even if they are implemented successively. This is what may be called the *non-separability principle* (de Boissieu 2013).

5.3.2 The Central Role of the ECB

The SSM benefits from the global reputation and credibility of the ECB. The independence and "distance" of the ECB from national authorities are valuable features of the SSM. Moreover, the ECB has a comparative advantage in collecting microeconomic information about bank condition and risks, and this advantage has been increasing with the implementation of unconventional monetary policy, which requires more transparency about bank balance sheets. The idea was to give the leadership to the ECB but to benefit from more coordination between the ECB, the European Banking Authority (EBA) and other existing institutions.

The ECB started its supervisory activity as of November 2014 by directly supervising the most "significant" banks of the Eurozone, 129 of them, which taken together represent a market share of 80–85 % of bank assets in the euro area (ECB 2016). Given the list of global systematically important banks (GSIBs) published each November by the FSB, which includes 30 banks at the world level (as of November 2015) of which eight have their seat in the euro area, it means that the ECB is supervising many non-GSIBs but "significant" banks. For a bank to be qualified "significant" the relevant criteria are: the size (namely assets over €30 billion, assets over 20 % of a member country's gross domestic product) and the magnitude of cross-border operations. These criteria differ from the ones put forward by the FSB to designate the list of systemic banks at world level (BCBS 2013) but they also concur with some of them.

5.3.3 The Necessity of Coordination

The coordination challenge is twofold: (1) cooperation between the ECB and the NCAs as regards the concrete functioning of the SSM, and (2) relationships between the ECB and other existing bodies in charge of prudential policy.

The first aspect raises a difficult but relevant issue. What will be for the SSM, both during the transition phase and in the steady-state regime, the balance between centralization forces giving a growing role to the ECB and decentralization forces maintaining a very significant role for NCAs because of their privileged access to local information, of the valuable argument of "proximity" (which is a multidimensional concept: geographic, cultural, political)? The answer, which is quite impossible to provide on an *ex ante* basis, will lie in the combination of two necessities: the fruitful division of labour between the ECB and the NCAs (in many cases the national central banks or institutions which are closely related to them), and the necessary cooperation between them. The basic split between large banks directly supervised by the ECB and the small and medium-sized banks ("less significant" banks which number slightly less than 3,200 as of 2016) directly supervised by the national authorities is useful and apparently clear cut. But even the size criterion will pave the way for some overlapping and competition between the "centre" and the "periphery." This wording is not intended to be pejorative, in view of the fact that the NCAs will continue to care for their "significant" banks whereas the ECB cannot neglect less significant banks in light of the Cyprus crisis and some other banking crises. Coordination does not mean the absence of hierarchy: the ECB is ultimately in charge and always able to look at some less significant banks. For the sake of consistency at Europe level, it exercises oversight of the NCAs. This fragile balance between cooperation and leadership is best illustrated by the concrete functioning of the Joint Supervisory Teams (JSTs), which gather both experts from the ECB and NCAs and undertake a review of significant banks. The chief of a JST is always from the ECB staff.

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

With Basel II and Basel III, the supervisors have to assess the quality of internal models used by banks (in particular the A-IRB models for "advanced internal rating based") to compute their risk-weighted assets (RWA). This referee function is crucial for comparing and rating bank internal models and therefore creating a level playing field. In the SSM, the ECB and the NCAs will have to cooperate to fulfil this function. De facto, the ECB will be more

involved in the rating of large banks' internal models while the NCAs will focus more on small and medium-sized banks (by the way, those banks mostly rely on the standard model or on the Foundation-IRB). But the two levels of decision have to be fully consistent since any significant discrepancy between them could generate competitive distortions.

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

The other aspect of the coordination puzzle concerns the relationships between the ECB and other existing institutions at the European level. A frequent debate concerns the role and the very existence of the ESRB (European Systemic Risk Board), which as a group is too large (about 60 people around the table), has no executive power and has no impact on the decision-making process. It has not issued any recommendation to any authority (Cyprus, Slovenia, etc). On the contrary, some economists pointed out the usefulness of the ESRB when it made some strong recommendations concerning money market funds at the end of 2012 and when it published scoreboards concerning systemic risks.

