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BANKING UNION: A SOLUTION TO THE EURO ZONE CRISIS?¹

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In June 2012 European Council launched the banking union as a new project expected to contribute to solve the euro area crisis. Is banking union a necessary supplement to monetary union or a new rush forward? A banking union would break the link between the sovereign debt crisis and the banking crisis, by asking the ECB to supervise banks, by establishing common mechanisms to solve banking crises, and by encouraging banks to diversify their activities. The banking union project is based on three pillars: a Single Supervisory Mechanism (SSM), a Single Resolution Mechanism (SRM), a European Deposit Guarantee Scheme (EDGS). Each of these pillars raises specific problems. Some are related to the current crisis (can deposits in euro area countries facing difficulties be guaranteed?); some other issues are related to the EU complexity (should the banking union include all EU member states? Who will decide on banking regulations?), some other issues are related to the EU specificity (is the banking union a step towards more federalism?); the more stringent are related to structural choices regarding the European banking system. Banks' solvency and ability to lend, would depend primarily on their capital ratios, and thus on financial markets' sentiment. The links between the government, firms, households and domestic banks would be cut, which is questionable. Will governments be able tomorrow to intervene to influence bank lending policies, or to settle specific public banks? An opposite strategy could be promoted: restructuring the banking sector, and isolating retail banking from risky activities. Retail banks would focus on lending to domestic agents, and their solvency would be guaranteed by the interdiction to run risky activities on financial markets. Can European peoples leave such strategic choices in the hands of the ECB?

Keywords: Banking union, European Construction.

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Since early 2011, the European authorities have tried to find ways to solve the public debt crisis in the euro area. This crisis revealed the drawbacks in the euro area organisation; they led to a rise in imbalances between euro area countries from 1999 to 2007; they did not allow the implementation of a common economic strategy after the 2008 financial crisis. The 28-29 June 2012 European Council was a new attempt from European bodies and member states to solve the euro area crisis. A new project emerged: the banking union, which was more precisely defined at the 13 December 2012 Summit. Is banking union a necessary supplement to monetary union or a new rush forward?

The current crisis is originally a banking crisis. Prior to the crisis, European banks had fed the rise in the financial and housing (especially in Spain and Ireland) bubbles; they had invested in risky investment or in hedge funds in the US;² they were making a significant part of their profits on financial markets, but were risking their own funds. They experienced significant losses due to the 2007-2009 crisis and the burst of the bubbles.³ Governments had to come to their rescue, which was particularly costly for Germany, the UK, Spain, and, above all, for Ireland.⁴ The euro area sovereign debt crisis increased banks' difficulties; public debts which they held became risky assets. A dangerous resonance appeared between the difficulties of public finances and those of the banks of the same country. Doubts on public debt weaken national banks which generally own a certain amount of government bonds; markets consider that governments will have to rescue domestic banks, which increases the fears on governments' solvency and on capacity to support domestic banks (Pisani-Ferry and Wolff, 2012). Mistrust grows in an uncontrollable vicious circle. Last, the debt crisis destroyed the euro area unity and the

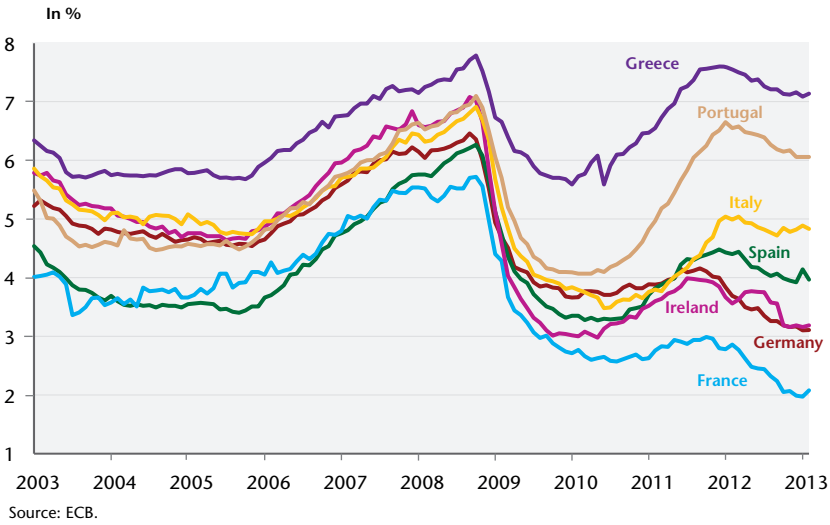
2. Euro area banks' foreign assets in US dollars reached 4 trillion dollars in 2008, four times the figure for US banks' assets in European currencies (Baba *et al.*, 2009).

3. Their writedowns related to US dollar-denominated non-bank assets are estimated at 423 billion dollars between 2007 and 2009 (McGuire and Von Peter, 2009).

4. Between 2008 and October 2012, the approved amounts of rescue packages to financial institutions reached 5.1 trillion euros (40.3% of EU GDP), 365% of GDP for Ireland, 256% for Denmark, 97% for Belgium. The amounts effectively used reached 1.6 trillion euros (12.8% of EU GDP), 224% of GDP for Ireland, 66% for Denmark, 32% for Greece (European Commission, 2012 d).

notion of 'single currency': a Spanish company cannot borrow at the same interest rate as a German one (Figure 1).

Figure 1. Interest rates on short-term loans to non-financial companies

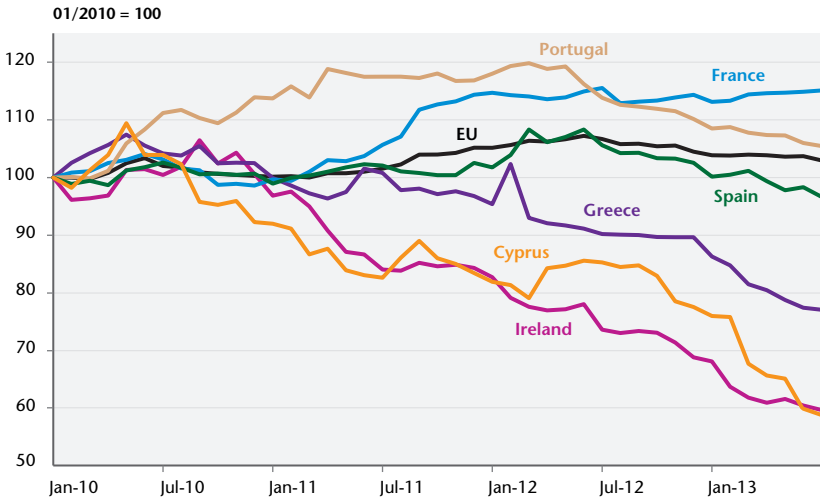


Due to the liberalisation of capital movements, small countries (Ireland, Iceland and Cyprus) developed banking systems far too big for their size, and were unable to rescue them. The issue of banking regulation is addressed at the international level (new Basel III standards), in the United States (Volker rule and Dodd-Frank Act) and in the United Kingdom (Vickers' report).

In June 2012, the robustness of European banks was once again questioned. The measures introduced since 2008 to stabilise the financial system turned out to be insufficient. When Bankia, the fourth bank in Spain requested a 19 billion euros support from the Spanish government, concerns on Spanish banks' balance sheets strongly rose. The share of bad debts in Spanish banks, whose balance sheets have been weakened by the burst of the housing bubble, rose from 3.3% at the end 2008 to 8.7% in June 2012, and 11.3% at the end of 2012 (according to the Bank of Spain). Furthermore, many European depositors reduced their domestic bank deposits fearing their country could leave the euro area: during the first half of 2012, bank deposits fell by 5.6% in Greece, 12% in Ireland, 4.5% in Portugal. From June 2012, this started also to

occur in Spain: bank deposits declined by 90 billion euros in the summer (Figure 2). The TARGET 2 system automatically re-lent to Spanish banks the Spanish deposits held in German banks, but the ESCB was thus playing a role of guarantee of Southern countries' banking systems, which could be dangerous and raised the concerns of German politicians and economists.

Figure 2. Bank deposits



Source: ECB.

In May 2012, in response to these risks, Mario Monti re-launched the objective of a European banking union, taking up projects already in preparation at the DG Internal Market and Services of the European Commission. Germany was reluctant, considering that there can be no banking union without a fiscal union. Even though Angela Merkel acknowledged the importance of having a European supervision with a supranational banking authority, she refused that Germany takes the risk of new transfers or guarantees, without enhanced budgetary and political integration. However, the banking union project received the support from the European Commission, the ECB, and several countries (Italy, France, Spain...), some wishing to accelerate the move towards a federal Europe, some looking for a lifeline emergency. Thus, the need for urgent action to save the euro area could have heavy consequences, with reforms implemented too rapidly, without fully considering their consequences.

The banking union would, according to its proponents, break the nexus between sovereign debt crisis and banking crisis, by entrusting bank supervision at the EU level, implementing common mechanisms for banking crises resolution and for deposit guarantee, and encouraging banks to diversify their activities and their loans in Europe. It would help to unify credit and deposit markets in Europe (see Dai and Sarfati, 2012, Pisani *et al.*, 2012). Conversely, it would introduce in each country a break between banks on the one hand, governments and national companies on the other hand. It would be a new step towards federalism by a new transfer of competence from the Member States to European authorities. The project raises again unresolved issues: can there be an economic and monetary union without a fiscal and political union? Is there any limit to EU integration? How to take national differences into account?

Can banking union offset four major drawbacks of the Monetary Union: the absence of a “lender of last resort”, which allows financial markets to bet on the possible bankruptcy of States; the absence of rigid solidarity, control or coordination mechanisms which weakens the single currency; the inability to implement a crisis exit strategy, which has led several economies to fall and remain in recession, which weakens further their banking system; the fact that a single interest rate set by the ECB, with arbitrary risk premia requested by financial markets, leads to uncontrollable credit conditions in member countries?

