



**EUROPEAN BANKING UNION:  
STATUS OF IMPLEMENTATION AND  
THE NEED FOR IMPROVEMENT**



## TABLE OF CONTENTS

<b>4  </b>	<b>FOREWORD</b>	
<b>5  </b>	<b>SUMMARY</b>	
<b>6  </b>	<b>WHY THE MONETARY UNION REQUIRES A BANKING UNION</b>	
	Risks Shared by Banks and States .....	7
	The Possibility of Regulatory Arbitrage .....	9
	Ratings Benefits of System Relevance .....	9
<b>11  </b>	<b>THE THREE PILLARS OF THE PROPOSED EUROPEAN BANKING UNION</b>	
	Common Banking Supervision .....	11
	▪ <i>Banking Supervision within the European Central Bank</i> .....	12
	▪ <i>Conflicts of Interest between Monetary Policy and Banking Supervision</i> .....	13
	The Common Resolution Mechanism .....	15
	▪ <i>Resolution Decisions and the Commission's Right of Final Decision</i> .....	15
	▪ <i>Resolution Instruments and Exemptions in Bail-in Cases</i> .....	16
	▪ <i>Resolution Financing and Burden Sharing</i> .....	19
	Harmonised Deposit Guarantee Schemes .....	21
	▪ <i>The Quality of National Deposit Guarantee Schemes</i> .....	21
	▪ <i>Oversight of Private Institutional Guarantee Schemes</i> .....	26
	▪ <i>The Role of Deposit Protection in Cases of Creditor Participation</i> .....	27
<b>29  </b>	<b>WHAT THE BANKING UNION IS STILL LACKING</b>	
	Bank Capital Requirements for Government Bonds .....	29
	The Solution to the Problem of Inherited Liabilities without Collectivisation .....	30
	Creditor Participation with Few Exceptions .....	31
<b>32  </b>	<b>CONCLUSIONS AND RECOMMENDATIONS</b>	
<b>33  </b>	<b>LITERATURE</b>	

# Foreword

In the public debate about the future of the eurozone, an impression is often given that a common European currency has no future without a fiscal union. In this context, it is often cited that a common monetary policy is not capable of adequately addressing negative economic developments in individual Member States on its own – including sovereign debt crises. From this polarisation follows the mistaken belief that the euro will ultimately fail unless the European Member States relinquish their national fiscal policy competencies to Brussels for the foreseeable future.

Scientific representatives are regularly drawing on the theory of optimal currency areas, arguing that more fiscal transfers from the centre to the European periphery are completely worthwhile. However, this is not essential for the survival of the European Monetary Union. In fact, fiscal discipline by national governments must be effectively anchored and the vicious cycle of banking crises and sovereign debt crises must be broken. Ultimately, it has been the financial market crisis that further ballooned the already excessively high levels of public debt in parts of Europe and led individual governments to the brink of bankruptcy.

On the one hand, the political plans to establish a common European Banking Union will be followed with the aim of establishing a more stable financial market structure in Europe and thus minimising the potential of future crises that may threaten the survival of the European Monetary Union. On the other hand, a common banking supervision and common resolution mechanism should ensure that European taxpayers will no longer be made to bear the losses in the banks' balance sheets. From a regulatory standpoint, these goals should be initially approved because they are ultimately supported by the established principle of subsidiarity: Member States will

remain responsible for the common currency, while better institutions for financial market structure will be established at the European level.

The effective implementation of these objectives is nevertheless difficult. Although a common banking supervision under the umbrella of the European Central Bank has already been established, there is still no political consensus regarding the controversial procedural organisation of a common resolution mechanism. From a regulatory perspective, the establishment of a supervisory authority at the European Central Bank and the lack of automation in bank resolution are particularly problematic. As regards additional regulation, the planned harmonisation of national Deposit Guarantee Schemes is just as controversial, as is the option proposed by the European Commission for mutual lending among these schemes. The latter would especially allow for questionable latitude regarding the collectivisation of losses and debts.

The Konrad-Adenauer-Stiftung is interested in a fundamental debate on the design of a forward-looking European economic policy within the meaning of the regulatory principles of the Social Market Economy. The following study by the Cologne Institute for Economic Research on behalf of the Konrad-Adenauer-Stiftung sheds light on the current proposals and decisions on the European Banking Union.

We wish you pleasant reading.

**Dr. Matthias Bauer**

Coordinator for International Economic Policy



## Summary

The crisis in the euro area revealed points of weakness in the architecture of the Monetary Union. It appeared that the common monetary policy also required a common system of banking supervision. Ultimately, this resulted in banking crises and bailouts at the taxpayers' expense. In addition to weaknesses in national financial supervision, legal resolution options for banks in precarious situations are also lacking. This, along with a lack of capital requirements for government bonds meant that a shared risk was generated by the states and banks in the euro-zone whereby sovereign debt crises and banking crises mutually reinforced each other. A banking union therefore seems necessary as a long-term framework for the completion of the European Monetary Union.

This report summarises the current proposals and decisions regarding the Banking Union and evaluates the Banking Union's three pillars – banking supervision, bank resolution and common standards for deposit guarantees – from a regulatory economic perspective. Particular emphasis is placed on the proposed design of the resolution mechanism and coordination of national deposit guarantee systems and their consequences for Germany's banking system. The consequences for private institutional guarantee systems are also analysed. The planned exemption provisions for creditor involvement are also discussed critically, as is the European Commission's proposed right of last decision for cases of bank resolution and the lack of capital requirements for European government bonds.

Burden-sharing in bank resolution is also a point of contention. The European Commission favoured a common European Resolution Fund, while Germany instead preferred a network of national resolution funds. Both variants are contrasted with an alternative proposal by the

Cologne Institute for Economic Research. This model avoids the situation automatically resulting in the pooling of costs and losses. The ministers of finance in the EU have agreed to a similar model. Under this plan, a network of national funds will gradually be transferred to a European fund.

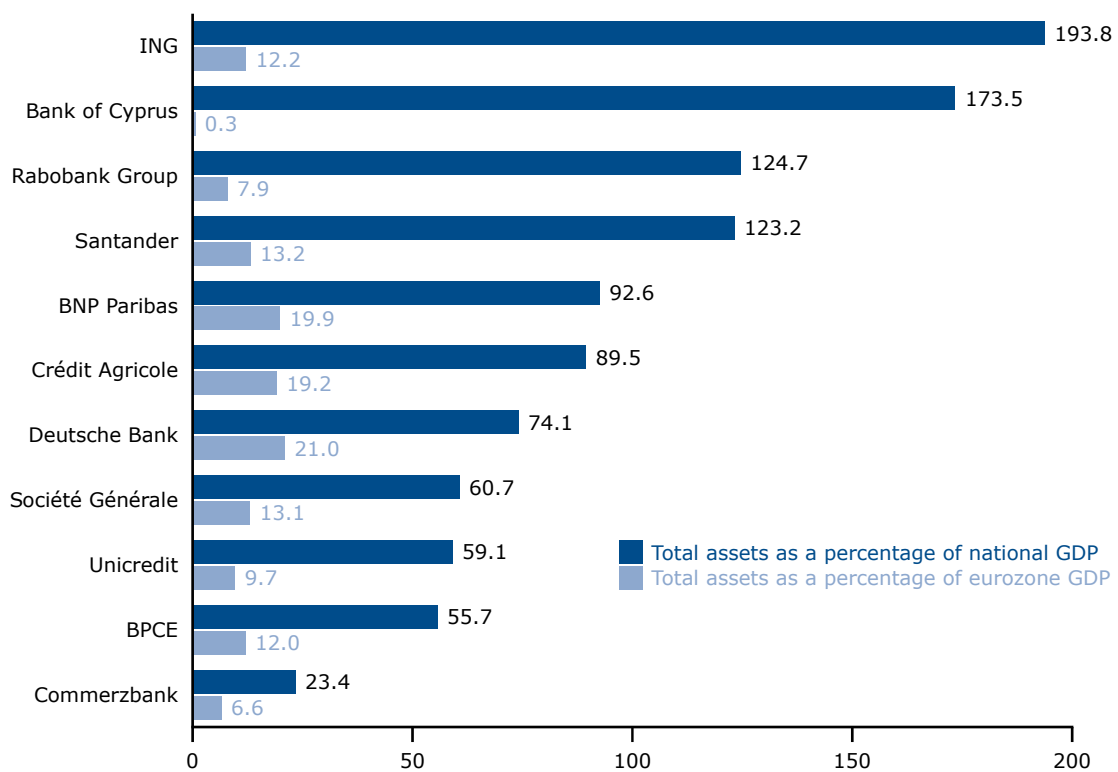
The implementation of the Banking Union is discussed against the backdrop of still existing legacy liabilities in the bank balance sheets. To that end, the Cologne Institute for Economic Research proposes an alternative timetable for the implementation of the three pillars that would prevent excessive demands being placed on the Banking Union from legacy liabilities in the bank balance sheets. This proposal provides for a quarantine period for banks that do not qualify for the Banking Union under the audit. According to the proposal, they will be placed under special supervision by the European Central Bank (ECB) during this time and will be required to submit detailed restructuring plans. If the ECB does not approve these plans or if the restructuring objectives are not met, the Cologne Institute's proposal stipulates resolution for the banks in question.

This report recommends further improvements on the previous plan for the Banking Union. In the process, reliable creditor involvement should be confirmed for bank resolutions as early as 2014. Furthermore, the Banking Union will be accompanied by risk-based capital requirements for government bonds. Through better risk provisions, banks, including their owners and creditors, must be robust enough to ensure that in the case of future banking crises, a burden on the taxpayer can be avoided as much as possible.