What will be the role of the EBA when a full BU is in place? No one really questioned the very existence of the EBA, but it will have to adjust to the new institutional framework. EBA could contribute to many aspects of the BU except that it cannot provide liquidity in case of a need for it. Some analysts point out to the fundamental limits of EBA because it is not a regulator. What can be considered to be fairly certain is that EBA will continue to be deeply involved in bank stress tests in cooperation with the ECB and the NCAs. The participation of EBA in the assessment of banks by the ECB is a positive token of the prevailing spirit of cooperation (rather than competition) between the various stakeholders of the BU. We are here also confronted with the question of what is the best incentive structure to fulfil the objectives defined by the European and national policymakers.

5.3.4 Micro- and Macroprudential Measures

Banking supervision is mostly microprudential. It is a continuous policy applied to all relevant financial institutions. Today everyone underlines the unavoidable "granularity" of macroprudential measures, namely the necessity

to index them on the economic cycle in order to limit their procyclicality and if possible to make them contracyclical.

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

As Charles Goodhart has pointed out many times, it is much easier to tighten up banking and financial regulation in a boom than it is to relax it in a bust. Some empirical evidence of this asymmetry comes from convergent International Monetary Fund studies on macroprudential policy. Moreover micro- and macroprudential policies could work in opposite directions. Whereas during the boom both micro- and macropolicies converge to tightening (higher capital and liquidity requirements), they diverge during the bust with micropolicy pushing towards tougher measures and macropolicy trying to "lean against the wind" (i.e. to be contracyclical by lowering relevant ratios). Here there is a clear conflict of objectives within the overall prudential policy and the need for more instruments to reach the various objectives attached to financial stability. This is another application of the Tinbergen Rule, but we also have to consider the Mundell Rule; that is, how to assign the different prudential measures to the various goals of financial stability. We need here more research and academic analysis. Could we assess and implement the optimal degree of granularity and selectiveness as regards geographic and temporal criteria? The split between micro- and macromeasures is necessary but not sufficient, and in many respects we have to go beyond.

5.3.5 Potential Conflicts within the ECB

Possible trade-offs between monetary policy and prudential policy are well known and documented. It is known that such a trade-off could occur when monetary policy has to be tightened. The higher interest rate warranted from the monetary policy viewpoint could enhance the fragility of some banks

whose financing costs are indexed on market rates. The impact could therefore challenge the supervisory function of the central bank.

There exists another potential conflict which is both functional and institutional. It relates to the links between the Governing Council and the Supervisory Board of the ECB. One option would have been the full separation between the two bodies, the Governing Council being no more than an observer at the Supervisory Board (and vice versa). There is some overlapping as regards the membership of the two Boards. A huge dose of pragmatism is required.

5.4 The Single Resolution Mechanism

From the viewpoint of the sequencing, the SRM is the second pillar of the BU. The problem of bank resolution was alluded to at the Washington DC, G20 Summit in November 2008, which called for a review of resolution regimes and bankruptcy laws "to ensure that they permit an orderly wind-down of large complex cross-border financial institutions." Owing to the impact of the Eurozone crisis on banks, the challenge of resolution has become still more topical. A sense of emergency has developed in particular after the Cyprus crisis. The 2014 BRRD (Bank Recovery and Resolution Directive, 2014/5/UE) has set the rule for banking resolution in the euro area.

5.4.1 The Legal Basis for Bank Resolution

In 2013–2014 the debate about the legal basis for bank resolution was still lively. For sure, there was and there is a consensus not to change the Treaties for this purpose. This is a sound position given the general mood in Europe and the economic and social circumstances. The SRM will facilitate the orderly resolution of cross-border banking groups and the belief that this is a single market issue.

Here the cross-border dimension of bank activity is underlined, but the SRM will be applicable to any credit institution "failing or likely to fail" whatever the respective weights of purely domestic and cross-border operations in its net income. The legal debate is over, at least for now (but we cannot discard completely the scenario of legal and judiciary disputes). A comprehensive analysis of the legal basis for resolution is proposed by Micossi et al. (2013).

5.4.2 The Basic Ingredients of Bank Resolution

The general idea was to set up a Single Resolution Board (SRB) which works in close cooperation with the NCAs. As for supervision, the debate concerning the balance between centralization versus decentralization forces does exist for resolution. However, the size criterion, which is relevant to assign responsibilities between the ECB and national supervisors, applies less to resolution. The SRM will cover all banks whatever their size and "significance." In this respect the ECB's view is at odds with that of the German authorities. Wolfgang Schäuble, the German Minister of Finance since 2009, has repeatedly said that the SRM must work as a network of the NCAs rather than as a centralized authority. This is not the view of the Commission, the ECB, the European Council or many member countries. There is even no place for a two-tier resolution system based on a size criterion as it could be for supervision. Nevertheless there could be no real decoupling between supervision and resolution. First, there exists a logical sequencing. The SSM (either the ECB or the NCAs) should be solely responsible for assessing whether a credit institution is failing or likely to fail. The supervisory assessment will therefore be a necessary precondition for putting an institution into resolution. Second, the relevant geographic areas for the SSM and the SRM have to coincide. A country cannot be part of one without participating in the other. As already mentioned, this is what the non-separability principle dictates.

