The New Financial Architecture

in the Eurozone

Franklin Allen | Elena Carletti | Joanna Gray

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In the 1980s and 1990s he held several positions in the Banca d'Italia, in the areas of international economics, econometric modelling and monetary policy. In 1995 he was appointed Director of the Monetary and Financial Sector of the Research Department. In 1998 he moved to the ECB as Head of the General Economic Research Division and Deputy Director General of Research. In that position he headed several Eurosystemwide research initiatives, including the Monetary Transmission Network and the Inflation Persistence Network. In 2005 he was appointed Director for International Financial Affairs in Italy's Ministry of Economy and Finance. In that role he also acted as G20 Finance Deputy; Deputy Governor for Italy in the World Bank, the European Bank for Reconstruction and Development, the Asian Development Bank and the African Development Bank; President and chairman of the Board of SACE SpA. (Italy's state-owned export-credit insurance company); member of the Board of Directors of the European Investment Bank; member of the Supervisory Board of MTS SpA (the screen-based bond market); member of the Working Party 3 of OECD; member of the Bellagio group. In 2008 he moved back to the ECB as Advisor to the Executive Board, then Director General for Macro-Prudential Policy and Financial Stability. In this position he coordinated the ECB negotiation and preparation for the banking union. In March 2014 he joined the Supervisory Board of the ECB. A Fellow of Bruegel (the Brussels think-tank), in his career Ignazio held teaching positions at the University of Pennsylvania, Bocconi and LUISS (Rome). He published books and articles published in top US and European academic refereed journals. Ignazio and his wife Ester Faia have four children: Ferdinando, Vittoria, Sebastiano and Giorgia.

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Christos Hadjiemmanuil, born in Athens, Greece (1964), is a university professor and a lawyer (member of the Athens Bar, admitted in 1989). He serves as advisor to the Governor of the Bank of Greece (2014–present). A graduate of the University of Athens School of Law (LL.B., 1987), he obtained an LL.M. in International Business Law (University

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Preface

The European University Institute (EUI) and the Brevan Howard Centre at Imperial College London organised a conference entitled "The New Financial Architecture in the Eurozone" at the EUI in Florence, Italy, on 23 April 2015. The conference brought together leading economists, lawyers, historians and policy makers to discuss various aspects of the performance so far, as well as the prospects for the future shape, of the financial architecture for regulation and supervision of finance within the Eurozone established in the wake of the financial crisis.

The Director of the Robert Schuman Centre for Advanced Studies at the EUI, Professor **Brigid Laffan**, opened the event, which consisted of three panels, a keynote speech and a dinner speech. The first panel, chaired by **Elena Carletti** (EUI), posed the question "Is the Banking Union as Stable and Resilient as it Looks?" **Mario Nava** from the European Commission opened the discussion talking about the achievements of the Banking Union so far. **Christos Hadjiemmanuil** (University of Piraeus and London School of Economics) continued the session with a consideration and critique of the legal instruments underpinning financial stability and integration in the Banking Union. He was followed by **Sascha Steffen** (European School of Management and Technology), who presented an analysis of data from 41 publicly listed banks used to gauge the current strength of European banking. **Natacha Valla** (French Research Center in International Economics) concluded the discussion focussing on the issue of the Banking Union's failure to deal with the issues of defeasance structures and State guarantees.

In his keynote address to the conference, **Ignazio Angeloni**, Member of the Supervisory Board of the Single Supervisory Mechanism, considered the nature of "supervision" and distinguished it from its near relation "regulation". He made reference to the seminal work of the late Tommaso Padoa-Schioppa to highlight the peculiar nature of the role of all banking supervisors wherever they may be and encouraged a stronger dialogue between academics and supervisors.

The speakers participating in the second panel, chaired by **Franklin Allen** (Brevan Howard Centre, Imperial College London and Wharton School, University of Pennsylvania) took the need for a European Capital Market as its theme. **Thorsten Beck** (Cass Business School) asked whether the case for a European Capital Market was made out and, if so, how best should it be achieved? **Giovanni Dell'Ariccia** (IMF and CEPR) explored the barriers to market efficiency in the existing fragmented capital markets within Europe. **Mitu Gulati** (Duke University) then presented an evaluation of the Eurozone experiment with Collective Action Clauses since 2013 and **Pierre Schammo** (Durham University Law School) addressed the question of the need for a Capital Market Union from the perspective of SMEs.