# Why the Monetary Union Requires a Banking Union

During the financial crisis in the European Monetary Union, it became apparent that the common monetary policy is overburdened in cases of banking crises and sovereign debt crises. The ECB has had to prop up the banking system in the eurozone with extensive liquidity measures.<sup>1</sup> Banks are essential for corporate financing and the ECB depends on a stable banking system to direct instruments of monetary stimulus. The sovereign debt crisis restricted their effectiveness to such an extent that the ECB was forced to resort to purchasing government bonds, which was highly criticised by the public.

**Figure 1: Bank size relative to the economic performance of their states**  
Total assets of banks as a percentage of gross domestic product (GDP)



Source: Bloomberg, Eurostat, own representation

<sup>1</sup> In the past, the Bundesbank has avoided doing this as a lender of last resort in order not to allow conflicts of interest between the stabilisation of the value of the currency and the stabilisation of the banking system to arise in the first place (Deutsche Bundesbank, 1992). Instead, liquidity assistance for sound banks in Germany is available through the Liquiditäts-Konsortialbank, founded in 1974. Such an institution for the provision of emergency liquidity was absent at the European level, necessitating the intervention of the ECB.

In absolute terms, European banks are smaller than U.S. banks. In terms of the economic performance of their home country, however, they outperform the U.S. banks (Figure 1). Thus, the total assets of some European banks exceed the gross domestic product (GDP) of their home country, while no U.S. bank assets are greater than one-eighth of U.S. GDP (Shambourgh, 2012). The relative size of European banks is only problematic because, unlike in the U.S., bank resolution in Europe is not a community task. Should such a major European bank experience financial difficulties, its bailout brings the state financial difficulties, as in the case of Iceland, Ireland and Spain.

The relative size of European banks is not the only argument for mutualisation of banking supervision and resolution, but so is the extent of their cross-border activities. Some European banks command more than 1,000 subsidiaries that operate in more than 50 countries (Claessens et al., 2012). The cooperation between national supervisory authorities has reached its limits in the past since national authorities' committed goal was not the stability of the euro area, but only the stability of the domestic banking sector.

A banking union – consisting of European banking supervision, bank resolution and common standards for deposit guarantees – is presented as a long-term regulatory framework to complement the Monetary Union. However, in order to stabilise the banking sector, it must address the following problem areas:

- ease the **risks shared by banks and states** so that banking and sovereign debt crises no longer mutually reinforce each other;
- **prevent the possibility of regulatory arbitrage** by elevating banking supervision and resolution to the European level; and
- **reduce distortions of competition from systemic relevance** by placing large and system-relevant banks under special European supervision.

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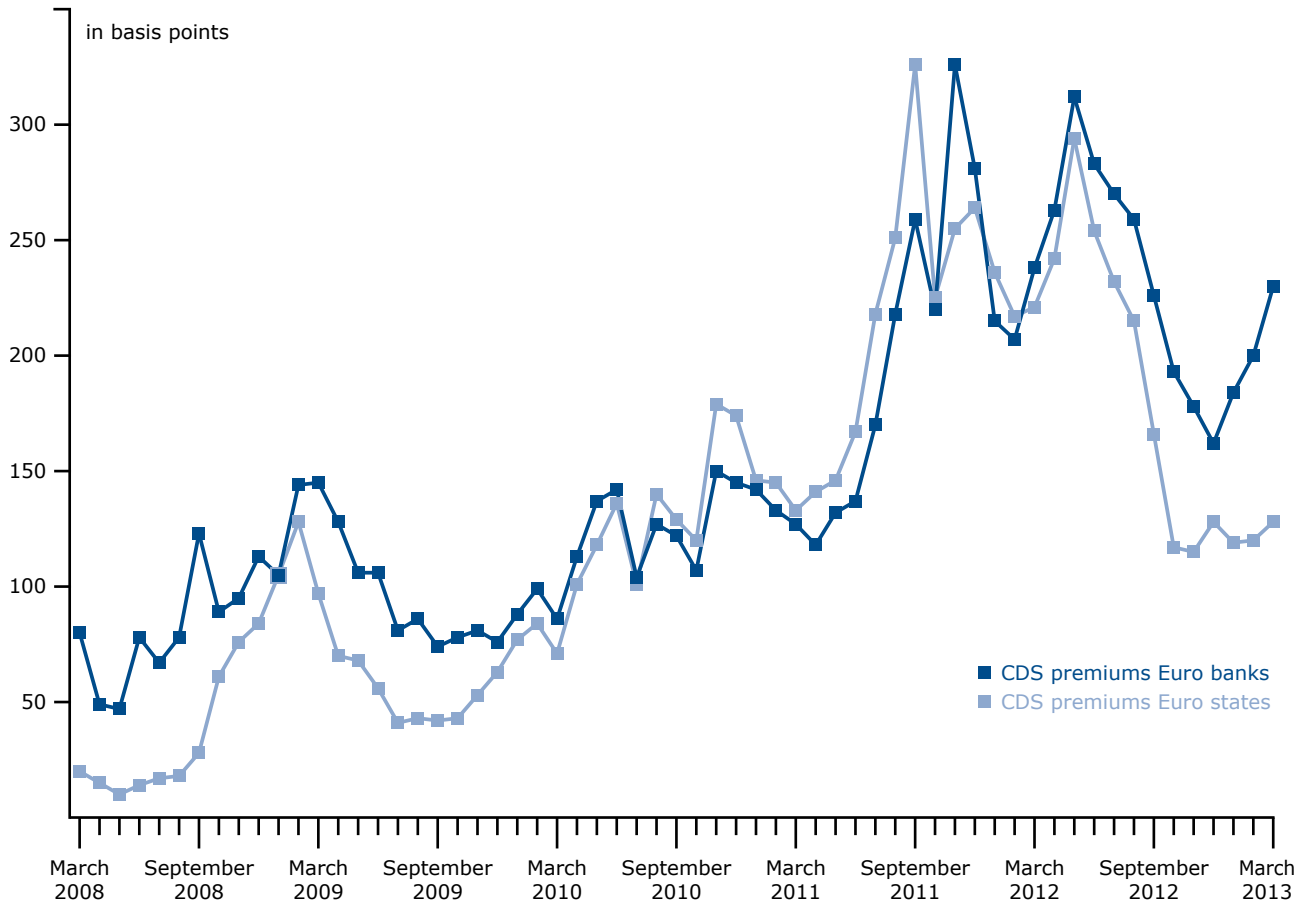
## **RISKS SHARED BY BANKS AND STATES**

Banks in the euro area are not only very large and active transnationally, they are also closely interconnected with their states. This has led to a vicious cycle of banking crises and sovereign debt crises. Banking crises lead to sovereign debt crises if states are forced to bail out their large banks, which are highly interconnected with the rest of the financial system, with public money in order to prevent a systemic banking crisis. A high level of debt makes banks vulnerable to crises because they have too little capital to be able to absorb losses. Apart from the strong interconnectedness of banks among each other, the insolvency of a single large bank that is highly intertwined with the rest of the banking system can lead to a systemic crisis.

However, a high level of sovereign debt can also lead to a destabilisation of the domestic banking sector because the banks hold a large portion of the domestic public debt without having to bolster this with capital. If it amounts to losses in the value of government bonds, the banks must record the net losses that reduce their capital, which may lead them to financial problems. This, in turn, may make government bailouts necessary.

This combined risk of bank debt and public debt is readily apparent in the premiums for tradeable credit default swaps (CDS). As shown in Figure 2, the premiums for CDS from bank bonds and government bonds move almost in lock-step.

**Figure 2: Shared risks of bank debt and public debt**  
*Premiums on credit default swaps, weighted averages<sup>2</sup>*



Source: Bloomberg, Cologne Institute for Economic Research

The planned European Banking Union should therefore be reviewed for its potential to decentralise this shared risk.

<sup>2</sup> To create the CDS indicator for the eurozone states, the premiums of the CDS of eurozone states were weighted using their national GDP. The CDS indicator for banks is based on the banks identified as system-relevant in the Liikanen report (Liikanen et al., 2012). The CDS of individual banks were weighted by their respective total assets.



## THE POSSIBILITY OF REGULATORY ARBITRAGE

Regulatory gaps arise when banks operate across borders but their supervision is a purely national responsibility. Thus, national supervisory authorities are not committed to the objective of a stable European banking sector, rather only to the objective of the stability of their own national banking sector. Furthermore, banking supervision is not independent of the political sector in every country, and these politics often favour the strengthening of the national financial centres. Because the financial centres of individual member states compete with one another, from an individual standpoint, national financial policies that are too stringent present a disadvantage for individual states. It generates a situation similar to the prisoner's dilemma in game theory, in which the overall optimal economic solution is not reached because deviating from this solution is more advantageous from an individual economic perspective.

In such a case, no country has an incentive to impose more stringent standards so long as the other countries do not also raise their standards. As long as different national supervisory and regulatory standards apply, banks can choose the degree of supervision and regulation they are subject to by shifting their operations to countries with less stringent regulatory and supervisory standards. Countries have an incentive to attract these businesses by having less stringent standards. Higher standards can only insufficiently be achieved through stronger cross-border cooperation between national supervisory authorities as long as the goal of the stability of the entire eurozone is not prioritised over the goal of the stability of national financial sectors by national authorities.