5.4.3 Organizing Bail-in Procedures

The main objective of the new procedure is to count on private rather than on public money whenever a bank in the euro area is failing or likely to fail. Bail-in must be the rule, bail-out the exception. States and taxpayers will become payers of last resort, not of first resort as they were in 2008–2009 and more recently with the Irish, Spanish and Cypriot crises owing to the systemic nature of those crises and the prevalence of the "too big to fail" argument. Before coming to resolution, everything must be done to avoid such a situation through the adoption of preventive measures, early intervention with the power given to the authorities (European and national) to appoint a new management in case of a significant deterioration in the bank's financial situation or of serious violations of the law. Resolution itself is a multidimensional procedure since it could involve several steps, such as partial sale of bank business, defeasance operations (transfer of impaired assets to a special vehicle) and bail-in measures. Indeed a concise definition of bail-in has been

put forward by the EU: "the imposition of losses, with an order of seniority, on shareholders and unsecured creditors" (Council 11228/13).

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

5.4.4 Governance, Funding and Fiscal Backstop

The SRB is based in Brussels and independent from the ECB in order to avoid conflicts of interest between supervision and resolution. The ECB has been very clear in its opinion on the SRM. "The ECB seeks representation in all plenary and executive meetings of the Single Resolution Board as an observer."

As far as funding is concerned there was also much convergence of views. The system has to be funded on an *ex ante* basis through premia paid by banks. This is very similar to most deposit insurance schemes which are also "funded," that is financed, on an *ex ante* basis. For most deposit insurance schemes, the premium paid by each bank has to be an increasing function of three factors: (1) a scale variable such as the level of bank liabilities eligible for a bail-in; (2) the global bank risk, computed in aggregating credit, market, liquidity and operational risks. A risk-based pricing is the way to deal with moral hazard; (3) the rate of global economic growth, taken as a proxy for the cycle. The positive relationship between premium and growth makes the system contracyclical since banks pay more during the boom, less during the bust.

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

To finance the SRF, it has been decided to implement a gradual phasing in. The banks in the euro area are paying premia depending on the size and the risk profile of each bank. This regime comes from a compromise between the German (in Germany banking concentration is rather low compared to other European countries) and the French (in France banking concentration is much higher) and therefore from the necessity to combine the size and risk criteria. As of 2024, in the steady state, the SRF will get €55 billion, an amount which is sufficient to bail out a significant bank (e.g. a Landesbanken in Germany) but not enough to face a big systemic crisis. Therefore the creation of a common backstop to the SRF is crucial for the credibility of Pillar 2. The European Stability Mechanism (ESM) is a natural candidate for such a backstop. It manages around €500 billion, and such an amount could be enough to face a big systemic crisis in the Eurozone. Moreover the ESM has already some experience regarding the resolution of banks since it has been deeply involved in the resolution of several Spanish banks. The German authorities are still reluctant to give this new role to the ESM, seen by them as a way to inflate the European budget. The debate about the backstop illustrates the fact that the border between bail-in and bail-out, between private and public money, between prudential policy and fiscal policy, is tenuous and could be removed whenever the banking crisis reaches a certain threshold of intensity.

