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From the Internal Market to a Banking Union:
A Proposal by the German Council of Economic Experts

German Council of Economic Experts

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From the Internal Market to a Banking Union: A Proposal by the German Council of Economic Experts (GCEE)

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I. Background¹

The European sovereign debt crisis has revealed severe flaws in the design of the internal market. Both, private and public borrowers had incentives for excessive borrowing, which have been created by deficits in the regulatory structure of financial markets. Capital requirements for banks were too low and had procyclical effects (Favara and Ratnovski 2012). Supervision has been ineffective with regard to containing the build-up of risks in banks' balance sheets. Common monetary policy in the Euro Area has not been accompanied by the transfer of authority to supervise and restructure banks which has, in turn, created incentives to shift risks to the European level. Risks of banks and states have become dangerously intertwined.

Proposals for a banking union aim at correcting these deficits. In principle, a banking union is a necessary complement to other elements of the internal market. In an integrated capital market, banking distress in one country can have negative externalities for the stability of financial systems in other countries. Such risks are even more pronounced if other countries are affected through a common monetary policy. The banking union currently being discussed has three elements (President of the European Council 2012): banking supervision at the European level, a European authority for bank restructuring and resolution financed by a bank resolution fund, and a European deposit insurance fund. So far, concrete proposals have been made for the establishment of a Single Supervisory Mechanism only. However, a banking union is a long-term project. It is not the key to a solution to the acute problems in Europe's banking sectors (Buch and Weigert 2012, GCEE 2012a) .

II. Cornerstones of a Banking Union

A European supervisor needs a clear mandate, and the sharing of responsibilities between the European and the national level need to be clearly defined. European supervision should be responsible for **all banks**. Specific supervisory functions can be delegated to national authorities in order to address capacity constraints at the European level. Including all banks reduces the risk of regulatory arbitrage and ensures that all banks have to fulfil the same supervisory standards. Also, European supervision should in principle cover **all countries** in

¹ This contribution summarizes a proposal of the German Council of Economic Experts (GCEE) developed in its recent annual report (GCEE, 2012b). It complements previous contributions of crisis management in the banking sector (Buch and Weigert 2012, GCEE 2012a) and on the Debt Redemption Pact (Doluca et al. 2012, GCEE 2011).

the internal market and thus the EU-27. While participation in the banking union should be mandatory for the Euro Area countries, non-Euro Area members should have the possibility and the incentives to join the banking union (**opt in**). In order to ensure effective and timely supervision, all supervisory institutions require detailed information about banks' financial situations and risk profiles. **Information sharing**, which is complicated by a number of legal and institutional obstacles, needs to be improved significantly.

According to the current proposals for a Single Supervisory Mechanism, the ECB would be closely involved in the supervision of financial institutions. Yet, involving the **European Central Bank (ECB)** in banking supervision entails **severe risks for the independence of monetary policy**. These risks are even more acute the greater the national leeway will remain with regard to the implementation of regulatory standards and to the restructuring and resolution of banks. The ECB runs the risk of being in charge of supervision, on the one hand, while lacking effective powers to intervene if banks are in distress, on the other hand. In times of crises, the ECB is likely to come under pressure to refinance illiquid and possibly insolvent banks and thus to employ its monetary policy instruments for fiscal purposes.

In order to ensure that monetary policy and banking supervision are clearly separated, two conditions have to be fulfilled. First, competence for the restructuring and resolution of distressed banks should be delegated to a European resolution authority outside the ECB. Second, monetary policy and supervisory functions need to be clearly separated, both institutionally and with regard to the personnel involved. The current legal framework for the Single Supervisory Mechanism does not fulfil this requirement. Hence, amendments of the legal framework are necessary. In order to clearly separate monetary policy and supervision, the German Council of Economic Experts (GCEE) recommends a solution in which supervisory functions are delegated to a European institution *outside* the ECB.