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## RATINGS BENEFITS OF SYSTEM RELEVANCE

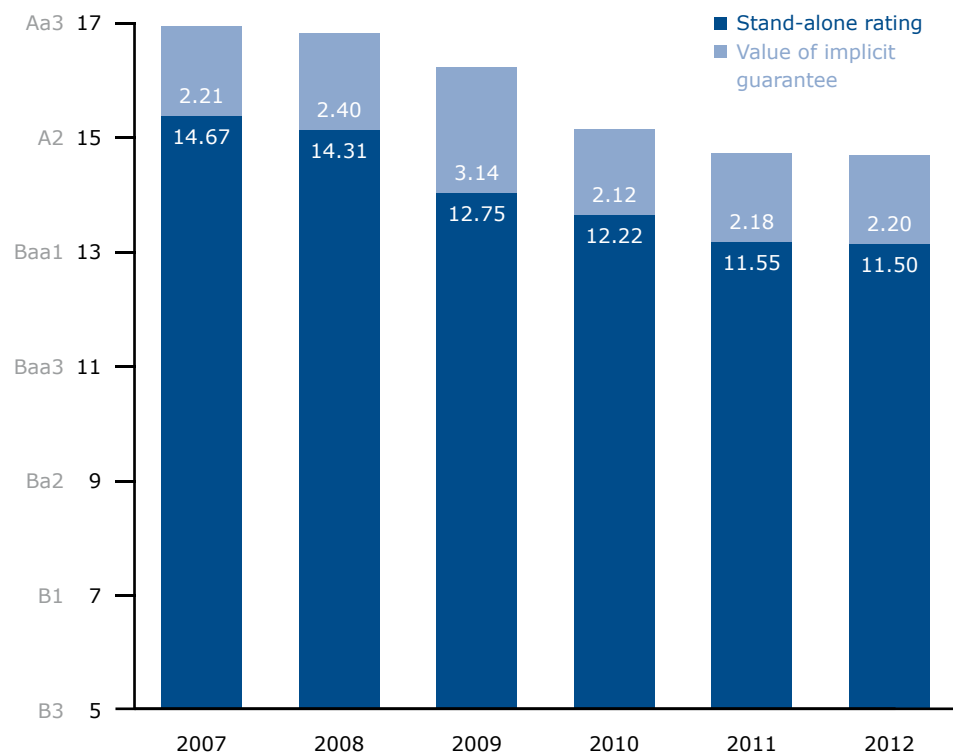
Due to the strong interconnectedness among banks and the combined risk from bank debt and national debt, large banks that are strongly linked to the financial system become system-relevant. This means that, in the event of insolvency, they cannot leave the market without a comprehensive failure of system-relevant financial services, such as lending and payment services. This makes a government bailout of these banks highly likely. In addition, a distortion of incentives arises for banks if taxpayer money can be made liable for individual banking risks.

Additional competitive advantages arise from system-relevant banks' inherent status that banks that are not system-relevant do not have. This competitive advantage is clearly demonstrated by the bank ratings (Liikanen et al, 2012; Haldane, 2009). The rating agencies publish an all-in rating and a stand-alone rating for the banks. Here, the all-in rating is always better than the stand-alone rating because it implies the possibility of a government bailout – something that is not included in a stand-alone rating. Figure 3 shows the ratings advantage from system relevance, calculated by Schich/Lindh (2012). Accordingly, in March 2012, the average stand-alone rating of a system-relevant bank was a ratings class of 11.5, which equates to a Moody's rating ranging from Baa1 to A3. The all-in rating for the same time period was a ratings class of 13.7, thus equating to a rating of almost A2. The implicit government guarantee thus leads to an improvement in the ratings by an average of 2.2 rating classes.

Market participants measure the amount of interest on borrowed capital using the all-in rating, making it so that system-relevant banks have an advantage in refinancing over banks that are not system-relevant because of this better rating. Since creditors factor in the government bailout, the interest rate for refinancing does not reflect the inherent business risks (Liikanen et al., 2012). This allows system-relevant banks to take on high risks without being confronted with a high interest rate for borrowing capital by financial market participants as compensation for the higher risk of insolvency (Liikanen et al, 2012; Haldane, 2009). This, in turn, promotes an increase in system relevance (Haldane, 2009).

**Figure 3: Ratings benefits of system relevance**

*Stand-alone rating and value of the implicit guarantee (difference between all-in-rating and stand-alone rating), ratings classes under the Moody's ratings system*



Source: Schlich/Lindh (2012)

The proposed Banking Union should therefore be reviewed for its potential to reduce this distortion of competition in the banking sector.

# The Three Pillars of the Proposed European Banking Union

A banking union is in development for the countries in the euro area. The other European countries that do not use the euro as their national currency can join the Banking Union on a voluntary basis. The European Banking Union is based on a concept of common financial market regulation, the so-called Single Rulebook, and should be based on three pillars:

- a European system for banking supervision (single supervisory mechanism, SSM), which is housed at the European Central Bank (ECB);
- a European mechanism for the resolution of insolvent banks (single resolution mechanism, SRM), which consists of a European resolution authority and a European Resolution Fund to finance resolution measures; and
- common standards for deposit guarantee schemes of Member States.

Without this three-pronged approach, the Banking Union would be incomplete. Its stabilising effects are then unable to develop. This is supported by the following:

- The SSM cannot break up the combined risk of bank debt and public debt without the SRM because a purely national resolution authority would probably take a long time to determine the fiscal consequences of the resolution decision if the SSM does not have authority over them (Goyal et al., 2013).
- The threat of resolution to a bank by the SSM and SRM will only be credible if the resolution's financing and the burden-sharing between the countries involved are previously fixed and do not have to be negotiated after the case of insolvency occurs (Goyal et al., 2013).
- Safety nets in the form of deposit guarantee schemes without European banking supervision distort the incentives for nation states to be too lenient with supervision and passing on the costs and the losses to the European level (Goyal et al., 2013).

In the following section, the three pillars and their functions, authority and decision-making mechanisms are explained in greater detail.

## COMMON BANKING SUPERVISION

The regulation regarding the SSM came into effect on 4 November 2013. The SSM is comprised of the ECB as the head banking supervisor and the national regulatory authorities. However, the ECB was not granted oversight over all of the approximately 4,500 banks in the euro area, rather only approximately 130 of the largest banks identified as system-relevant. Banks with total assets of over 30 billion euros, or a ratio of total assets to GDP of their home country of over 20 per cent, or that are otherwise significant to the financial system fall into this category (Council of the European Union, Article 5). The list of institutions regulated by the ECB contains 24 German banks, including two major banks, six regional banks, both cooperative

central banks and four development banks (ECB, 2013). Supervision of banks that are not system-relevant remains the responsibility of the national supervisory authorities. However, the ECB has the fundamental right to intervene with these banks.

### **Banking Supervision within the European Central Bank**

As part of its regulatory mandate, the ECB holds the following functions and powers (Council of the European Union, 2013a, Article 4):

- the authorisation of banks and the withdrawal of authorisations;
- the assessment of notifications of the acquisition and disposal of holdings in banks;
- ensuring compliance with regulatory requirements, such as own funds requirements or large exposure limits;
- ensuring compliance with the requirements regarding the governance of banks;
- supervisory reviews and stress tests; and
- the supervision of recovery plans and early intervention when a bank does not meet the regulatory requirements.

Furthermore, the ECB may make resolution recommendations to the SRM's Supervisory Board.

***Because banking supervision constitutes an additional mandate to its previous mandate of ensuring monetary stability and supporting the general economic policies in the euro area, conflicts of interest within the ECB are possible.***

Because banking supervision constitutes an additional mandate to its previous mandate of ensuring monetary stability and supporting the general economic policies in the euro area, conflicts of interest within the ECB are possible. To avoid such conflicts of interest, the ECB's statute provides that the ECB's primary objective remains ensuring monetary stability, whilst maintaining the stability of the financial market must be compatible with the objective of monetary stability. It should take compliance with this objective into consideration when engaging in banking supervision. It is thus permitted to lower the prime rate to shore up the banking system in the process of combating a banking crisis with a systemic character or to take other expansionary measures only if doing so does not result in any inflationary pressures.

Weber (2009) had already pointed out that monetary stability requires financial market stability and financial market stability, in turn, requires monetary stability. He cites the reason for this as the requirement of a stable financial system for the transmission of monetary policy stimuli. This is because monetary policy instruments, such as lowering the prime rate, do not directly affect the national economy since companies and households are not able to borrow money from the central bank at this rate. Instead, monetary policy is effected indirectly via banks through credit conditions for companies and households (Weber, 2009). This route of transmission is referred to in the literature as a bank lending channel.