5.5 Deposit Insurance

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

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

It should be expected that coordination between the national deposit insurance authorities and any projected European fund will become necessary. Moreover, cooperation will be necessary but not sufficient. In the medium and long run, the EU will have to develop a more centralized system, such as a European Insurance Fund like that of the Federal Deposit Insurance Corporation (FDIC). The main reason is the non-separability principle mentioned earlier. In the steady-state regime, the three pillars of BU are not separable from each other. In the USA, which is more of an example than of a model, the FDIC is also deeply involved in the resolution of banks by addressing bank failures through mergers and acquisitions. In November 2015 the European Commission released a proposal in order to establish a European Deposit Insurance Scheme (EDIS, see IP/15/6051)[1] in three successive steps. (1) The reinsurance phase (2017–2018–2019): deposit insurance remains national and the European Deposit Insurance Fund (EDIF) will intervene as an insurer of last resort vis-à-vis the national Deposit Guarantee Schemes (DGSs). During this period EDIS may provide limited funding. (2) The coinsurance phase (2020 up to 2023 included) during which there will be a pragmatic division of labour between EDIF and the national DGSs. Coinsurance means that when necessary pay-outs would be shared between national DGSs and EDIF. (3) As of 2024 a fully integrated deposit insurance scheme, EDIF becoming therefore a FDIC-like European Insurance Fund with some important idiosyncracies when compared to the US case. Such an ambitious blueprint for Pillar 3 of BU still faces many uncertainties. In particular the Germans remain strongly opposed to the European Commission's proposal and timetable. Therefore we cannot take for granted that a compromise is going to be easily and quickly accepted for Pillar 3.

5.6 Other Structural Issues

5.6.1 The Ins and the Outs

It has been very clearly stated that the BU is also open to member states which are not in the eurozone. Some member states such as Poland seem to be interested to join whereas the UK, even before Brexit, and Sweden are very likely to stay

[1] http://ec.europa.eu/finance/general-policy/banking-union/european-deposit-insurance-scheme/index_en.htm.

outside. Jörg Asmussen (2013), then member of the Executive Board of the ECB, pointed out that the BU is "critical for the ins and desirable for the outs." If they join, the outs would participate on equal terms as euro countries to ensure a level playing field between the ins and the outs. They would also participate in the governance of the BU in a way which yet remains to be determined. Conversely, owing to the non-separability principle, the BU is a "package." It is not possible to be a member of one or two pillars without accepting the other(s). Hüttl and Schoenmaker (2016) have underlined that out countries could profit from joining BU, which is "a stable arrangement for managing financial stability." However, from a practical viewpoint, we must acknowledge that it would be uneasy and complex in terms of management and governance for a country to participate in BU without being a member of the euro area.

5.6.2 The Separation of Bank Activities

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

The justification for bank separation is open for debate. At the start, the subprime crisis was very classical: the outburst of a real estate bubble. It had nothing to do with proprietary trading. Implementing the separation will be complex. On the one hand, separation between commercial banking and trading addresses two major challenges. (1) Time inconsistency: banking is long term while trading is short term. (2) The distribution of risks, which raises several problems such as transparency, traceability, risk shifting. On the other hand, however, banking and trading are so intimately connected that a full separation is not warranted. It is not always easy to separate market making from proprietary trading. Given the development of new forms of

investment banking, regulators must be very pragmatic when implementing some separation of bank activities With one form or another of separation, where will the risks be allocated? What is the best place to manage them? To ask those questions is not a way to condemn separation but is an appeal for more academic research and more empirical (and historical) studies.

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

5.6.3 CMU and the Financing of the Real Economy

In Europe as in many other areas, we are entering a new phase of disintermediation: less bank financing and more non-bank financing, which could be either market-based financing or fund-based financing. Beside markets and banks, it is useful to make more explicit the role of funds such as alternative investment funds (private equity, hedge funds, money markets funds, real estate funds, etc.) regulated in the EU under the AIFM directive. This new disintermediation will be induced by many factors including the impact of Basel III on the willingness of banks to lend to risky borrowers such as most small and medium-sized enterprises (SMEs). It will generate winners and losers, and it is very likely that many SMEs could belong to the losers group by facing bank credit rationing. Were it the case, a serious challenge for public policy would arise since in most EU and euro area countries SMEs and intermediate-sized firms are crucial for growth and job creation.

The prospect of changing financial structures has given the background for the launching of an action plan on building a CMU by the European Commission in the autumn of 2015 (COM(2015) 468).[2] Whereas BU primarily concerns the euro area, CMU applies to all EU countries, but not the UK after the Brexit takes place. There is still today a big gap between the very ambitious goals of CMU and the lack of a concrete and credible roadmap for such a project. The goals of CMU are clear and widely acceptable: (1) to boost investment, growth and employment; (2) to reduce financial fragmentation and deepen the single market for financial services; (3) to get more integrated, efficient and competitive financial markets. In this

[2] http://ec.europa.eu/finance/capital-markets-union/.

search for financial competitiveness, the action plan takes US capital markets as a reference to be replicated by European markets regarding their depth, liquidity and resilience.