Such a banking union would be based on three pillars:

- A Single Supervisory Mechanism (SSM).
- A Single Resolution Mechanism (SRM).
- A European deposit guarantee scheme.

Each of these pillars is subject to specific problems. Some of this problems are related to the complexity of the functioning of the EU (Is banking union limited to the euro area or does it include all EU countries?) some others to the crisis context (should Europe guarantee depositors against the exit of their country from the euro area? Should Europe support banks already facing difficulties?), some others linked to the EU specificity (Is banking union a step towards more federalism? How to reconcile it with national prerogatives?), finally other problems linked to structural choices on the functioning of the European banking system (should there

be a better surveillance of a European banking system, which is internationally diversified and integrated to financial markets? Should banks refocus their activity on their core business, credits and deposits?).

However on 29 June 2012, the euro area summit agreed that the Commission would make proposals for a SSM for euro area banks (European council, 2012b), which was the condition for allowing the European Stability Mechanism (ESM) to directly recapitalise banks, thus breaking the vicious circle.

On 18 October 2012, the Council launched the legislative work on a banking union while insisting on the need to strengthen the surveillance of fiscal policies (six-pack, two-pack, Fiscal Compact), by the monitoring of macroeconomic imbalances and by increasing incentives for structural reforms.

On 13 and 14 December 2012, the Council agreed on the SSM, giving the ECB the full responsibility for the European banks supervision. This allowed launching the trilogue discussion with the European Parliament. On 12 September 2013, the European Parliament agreed to set up the SSM. These powers will be effective from September 2014.

With regard to the SRM, on June 2013, the Council agreed on the Bank Recovery and Resolution Directive (BRRD), proposed by the EU Commission in June 2012. An agreement with the European Parliament was announced on 20 December 2013. An intergovernmental agreement on a Single Resolution Board (SRB) and a Single Resolution Fund (SRF) was announced on 18 December 2013, but no agreement has yet been reached with the European Parliament.

We will analyse the issues and problems of each of these three pillars, and we will then discuss the future model of the banking system in the European banking union.

1. A Single Supervisory Mechanism

The objective of setting up a single European banking supervisor is to have an independent and powerful institution supervising European banks. The arguments in favour of such a supervisor are the same as for an independent central bank. Banks, like money,

should escape from the political sphere to be entrusted to experts. Banking supervision by an independent supranational authority prevents national or political factors to influence decisions and strengthens the credibility of strict rules (Rochet, 2008). An independent supervisor will be credible when asserting that not all banks will be necessarily bailed out in the event of bankruptcy, which will encourage banks to reduce their risks. This will reduce the moral hazard of banks otherwise encouraged to take risks under the insurance of being bailed out by their State. Independence also ensures shorter delays for the implementation of bankruptcy procedures, delays that are detrimental to the effectiveness of the adopted resolution procedure and create the possibility of lobbying actions limiting the credibility of the overall scheme. The supervisor should be able to monitor banks in trouble before they become a threat to financial sector stability. Speculation on bank failures which has fed the crisis, would be substantially reduced. Confidence depends strongly on the quality of supervision. Uncertainties about the quality of the banking sector, on its capitalisation, on the amount of bad debts caused difficulties for banks to refinance themselves on the interbank market.

The European banking supervisor should facilitate the implementation of the common scheme of crisis resolution, by acting both in normal times and in times of crises for the resolution of bankruptcy procedures. Finally, it will monitor the implementation of the new Basel III standards. From 1 January 2014, banks will have to increase the level and quality of their capital: the Core Tier 1 ratio (comprising core equity: common stock and retained earnings) should increase from 2 to 4.5% of banks' assets, while the TIER 1 ratio should stand at 6% at least, versus 4% previously.

The single banking supervision should enable to set up both a single mechanism of deposit guarantee and a single mechanism for assistance to banks in difficulty (Véron and Wolff, 2013).

There has been a debate on whether the European banking authority (EBA) or the ECB should be in charge of the SSM. The EBA was founded in November 2010 to improve the EU banking system supervision and is a young institution. It already ran two series of "stress tests" on banks. In October 2011, Bankia's tests results pointed to a 1.3 billion deficit of core capital. Five months later, this deficit was 23 billion. This weakened the EBA's credi-

bility. Moreover, the EBA has no national correspondents; it is based in London, and has authority on the British system while the United Kingdom does not wish to be part of the banking union.

The ECB lobbied to be entrusted with this task. Hence, Mr Constancio, Vice-president of the ECB, said on 12 June 2012, that “the ECB and the Eurosystem are prepared” to receive these powers; “there is therefore no need to create a new institution”. Section 127.6 of the Treaty on the functioning of the European Union,⁵ quoted at the 29 June euro area summit, makes it possible to give supervisory authority to the ECB.

Financial stability is already an objective of national central banks and the latter already had a role in the banking sector supervision. In France, for example, the Prudential Supervisory Authority is responsible for the agreement and supervision of banks and insurance institutions; it an independent authority, but remains backed by the Bank of France.

The European Commission estimated that the ECB has an established reputation of political independence. The ECB’s good knowledge of the interbank market, of liquidity in circulation, of the situation and reputation of each bank was an advantage over an independent agency.

So, the Commission chose the ECB to conduct banking supervision within a single supervisory mechanism (SSM) including the ECB and the existing national prudential authorities (European Commission, 2012 a). The ECB will receive the responsibility of monitoring missions for all the participating member states’ credit institutions, regardless of their business model and their size. It will ensure the implementation of standards for the degree of leverage, of liquidity, of own funds and it may, in coordination with the national authorities, impose the constitution of capital buffer or the introduction of corrective measures as deemed necessary. It will be the relevant authority to approve credit institutions. It will ensure the coherent application of the EBA single rulebook.

5. Art 127.6 “The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.”

In addition to its role as lender of last resort, the ECB would thus be responsible for supervising all banks in the banking union, but it will directly supervise banks with assets amounting to more than 30 billion euros or at least 20% of GDP of the country where their headquarters are located, as well as the banks which will request or receive assistance from the ESM, i.e. 200 banks on a total of 6 000 banks in Europe (European Commission, 2013c). It will monitor the supervision of other banks which will be conducted by national supervisory authorities, who will be accountable to the ECB. The ECB may decide, at any time, to supervise any credit institution. The SSM will benefit from the expertise of national supervisory authorities. The ECB shall have access to all the information available to national supervisors. As the ECB is an EU institution, it will be possible to appeal a decision according to the principles defined in the European treaties.

The ECB's new prerogatives as a single supervisor will have to take into account the presence of non-euro area countries in the banking union. Non-euro area EU countries are already represented in the ECB within the General Council which brings together all the governors of central banks of the EU. But currently this Council does not have any power. A fair distribution of powers between euro and non-euro area countries on European banking supervision is going to be very delicate within the ECB, this institution being primarily the Central Bank of euro area countries. So the European Parliament decided that all countries participating to the SSM are entitled to the same representativeness within the Council who will lead the supervision tasks of the ECB. In fact, in January 2014, the UK, Sweden and the Czech Republic already announced that they will not participate; no non-Euro area EU country has already decided to join the SSM.

A Supervisory Board (SB) and fully independent services will have to be created within the ECB to avoid conflict with the monetary policy objective. The SB would have six members from the ECB (the Chair, the Vice-Chair and four other members) and representatives of each national supervisor (which may be the national central bank or a separate authority). However the Board of Governors will have a right of veto on all decisions. To ensure the democratic legitimacy of the process, the Commission claims that the project ensures "strong accountability safeguards, notably vis-

à-vis the European Parliament and the Council” (European Commission, 2012 b). In practice, the ECB will have to present to the European Parliament the key points of the supervisory board’s minutes and the appointment of the Chair and of the Vice-Chair of the Supervisory Board will have to be approved by the Parliament. The supervisory power of the ECB voted on 12 September 2013 will be fully effective in November 2014, one year after the entry into force of the texts.

The Commission claims that the ECB will take no mission from the EBA, whose mandate in the European monitoring mechanism was specified (European Commission, 2012b): the EBA should elaborate a common legal framework for surveillance through a single rulebook for banking supervision in Europe, including the countries which would not be part of banking union. It should also provide the texts of laws that will govern the management of banking crises in the euro area. It should ensure regular stress tests on European banks. The EBA may make decisions on the double majority (group of countries subject to the SSM, group of countries not subject to it), which in practice gives a right of veto to the UK. So the EBA existence allows the UK to maintain a link with the banking union.

The ECB and the EBA are expected to work closely within the European Systemic Risk Board, responsible for alerting the European authorities about banking and financial instability risks in Europe. It is not yet certain that this committee will have an effective role, in the absence of any established doctrine and of any strong will.

1.1. Delicate transfers of sovereignty for a single supervision

The risk is great that entrusting these issues to the ECB is a new step towards the de-politicisation of Europe. Certainly, the European authorities claim that the ECB will be subject to enhanced transparency and democratic accountability requirements. Although the President of the ECB is often heard by the European Parliament, the Parliament control remains formal; the ECB maintains a full independence vis-à-vis national governments and European institutions. Although a Monitoring Committee is created, the Governing Council will remain responsible for banking supervision and monetary policy decisions. Despite the

creation of a single supervisory mechanism including national authorities, the ECB will make decisions in full independence, and simply has to “account for” and “reply to parliamentary questions” but these decisions will not be questionable, as is the case today with monetary policy decisions.