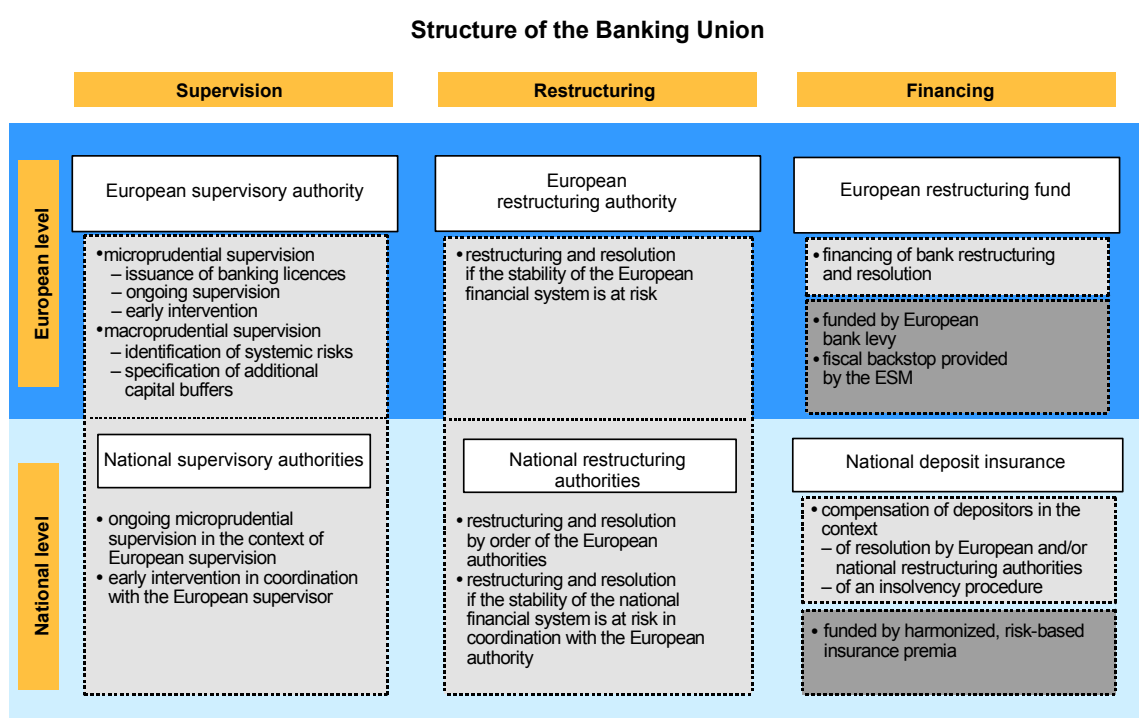
In addition, a **European resolution authority** is a necessary element of a banking union. This resolution authority should be funded through a bank levy. The fiscal backstop could be provided by the European Stabilization Mechanism (ESM). Resorting to centralized fiscal resources at the European level is unlikely to be feasible in the foreseeable future, given the incentives to shift risks to the European level and the lack of willingness to give up fiscal sovereignty. Should additional fiscal resources for bank restructuring and resolution be needed, clear rules for fiscal burden sharing need to be defined *ex ante*.

The GCEE **warns** against the introduction of **European-wide deposit insurance**. A necessary pre-condition for European deposit insurance is the prior establishment of an effective and powerful European resolution authority. This precondition will not be met in the near future. Hence, introducing European deposit insurance would imply the introduction of a common risk sharing mechanism without establishing centralized control functions and rights to intervene. Such risk sharing mechanism would undermine incentives to reduce excessive borrowing through tighter banking regulations and tighter fiscal rules. At the same time, individual countries need to reform their deposit insurance systems by introducing risk-based insurance premia.

A banking union requires **stricter regulation of banks**. Better capitalized banks have higher buffers against losses, which reduces the costs of banking failures for the taxpayer. Currently, discussions take place against the background of the existing financial reform process in the EU. In order to enhance the resilience of banks, two amendments to this process are necessary. First, in contrast to current capital adequacy regulation based on risk weighted assets, banks should, in the medium- to long-run, be required to maintain also a leverage ratio

of at least 5%, which specifies capital requirements relative to banks' total on- and off-balance sheet activities.

Second, existing privileges for investments into government bonds should be abolished. This pertains in particular to zero risk weights that apply to government bonds of EU countries as well as to the exemption of government bonds from large exposure rules. Also, liquidity requirements for banks should be specified without building in incentives to invest into government bonds.



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Current plans for a banking union refer to Article 127(6) TFEU which states that “The Council [...] may unanimously [...] confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions [...].” However, the corner stones for a banking union sketched above are incompatible with this legal framework for the following reasons.