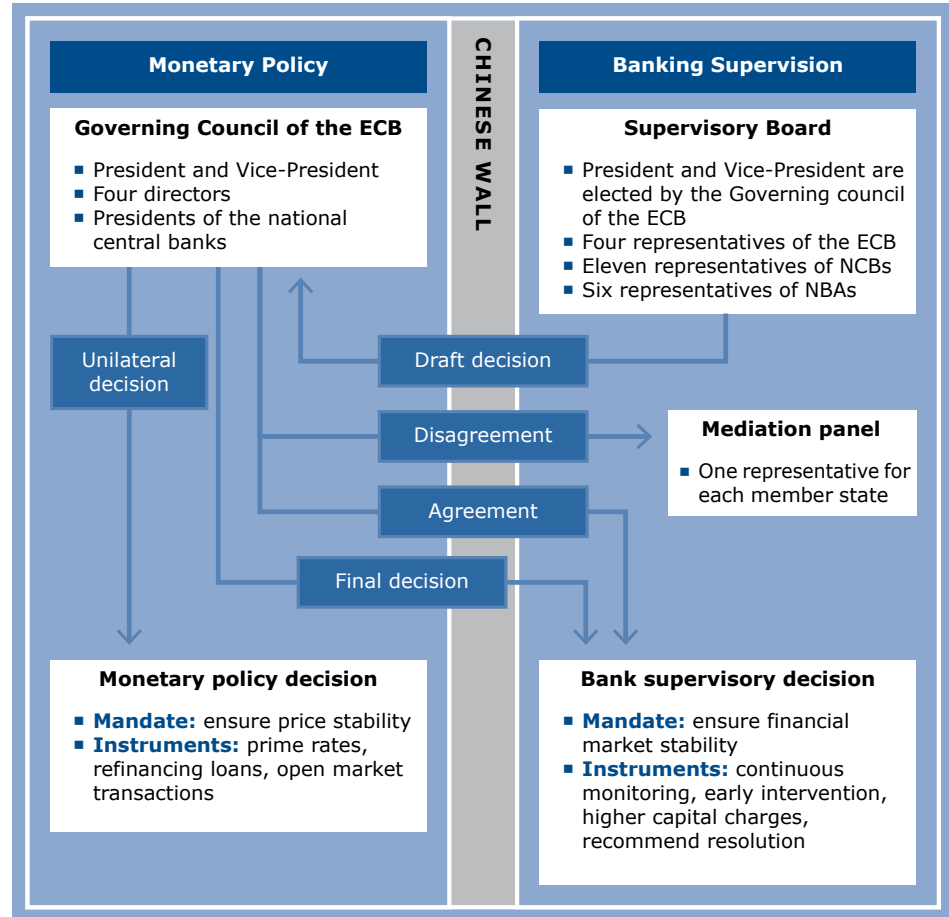
At the moment, the bank lending channel in the eurozone crisis countries has been disrupted (Demary/Matthes, 2013). The highly indebted banks in these countries are currently engaged in cleaning up their balance sheets, i.e. they must offload their commercial operations that are making losses and reduce their debt. At the same time, they must meet higher regulatory capital ratios. This can be done in two ways: either they take on additional equity, or reduce their debt. Because it is difficult to

take on capital in the market, and because this does not come with profits they can retain, the only option available to increase capital ratios is to reduce lending. Although the ECB lowered its prime rate to a record low of 0.25 per cent in November 2013, this interest is not reflected in the credit conditions in the crisis countries (Matthes/Demary, 2013). For many small and medium-sized companies in Greece, Spain and Portugal, the main problem is currently access to financing (IW-Forschungsgruppe Konjunktur, 2013). Since monetary policy is directed to achieve its mandate of price stability and supporting general economic policies in a functioning banking sector, the Banking Union represents an important method of achieving its monetary policy objectives.

### **Conflicts of Interest between Monetary Policy and Banking Supervision**

In order to limit trade-offs in the transfer of supervisory tasks to the greatest possible extent, a “Chinese wall” has been implemented within the ECB for monetary policy (Figure 4). While the conduct of monetary policy will continue to be determined solely by the ECB’s Governing Council, banking supervision in the ECB will be conducted by a newly established Supervisory Board. Both the President and the Vice-President of the Supervisory Board will be elected by the Governing Council. In addition, the Supervisory Board will consist of four representatives from the ECB, eleven representatives from the national central banks and six representatives from the national financial authorities.

**Figure 4: The process of coordination between the Governing Council and the Supervisory Board**



Source: Demary (2013) according to Beck/Gros (2012) and the Deutsche Bundesbank (2013)

The Supervisory Board cannot reach a regulatory decision on its own. It can only generate a draft decision and provide this to the Governing Council. In the event that the Governing Council does not agree to this draft decision, a Mediation Panel must be activated, which consists of one representative from each Member State participating in the Banking Union. Member States may decide on the appointment of a representative. Should all attempts at mediation fail, the Governing Council has the final say (Figure 4).

Despite the formal separation of monetary policy and banking supervision, many critics see the potential for conflicts of interest within the ECB. Allen et al. (2012) fear that the ECB could stand in the way of potential creditor participation in the case of the resolution of a bank operating transnationally; they fear cross-border contagion effects on other banks, leading to a systemic banking crisis and preventing the ECB from implementing its monetary policy.

Ioannidou (2012) infers potential conflicts of interest between monetary policy and banking supervision from a study on the Federal Reserve (Ioannidou, 2005). In this study, he finds that the monetary authority will simultaneously be more lenient in

their banking supervision under a restrictive monetary policy since the restrictive monetary policy primarily worsens the conditions of banks having problems. In order not to jeopardise financial stability from a bank failure, the bank of issue is therefore more lenient in its banking supervision. In principle, this trade-off is also a possibility within the ECB because the objective of monetary policy stands in opposition to financial stability and the Governing Council has the final say, even in supervisory decisions (Demary, 2013).

Beck/Gros (2012) fear that the ECB will become more highly politicised through its banking supervisory function. However, this is countered by the fact that the ECB needs to signal a high degree of political independence in order to keep expectations of inflation low.

Beck/Gros (2012) also see the fact that the ECB receives too much influence as a problem. This stems from the fact that the ECB is not accountable to a parliament. However, the proposals for the SSM stipulate that the European Parliament be permitted to summon the Chair of the Supervisory Board to hearings. However, the Chair is not required to comply with the summons (Deutsche Bundesbank, 2013).

## THE COMMON RESOLUTION MECHANISM

As yet there has been no uniform European legal framework for the orderly resolution of financial institutions in the event of insolvency. The financial crisis has demonstrated that banks cannot be resolved like other companies because financial services, such as payment transactions, lending or asset management cannot be shut down without significant frictions and losses by the customer. Instead, these services must be maintained during the course of the insolvency proceedings. However, this requires external transition financing since the insolvent institution can no longer afford to finance its resolution. Moreover, the various national solutions for bank resolution did not account for the fact that the large, system-relevant banks are increasingly active transnationally and their assets and liabilities are also linked across borders. European-wide common resolution instruments were implemented (Council of the European Union, 2013b) by the Bank Restructuring and Resolution Directive (BRRD), which will come into effect on 1 January 2016 for all 28 EU Member States. The SRM is based on the BRRD, but instead provides for centralised decision-making and resolution financing. An intergovernmental treaty should have been passed on 1 March 2014 to ensure that the SRM can begin its work on 1 January 2015. The SRM will apply to all banks in the eurozone, as well as the banks in countries that voluntarily join the Banking Union (COM, 2013).

*The financial crisis has demonstrated that banks cannot be resolved like other companies because financial services, such as payment transactions, lending or asset management cannot be shut down without significant frictions and losses by the customer.*

## Resolution Decisions and the Commission's Right of Final Decision

Resolution decisions are made by the SRM's Resolution Board, the national resolution authorities and the European Commission. They may be preceded by a resolution recommendation from the ECB. The Resolution Board consists of an Executive Director and a Deputy Executive Director, other representatives appointed by the Commission and the ECB, as well as committee members appointed by each Member State participating in the Banking Union. For resolutions, the Commission has to assess the extent to which resolution measures are consistent with state aid.

Issues are discussed at length over the course of a resolution decision. The European Commission has insisted on a right of final decision, while Germany has insisted on the affected nations having the right of final decision. The original proposal for the SRM envisioned a resolution proceeding as follows (Council of the European Union, 2013c):

- The ECB notifies the SRM's Resolution Board, the Commission and the relevant national ministries that a bank is in default.
- The Resolution Board then decides whether the bank's distress represents a systemic risk, prepares a resolution or restructuring plan based on this analysis and recommends this to the Commission.
- The Commission makes a decision on the plan, as well as on the use of funds from the Resolution Fund. The Commission may also independently initiate a resolution without the Resolution Board. However, the resolution decision is subject to the limitation that the Commission cannot force a state to provide aid with public money.

The disadvantage of this proposal is that extensive authority will be delegated to the Commission whereby it can make decisions on sums amounting to billions of euros, for example in the case of creditor participation, a so-called "bail-in". Furthermore, the resolution of a bank may have consequences for national budgets if the Resolution Fund has insufficient means. It is also critical to recognise that the Commission will decide on the allocation of state aid as well as on the resolution.

However, the ministers of finance have agreed on an alternative approach to resolution decisions. Under this approach, the Resolution Board's decision will apply unless the Commission objects. In cases where it does object, the ministers of finance from states participating in the Banking Union must come to an agreement. It is questionable, however, whether it is possible to reach a decision under this approach outside of market hours. In contrast, the President of the European Parliament has stressed that the EU plays too small a role in bank resolutions. He argues that the European Commission should take a central role in bank resolutions (European Parliament, 2013).