Will the ECB be able to account for European banks diversity? The European Parliament says that it will be one of its duties but it does not explain how financial institutions diversity will be preserved (Committee on Economic and Monetary Affairs, European Parliament, 2012). The single rulebook on which the EBA works and which must serve as a code of conduct for the ECB advocates a uniform regulation for all European banks. However, should governance or the capital ratio be the same for a small German retail bank and a large European banking institution?

One should have considered a dual system: the ECB would manage large transnational banks and national regulators would supervise national and regional banks and would preserve their specificities. However, national regulators are facing today unequal risks: they are facing much bigger risks in Southern countries (Greece, Spain, and Portugal) than in Germany or Finland. A dual system would have risked accelerating the withdrawal of deposits from medium-size banks in Southern countries.

The main point is the objective for the European banking system: large transnational banks, with cross-border deposits or credits, with substantial financial markets activities, or national and regional banks of reduced sizes, well inserted into real economic activities.

Banks are encouraged to diversify internationally to reduce their risks. But the crisis showed the dangers of diversification on foreign markets where banks are not familiar with.⁶ Banks lose contact with domestic firms, which deteriorate the quality of credit. Local authorities would no longer have dedicated banks.

6. For instance, studying micro-level data on 105 Italian banks over 1993–1999, Acharya *et al.* (2002) show empirical evidence of diseconomies of diversification for certain banks which expand their activities in industries where they face a high degree of competition or lack prior lending experience. This generates an increase in credit risk of loan portfolios or poor monitoring incentives.

Governments will lose their ability to influence bank credit supply, which, for many people, is desirable (no political influence on credit supply), but is dangerous in our opinion: governments will lose an industrial policy tool that could be used to finance small and medium size firms, or to promote environmental transition.

For instance, in the case of the Dexia bank, the opposition between on the one hand the European Commission and on the other hand France, Belgium and Luxembourg, has for a long time blocked the plan to dismantle the bank. This plan includes the resumption of financing activities of local French authorities of Dexia by a public bank, created by the cooperation between the *Caisse des dépôts* and the *Banque Postale*. On fair competition grounds, Brussels questioned the financing of local authorities by such a bank because Dexia received public aid for its dismantling plan. This threatens the continuity of the financing of local French authorities, could block their projects and especially forbid France to provide specific and secure mechanisms to finance local projects by local savings.

Similarly, in October 2012, the French Government rescued the BPF, *Banque PSA Finance*, the Bank financing the Peugeot group, in order to avoid that PSA can no longer provide credit to its customers. France guaranteed 7 billion euros of PSA bonds and got a commitment from the BPF's creditor banks to increase their loans. Is this compatible with a banking union?

Finally, the French project of a public investment bank (*Banque publique d'investissement*, BPI) is problematic in this context. This bank should provide credit according to specific criteria, linked with the French industrial policy. The question of the compatibility of such a public institution with the banking union will arise.

European banks will have to account for different national regulations on interest income taxation, special deposits regulation or financing circuit organisation. Is this compatible with the banking union or does convergence need to be organised? And who will decide about it?

In any case, the SSM does not address the question of how to ensure similar credit conditions in different countries sharing the same currency but in different economic situations. In the recent past, equal nominal interest rates encouraged rising debt in coun-

tries with strong growth and inflation. Today, interest rates are strongly influenced by risk premia imposed by markets, with no link to the macroeconomic situation.

It is difficult to assess if there will be (and if there should be) a Chinese wall between bank supervision and monetary policy (see Beck and Gros, 2012, for a discussion). The two functions are closely correlated when the Central Banks provide liquidity to banks, especially in times of crisis. Some economists (Goodhart, 2000 or Darvas and Merler, 2013) have raised the possibility that the Central Bank's role as banks' supervisor may enter into conflict with its objective of maintaining price stability. In the future, the ECB may decide not to raise interest rates, when necessary, in order to avoid downgrading banks' financial position. But this problem is not specific to the SSM implementation; it is always a concern for monetary policy that a strong interest rise deteriorates the balance sheet of some financial agents.

One could imagine that the ECB implements diversified macro-prudential policies imposing higher capital ratios to banks in countries in economic expansion and lower ratios for countries in difficulty. But this raises three questions: the macro-prudential logic will go in the opposite direction of the micro-prudential one; this implies that banks remain national; the ECB's strategy is likely to go in the opposite direction of the economic and fiscal strategy of the Member State (MS). Will the ECB punish a country running a too expansionary policy according to the Bank views by imposing strong capital ratios to its banks? In 2014, for instance, a MS like France may want domestic banks to increase credit supply to French firms to support an industrial recovery, but the ECB may consider this is a dangerous strategy for French banks financial stability. Diversified macroprudential policies would require a MS-well-defined coordination of European monetary policy, country-specific monetary measures and domestic fiscal policies which is not on the European agenda today.

A common vision on the banking system regulation is a prerequisite to European supervision. An agreement needs to be reached on crucial questions such as: is it necessary to separate retail banks from investment banks? Should banks be prevented to intervene on financial markets for their own profit? Should we promote the development of public, mutual, or regional banks or on the contrary

the development of internationalised banks? Should we encourage banks to supply credit primarily to households, businesses and governments of their countries of origin or on the contrary to diversify? Will macro-prudential rules be national or European? On each of these issues, the MS, the Commission, the ECB, and the EBA may have different points of view: who will decide?

Of course, in theory, it would be easier and more legitimate to rescue banks under a single supervision. But this prospect is hardly useful in the current crisis, where the problem is to help banking systems already in trouble in Spain, Cyprus, Ireland, or Slovenia.

Southern countries' current difficulties oblige the entire euro area to a rapid and full centralisation of banking regulation, the defaults of which may appear in a few years. In our view there is a major risk that euro area countries agree in emergency to enter a dangerous path, and that the banking union is as badly analysed *ex-ante* as were the single currency, the Stability and Growth Pact, the Fiscal treaty.

The Cypriot crisis has highlighted the difficulties of a European supervision. The European banking system is currently highly heterogeneous. Banks' balance-sheets-to-GDP ratios differ strongly among countries (Table 1). In some countries, banks have a significant share of deposits from non-residents. Does the SSM need to make national systems converge or can it accommodate their diversity?

The risk is that the banking union leads to conflicting situations between national strategies on banking and financial matters and the ECB, either because some countries may wish to keep certain public or regional features in their banking system, or because some others will want to maintain their predatory features (to attract foreign deposits). Economic issues will also arise: will governments still have the responsibility and the ability to influence credit policy either according to the real estate market developments, or to the macroeconomic context?

In November 2013, ECB undertook a comprehensive assessment of the euro area banking system before assuming its supervisory tasks in November 2014. The ECB's note (ECB, 2013) gives a provisional list of the 123 concerned banks and confirms that no non euro area country will participate. "The exercise will

comprise a supervisory risk assessment, an asset quality review and a stress test". Common methodologies will be developed in these three areas. The ECB may require corrective action as recapitalisation, profit retention, equity issuance, assets' sales. Capital shortfalls for viable banks should be provided by private capital or, if private capital is insufficient, by public backstops. After this exercise, the ECB will have a clear view of the situation of the European banks and will be able to take the responsibility to supervise them. The process should increase the confidence about banks' situations: if some European banks are not in a viable situation, their case should be resolved in 2014. The limitation (or maybe the strength) of this exercise is that the ECB is both judge and party.

Table 1. Banks' consolidated balance sheets-to-GDP ratios

	2007	2012
Luxembourg	27.3	20.2
Malta	6.8	7.8
Cyprus	5.8	7.2
Ireland	8.5	6.9
United Kingdom	4.8	4.9
Netherlands	3.8	4.2
France	3.6	3.8
Spain	2.9	3.5
Portugal	2.6	3.4
Austria	3.2	3.2
Germany	3.1	3.1
Finland	1.6	3.1
Sweden	2.5	3.0
Belgium	3.9	2.9
Italy	2.1	2.7
Greece	1.7	2.3
Slovenia	1.2	1.4
Latvia	1.5	1.3
Estonia	1.3	1.1
Poland	0.8	0.9
Slovakia	1.0	0.8
Euro Area	3.2	3.4

Source: ECB.

The ECB must assess the riskiness of MS public debts, which depends on its willingness to guarantee them or to respond to speculative attacks. It must evaluate the size of macroeconomic shocks that banks should be able to resist, but this size depends on the ability of the ECB to implement countercyclical policies and the banks resilience depends on the ECB's willingness to help them in a strong recession. So, the ECB evaluation is not neutral; it can be seen as a commitment to rescue the banks proclaimed healthy.

Box 1. Banking regulation in the United States

In the US, banking supervision is dual: it adapts to the two types of US banks: national banks (intervening at the federal level) and State banks (specific to each State). Supervision is carried out by the Fed and the Federal Deposit Insurance Corporation (FDIC). The Federal Reserve membership is mandatory for national banks and optional for State banks. In the event of joining, banks must subscribe to their regional reserve Bank and deposit the corresponding reserves. The Fed is independent of the government as it is ultimately accountable to the Congress which establishes the key macroeconomic objectives for monetary policy and as members of the Board of Governors and the Chairman are confirmed by the Congress. The Fed regulates and supervises the banks which are members of the Federal Reserve and the Bank Holding Companies system (12% of commercial banks and through the BHC 96% of commercial banks' assets). It sets the level of mandatory reserves. The FDIC is an independent agency of the federal government and receives no Congressional appropriations. The five members of its Board of Directors are appointed by the President and confirmed by the Senate. It is responsible for the supervision of State banks that are not members of the Federal Reserve System. It is also responsible for bank bankruptcy procedures resolutions and ensures the continuum of prudential policy and resolutions procedures.