First, only *specific* tasks can be transferred to the ECB and it is not clear whether this could involve the *permanent* and *full* transfer of supervisory powers also. Second, the legal provisions do not a priori involve transferring broad tasks with regard to restructuring and resolution of banking institutions to a European authority. Third, according to the proposal for a Single Supervisory Mechanism by the Commission, the ultimate decision power would rest with the Governing Council of the ECB. Hence, a sufficient separation between monetary policy and supervisory decisions would not be guaranteed. Fourth, the non-Euro Area members of the EU would have insufficient incentives to join the banking union because they are not represented in the ECB's Governing Council and are thus not involved in the decision making process. In short: It is hard to see how a functioning banking union could be established without amendment of the Treaty. In its current form, the banking union is likely

to remain partial, thus bearing the risk of an unstable and not fully functioning institutional structure.

III. Steps Towards the Establishment of a Banking Union

Designing banking supervision at the European level requires a balance between national and European liability and control. Figure 2 shows that there are two stable and two unstable constellations. The first constellation (Case I) in which control and liability are at the same level is the concept of the internal capital market where, in the context of harmonized rules, supervision rests with the national authorities. In this case, individual states are liable for the costs of banking crises. The second constellation is the banking union (Case IV) with common resources for the restructuring of banks and control rights at the European level.

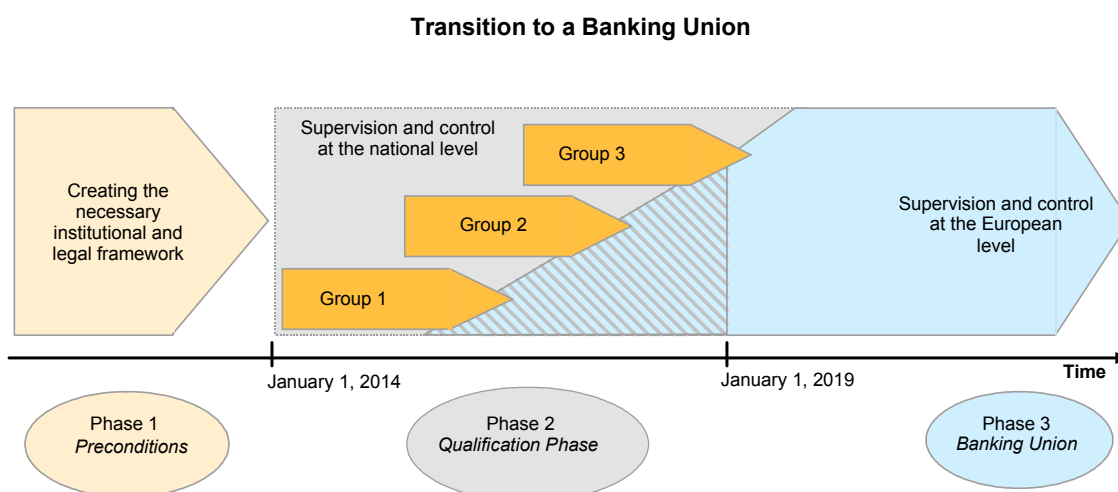
Banking Supervision in the Internal Market and the Banking Union

Liability Control	Decentralized	Centralized
	I. Current concept of the Internal Market – Minimum Harmonization – Home Country Control – Mutual Recognition ESM with liability of single member states	II. Financing illiquid and insolvent banks through the central bank ESM with direct recapitalization of banks without sufficient transfer of control rights
Decentralized		
Centralized	III.	IV. Banking Union – centralized supervision – centralized restructuring competence and financing mechanism (e.g. through the ESM) – national deposit insurance

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During the crisis, the members of the Euro Area have successively assumed common liability, notably because refinancing through the ECB has substituted refinancing via the interbank market. Supervision and control of the banks affected has remained with national authorities though. Also, a direct recapitalization of banks through ESM funds without the government being liable for these funds would, in the current situation, amount to a centralization of liabilities without the appropriate transfer of control rights.

Currently, two main obstacles prevent the introduction of a banking union. The first are bad assets on banks' balance sheets. During the crisis, the share of nonperforming assets on banks' balance sheets, in particular in the crisis countries, has increased quite significantly. Dealing with these legacies from the past should remain the task of national governments. The second obstacle is the lack of an appropriate legal and institutional framework for a functioning banking union. For these reasons, the German Council of Economic Experts has developed a three-stage plan for the transition to a banking union. In each phase, liability and control are at the same level. Also, the costs of dealing with legacies from the past should not be shifted to the European level.



Phase 1: Legal and Institutional Preconditions

In a first step, binding deadlines for the banking union and for the transitory arrangements will be specified. This would be followed by the creation of the legal prerequisites in each individual member state and the establishment of the European institutions. Changes in the relevant European treaties would be required in order to implement the banking union as described above. Ideally, this phase should be finished within one year's time.