### **Resolution Instruments and Exemptions in Bail-in Cases**

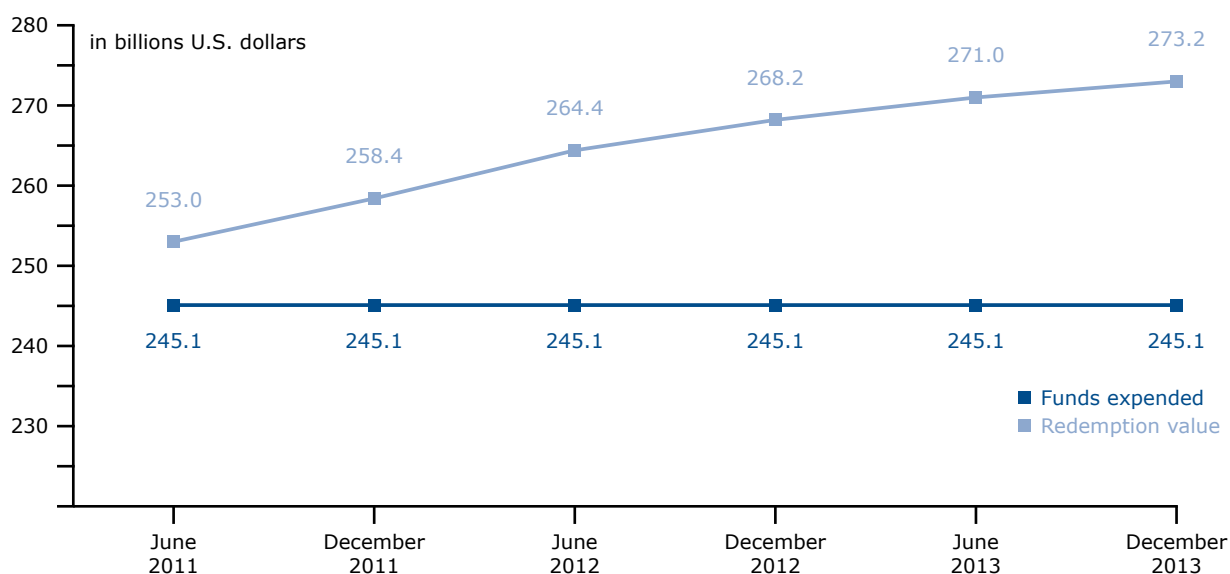
The BRRD establishes standard resolution instruments for all EU countries. In doing so, standard instruments are made available to all national supervisory authorities for crisis situations. Within the SRM, the following resolution instruments apply for the resolution of non-performing banks while preserving the stability of the system (Council of the European Union, 2013, Article 31):



- the sale of a business;
- the establishment of a bridge bank under public ownership and under public control for the bank's system-relevant functions;
- cleaning up the bank's balance sheets by outsourcing non-performing assets to a special resolution bank (bad bank); and
- the conversion of creditors' claims into equity, allowing for a fixed liability order (bail-in).

The establishment of a bridge bank accommodates the system relevance of banks so that system-relevant financial services continue to operate within the bridge bank during resolution. By doing so, negative consequences for the real economy can be avoided that would result in the collapse of payments or a credit crunch, for example. A special resolution bank, the bad bank, will be set up to handle costly commercial operations that are not system-relevant. In it, the non-performing assets will be resolved over a long period of time. In order to be able to engage this instrument in the past, the Act on the Further Development of Financial Market Stabilisation (*Gesetz zur Fortentwicklung der Finanzmarktstabilisierung*) was adopted in Germany in 2009 (Demary/Schuster, 2013).

Figure 5: Value of the Troubled Asset Relief Program (TARP)



Source: U.S. Treasury, various editions

Although the bad bank buys securities that are under stress, they do not necessarily realise losses with the acquired assets. Because these securities are transferred to them in times of stress, the price of these securities is lower than their nominal value. If anything, they are even undervalued because the non-performing bank is forced to transfer them to the bad bank in a distress sale. If the bad bank were to take over the stressed securities without the discount, this would amount to full-value protection and would provide the banks with incentives to make risky investments. But this is not the function of the bad bank. Rather, it acts as a conversion bank for stressed securities in times of crisis whose prices have a long-term chance

of recovery. However, these securities cannot recover in the balance sheet of a bank facing difficulties, making outsourcing to a special resolution bank necessary. By outsourcing stressed assets, the bank suffers a loss due to the discount, which must be borne by the Resolution Fund.

Since the bad bank is provided with guarantees, they are able to refinance at a favourable rate despite the risks taken. In addition, under the appropriate legal framework, they do not have to enter these assets in their balance sheets at market value and, in doing so, they do not have to make any deductions for depreciation for these securities in the case of a loss in market value. They are thus able to hold the transferred assets until their maturity while the prices of these securities slowly recover and return to their nominal value. In the process, the bad bank is not forced to sell these securities before they mature to avoid possible losses. By the time they reach their maturity, the prices of these assets should have then stabilised so much that it may even be possible for the bad bank to show a profit. This scenario is not entirely unlikely. The U.S. Troubled Asset Relief Program (TARP), a programme for buying up stressed securities, purchased assets worth 245.1 billion U.S. dollars. These are currently worth 273.2 billion U.S. dollars, representing a yield of 11.5 per cent (Figure 5).

*The establishment of a bridge bank accommodates the system relevance of banks so that system-relevant financial services continue to operate within the bridge bank during resolution.*

Before the bank to be resolved is split into a bridge bank and a bad bank, the financing of the resolution must be certain. Before funds can be deployed from a resolution fund or from the state, the BRRD and the Directive on state aid stipulate that losses must first be borne by the bank's owners and creditors. The SRM proposal provides the following liability ranking (Council of the European Union, 2013c, Article 15):

- claims related to common equity (including share capital and surplus reserves) are initially liable for losses incurred;
- then the additional common equity (including convertible bonds and silent partnerships) and supplementary capital (including contingency reserves) are used;
- then claims from executives and directors (bonuses in the form of bonds) must be used;
- then subordinated borrowed capital is liable;
- only then do unsecured non-preferred claims against creditors follow;
- and finally, eligible deposits and claims from deposit guarantee schemes form the end of the ranking.

In certain cases, the resolution authorities can exclude liabilities higher up on the chain of liability other than those already excluded from bail-ins, e.g. unsubordinated bonds. Substantiated cases of this include the non-availability of these liabilities within a reasonable time frame, or if these liabilities are necessary for the maintenance of system-relevant bank functions. Furthermore, liabilities may be excluded from bail-ins if this leads to losses in value for other liabilities, thus resulting in additional losses for the other creditors. Nevertheless, the condition that at least 8 per cent of total liabilities and equity capital are used in the bail-in must be met. In addition, the funds provided by the Resolution Fund may not total more than 5 per cent of the total liabilities and equity capital (Council of the European Union, 2013c, Article 24).

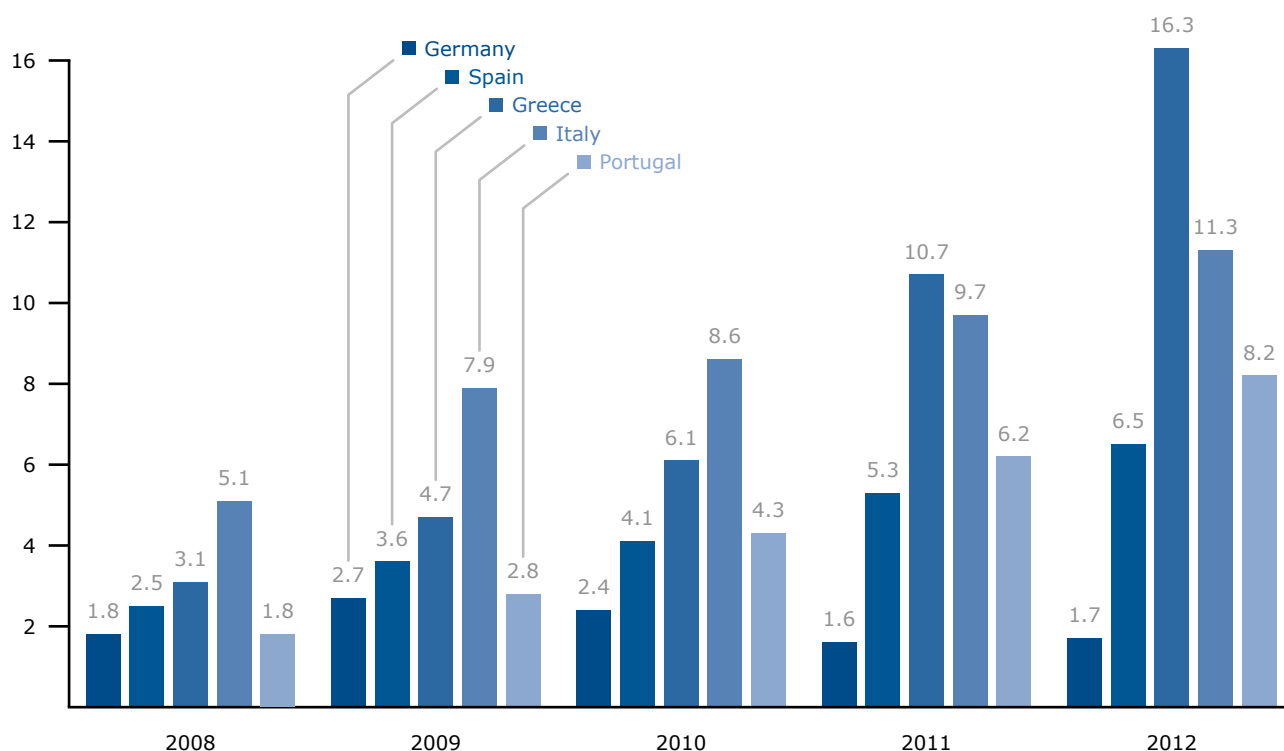
## Resolution Financing and Burden Sharing

Costs of bank resolutions in excess of the bail-in must also be covered. This includes the pre-financing of the bridge bank and the bad bank, but also the reimbursement of creditors if they experience losses during the bail-in that exceed their losses should a bank be liquidated. There are different models for financing resolutions:

- The BRRD envisages a network of national resolution funds for the EU-28; banks would pay into their respective national fund.
- The SRM proposal, however, provides for a common Resolution Fund into which all banks in the Banking Union will pay.
- The Cologne Institute for Economic Research’s proposal argues for a European system of resolution funds comprised of the national resolution funds of participating countries, as well as a common Resolution Fund. Banks will contribute according to their degree of relevance to national and European financial stability; they pay into either the national or the common European fund (Demary, 2013).