2. A single resolution mechanism (SRM)

Until now, within the European Union, the legal provisions governing bank failures were country-specific. In some countries, like the UK, banks are submitted to the general code of firms bankruptcy and thus to a judicial procedure. Other countries, such as France have mixed regimes: an administrative procedure conducted by the banks' supervisor coexists with a judicial proce-

dure; this allows to take into account the specificity of the banking sector (for instance, to involve other banks in the procedure; to protect the smaller deposits).

In June 2012, the European Commission proposed to establish a single resolution mechanism (SRM). This SRM will be based on the Bank Recovery and Resolution and Directive (BRRD) agreed by the Council in June 2013, by the trilogue in December 2013, but not yet formally voted by the European Parliament. The scheme has five pillars. The first one is to improve prevention by requiring banks to establish *wills*, i.e. to provide strategies for recovery, or even for dismantling, in case of crisis. The second gives the European banking authorities the power to intervene to implement recovery plans and to change bank managers if the bank does not meet the capital requirements. The third indicates that, if a bank fails, national authorities will be able to take control of it and use instruments of resolution such as the transfer of activities, the creation of a defeasance bank (a “bad bank”) or the bail-in. The bail-in tool will give resolution authorities the power to write down the claims of unsecured creditors of a failing institution and to convert debt claims to equity. In the event of a bank failure, shareholders will be affected first, then subordinated claims and, if necessary, claims of higher categories. These claims could be transferred in equity. Some liabilities are permanently protected: deposits below 100 000 euros, liabilities to employees, and inter-bank liabilities with a less than seven days maturity. Others deposits (from individuals or SMEs) could have a specific treatment. National resolution authorities could also exclude liabilities to avoid contagion or value destruction in some creditors. The fourth pillar requires MS to set up a resolution fund, which must amount within 10 years, to 1% of the covered deposits of all credit institutions, which would have to finance it. The fund would provide temporary support to institutions under resolution. But the share of losses between ordinary creditors, privileged creditors and the resolution fund remains uncertain. According to the fifth, Member States shall ensure that the institutions maintain, at all times, a sufficient aggregate amount of own funds and eligible liabilities expressed as a percentage of the total liabilities of the institution (European Commission, 2012) to absorb losses. This percentage is estimated to be at least 10% but will be fixed in 2016 after a recommendation by

the EBA. So, in principle, taxpayers would not have pay for the creditors of insolvent banks. The EBA will have to set out the legislative framework for these instruments of resolution. The administrative body responsible for the resolution at the national level is left to the discretion of each country: Central Bank, finance ministry or a specific institution.

On 10 July 2013, the Commission proposed to move further towards the SRM centralization (European Commission, 2013b). The ECB would signal banks in difficulty to a Single Resolution Board (SRB), consisting in representatives from the ECB, the Commission and the supervisory authorities of the relevant country). The SRB would propose a resolution procedure, which would be formally decided by the Commission (as the SRB has no constitutional existence) and implemented by the relevant country under the SRB control. If a national resolution authority does not comply with the decision of the Board, the latter could address executive orders to the bank in trouble. National resolution funds would be replaced by a Single Bank Resolution Fund. Due to the reluctance of some MS, particularly Germany, the draft adopted by the Council on 18 December 2013 states that the pooling of national resolution funds will be carried out gradually in 10 years, from 2015 to 2025. It is only at this horizon that banks financing or recapitalisation funds will be provided at the European level. The decision to place a bank under the resolution procedure will depend on the Resolution Fund Board, where sit MS representatives (and not of the Commission or the ECB). The restructuring projects will be developed by the Fund Board, submitted to the Commission and then to the Council (this procedure is not credible, taking into account the short delay required). A MS will not be required to provide funds without the approval of its Parliament. The Fund will be organised by an intra-government agreement, i.e. without the European Parliament. This project faces the reluctance of the European Parliament, which would have preferred the immediate introduction of the Single Resolution Fund at the EU level, so that the MS have no more power in this matter. But, in our view an EU organization cannot impose expenditures to MS public finances without their agreement, and MS cannot accept to lose any power on their national banks restructuring.

After an appropriate “burden-sharing” by private investors, banks may benefit, for their recapitalisation, from funds from the European Stability Mechanism (ESM), set up on October 8 2012. The ESM will borrow on financial markets at low rates (it aims to be AAA rated) and will be able to provide financial assistance to the European countries in difficulty through a European assistance under a *Memorandum of Understanding*. It will buy public debt bonds on primary and secondary markets and will thus contribute to lower interest rates. It will be able to mobilize 700 billion euros with 80 billion euros being effectively paid-up capital, the rest remaining available if needed. According to the Treaty establishing the ESM, the latter will have a status of senior creditor for public debts. When the European supervisor is in place, the ESM will have the possibility to recapitalise directly euro area banks in difficulty (and, in this case, it will intervene without the senior creditor status).

Here also, this leaves open the question of the potential intervention of the ESM for banks currently in difficulty. A choice needs to be made between two strategies: either the ESM only benefits banks subject to the SSM, which means that the ESM will only intervene in the next crisis; or the ESM rescues banks currently in difficulty because of the financial and economic crisis, which means that the ESM will play a central role quickly.

If this mechanism works effectively, if the ESM supports, recapitalises and restructures all European banks in difficulty, it will be a shareholder in a large number of banks. This would raise the issue of the management of such participations. Is it the role of the ESM?

The system introduced remains complicated, with the intervention of the ECB (*via* the SSM), of the ESM, of the national authorities of resolution and possibly of the deposit guarantee fund.

Box 2. Banking crisis prevention and resolution in the United States

This European crisis resolution scheme belongs to early corrective action policies which already exist in other countries. In the United States, following the savings and loans crisis in the eighties, the Federal Deposit Insurance Corporation Improvement Act was adopted in 1991. This text establishes a resolution framework structured in two pillars: early corrective action and resolution at low cost. The first pillar is an

“institutional response to the problem of capture of the regulator by the regulated” (Scialom, 2006): its objective is to decrease the regulators waiting propensity. Banking supervision and monitoring are done through two tools: on-site inspections and reporting obligations. The FDICIA determines the actions of the regulator and banks on the basis of their capital ratios. When banks fall below established in advance levels of funds, pre-defined corrective measures are applied. These measures are: the suspension of bonuses and dividends, a plan for the recovery of own resources, the obligation to recapitalise, the restriction of deposits remuneration, the limitation of the payment of the executives’ compensation, a placing under administration or the liquidation if the bank fails its recapitalisation, the suspension of subordinated debt payments. The FDIC may decide the bank liquidation if it remained more than 90 days below the “critical undercapitalization” level. The codification of the sanctions makes predictable the choice of regulator and prevents arrangements between the bank and its regulator. The second pillar means that the method of resolution chosen for a bank in difficulty shall be the one which minimizes the cost of liquidation for FDIC.

2.1. A not-yet credible crisis resolution scheme

According to Finance Watch (2013), it is not sure that these dispositions could avoid a full taxpayer protection, if banks remain interconnected and too big. If a systemic bank is in financial difficulty, it would be difficult to report its losses on other credit institutions without creating a contagion effect. The scheme would require first to reduce the banks’ size and to separate financial and market activities from credit activities.

A perverse effect of the projected crises resolution scheme is that the potential involvement of shareholders and subordinated creditors would make banks’ shares and claims much riskier. Banks’ reluctance towards the interbank credit and the drying up of the interbank market will persist; banks will find it difficult to issue securities and will have to increase their remuneration. Banks will be subject to financial markets’ appreciation. However, Basel III standards require banks to link their credit distribution to their own funds. The risk is that banks are weakened and that credit supply is reduced, contributing to maintain the zone in recession.

Aglietta and Brand (2013) clearly approve of shareholders’ involvement: “the best established principle of the market economy is that it cannot function properly if the threat of bank-

ruptcy is not effective for all private agents.” But are banks private agents like any other agent? We would prefer a clear separation between banks playing a quasi-public role (management of deposits, loans to households, enterprises, public authorities) and banks with financial market activities, the first would benefit from a public guarantee directly by their State (and indirectly by the ECB), the others not.

The SRM project deprives the national authorities from all powers. They would be obliged to obey the Single Resolution Board instructions. The losses of a bank would be supported by all countries belonging to the banking union, thereby justifying a single control. According to the project, the Commission and the SRB would be able to decide to impose a resolution plan to a bank, without the agreement of the relevant governments. It is an important step toward European Federalism, which has not yet been accepted by Germany, for instance, which claimed for more political union though a constitutional reform before this hidden step.

The implementation of the guidelines of this new authority may be problematic. A banking group in difficulty may be requested to sell its shares of large national groups. But will national governments agree to expose a national champion to a foreign control? As shown in the case of Dexia, the terms of a bank restructuring can have serious consequences for the countries where it was operating. Are governments (and citizens) willing to lose all power in this area?

We cannot agree with the Finance Watch Report (2013), which writes: “a bank resolution mechanism must not be left in the hands of politicians, and even less of national interests” as if the organisation of the banking system was a purely technical matter and should not depend on economic policy choices made by the Member States.

Following the decisions of the 29 June 2012 Summit, Spain could be the first country where banks would be directly recapitalised by the ESM. However, this would not occur before 2014; the modalities of such a procedure and the impact of the ESM support on the governance of recapitalised banks still have to be specified.