The final panel, chaired by **Joanna Gray** (Birmingham University) considered the more general theme of the implications of the deepening integration within the Banking Union for the relationship between the European Union and the Eurozone. **Simon Gleeson** (Clifford Chance) opened the discussion by declaring the improbability of BREXIT and pointed out that there was already in existence a single European Capital Market in the form of the City of London. **Carmelo Salleo** (ECB) explored the points of tension around financial stability and macroprudential policies between the single market and the Eurozone. **Kasper Roszbach** (Riksbank) followed with a perspective on the Banking Union from those countries that have decided to remain outside of the SSM. Finally **Harold James** ended the day's formal proceedings with a historical perspective on the question of the relationship between the EU and the Eurozone. A question made all the more acute by the prospect (now a certainty) of a referendum in the UK on EU membership.

An entertaining but thought provoking after-dinner speech was given by **Richard Portes** (London Business School and EUI) in which he touched on many of the issues considered during the day and posed the challenges that lie ahead for Europe, its markets, its leaders and its people. His speech was largely motivated by the ESRB report on "The Regulatory Treatment of Sovereign Exposure" available at https://www.esrb.europa.eu/pub/pdf/other/esrbreportregulatorytreatmentsovereign-exposures032015.en.pdf?4d3d71b889b28a86d63216003ad0cdd0.

The conference follows a 2014 conference entitled “Bearing the Losses from Bank and Sovereign Default in the Eurozone”, a 2013 conference “Political, Fiscal and Banking Union in the Eurozone”, a 2012 conference, “Governance for the Eurozone: Integration or Disintegration” and that of 2011, “Life in the Eurozone With or Without Sovereign Default.” As with all four of those previous conferences, the debate after each panel and guest speakers was lively and thoughtful. We prefer not to take a stance here on any of the issues but simply present all the papers presented and let the reader draw his or her own conclusions.

Executive Summary

Pierre Schlosser

Highlights

The logic, features and future shape of the new financial architecture of the Eurozone were discussed under Chatham House Rules on the occasion of a high-level conference hosted in Florence on 23 April 2015, by the European University Institute in cooperation with Imperial College London. The conference was attended by central bankers, EU policy-makers, members of the financial industry as well as by academics. The following key conclusions came out from the discussion:

1. Despite its incomplete nature, the Banking Union represents a great achievement in terms of financial stability control, thus ensuring a more resilient euro area.
2. By contrast, the exact objective, scope and institutional capabilities of the Capital Markets Union remain a puzzle to many participants.
3. Risks of regulatory fragmentation arising between the European Union and the Euro Area are somewhat exaggerated, it was overall felt. The existence of European platforms such as the European System of Financial Supervision (ESFS) acts as a safeguard to the integrity of the single market.

Background

Meeting in June 2012, at the height of the euro crisis, European heads of state and government established a “Banking Union” with a view to breaking the deadly embrace between sovereigns and their home-grown banks. Following this policy commitment, two major mechanisms came into life to provide a sounder institutional framework for the euro area's banking system. The Single Supervisory Mechanism (SSM), adopted in December 2012 and located within the European Central Bank (ECB), strives to improve the supervision of Euro-area banks by centralizing it at a supranational level. The Single Resolution Mechanism (SRM), which followed one year later, foresees the constitution of a privately financed resolution fund of € 55 bn to address insolvent banks. Other elements complement the overall concept, although they remain to be adopted (i.e. a European Deposit Guarantee Scheme and a fiscal backstop) or fully enforced (i.e. the Single Rulebook).

In the meantime, the entry into office of the Juncker Commission in September 2014 coincided with a new priority: establishing a European Capital Markets Union. A Green Paper was hence published on this topic by the Commission on 18 February 2015 and it stirred a debate on the key regulatory barriers impeding such a Union. The creation of both a Banking Union and a Capital Markets Union occurs against the backdrop of a hectic reform activity of the European Union institutions in banking and finance regulation. Over the past 5 years, 41 new directives and regulations have been adopted to strengthen and reinforce Europe's banking and financial markets regulation. This caused uproar in several Member States, including in the United Kingdom, which heavily relies on the City for its prosperity. As a result, the UK has become increasingly defiant about integration steps taken at euro area level, leading some analysts to consider it as a possible argument in favour of a British exit from the EU (also called "Brexit").