**Figure 6: Banks’ anticipated capital gaps**

*Problematic and non-performing loans as a percentage of all loans and debt certificates granted*



Source: European Central Bank

In its original SRM proposal, the European Commission decided in favour of the second model and thus for a central fund rather than a large number of national funds. They justified this by the fact that a common fund has positive external effects on individual Member States because their national banking systems will be protected against losses through the resolution of a system-relevant bank. Moreover, a joint fund could be more cheaply refinanced in the capital market than individual national funds could. The target fund size should be 1 per cent of the guaranteed deposits in the banking sectors of the Member States and should represent approximately 55 billion euros.

From a German perspective, however, this network of national funds was preferred, as stipulated in the BRRD (Koschyk, 2013). This is based on the fear that, with the help of the common Resolution Fund, past bank debt would be collectivised. Because these were generated under national supervision and not under European supervision, this leads to an undesirable redistribution of legacy liabilities. In terms of regional distribution of problematic and non-performing loans on bank balance sheets, this argument is completely justified. Though only 1.7 per cent of loans in the German banking sector were considered non-performing in 2012, in the Portuguese banking sector this number was 8.2 per cent, 11.3 per cent in the Italian banking sector and 16.3 per cent in the Greek banking sector (Figure 6).

*The proposed Resolution Fund will probably only be able to sustain individual bank insolvencies. In the event of a systemic banking crisis, it will need an appropriate backstop.*

The Cologne Institute for Economic Research proposed an alternative in the course of this discussion, which combines both of these models into one European system for bank resolution funds (Demary, 2013). Under this system, the resulting inherited liabilities would be resolved by the relevant national fund, while the European fund would only be used for new resolution measures in which a bank failure would threaten the stability of the entire European banking system. Ultimately, the finance ministers agreed on a similar model in which the common European fund would be used in 10 years at the latest, while the national funds for resolution measures would be used in the transitional period until the problem of inherited liabilities in the banks' balance sheets is resolved (Council of the European Union, 2013d).

The proposed Resolution Fund will probably only be able to sustain individual bank insolvencies. In the event of a systemic banking crisis, it will need an appropriate backstop, i.e. a state containment solution. This is there to restore confidence among market participants in the case of such a crisis and to counteract capital flight (Goyal et al., 2013). Pursuant to the Commission's proposal, in cases where contributions collected in advance (ex-ante contributions) are insufficient and contributions collected afterwards (ex-post contributions) are not immediately available, the Resolution Fund may borrow using the European Stability Mechanism (ESM). Lending between the national departments is also possible. During the Resolution Fund's expansion phase, a common backstop should be implemented. This support will subsequently be distributed to all the banks using ex-post contributions (Council of the European Union, 2013d).

## HARMONISED DEPOSIT GUARANTEE SCHEMES

As part of the discussion on the third pillar of the Banking Union, a common deposit guarantee scheme was discussed at length. Resolution and deposit protection are closely linked. As such, in the U.S. they have been integrated into one public agency, the Federal Deposit Insurance Corporation (FDIC). In the EU, the fact that such a common deposit guarantee scheme automatically leads to a collectivisation of bank losses was particularly controversial. Instead, the final compromise now envisages common standards for national deposit guarantee schemes. In order to understand the objections to a common deposit guarantee scheme, it is necessary to look at deposit protection in Germany, which is based on the German banking sectors' three pillar model, taking into account its different business models and risk structures.

### The Quality of National Deposit Guarantee Schemes

#### ***Reasons for Deposit Protection***

Creditor protection in the event of a bank failure is advised because small depositors do not really have the ability to assess their bank's financial risks. Creditor protection can only be achieved if banking supervision is supplemented by deposit protection (Deutsche Bundesbank, 1992). In addition to social and economic reasons, protection of bank creditors may, however, also be necessary for regulatory reasons. The banking system is vulnerable to so-called bank runs that can even cause difficulties for healthy institutions due to depositors' self-fulfilling expectations (Diamond/Dybvig, 1986).

Banks' vulnerability to runs stems from the fact that banks provide their customers with the option of holding overnight deposits (Diamond/Dybvig, 1986). Normally, it is unlikely that all the deposits will be withdrawn within the space of one day, rather only a certain percentage of deposits will be withdrawn for transactional purposes. The percentage of deposits not normally withdrawn every day is placed in less liquid, but higher-yielding assets by the banks. The bank earns a profit from the difference between the higher return on their less liquid assets and the interest payments on the overnight deposits.

However, it may be the case that unfavourable rumours develop regarding a bank's financial position, leading customers to fear for their deposits and want to withdraw them (Diamond/Dybvig, 1986). Since the bank has invested a portion of the deposits in illiquid assets, every customer must then be concerned that they may not necessarily have immediate access to their deposits. It is then rational for every customer to withdraw their deposits as quickly as possible so as not to be left empty-handed. If customers abruptly withdraw their deposits because of these concerns, the bank is forced to liquidate their long-term investments with a potential loss in order to be able to meet the demand of their customers. In the event that the bank is unable to liquidate any assets in such a short time and is unable to borrow any funds from other banks, it is threatened with insolvency (Diamond/Dybvig, 1986). If the bank's insolvency leads to losses at other banks, this may lead to a crisis of confidence and a massive withdrawal of deposits from the banking system, which brings with it the threat of a systemic crisis.

***Creditor protection in the event of a bank failure is advised because small depositors do not really have the ability to assess their bank's financial risks.***

Diamond/Dybvig (1986) demonstrate that a deposit protection fund may be able to stabilise such a situation. If every depositor can be confident that his deposits will be reimbursed in the event of the bank's insolvency through the deposit protection fund, there will no longer be any incentive to abruptly withdraw deposits. This prevents a bank run and contributes to the stabilisation of the banking system. However, the deposit protection fund can only build trust if its volume is sufficiently large. This requires additional guarantees to be able to reimburse all depositors in the event of a systemic crisis. For this reason, German Chancellor Angela Merkel and then Finance Minister Peer Steinbrück guaranteed the security of German investors' deposits after the collapse of the Lehman Brothers investment bank (Schrörs, 2008).

### ***Deposit Protection in Germany***

In the 1930s, the cooperative banks were the first banking group to establish aid and guarantee funds for affiliated institutions facing financial difficulties. The first national community fund for private banks followed in 1966, and in 1969, the Deutscher Sparkassen- und Giroverband's (DSGV) savings bank guarantee fund was established. After the closure of the I.D. Herstatt KGaA bank in 1974, private banks responded with comprehensive deposit protection (German Bundesbank, 1992).

**Table 21: Structure of Deposit Guarantee Schemes in Germany**

	<b>COOPERATIVE BANKS</b>	<b>PUBLIC SECTOR BANKS</b>	<b>PRIVATE BANKS</b>
Legally mandated deposit guarantee schemes	Released because of the institutional guarantee scheme from the statutory deposit guarantee	The Association of German Public Banks' compensation scheme <ul style="list-style-type: none"> <li>■ Ex-ante and possibly ex-post contributions by member institutions</li> <li>■ Up to 100,000 euros per creditor and per bank are compensated</li> </ul>	Entschädigungseinrichtung deutscher Banken GmbH (EdB) <ul style="list-style-type: none"> <li>■ Ex-ante and possibly ex-post contributions by member institutions</li> <li>■ Up to 100,000 euros per creditor and per bank are compensated</li> </ul>
Institutional guarantee schemes	Federal Association of German Cooperative Banks (BVR) guarantee mechanism <ul style="list-style-type: none"> <li>■ Guarantee network secures deposits indirectly through insolvency protection of member institutions</li> <li>■ Conditional joint risk monitoring, early intervention, restructuring of affected institutions</li> <li>■ Practically unlimited guarantee of deposits</li> </ul>	German Savings Banks Association's (DSGV) loss-sharing agreement <ul style="list-style-type: none"> <li>■ Loss-sharing agreement secures deposits indirectly through insolvency protection of member institutions</li> <li>■ Eleven regional savings bank guarantee funds, guarantee reserves of regional banks and clearing houses, guarantee funds of regional building societies</li> <li>■ Joint risk monitoring and early intervention</li> <li>■ Practically unlimited guarantee of deposits</li> </ul>	None, because private banks compete with each other
Voluntary deposit guarantee schemes	None, because all deposits are indirectly guaranteed through the institutional guarantee system	Deposit guarantee fund of the Association of German Public Banks <ul style="list-style-type: none"> <li>■ 13 members</li> <li>■ Discretionary voluntary benefit</li> </ul>	Deposit guarantee fund of the Association of German Banks <ul style="list-style-type: none"> <li>■ 170 members</li> <li>■ Discretionary voluntary benefit</li> </ul>

Source: according to Greve (2013), Federal Association of German Cooperative Banks (BVR), Association of German Public Banks, German Savings Banks Association (DSGV), Association of German Banks.

The deposit guarantee structure in Germany is based on the German banking sector's three-pillar system (Greve, 2013). Private banks, cooperative banks and public banks are affiliated with different deposit guarantee schemes. Statutory and voluntary deposit guarantee schemes, as well as institutional guarantee schemes all exist in parallel.

Private banks and public banks must be affiliated with a statutory deposit guarantee system. The cooperative and savings banks are excluded from this obligation. Both of these kinds of banks guarantee their customers' deposits indirectly through their institutional guarantee schemes that ensure the solvency of each member institution. These institutional guarantee schemes include the BVR's guarantee mechanism and the DSGV's loss-sharing agreement. The institutional guarantee schemes consist of joint supervision of member institutions, a restructuring framework and a common loss-sharing agreement. Typical restructuring measures include the injection of equity capital or granting guarantees and warranties (Greve, 2013). Restrictions counteract a moral hazard by individual institutions with respect to the loss-sharing agreement. Thus, an institution in distress must often anticipate a merger with another institution (Greve, 2013).