The assistance to Spain agreed in summer 2012 foreshadows what could the European procedure for banking failure resolution

be. On 25 June 2012, the Spanish government requested assistance from Europe to restructure and recapitalise its banking sector. The 29 June 2012 Summit agreed to that request and entrusted this task to the ESM. The required conditions have been specified in a *Memorandum* agreed by the European Council. The document points out the weaknesses of the Spanish economy: growth boosted by strong households' and firms' borrowing, persistent external imbalances, a banking sector weakened by the burst of the financial bubble in 2007, which faces very high interest rates on the interbank market and implements credit rationing. The EU assistance is designed to clean up balance sheets of Spanish banks, which have a large amount of bad debts, to restore credit supply by allowing the return of Spanish banks on the interbank market and to improve financial sector's transparency.

The assistance programme has three steps: the detailed assessment of the situation and needs of banks; their recapitalisation and restructuring; the withdrawal of their bad debt in a *bad bank*, created for this purpose (the AMC: *Asset Management Company*). But the aid is awarded according to two sets of conditions, the first one concerning banks, the second one Spanish governance. Based on the results of *stress tests*, banks must offer recapitalization plans that will be evaluated by the Spanish authorities, the EBA, the ECB, the IMF and the European Commission. Banks had to achieve an equity ratio of 9% in December 2012. The Commission, the EBA and the ECB can examine the banks having received European aid and may choose to liquidate an institution they consider too fragile. The independence of the Central Bank of Spain and its supervisory power should be strengthened. The Spanish authorities must encourage disintermediation and financing *through* markets. Finally, the Spanish Government must reduce public and external deficits and undertake the structural reforms recommended in the context of the European semester.

The aid was spread into two parts: a first part, a 39.5 billion euros loan with an average maturity of 12.5 years has been agreed in December 2012 by the Eurogroup and the ESM to support the most vulnerable banks. All Spanish banks have run *stress tests* that assessed their recapitalisation needs; their results were published in September. Banks were then classified into four groups. The most solid (without recapitalisation need) will be in group 0; Banco

Santander, BBVA, La Caixa, Sabadell, Kutxabank, Bankinter and Unicaja are part of this group according to the report by Oliver Wyman's firm. The four banks already nationalized by the Fund for Orderly Bank Restructuring (FROB) are classified in Group 1. Other Spanish banks are either in Group 2 (for those unable to recapitalise on their own) or in Group 3 (for those which obtained a delay until June 2013 to raise capital by themselves). Banco Popular, MNB and the merged group between Ibercaja, Liberbank and Caja 3 benefited from a delay until 2014 to recapitalise while Catalunya Banco, NGC Banco, Banco de Valencia and Bankia must present a restructuring plan and transfer their unsafe assets to the bad bank, the Sareb. This institution, created on 1 December 2012, will be able to buy assets up to 90 billion euros. According to Fernando Restoy, the FROB president, haircuts applied to the loans transferred to the *bad bank* will be 45.5% on average and haircuts applied to real estate assets will reach 63% (see Birambaux, 2012). Junior and hybrid debts will be converted into equity or will be redeemed with a high discount.

Spanish banks received the second part of 1.9 billion euros for the recapitalization of the second group of banks in difficulty. The Commission report from March 2013 (see, European Commission, 2013) is optimistic about the recovery of the sector and does not expect other recapitalizations for the moment.

This ambitious assistance plan did not receive investors' full confidence: Spanish banks soundness is tested via *stress tests*. However these *stress tests* had failed in 2011 to foresee Bankia's difficulties: are they really able now to assess the needs of Spanish banks? Besides, this project monitoring is extremely complex. In the absence of a European supervisor, Spanish public authorities are responsible for the resolution: they are supported by the FROB, the public fund introduced in 2010 to reform the banking sector. The European Commission, the ECB, the EBA and the IMF monitor the proper conduct of the proceedings and may intervene on site. The difficulty of coordination of such an organisation diminishes the credibility of the project. The drastic recapitalisation that Spanish banks will have to perform may decrease credit availability, which will deepen recession in Spain. Spain has benefited from a substantial drop in the interest rate it has to pay: from 6.5%

in summer 2012 to 4.3% in April 2013, but Spanish GDP decreased until middle 2013.

In order to set the bases of the future European banking union, the European banking crisis management could extend to all European banks balance sheets the withdrawal of bad loans to an *Asset Management Company*. Since 2008, the United States has implemented such a measure through their TARP: *Troubled Asset Relief Program*, which was intended to clean the financial sector from its toxic assets. The US Treasury also purchased preferred shares for 205 billion dollars in the benefit of 707 companies, in order to strengthen financial institutions' and banks' own funds. On the whole 389 billion dollars were mobilized for this project; banks and other beneficiaries have currently refunded 80% of this amount.

Note that the *Bad bank* strategy, which was successful in Sweden in the beginning of the 90's, has its dangers. In 1995, the Credit Lyonnais, owned by the French State, was split into a healthy entity pursuing the bank activity and a bad bank responsible to sell all non-performing assets and activities of the Credit Lyonnais (Blic, 2000). However the pooling of assets within this bad bank generated a global fall in the value of transferred assets, the sale of which was an additional cost for taxpayers.

The Cypriot crisis led to the first implementation of the new method of banking crises resolution. European institutions refused to go beyond an aid of 10 billion euros to Cyprus, considering that this would have induced an unsustainable debt. They refused to help directly a banking system they judge oversized for the country, badly managed, specialized in money laundering and securing dubious Russian assets. Thus, the new method has been implemented: deposits are guaranteed up to 100.000 euros (after an initial version of the plan, which awkwardly planned to tax deposits under this level). Shareholders and creditors of Laiki, the second bank of Cyprus, which will be closed down, lose all their assets. The amounts of less than 100.000 euros deposits will be transferred to the Bank of Cyprus. The amount of deposits in excess of 100.000 euros is frozen and will be refunded according to the results of the Bank's assets liquidation (losses are estimated to be of 60%). Debts and deposits over 100,000 euros at the Bank of Cyprus, which is restructured, are frozen and will be partly

converted into shares to recapitalize the Bank (in application of the bail-in principle); their losses should amount to 40%.

However, this implementation of the new European scheme of crisis resolution revealed its weaknesses: banks have faced huge withdrawals from depositors and were forced to close for several days. Capital flows controls had to be introduced when banks reopened. Frozen assets and losses for large deposits have affected SMEs and some households doing real estate transaction, having just received an inheritance or saving for their retirement. Above all, Jeroen Dijsselbloem, the Eurogroup President, who said that the model applied in Cyprus corresponded to the future practice of the banking union, had to step back and pretend that the case of Cyprus was unique. The Eurogroup and several leaders of the ECB made similar statements, in full contradiction with on-going projects, thus weakening the choice of bail-in as the method of resolution.

3. The European deposit guarantee scheme

The banking union should include a European deposit guarantee scheme. A deposit guarantee system protects savers in case of bank failure by refunding their deposits up to a certain ceiling. It is one of the sovereign tasks of the State to provide citizens with a risk free instrument of payment and saving. Customers do not exactly know their bank's financial health; the majority of depositors, with deposits not exceeding a certain amount, cannot be asked to be interested in that; they are subject to information asymmetries which, in normal times, promote confidence in credit institutions. On the other hand, in a banking crisis, information asymmetries between depositors and towards banks strengthen the contagion of panic and cause a rush of investors seeking to withdraw their deposits massively. Then liquidity crises turn into solvency crises threatening to spillover to the entire banking system. A bank failure deteriorates stakeholders' confidence on the interbank market and decreases credit supply; therefore, it has a negative impact on the real economy halting activities that depend on these credits and causing a sudden stop of investments. However, it is necessary to distinguish between relatively small deposit amounts, with interest rates incorporating no risk premium, which must be guaranteed and other deposits, with

interest rates incorporating risk premia for, deposits that should rightfully bear the risk of losses.

The Diamond and Dybvig's model (1983) shows that a bank run is an undesirable equilibrium of the deposit contract in which all depositors panic and withdraw their deposits, even if they would prefer not to do so, pushing even healthy banks to fail. So a government deposit insurance which guarantees that the promised return will be paid to all who withdraw their funds, has a key social benefit because it allows banks to follow a desirable asset liquidation policy, separated from the cash-flow constraint imposed by the panic of depositors.

The harmonisation of the deposit guarantee level in Europe would avoid that some countries attract deposits from their neighbours by offering a full guarantee of deposits, a strategy implemented by Ireland during the crisis, knowing that this full guarantee may have heavy consequences for the population of the country concerned. On the other hand, given the differences in standards of living, the share of guaranteed deposits would widely differ from one country to another.

There were, in 2010, 40 different deposit guarantee regimes in the 27 EU countries (European Commission, 2010). Depending on countries, these schemes are managed by the government, by banks or by both. A group of banks may decide to create a common private fund to guarantee their deposits according to specific rules of their choice. EU lawmakers have developed the deposit guarantee *via* several directives: in 1994 [Directive 1994/19/CE] a first legislative text set a minimum level of guarantee corresponding to 20.000 euros per depositor; it requires that each MS sets up officially a guarantee fund and that all credit institutions subscribe to a guarantee scheme. The minimum level of guarantee was raised to 50.000 euros in 2009 and to 100.000 euros on 31 December 2010 [Directive 2009/14/CE].

In 2010, the European Commission put forward the idea of a pan-European deposit guarantee system by 2014 [European Commission, 2010]. It called for a networking of existing systems by proposing the establishment of a mutual borrowing facility between all funds and a gradual harmonisation of procedures. But the European Parliament and the Council disagreed on how to

harmonise the systems. The Member States wanted to reduce the financing rate of funds paid by banks, while MEPs wanted to make risky banks contribute more significantly *via* a system of risk premium. An agreement was reached in December 2013: in each MS, the target level for *ex ante* funds of DGS is 0.8% of covered deposits to be paid by member banks. The target fund level must be reached within a 10-year period. In case of insufficient *ex ante* funds, DGS will collect immediate *ex post* contributions from the banking sector, and, as a last resort, they will have access to alternative funding arrangements such as loans from public or private third parties. Bank contributions to DGS will reflect individual risk profiles. The Commission wishes now to launch discussions on the establishment of a pan-European guarantee scheme.