1. Is the Banking Union stable and resilient as it looks?

The first conference session revolved around the intricacies and challenges left open by the recently established Banking Union (BU). While some attendees contested the idea that Europe can praise itself to have a genuine Banking Union, the overall mood in the audience was that with the advent of the SSM and of the SRM substantial progress was made in terms of centralized supervisory and resolution capabilities. In contrast to earlier timid and slow attempts to promote further harmonization steps in this domain (like the Segré Report or the De Larosière Report), the Banking Union materialized literally over a matter of weeks. Its advent coincided with an intellectual shift from bail-out towards bail-in considerations.

There was however also broad agreement, despite the advances made, on the incomplete and at times complex nature of the BU and of its chaotic governance. The BU's announcement, one participant claimed, was much more effective in quelling turbulences than its actual implementation.

Participants proved to be particularly convinced by the strength of the new supervisory capabilities of the SSM, backed by the credibility of the ECB. Nevertheless, the duplicity of roles between the ECB's monetary policy function and its banking supervision function remains a crucial challenge faced by the institution. So far however, Chinese Walls seem to be operational and conflicts of interests between the SSM's Supervisory Board and the ECB appear to be neutralized by the new governance framework. Participants agreed that it was too early to tell whether the current governance is optimal as it was recognised that the Eurozone architecture is still in the process of being built-up and is likely to take more than a decade to reach its maturity. Criticism was stronger on the Single Resolution Mechanism whose firepower remains too limited to make a key contribution towards financial stability. Touching on the borders of the current Banking Union, one participant complained about the fact that state guarantees of banks seems so far to be a non-issue although nothing seems to prevent the ECB to exclude those assets from being eligible as collateral for ECB credit provision. Another attendee explained that absent a European Deposit Guarantee Scheme, European savers would continue to face a fragmented system of Deposit Guarantee Scheme with varying values throughout Europe. Lastly, against the background of the coordination role it performed during the phase of national bail-outs, the role and scope of EU competition policy in the future banking union was questioned.

Overall, some reassuring signals came from a *tour d'horizon* of the European banking sector whose fundamental health is sounder than a few years back. There has been considerable deleveraging, a substantial shift in the liability structure (from wholesale funding to deposit funding) and capitalization has improved markedly. Several participants even claimed that the European banking sector is now over-capitalized compared to its profitability. However, there remain challenges in assessing risky assets and as a result in determining the adequate risk weights. Similarly, there is no clear evidence that the loop between sovereigns and banks has been reduced. Lastly, the proclaimed single rule book is not 100% unified nor is it fully implemented. There are thus challenges left open on the Banking Union side.

Public keynote lecture: Rethinking Banking Supervision from an SSM perspective
Ignazio Angeloni, Member of the Supervisory Board of the Single Supervisory Mechanism, addressed the audience in a public keynote. He highlighted the peculiar nature of banking supervisors' role in an intellectual dialogue with the seminal works performed by late Tommaso Padoa-Schioppa. Mr Angeloni encouraged a stronger dialogue between academics and supervisors.

2. Is a Capital Markets Union needed?

The second session dealt with the Capital Markets Union (CMU). The CMU's declared objective is to pursue deeper capital markets and enhance their integration to diversify sources of funding and provide an alternative to banks. Compared to the US, whose financing model relies more on financial markets – not to mention the 100% equity model of the Silicon Valley – Europe is characterised by a twin focus on bank financing and on debt financing (as opposed to market-based & equity financing). As one participant put it, both bank-based and market-based systems should however complement each other to fit the varying risk appetite of the demand side. In this spirit, the audience seemed to agree that efforts towards a Banking Union and towards a CMU should go hand in hand.

However, participants were puzzled by the exact meaning and regulatory implications of a CMU. Despite the merits of the recent Green Paper, its scope and precise building blocks are not yet clearly delineated. As such CMU risks falling short of expectations. This has led some to believe that, at best, it is in line with earlier reform mapping attempts like the Financial Services Action Plans or the Giovaninni Reports or, at worse, that it remains a mere PR exercise. Consensus gathered on the idea that the emergence of a genuine CMU in Europe is impeded by political, fiscal and most importantly legal factors. A key challenge lies with the co-existence of several national legal systems with their distinctive culture and logic; the persistence of which is likely to hamper the convergence of capital markets regulation principles and practices. Insolvency law is a case in point. The argument was illustrated by the varying stringency of Collective Action Clauses (CACs) in Northern and Southern Europe as most recent CACs have been quite oddly written under local law. Lastly, delegates felt that the CMU will not improve SME's market access as the latter are structurally attracted by bank financing because of their limited funding needs and information access.