With the exception of savings banks, private banks and public banks do not have any such institutional guarantee schemes at their disposal because these banks compete with one another, excluding any mutual liability. These banks are required to join a statutory deposit guarantee scheme. These include the EdB and the compensation scheme through the Association of German Public Banks. Both systems are financed through ex-ante contributions from affiliated banks, which are supplemented by ex-post contributions in cases of heavy strain on the funds. In both systems, the contributions made by each customer are guaranteed up to a limit of 100,000 euros. In addition to the statutory deposit guarantee, there is the Association of German Public Banks' voluntary deposit guarantee fund and the Association of German Banks' voluntary deposit guarantee fund. Both funds pay compensation for deposits of more than 100,000 euros on a voluntary basis. Customers have no legal right to compensation because the fund only provides guarantees with its own volume and does not borrow beyond this.

*Both kinds of banks, private and public as well as cooperative and savings banks, guarantee their customers' deposits indirectly through their institutional guarantee schemes that ensure the solvency of each member.*

### **Deposit Protection in Other EU Countries**

A 2008 report on the effectiveness of the EU deposit guarantee schemes (DGSs) concluded that deposit guarantee schemes significantly vary among individual Member States (COM, 2008). At that point, an average of 90 per cent of deposits but only 70 per cent of depositors had been reimbursed within the three-month deadline that was valid at the time. The national deposit guarantee funds reported that the availability of data, funds and personnel were responsible for the time it took for reimbursement. Furthermore, national deposit guarantee schemes vary in terms of compensation for depositors, as well as in terms of the possibility of early intervention measures (COM, 2008). The report's findings are crucial, namely that many national deposit guarantee schemes are only able to endure the insolvency of small banks, but not a crisis of systemic proportions.

Another problem with the different national schemes became apparent in the autumn of 2008, when the financial crisis intensified and depositors transferred their money from countries with a deposit guarantee scheme with a lower coverage amount to



countries with higher protection for depositors. The coverage levels in Member States vary between 50,000 and 103,291 euros in Italy to an unlimited amount of coverage in other Member States (COM, 2010a). A sudden deposit withdrawal from a country's banking sector due to lower local depositor protection may lead to a bank run on this country's banks and thus to capital flight.

The current minimum guarantee was originally laid down in Directive 94/19/EC and at that time amounted to 20,000 euros, although Member States could also set higher amounts of coverage. This was increased to 100,000 euros on 31 December 2010. Moreover, the existing reimbursement deadline of three months, which could be extended to nine months, was shortened to 20 working days (EU, 2009).

In addition, the Commission sought to establish an EU-wide deposit guarantee scheme (COM, 2010a). To that end, they proposed three models:

- replacing national deposit guarantee schemes with a single European deposit guarantee scheme;
- an additional 28<sup>th</sup> scheme that would supplement the 27 schemes of the Member States; and
- a network of existing systems in which national deposit guarantee funds could award lines of credit to each other.

Common deposit protection potentially poses the risk of collectivising losses but has the advantage of a high degree of financial power in cases of systemic banking crises. However, there is the risk of moral hazard since higher individual risks may be taken because of the group guarantee. To avoid this, the deposit guarantee must be coupled with a resolution authority, as is the case with the U.S.'s FDIC. This combination of insurance, supervision and sanctions also follows the German institutional guarantee system.

A possible moral hazard can be better controlled with the other two deposit protection alternatives mentioned above because there is a limited possibility of collectivisation. However, this, in turn, entails the risk that a poorly equipped national deposit insurance fund will be insufficient in the case of a systemic crisis and this will lead to a flight of capital to a country with a better system.

Elliot (2012) emphasises that common standards for deposit protection are absolutely mandatory in a banking union. Only then could a common deposit guarantee scheme be dispensed with. Pisany-Ferry/Wolff (2012) also argue in favour of maintaining national deposit guarantee schemes. In their opinion, these only constitute insurance against the failure of small banks and are not designed for the systemic crises. In the case of a systemic crisis, the ESM would take on the role of deposit insurer instead.

*Common deposit protection potentially poses the risk of collectivising losses but has the advantage of a high degree of financial power in cases of systemic banking crises.*

## Oversight of Private Institutional Guarantee Schemes

The European Commission was already trying to harmonise deposit protection in 2010 (COM, 2010a, 2010b). Common deposit protection was long discussed as the third pillar of the Banking Union, but was then substituted with a compromise on common standards for deposit protection. The Commission has pursued the following objectives with maximum harmonisation:

- partial deposit protection
- increasing depositor confidence
- integration of a European internal market
- fair competitive conditions between EU banks
- unobstructed business activities of EU banks

European deposit protection should include the following elements, among others:

- coverage of deposits up to 100,000 euros
- coverage of deposits by non-financial companies
- payout within seven days
- restricting the use of funds for bank resolution purposes
- mutual borrowing among deposit guarantee schemes

The SRM proposal also regulates deposit protection (Council of the EU, 2013c, 17 ff.) According to this, national deposit guarantee schemes should bear the costs of a bank resolution to the extent that deposits are protected. Moreover, the institutional guarantee schemes in the financial group consisting of cooperative banks, Raiffeisen banks and savings banks are considered private solutions in which the SRM does not necessarily intervene. According to the SRM proposal, it would only do so if there were a possibility of system-wide contagion and if an institutional guarantee scheme would not sufficiently prevent this.

From an economic regulatory perspective, the characteristics of institutional guarantee schemes should also be echoed within the European Banking Union. Cooperative banks, Raiffeisen banks and savings banks are labelled as small, economically independent local banks whose main role lies in local lending. Thus, both groups of banks are featured in the network. In this particular form of organisation, elements of centralisation, the franchise system and the strategic alliance of legally independent banks are combined (Hartmann-Wendels/Jäger-Ambrozewic, 2010). The network has the following advantages that are inextricably linked to institutional protection (Hartmann-Wendels/Jäger-Ambrozewic, 2010):

- the establishment of trust because small member institutions are considered protected parts of the network;
- the guarantee mechanism indicates actionability through prevention and restructuring instruments and thus the possibility of overcoming economic problems;
- the loss-sharing agreement creates incentives for internal regulation; and
- the loss-sharing agreement compensates for the advantage of large banks by being “too big to fail”.

The maximum degree of harmonisation of deposit protection would jeopardise institutional security systems. Restricting the use of funds would result in significant problems because institutional guarantee schemes use these funds to restructure affected banks so that no claim for compensation for the depositor occurs in the first place. The goal of restructuring is so that the bank is able to continue doing business after receiving aid (Hartmann-Wendels/Jäger-Ambrozcewic, 2010). However, with the maximum degree of harmonisation, the funds would primarily be spent on reimbursing depositors. In addition, maximum harmonisation would violate the principle of subsidiarity, according to which every problem should be solved at the lowest possible level (Hartmann-Wendels/Jäger-Ambrozcewic, 2010).

Furthermore, institutional guarantee schemes do not constitute distortions of competition, as depicted in the Commission's proposal, rather they are the hallmark of a safe product (Hartmann-Wendels/Jäger-Ambrozcewic, 2010). The Commission's fear that depositors will choose banks with deposit guarantee schemes with the highest amount of coverage cannot be fully shared. Customers who want a highly secure bank for their deposits will opt for a bank with a low-risk business model and sufficient deposit protection (Hartmann-Wendels/Jäger-Ambrozcewic, 2010). Banks with institutional guarantee schemes therefore interest these customer groups because they protect customers' deposits in virtually unlimited amounts. The monitoring and restructuring mechanisms associated with institutional guarantee schemes countervail risky behaviour of individual banks. It acts as a conditional protection, or protection with conditions attached. Maximum harmonisation would counteract competition for the safest deposit contract, therefore hurting the customer (Hartmann-Wendels/Jäger-Ambrozcewic, 2010).

*What does make sense from a public policy standpoint is the harmonisation of the minimum standards in each country.*

What does make sense from a public policy standpoint is the harmonisation of the minimum standards in each country. By doing so, the risk that customers will transfer their deposits to the country with the highest deposit protection is reduced. At the same time, however, a scenario in which a national deposit guarantee fund is insufficient due to its low volume and must then fall back on Community funds in cases of bank resolutions is prevented. With differing minimum standards and the option of using Community funds, an incentive would be created for individual countries to set a low level of coverage for their deposit protection funds.

### **The Role of Deposit Protection in Cases of Creditor Participation**

Under the Commission's proposal, both large, system-relevant banks and smaller deposit banks and promotional lending institutions must provide so-called bail-in-eligible bonds. This is debt that can be used for creditor participation. Small banks that mainly take in customer deposits and have barely issued any bonds in the past would then have to organise this additional borrowed capital by issuing bonds. This even includes banks that are affiliated with an institutional guarantee scheme. However, it is possible that this will not result in the use of bail-ins at all under such a scheme. In this case, a banking group with an institutional guarantee scheme would be penalised if they provided bail-in-eligible bonds. Bail-in-eligible bonds must be subject to a higher interest rate in order to be desirable in the marketplace. However, the idea of the bail-in is to reduce distortions of competition by being too big to fail and not to counteract the legitimate competitive advantages offered by institutional protection.

Another problem then arises if the supervision pre-empts a bail-in even before the institutional guarantee schemes have completed their restructuring measures. The resolution instruments in the BRRD should allow for the resolution of large, system-relevant banks and are not meant to reduce the effectiveness of private sector restructuring frameworks. The combination of new resolution instruments and established protection mechanisms places high demands on the communication and coordination between banks and financial supervisory authorities. In any case, it would be better to have clear rules that stipulate that a bail-in would only occur if institutional protection has already failed with its restructuring measures.