Already in this phase, financial institutions should consent to the sharing of information between the relevant authorities at the national and European level. In parallel, elements of mutualisation of risk should be reduced gradually. The ECB should, if financial market conditions allow, tighten conditions for refinancing credit gradually by conditioning access to refinancing facilities on the soundness of the financial institution in question. It needs to be ensured that such tightening of conditions for ECB refinancing is coordinated with access to ELA (Emergency Liquidity Assistance).

Phase 2: Qualification Phase

In the second phase, banks qualify for entry into the banking union and for a European banking licence. Both, banks and national supervisors, can apply for admittance of a bank into the banking union. In order to prevent delayed applications, a fixed deadline after which only banks with a European banking license remain on the market will be specified. Qualification for a European banking licence involves a complete re-assessment of the value of banks' assets – including claims vis-à-vis the government – through external experts. Also, banks obtaining a European banking licence must meet the full regulatory requirements of Basel III as well as a Leverage Ratio of at least 5% of total on- and off-balance sheet activities.

European authorities can admit a bank into the banking union after the qualification phase has successfully been completed. Hence, banks would enter the banking union successively. Until banks have obtained a European banking licence, liability and control would remain at the national level. In order to prevent European authorities to be swamped by applications of possibly thousands of banks, banks would be classified into different groups according to, for example, their size. In a first phase, only the largest banks such as those currently monitored by the European Banking Authority (EBA) would have to qualify for entry into the banking

union. They would be followed by the mid-sized and, finally, the smallest banks. For each of these banks, group-specific deadlines for application for a European banking licence would be specified. The criterion according to which banks are classified should refer to a point in time in the past in order to prevent manipulation.

Given the continuing instabilities on financial markets, restructuring and, in particular, the winding down of large financial institutions is unlikely to occur. Authorities might fear that such an event could trigger contagion effects. This implies though that larger and potentially systemically important financial institutions in distress have incentives to gamble for resurrection. In order to minimize the risk emanating from such behaviour, European authorities established in the first phase should, in parallel to national authorities, supervise even those financial institutions for which the group-specific deadlines have not yet been reached. In particular large, global banks should be supervised by the European authorities as quickly as possible. Stress-tests can be used to determine possible capital shortfalls, and capitalization plans to restore a sufficient volume of capital shall be developed. Care needs to be taken that such capitalization plans do not involve the shedding of assets in order to restore a sufficient level of capital adequacy.

One objection against gradual entry into banking union could be that it might lead to a segmentation of financial markets and to a potentially destabilizing shifting of deposits among banks. Yet, this concern would be mitigated by the fact that deposit insurance would remain at the national level. Hence, the explicit guarantees for bank deposits would not change if banks eventually obtain a European banking licence. Also, the general regulatory framework under which banks operate would be the same for all banks. There would be differences across banks with regard to the solvency of the fiscal authorities behind each bank and thus with respect to the implicit guarantees of banks' deposits. This is a substantial element of uncertainty for depositors, in particular for the banks from the crisis countries. With a structured transition to a banking union, however, uncertainty should decrease rather than increase.

During the transition, it is likely to be necessary for some banks to be restructured and possibly even resolved. In particular, banks which have not applied for a European banking licence until the end of the group-specific transition phase as well as banks that have been denied a European banking licence should enter a mandatory restructuring process. If fiscal resources beyond the fiscal capacities of the government in question are necessary, the government could apply for funds for bank recapitalization from the ESM. The conditions under which such funding should be granted could be related to the Memorandum of Understanding recently been specified for the case of Spain (Council of the European Union, 2012), and it should particularly be ensured that existing shareholders bear losses. During this phase, the government would assume the liabilities for funds provided by the ESM, and the European Restructuring Authority established in Phase 1 should accompany the process. Hence, "recapitalization" of banks does not imply the unconditional rescue of distressed banks with taxpayer's money. Rather, recapitalization is part of a process in which only viable banks with a sound business model remain in the market.

Phase 3: Full Banking Union

After completion of the second phase, supervision of all banks will rest with the European authorities. The European Restructuring Authorities will be in charge of the restructuring and resolution of banks. It can resort to funds from a European bank restructuring fund, the ESM and pre-specified rules for fiscal burden sharing. All banks remaining in the market would have a European banking licence; both control and liability would be at the European level.

Given that Phase 1 would be completed within a year's time, Phase 3 could potentially resume in the year 2019, i.e. in the year in which banks have to meet the new Basel III regulatory requirements.

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