The actions envisaged to reach such goals are numerous. The list deals with many items and persistent challenges: (1) to attract more SMEs on stock markets in order to facilitate their financing and growth; (2) to boost the rebound in private equity funding; (3) to speed up the development of securitization in light of the crisis that securitization had to face since 2007–2008, by promoting STS ("simple, transparent and standardized") vehicles possibly at the European level (see Daphné Héant et al., Chap. 16, this volume); (4) to promote the growth of crowdfunding in Europe; (5) to update some financial regulations such as the Prospectus directive. The list of actions given here is partial, but it is sufficient to understand that most actions are intended to boost non-bank financing (market or fund financing) tailored in particular to SMEs and intermediate-sized firms. CMU intends to make the new disintermediation phase which has just started sustainable and possibly positive for those firms. It has also to be analysed in connection with the implementation of the Juncker plan even if the time horizon of the two actions is different: three years initially for the Juncker plan (mid-2015/mid-2018) and an infinite horizon for CMU provided that it is actually implemented.

Will CMU be effective and succeed? It is clearly too early to have a definite answer. But we could already raise an incomplete list of issues. (1) The timetable of CMU is still too vague and not binding enough. (2) Concerning the canonical debate why SMEs are reluctant to go to stock markets, we know the long list of arguments put forward both by SMEs and by investors. But the action plan does not propose really new ways to overcome such structural difficulties. (3) Who is going to put the STS label on some securitization vehicles? ESMA or national financial regulators or independent rating agencies either already in place or to be created for such a business? If we want to get a true European market for securitization vehicles it would require a European STS label. (4) We have no European regulation for crowdfunding yet. Since Internet has no borders, if we want to reach a true level playing field for crowdfunding within the single market, we would need some specific EU regulation at some point in the future. (5) CMU means more intra-European harmonization regarding corporate law (e.g. bankruptcy rules) and corporate taxation. For reasons which are more political than technical we are very far from such a move. (6) Does CMU, like BU, entail more centralization of financial markets regulation at the European level? This topic is today somewhat taboo, but we can take it for granted that it will emerge as soon as CMU is made effective. Clearly ESMA could be a natural candidate for such a role.

5.7 Concluding Remarks

The main challenge of the ongoing reregulation process both at the world level and in Europe is the following: how to strengthen the banking and financial sector and to contain systemic risks without jeopardizing the financing of the real economy, growth and employment. An application of this general consideration is the transition from Basel II to Basel III and possibly to the controversial Basel IV and its implications for investment and growth. What is at stake is the good calibration of the new prudential rules. In the spring of 2016 and for the first time, the European Commission has recognized that the calibration challenge could be essential. It has already accepted some relaxation as regards Solvency II by reducing capital requirement for insurance companies when they finance infrastructure. This marginal evolution was necessary to make some prudential rules consistent with the concrete implementation of the Juncker plan's goals and means. For banks, the Basel Supervision Committee and thereafter the European Commission adjusted in early 2013 the definition of the LCR (liquidity coverage ratio) in a direction more favourable to bank financing. Possible adjustments in the long-term liquidity ratio (NSFR, or net stable funding ratio) could occur in the short term. The debate about the optimal calibration of the new prudential rules is going to stay there for long. Everyone including the European authorities has to be pragmatic in the search for a better balance between the main objectives of financial reregulation, financial stability on the one hand and the warranted financing of the real economy on the other.

In any case the business model of banks is likely to change with the capping of bank maturity mismatch generated by the conjunction of the two liquidity ratios. The impact of Basel III on the quantity and quality of bank financing is critical for European economies which are mostly "bank-based"(the UK being a "market-based" financial system, which is an exception in Europe). Since we cannot assume that market financing or private equity or more generally alternative investment funds will automatically substitute for bank financing if it becomes one way or another more selective and scarce, the capability of Europe to rebound in terms of investment, growth and job creation is at stake. We must not forget either that the implementation of the new prudential rules at the world level could generate a non-cooperative game (some countries staying apart from the new rules), which could lead us very far from the ideal configuration of a true level playing field.

At present, Europe is the "low pressure" zone in the world economy, posting low growth and high global and youth unemployment. By itself BU will not solve the challenges of the real economy; but it is an opportunity not only to improve the resilience of European finance but also to think and to act

together for the long term, in a period of quasi-general myopia. BU is much more than a purely technical project, much more than the addition of integrated supervision, resolution and deposit insurance. It is one of the few political economy perspectives that we have in common today. It deserves a strong commitment, discipline and continuity from policymakers at European and national level, notwithstanding essential electoral cycles.

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