It is necessary for the Scheme to guarantee all European banks because if it covered initially only the strongest large transnational banks, depositors would rush to guaranteed banks and this would immediately increase the risk of a euro area break-up. Under the assumption of a 100.000 euros guaranteed ceiling, the amount of covered deposits would be 6.655 billion euros (European Commission, 2011). Compared to 2007 when regulations in Europe requested a guarantee of 20.000 euros only, the amount of guaranteed deposits would be increased by 18% (+ 994 billion euros) and the number of fully guaranteed deposits by 8% (+ 3 million deposits) but, in the event of a funding through a levy of a certain percentage of eligible deposits paid by banks, it would cost banks 815 million euros per year for 10 years on average in the EU which corresponds to a 4% decrease in their annual profit for 10 years as compared to 2007.

The crisis has shown the contradiction between the more and more internationalised structure of European banks and the deposit guarantee which remained at the national level. The problem turned out to be especially acute for countries like Ireland or Cyprus where banking systems were oversized. This can be prevented in two ways: setting the deposit guarantee at the European level or, on the contrary, setting limits to the size of each country's banking sector, to prevent credit bubbles and the accumulation of cross-border deposits, which are source of instability. The first solution is preferred in Europe today. But the Cypriot crisis will perhaps reopen the debate.

The Spanish banking crisis recalled the need to protect public finances in the event of bank failure, but in 2013, two issues remain problematic. According to Schoenmaker and Gros (2012), a banking union should be created under a “veil of ignorance”, i.e. without knowing which country exhibits more risks: this is not the case in Europe today.

As the risk of a euro zone exit of a MS has not entirely disappeared, the question is: what guarantee would be provided by the banking union for euro denominated deposits in case of a conversion into national currency? A European guarantee on deposits in euros is needed to prevent the capital flight away from countries believed to be likely to leave the euro area. But in the current situation, given the risk that such a guarantee would have to apply for some countries (Cyprus, Greece, Portugal or even Spain), it is difficult to implement due to the opposition of Northern countries.

The European Commission has not chosen between a uniform rate of contribution to the guarantee scheme and a variable rate depending on the risk level of guaranteed institutions. The majority of countries have a uniform assessment system, but Canada and France have a variable risk pricing, which tends to reduce banks' moral hazard.

Box 3. The bank deposits guarantee in the United States

In the US, the deposit guarantee is provided by the Federal Deposit Insurance Corporation (FDIC), an independent federal agency created in 1933 by the Glass Steagall Act, whose managers are appointed by the President of the US and confirmed by the Senate. The FDIC mission is to maintain public confidence in the US financial system. Almost all US banks are affiliated with the FDIC even if membership is required only for the bigger ones. UCITS and other collective funds are not insured. Deposits are covered up to an individual amount of 100.000 dollars. The FDIC guarantees more than half of the total amount of deposits in the US. It also intervenes to limit bank failures: it inspects and controls directly more than 53.000 banks, of which more than half are in the US. It has means of resolutions of failures; the most common means is the sale of deposits and credits to another institution. The FDIC resources come from premiums by banking institutions and insured savings, and from the certificates of association signed by the members at their membership and from earnings on investment in US Treasury bills.

Since 1993, the premium of credit institutions is based on their risk level (Morel and Nakamura, 2000): with capital ratios (Cooke and Tier 1 ratios) and a rating (determined according to five criteria: asset-liability management, asset quality, management quality, results and liquidity), the FDIC sets the institution's premium. Thus, until late 1995, the premium of institutions to the guarantee fund varied between 0.09% and 0.49% of deposits as determined by the FDIC depending on the risks of each institution. In the 2010-2011 period, 249 banks went bankrupt in the US, which divided by three (from 17.7 billion to 6.5 billion) the reserve available for possible losses of the guarantee Fund. The current reserve fund represents 0.17% of covered deposits. The FDIC plans to return to its long-term target, a reserve of 1.35% of deposits covered by 2018 (FDIC, 2012).

3.1. A European deposit guarantee scheme difficult to settle

The European Commission has worked for several years on the networking of European Union banking schemes. With the banking union project being focused on the euro area, the area of implementation of the guarantee fund remains undetermined; the harmonisation of existing systems is tricky. If the fund is rapidly introduced, there is a risk that it will have to deal with Southern Europe countries' difficulties, Germany or Finland possibly refusing to contribute to this fund in order to avoid an increase in wealth transfers from Northern to Southern Europe. Current projects do not specify if the fund will be financed by banks' contributions *ex ante* or if it will be based on a State guarantee and banks' refund *ex post*.

Schoenmaker and Gros (2012) propose that the European guarantee fund owns a permanent reserve representing 1.5% of covered deposits (i.e. nearly 140 billion euros). But this would only cover one or two major European banks' deposits. The credibility of such a fund in the event of a bank crisis with contagion risk is therefore limited. The fund permanent reserves are inevitably small as compared to the amount of deposits which need to be reimbursed in the event of a systemic crisis. Only a fund supported by a monetary authority can offer a full and credible guarantee in such an event. Even if the fund can raise contributions from banks *ex ante* in order to be able to intervene in the event of limited problems, the deposit guarantee will continue to depend as a last resort on the MS, on the ESM and on the ECB, these being requested to inter-

vene in turn in the short-term, depending on the severity of the problem. The guarantee should be unlimited, but the German Constitution (and German political opinion) opposes such a guarantee. Banks' contribution might intervene *ex post* to restore the level of the guarantee fund and possibly repay the first in line creditors. The difficult point remains to determine who pays for the guarantee as a last resort, between banks and States, between the country and the whole EU countries covered by the agreement. Does this mean that the banking union necessarily requires setting up a federal Treasury with a European tax (Aglietta and Brand, 2013) to cover this risk? This is probably excessive as the probability of such an event is very small.

The authority in charge of the fund is not yet settled. The ECB will supervise the banking system, but it is much more difficult to dedicate the management of the deposit guarantee scheme to it. According to Repullo (2000), the deposit guarantee must be separate from the function of lender of last resort. Otherwise, there may be a fear that the ECB uses excessively money creation to recapitalise banks, so that the monetary policy targets and support to banks could be in conflict. Therefore a deposit guarantee and crises resolution authority should be created. It should be separate from the ECB, which would necessarily have a right to look at banks behaviour, and would come in addition to the EBA, the ECB and national regulators. Such an authority was introduced by the French banking reform in 2013. On the other hand, the ECB would continue to play its role of lender of last resort. The viability of such a complicated system is unclear. We think that it should be stated that the ECB will intervene, if necessary, to guarantee deposits in a situation where States or the ESM could not do so, but that this intervention will only consist in a loan from the ECB to the bank guarantee fund or to States, which they will have to repay.

From 1979 to 2000, in France deposits were insured by the so-called "*solidarité de place*" mechanism (financial centre solidarity). In a crisis situation, the Governor of the Bank of France could "organize the participation of all credit institutions to take the necessary measures for the protection of the interests of depositors and third parties, for the proper functioning of the banking system as well as for the preservation of the reputation of the place"

(translation from: Marini, 1999) This mechanism was only implemented on one occasion, the bankruptcy of the Al Saudi Bank in 1988 (Goodhart, 1995). In case of a crisis the risk of a bank run pushes banks to show solidarity and coordinate themselves to avoid the effective implementation of this solidarity. Following the introduction of a deposits guarantee fund in 2000, the French Government chose to no longer mention this banking community solidarity, considering that the fund organised a permanent solidarity. The advantage of the *solidarité de place* is that it is not necessary to immobilise funds. Moreover the guarantee is *a priori* unlimited and the bank in difficulty could be taken over by another bank, which could be interested to do so to gain customers and market shares. But this system only worked for problems in small banks.

The Cypriot crisis has shown that the common deposit guarantee is not easy to implement as long as the banks' balance sheets are not effectively cleaned up, as long as concerns on bank failures remain and as long as banking systems are not under control in Europe. The common guarantee can only be the last stage of the banking union.

The crisis also showed the limits of the 100,000 euros ceiling. Some SMEs liquid assets, households' funds waiting to be re-allocated, etc. have been affected. Euro area countries must choose between two strategies: offering all depositors the possibility to have a fully guaranteed (at least in national currency) saving instrument, with no ceiling, but with limited remuneration; or leave depositors choose their bank, knowing that having funds in some banks implies some risks which are difficult to assess. Finally, the European institutions oblige shareholders, creditors and large depositors of banks in difficulty to pay for the deposit guarantee by aggregating the cost of this guarantee for the two banks in question. Implicitly, they called for the "*solidarité de place*", which means that the European guarantee fund will have only a decorative role.

4. What model for the euro area banking system?

There is no single banking system in the euro area today, but the juxtaposition of 18 domestic markets strongly divided by legal, economic, social, historical and tax barriers. There is a European interbank market and a competitive market for very large firms financing but retail banking remains mainly national (Table 2). Entering a domestic market goes through taking over existing entities. Until now, cross-border movements in own funds have been rare and of limited size.

Table 2. Cross-border penetration from EU countries*

In %	2007	2012
Belgium	21	51
Germany	10	11
Estonia	99	85
Ireland	39	29
Greece	23	16
Spain	11	9
France	11	10
Italy	18	13
Cyprus	26	17
Luxembourg	76	67
Malta	37	32
Netherlands	16	9
Austria	22	16
Portugal	23	20
Slovenia	29	29
Slovakia	86	96
Finland	65	67
Euro Area	17	16

* Cross-border penetration via branches and subsidiaries from EU countries is reported as a percentage of total banking assets.
Source: Schoenmaker and Peck (2014).