The fact that depositors place last in the chain of creditor liability does not mean that the deposit guarantee fund is actually ultimately liable in cases of SRM intervention. In the event that the SRM's Resolution Board does not execute the liquidation of a bank because of systemic risks, but rather stabilises the bank through other means, national deposit guarantee schemes must contribute the amount of hypothetical losses resulting from the liquidation of the bank (SVR; 2013, paragraph 420).

# What the Banking Union Is Still Lacking

A European banking union will have some advantages over the previous system of purely national financial supervisory authorities because it will allow for the supervision and resolution of large and system-relevant banks. In doing so, the Banking Union will close supervisory and regulatory gaps and prevent the possibility of supervisory and regulatory arbitrage. However, with regard to its potential for easing the risk shared by banks and states and for reducing distortions of competition through system relevance, the Banking Union needs to be further supplemented. In addition, the problem of inherited liabilities in banks' balance sheets should be resolved prior to the start of the Banking Union.

## BANK CAPITAL REQUIREMENTS FOR GOVERNMENT BONDS

Banks and states are closely linked, since banks are typically heavily engaged in domestic government bonds. This is promoted in the Capital Requirements Directive (CRD) by a lack of capital requirements for government bonds in the eurozone. The regulatory capital ratio is measured as the ratio of core capital to risk-weighted assets. Thus, riskier assets receive a higher risk weight than less risky assets. This rule should bring about that riskier transactions will have to be deposited with more liable capital than less risky transactions. In a simple example, a bank holds government bonds worth 100 million euros with an assigned risk weight of zero, an asset class worth 50 million euros with an assigned risk weight of 0.2, and a risky asset class worth 30 million euros with an assigned risk weight of 1.5. The bank's risk-weighted assets would then amount to 55 million euros that would have to be backed by 4.4 million euros in equity capital in order to meet a capital ratio of 8 per cent. Should the bank increase its holdings of risky securities from 30 million euros to 300 million euros, it would now have to raise 36.8 million euros in equity capital in order to meet the capital ratio of 8 per cent. But if the bank increased its holdings of European government bonds from 100 million euros to 1 billion euros instead of investing in risky securities, it would not have to raise any additional equity capital in order to meet the capital ratio of 8 per cent. This means that banks can finance government bond exposure to 100 per cent by raising debt. In fact, the CRD essentially provides risk weights for the capital requirements for government bonds, as proposed in the Basel III banking regulations; but eurozone government bonds are exempted from this insofar as they are refinanced in euros (COM, 2011). Against the backdrop that the sovereign debt crisis in the euro area has demonstrated that these bonds are quite risky, it is difficult to maintain that this exemption is justified.

To ease the vicious cycle of banking crises and sovereign debt crises, the CRD should be amended as follows:

*Banks and states are closely linked, since banks are typically heavily engaged in domestic government bonds. This is promoted in the Capital Requirements Directive by a lack of capital requirements for government bonds in the eurozone.*

- The introduction of a risk-based capital requirement is necessary, including for European government bonds, to ensure that banks have enough capital to be able to absorb losses from a sovereign debt crisis. In addition, a risk-based capital requirement will reduce the incentive for banks to engage heavily in government bonds. For states, this regulation has the disadvantage that public financing will become more expensive.
- The vicious cycle of banking crises and sovereign debt crises is strengthened in that banks engage too heavily in domestic bonds instead of investing in an internationally diversified portfolio (Pockrandt/Radde, 2012). The regulatory framework should counteract this by promoting diversification in banks' investment decisions without imposing too much on them. This could be done by having banks with a poorly diversified bond portfolio invest more equity capital than those with a better diversified portfolio (Demary, 2013). This could be implemented using risk weights.
- The equity rules provide for a limit on large exposures. These may not exceed 25 per cent of eligible equity capital (COM, 2011). However, these limits will not apply to the Member States' sovereign debt (COM, 2011). This regulation promotes banks engaging too heavily in government bonds. Thus, a 25 per cent limit for government bond exposure should also apply, as Demary/Schuster (2013) have already argued.

#### **THE SOLUTION TO THE PROBLEM OF INHERITED LIABILITIES WITHOUT COLLECTIVISATION**

Prior to the start of their supervisory mandate, the ECB will undertake a rigorous examination (comprehensive assessment) of the banks they supervise (ECB, 2013). This will consist of three modules:

- a regulatory risk evaluation in which each bank's risk factors, such as their liquidity position, their debt and their financing methods, are assessed.
- an asset quality review in which, among other things, each bank's quality of internal data, appraisal of asset positions and classification of non-performing loans are reviewed.
- a subsequent stress test in which the ability of each bank to absorb shocks is examined under a stressful scenario.

In this assessment, banks' outstanding capital requirements are disclosed. These must be resolved quickly so the Banking Union can begin under favourable initial conditions and is not burdened by inherited liability issues from the last crisis.

So the Banking Union can begin under ideal circumstances, new capital requirements should ideally be implemented that sufficiently recapitalise banks and resolve all inherited liabilities from the last banking crisis. Since this is probably not feasible until the scheduled start of common banking supervision by the ECB in the autumn of 2014, a quarantine period for weakly capitalised banks should be introduced. During this quarantine period, these banks will be under special supervision by the SSM. These banks should submit restructuring plans to the ECB on the attainment of the desired capital stock, which must be approved by the ECB. If banks are unable to meet their restructuring plans, they must be resolved with the help of their national resolution funds (Demary, 2013).

### **CREDITOR PARTICIPATION WITH FEW EXCEPTIONS**

As long as financial market participants expect a possible bailout, they will not demand an interest rate on borrowed capital that is adequate for the bank's business risks. This encourages banks to take risks and leads to distortions of competition since banks can borrow too cheaply (Liikanen et al., 2012). However, a bail-in may lead to contagion effects for other banks if other banks are among the creditors of the bank to be resolved. The BRRD and the SRM proposal aim to solve this problem with discretionary supervisory leeway. They can exclude certain groups of creditors from bail-ins in the event of suspected contagion effects.

However, this discretionary supervisory leeway will make it difficult for creditors to determine the amount of interest on debt capital so that it adequately reflects the banks' business risks. As long as creditors can expect that a bail-in will not happen due to exemptions, they will factor this information into the interest on debt capital and will continue to require an interest rate that is unreasonable for business risk.

The Liikanen Commission's recommendation that a certain percentage of bail-in-eligible capital must be held outside the banking sector to avoid contagion effects for other banks in the event of possible bail-ins is rather convincing because it promotes market discipline (Liikanen et al., 2012). Creditors who lose their investments in the event of bank insolvency will factor the bank's risk of insolvency into the calculation of the interest rate they request from the bank. Thus, they should demand a higher interest rate as compensation from banks with a riskier business model than banks with a low-risk business model. These securities can only be considered risk appropriate by market participants if they are aware of the securities' possible cash flows. To this end, a precise definition of the trigger that initiates the bail-in is required. Ideally, this should be an amount that is observable on the market and is easily verifiable.

*As long as financial market participants expect a possible bailout, they will not demand an interest rate on borrowed capital that is adequate for the bank's business risks.*

## Conclusions and Recommendations

The introduction of the Banking Union is a correct and important step towards the completion of the Monetary Union, and should not be rushed. In view of the many open questions and regulatory gaps, as well as the unresolved issue of resolving legacy liabilities in banks' balance sheets, a common Resolution Fund should only be used when the problem of legacy liabilities has been solved to the greatest possible extent. The model favoured by the European ministers of finance – a fund comprised of national departments – provides for the existing problem of legacy liabilities. Ideally, a European scheme of resolution funds will be implemented in which, depending on their system relevance and their cross-border functions, banks will either pay into a European or relevant national fund, as Demary (2013) recommends. In addition to the closure of the open issues regarding the architecture of the Banking Union – including the continued lack of bank capital requirements for government bonds – banks must be adequately capitalised prior to the start of the Banking Union and must clean up their balance sheets. This Herculean task now comes down to the ECB. Although their bank balance assessments are exposing banks' capital gaps, the ECB and the EU must counteract an intensifying crisis following the disclosure of the test results by specifying instruments to close the capital gaps in advance. It is therefore important for the SRM's resolution instruments to become available now and not on 1 January 2015, as planned.

It is absolutely crucial to consider the Commission's right of final decision on the Resolution Board. Instead of looking at the whole of the internal market, its resolution authority would relate only to the eurozone countries. There is also the danger of conflicts of interest if the Commission is responsible for resolution and aid monitoring while simultaneously equating Resolution Fund money with state aid. A critical view must also be taken of the fact that the Commission will gain the authority to push states

to have to mobilise billions of euros in bank assistance in the event of a resolution. It would therefore be better to establish a new authority with the resolution mechanism and to abolish the treatment of funds from the Resolution Fund as equal to state aid. However, to do so, an amendment to the EU treaties will be necessary.

Placing banking supervision with the ECB runs the risk of conflicts of interest between its supervisory functions and its monetary stability mandate. However, Beck/Gros (2012) also see the risk that the ECB could gain too much influence without being held accountable to a parliament. In the long term, supervision should be outsourced to its own office. The best case would be cooperation between the SSM and the ECB along the lines of the Federal Financial Supervisory Authority (BaFin) and the Bundesbank in Germany. It is only this construct that will prevent the ECB from being taken to court in the SSM for potential supervisory errors, which would threaten their independence as a central bank. Furthermore, a new authority should be accountable to the European Parliament.



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