A full banking union would involve direct competition between all banks in the euro area, on a unified basis. This implies to cut the links between the borrowers of a country (government, local authorities, firms and households) and national banks. This implies that the capacity of a bank to lend depends above all on its

solvency, own funds and financial markets' assessment, under the risk of blindness periods and excessive mistrust periods, which are usual in financial markets.

One could prefer the opposite strategy: a restructuring of the banking sector, where retail banks would be isolated from financial markets, should focus on their core business (credit to local agents, based on a detailed expertise, to domestic firms, households and local authorities). Their solvency would be guaranteed first by the prohibition of risky or speculative operations, and second by the State, whose debt would be guaranteed by the Central Bank. Certainly, a bank could be in trouble if its country is in a depression and if companies or households have difficulty in repaying their debt, but the State may come to his rescue, especially as the credits supplied by the bank fit into the domestic economic strategy.

4.1. The universal bank model in Europe

A choice needs to be made between two models: the universal bank or the return to banking specialisation. Will the banking union impose the separation of retail and investment banks? Will it prevent banks with guaranteed deposits to intervene on financial markets for their own account? Will it be a new step towards banks financialisation or will it signal a return to the Rhineland model?

On the one hand, the crisis has questioned the relevance of the universal bank model where deposits finance and guarantee market activities. On the other hand, the crisis has shown the fragility of specialised institutions which had an insufficient deposit base and depended heavily on markets for refinancing. Banks which in normal times used strong leverage effects to achieve high profitability levels suffered particularly. After the *Lehman Brothers* failure, banks such as *Goldman Sachs* or *Morgan Stanley* abandoned the Investment Bank model, affiliated to the Fed, strengthened their own funds, and can now collect deposits.

In Europe, the shift towards universal banks induced major structural changes. The rise in "non-banking" institutions such as insurance or pension funds (the institutional investors) occurred at the expense of the banks which had reacted by operating more and more on financial markets, for their proprietary trading or as inter-

mediates. The banking sector's connection with the financial sector increases contagion phenomena and the spreading out of the financial crisis into the real economy. According to Paulet (2000), there is an empirical link between the growing market share of institutional investors and banking fragility, the former strengthening the latter.

The universal bank model, which combines the different banking activities, has shown a better resilience during the financial crisis. The heavy losses of markets and investment banks activities have been offset by their retail bank activities. However, these losses have reduced banks' own funds. This link between banking activities destabilises retail banking activity which is essential to the financing of the economy. It has also contributed to the development of suspicion and concern on the strength and stability of the European banking system. Applying "fair value" accounting to the whole banks' balance sheet facilitates the propagation of the crisis: market fluctuations have an impact on credit supply even if they should obey different logics. Accounting rules should not be similar for so different activities: short-term for market activity and long-term for credit supply. The universal bank balance sheet is thus structurally opaque and fragile.

A better regulation of the EU banking system requires the separation within banks of activities with different logics, procedures and risks (Pollin, 2009, Scialom, 2012). The financial crisis has affected the core functions of banks (their capacity to supply credit and to manage means of payments), making it a serious crisis for the real economy. As in the 1929 crisis, the real economy financing has been interrupted. Banking regulation must be sought to avoid the occurrence of such a crisis.

4.2. Should we return to the Glass-Steagall Act?

As soon as in June 2009, the Obama administration published a draft for a financial markets reform, *the White Paper on Financial Regulatory Reform*. The United States in 2010, and the United Kingdom in 2012, have decided to implement a separation between investment and retail banking activities (Chow and Surti, 2011, Kregel, 2011).

The July 2011 US reform of the financial sector (*Dodd-Frank Wall Street Reform and Consumer Protection Act*) introduces the “Volcker Rule” designed to avoid that banks speculate against their clients. It prohibits banks protected by the FDIC deposit guarantee to run trading activities for their own account (proprietary trading) and to own participation in investment funds (hedge funds, private equity). These activities should be confined to a specific structure. Subscriptions to investment funds may not amount to more than 3% of the banks’ own funds. Banks can hold more than 3% of the capital of these funds. But the activities of market-maker and hedging may remain in the bank. The rule should apply from April 2014 but the Federal Reserve Board has extended the conformance period until July 2015.⁷

In the United Kingdom, the Vickers report should be implemented in 2019. Traditional banking activities (deposits and loans to households and SMEs) will be confined in a specific structure isolated from markets and investment activities. Transactions on derivatives, market-making and market interventions will no longer be made in the same bank as retail activities. However, the classical bank could engage in some markets activities requested by customers (exchange rate or interest rate risks hedging). Retail banking should have independent governance and be separate legally, in the form of a subsidiary for example.

In Europe, the Liikanen report (Liikanen, 2012) proposed to separate risky financial activities from traditional banking activities by splitting banks into two separate entities. It contains five proposals:

- The own account and financial activities should be included in a separate legal entity. Activities for own account, positions on assets or derivatives resulting from markets activities, unsecured loans to hedge funds, structured investment vehicles (SIV), investments in capital-risk, should be separate. This would apply only if assets exceed a certain

7. From June 30, 2014, banking entities holding 50 billion dollars or more in consolidated trading assets and liabilities will be required to report quantitative measurements. This will apply to banking entities with at least 25 billion dollars, but less than 50 billion dollars, in consolidated trading assets and liabilities from April 30, 2016; and to those with at least 10 billion dollars, but less than 25 billion dollars, in consolidated trading assets and liabilities from December 31, 2016 (US Securities and Exchange Commission, 2013).

level of the bank balance sheet (in % of assets or in volume). However, the traditional bank could engage in some markets activities requested by customers (interest rate and exchange rate risks hedging). The financial institution will not be able to be financed by guaranteed deposits. However, the report does not advocate the introduction of two types of banks so that retail banks can provide financial services to their customers. The two banks will be allowed to be in a common holding, but they will have separate capitalisations.

- Banks must develop banking crises resolution plans controlled by the EBA.
- Banks must hold a large amount of own funds and junior debt (which can absorb losses). Banks' managers will have to hold junior debt to be concerned by potential losses.
- Own funds requirements should be strengthened, accounting better for the risk, particularly for market activities and real estate loans.
- Banks governance should be reformed through accounting better for risk management, lowering bankers' compensation, and tougher sanctions.

Some European countries have taken the lead without waiting for the potential introduction of European legislation based on this report. Thus, in July 2013 France adopted a "law of separation and regulation of bank activities", intended to implement François Hollande's commitment "to separate the activities of banks that are useful for investment and employment from their speculative operations".

However, the French government refused to question the universal bank French model. Speculative activities, narrowly defined, will not be banned from retail banks, but will have to take place in a subsidiary.

Thus, the law obliges banks to put in separate bodies their "without any link with the service to customers" market activities. Banks can continue to run operations "that are useful for the economy". But the notion of utility is not questioned. Is the development of financial activities useful? Should non-financial agents be encouraged to go to financial markets, to use toxic loans, structured investments, derivatives? Similarly, the customer's concept

has not been specified in order not to apply to hedge funds and to speculative investment funds.

Banks have argued that this project could reduce credit availability. It's a strange argument as credit creates deposits. Banks would have to lend directly to firms and not through financial markets or hedge funds. The prohibition of speculative activities would sharply reduce banks capital requirements.

In theory, activities for own account are prohibited, but the provision of financial services to customers (risk hedging), the coverage of the own risk of the establishment (interest rate or credit risk), market-making activity, the prudent management of cash and long-term investments remain permitted. Hedge funds ownership is prohibited, as well as unsecured loans to these funds, but so-called secured loans are allowed. Packaging and marketing of structured financial products like derivative products remain at the level of retail banks. In total, the project isolates only 2% of banking activity.

Speculative activities must be restricted within an autonomous financial subsidiary. The latter will not be guaranteed by its parent (and thus by public authorities), should finance itself independently, can go bankrupt, and will need to develop a resolution scheme showing that its bankruptcy may be borne by creditors.

However, a prudential control and resolution authority (the ACPR, *Autorité de Contrôle Prudentiel et de Résolution*) will be settled. It may prohibit certain activities. The Finance Minister may require banks to limit the size of market operations carried out by the parent company.

The ACPR will manage a deposit guarantee and resolution fund (FGDR). Banks will have to develop a banking resolution plan which will have to be approved by the ACPR. A bank may be brought before the ACPR by the Bank of France Governor or by the Treasury Director-general. The ACPR will be able to remove the bank managers, to transfer the establishment, to make the FGDR intervene, to make losses be borne by shareholders or creditors (subordinate or junior), to ask them to bring new funds, to prohibit the distribution of dividends, to appoint a provisional administrator, to suspend managers compensations.

The Financial Regulation and Systemic Risk Council becomes the Financial Stability Board. It will have the right to increase the capital requirements imposed on banks to prevent excessive credit growth or to prevent a risk of instability of the financial system. It will be able to set standards for the evolution of credit to avoid increases in assets prices or excessive indebtedness.

The French government refused to prevent banks from having activities in tax or regulatory havens, but banks will have to publish a list of their subsidiaries abroad and the amount of their activities.

This French law may look strange insofar as it addresses issues which should be no longer under national legislation in two years, if the banking union is introduced. This law raises once again the issue of the link between national choices and decisions to be taken at European level. For example, the law gives the right to the ACPR to prohibit some too speculative activities, but will this be enforceable if these activities remain authorized at the level of the banking union. Will the French Finance Minister still have any authority on banks in two years?

France is not the only country to have taken the lead. On 6 February 2013 the German government adopted legislation on separation of banking activities (*Trennbankengesetz*). Retail activities should be split from the activities for own account when the latter amount to more than 20% of the balance sheet or more than 100 billion euros; banks will have to deposit a will. This law applies mainly to the largest two banks: Deutsche Bank and Commerzbank. It should be enforced from 2014, but banks will have an additional one and a half year to proceed to the separation.

In view of these national initiatives and of the Liikanen report, the Commission of economic and monetary affairs of the European Parliament urged the European Commission to propose a European legislation for a separation of a Vickers' type of banking activities: activities necessary to the real economy must be protected in a legally independent framework subsidiary.

4.3. A European regulation proposal

Under the initiative of the European Commissioner Michel Barnier, the European Commission proposed on 29 January 2014 a

regulation (European Commission, 2014) aiming to limit and to supervise financial activities for systemic-sized banks (i.e. about 30 of the 8000 banks in the European Union, representing 65% of European banking assets).

This project is more demanding than the Liikanen report or French or German laws. Like the Volker rule, it prohibits negotiations for own account on financial instruments and raw materials as well as investments in hedge funds. The supervisory authorities will have the power to impose banks to separate in a subsidiary body trading operations (such as market-making, complex derivatives and securitization operations, that would be deemed too risky, i.e. which induce too big positions financed by leverage). In our view, it is a shame that this separation is a possibility open to supervisors and not a strict obligation.

This reform proposal raises strong criticisms from some MS and banking lobbies. France and Germany claim to have already made their own banking reform. But the logic of the banking union is that the same rules apply everywhere. These countries have chosen to reform banking at the minimum to pre-empt the content of the European law. This is not an acceptable behaviour at European level. For the UK, the Barnier's project opens a way out: the regulation shall not apply to countries where legislation is more binding.

According to the banking union project, the ECB supervises European banks and the EBA sets regulations and rules of the supervision. The Commission can be accused to intervene in an area that is no longer of its jurisdiction. Conversely, the crisis clearly demonstrated that banking regulations are not only banks' matters. It is legitimate for political authorities (Commission, Council and Parliament) to be involved.

Christian Noyer, Member of the Board of Governors of the ECB, considered these proposals as "irresponsible". According to the European Banking Federation and the French Banking Federation (FBF), the universal banking model must be preserved. They criticize the obligation to separate the market-making (including the firms' debts market). According to the FBF, this regulation will "lead to a considerable increase in the cost of debt financing and risk-hedging services for firms". However, this requirement could be waived if banks prove that their interventions in markets do not

induce risks for them. Thus, banks could continue to play a role as market-maker, provided that they set strict limits on their own positions; they could provide simple hedge operations, by hedging themselves.

Certainly, European banks were right to point out that this reform comes in addition to the establishment of the SSM, the SRM, and banks scoring by the ECB. A more coherent schedule should have been established.

However, the separation advocated by the project would increase the credibility of the banking union and of its three pillars. The establishment of a consistent framework would simplify the SSM (the ECB should monitor 'normal' banking activities and ensure that speculative activities do not disturb them. The SRM would gain credibility: the losses from market activities would not affect banks credit and would not be supported by the taxpayers. By reducing the risk of failure of retail banks, it reduces the risk to have to activate the deposit insurance. In this sense, regulation could become the fourth pillar of the banking union. However, it will not be discussed before the election of a new parliament and the establishment of a new Commission. It will have to overcome the opposition of the big European banks.

4.4. Two European projects?

On 28 September 2011 the European Commission adopted a proposal for a directive on a common system of financial transaction tax (FTT). The European directive proposed to tax shares and bonds transactions at 0.1% and derivative contracts transactions at 0.01%. The gain was estimated to be 57 billion euros for the whole EU.

In the absence of a European agreement, and since August 2012, France has introduced a FTT, which includes a 0.2% tax on French shares purchases, a 0.01% tax on cancelled orders within *HF trading* in France, a 0.01% tax on naked CDS (which have been prohibited in France since 1 November 2012). The FTT was expected to raise 1.6 billion euros in full year. However, according to NYSE Euronext, the amount of securities transactions subject to the FTT has declined by about 15% in two months. The French FTT does

not apply to derivatives and some operators have therefore switched to this market.

A true FTT, applying to all banks and financial institutions financial transactions, would have three advantages: it would reduce the profitability of speculative activities, it would decrease financial markets liquidity, it would oblige banks to control better the operations of their market operators.

Eleven EU countries (France, Germany, Belgium, Portugal, Slovenia, Austria, Greece, Italy, Spain, Slovakia and Estonia) plan to introduce a FTT in the framework of enhanced cooperation. The European Commission assesses the potential of the tax revenues at between 30 to 35 billion euros (incorporating a decrease by 15% in the amount of the transactions).

Of course, the risk is high that European financial transactions are relocated in London and Luxembourg, but, in this case, the euro area will have to react, which will highlight the strategic differences on financial regulation within Europe. The banking union will have to choose between being an open area, with no specific rules, or a relatively closed area, with specific rules.

Yet the Commission's text is designed to prevent delocalisation: taxation will apply if one of the parties to the transaction is established in a participating country, regardless where the transaction is made (residency principle) but also if the transaction involves a financial instrument issued in a participating country (residence principle). Will the text resist the pressure from banking and financial lobbies and from the UK? The UK has introduced a legal challenge against the FTT at the Court of Justice of the European Union. The French government is proposing a watered down version of the text that affect buyers of stocks and bonds, and not financial speculators.

European banks continue to have subsidiaries in tax and regulatory havens, particularly in Luxembourg, Switzerland, Guernsey, Jersey, Bermuda Islands, Cayman Islands... The reporting obligation (a bank must declare to the tax authorities of its residence country the financial incomes of their clients) faces opposition from Luxembourg, Austria, and Switzerland. Europe should widen the list of tax and regulatory havens countries, should prohibit European banks and firms to locate profits and operate in these

countries, unless there is a specific justification linked to non-financial activities.

On these two issues, the banking union will have to make political choices. Who will have this responsibility in Europe?

4.5. What banks? What credit?

The problem remains: what financial system does the euro area need? Should the ability of euro area banks be in a position to compete more with Anglo-Saxon institutions or should their role in financing the economy be increased? Should we build a complex and unenforceable regulation, running behind financial innovations? It would have been better that the European institutions adopt the clear objective to reduce the weight of finance in the economy. Some speculative activities should be prohibited; most speculative activities should be prohibited for the banking system; they should be confined to specialized institutions, not guaranteed by the government, their financing cost would be high, which would reduce their profitability and their operations.

Europe needs a productive and industrial recovery. But it is necessary to define carefully the nature of this recovery. It must fit with the ecological transition. Industrial choices that engage future economic development cannot be left to shareholders, to financial funds looking for short term profitability, or even to the large companies' managers. The society must guide the evolution of the industry towards green, efficient and innovative techniques, to promote energy savings, renewable energies, financing urban renewal and collective transports.

This is the industrial policy in the broad sense which must ensure productive recovery which should include:

- a product axis: to promote the production of sustainable products, compatible with ecological requirements;
- a planning axis: to collectively define the sectors to promote, to develop cooperative strategies between large companies and SMEs, between public and private research.
- a sectorial axis: to identify areas for the future and to maintain the basic economic sectors, which play a structuring role and which are rich in employment;

- a production axis: to improve the working community, the promotion and the training of employees rather than the financialisation, the business leader and the sprawl of the income hierarchy.

This ambitious strategy must be financed by national banks for sustainable development. They must develop a strong capacity for prospective; be able to take risks, on industrial, ecological and employment criteria and have a strong financial capacity both in equity and credit. Projects may be regional, national or European. The objective must be to collect a large part of European savings, rewarded at low but guaranteed rates. These banks must develop simple and short circuits between household savings and loans to productive sectors, to local authorities, and to housing. This project could give another dimension to the banking union.

5. Conclusion

The challenge is huge: the euro area needs a strong banking system, able to finance growth recovery and to bring the economy out of the crisis. However, Europe has to make a clear political choice between two options.

A liberal option focuses on markets sentiment; banks are firms like any other firm; they must maximize their profit; they must be able to intervene freely on financial markets: they must be able to provide sophisticated investment and hedging tools to their customers. A unified European financial market will contribute to the European banking system regulation (see, for instance, Sapir and Wolff, 2013). However, there is a first risk is that banks chose market activities which are more profitable than credit supply. There is a second risk that banks are weakened, suffer from a rise in the cost of their resources (due to higher risks for their creditors to loss their claims if the bank runs into difficulty), and need to reduce their credit activities under the effects of higher capital ratios constraints. The third risk is that the link kept between banks and financial markets spreads out financial markets instability into the real economy banks' lending capacity would depend on their solvency, thus on their own funds, and so on markets' assessment, with the risk of switching from blindness to excessive distrust periods.

A more interventionist point of view stresses the need to protect specific banking activities (like credit distribution and deposit management), to isolate them from financial markets, to protect them by a public guarantee, to allow them to supply credit according to the needs of the real economy.

Another choice also has to be done: a European banking system, unrelated with national agents and states, with open competition of all banks in the euro area on unified basis; or the persistence of national systems, which would maintain a strong link with their territory. Will states be able tomorrow to intervene to influence banking credit, to rescue banks which are vital for certain sectors of the economy, to develop specific public banks? These choices cannot be left to the ECB, which is more concerned with the proper functioning of financial markets than with the real economy. These choices should not be hidden by short-term requirements, like rescuing Spain. They must be the subject of a democratic debate in Europe.

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