In contrast to the banking union – which resolutely entailed the centralization of powers in the hands of a supranational supervisor – the CMU appears, in its current form, as a legally focussed endeavour to remove barriers to cross-border trade. Yet, one participant argued that the CMU would end up sooner or later with a genuine and centralized CMU supervisor. Another delegate insisted that in the future the discussion would revolve around the mandate and scope for action of a 'prudential markets' supervisor and of its interaction with the banking supervisor. This will prove difficult as the two areas have different supervision logics: one focuses on actors (banks) while the other deals with activities (financial markets). On the other extreme of the spectrum, some participants questioned whether one would really need a European capital markets union in the first place. Diversifying the funding of Europe's economies could also be achieved within the realm of national markets.

3. Single Market vs. Eurozone

The last session dealt with the inconsistencies and possible tension stemming from the existence of a dual EU-Euro Area regulatory system. The first point of possible friction would lie with the narrow focus of the BU's SSM on the euro area. One participant explained that there are nine EU countries which are not part of the SSM. Yet, those nine countries host six out of the EU's fifteen systemically important banks. Those six banks have subsidiaries in the euro area. He thus asked whether it was so unreasonable to expect regulatory inconsistencies between the euro area and the other EU countries. Several speakers pointed, however, to the existing bridges between single market institutions and the banking union, outlining the latter's openness to new participants. Asked whether non-SSM countries were likely to join in the future, one participant explained that the SSM is leaned very strongly on the ECB, which means that the ultimate decision-making powers of non-euro area members would be structurally weaker than Euro Area members if they decided to join (making this more unlikely). The existence of the European System of Financial Stability (ESFS) was greeted as a safeguard to prevent regulatory fragmentation. Yet, in addition, joint-stress tests across EU jurisdictions could be promoted to avoid blind spots and the reinforcement of the European Systemic Risk Board could be contemplated (e.g. through the creation of a permanent head); the ESRB is indeed the only EU-wide macro-prudential institution.

Participants then considered the implications of the adopted capital requirements regulations for both Euro Area and non-Euro Area economies in view of possible divergences within the EU. While much of the immediate 'fixing' was done in the Euro Area, the EU level is however the level where the new Basel III requirements were transposed into law - through the Capital Requirements Directive IV and Capital Requirements Regulation. The aim was to increase the harmonization of prudential policies to avoid the build-up of financial instability risks (e.g. pro-cyclicality, too big too fail phenomena, contagion and fire-sale risks). As part of this development, the varying attitude towards capital requirements among Euro Area and non-Euro area countries (and before and after the crisis) was pointed out by a participant. Before the crisis, all EU Member States experienced a race to the bottom in the apparent belief that markets were self-regulating. After the crisis, the trend in some non-euro area countries seems to be opposite, i.e. one marked by 'gold-plating' capital requirements, doing more than necessary.

Another dividing line is the differing approach towards fiscal policy. As a speaker highlighted, outside of the euro area, policy makers can coordinate effectively fiscal, monetary and prudential policies, while in the SSM world fiscal policies remain at the national level and are difficult to coordinate among themselves, let alone with the other policies. With the Six Pack, the fiscal interdependence (mostly) among euro area members has been recognised. Greater cooperation has been achieved, in particular against the background of financial stability spill-overs. By contrast, this awareness is not yet so developed among all EU countries. However, the mood was not alarmist about the fragmentation risk that the progressive deepening of the Euro Area would pose to countries remaining outside of the euro area. The argument was advanced that any regulatory effort performed at the level of the euro area would in any case amount to a *de facto* European harmonization. The point was thus made that one should stop treating the euro area as a single large Member State. In the absence of credible scenarios of Grexit and Brexit, antagonizing the EU and the Euro Area would thus constitute nothing more than an irrelevant distraction.

Opening Remarks by Brigid Laffan

It was my great pleasure to welcome a distinguished audience of scholars and practitioners to the Robert Schuman Centre for Advanced Studies for this important conference on **The New Financial Architecture in the Eurozone**. I congratulate the co-organisers Professors Elena Carletti, Joanna Gray and Franklin Allen for their initiative in putting together such an impressive programme on this very important topic. The Schuman Centre is committed to research and debate on all aspects of the Eurozone given the nature and depth of the crisis that faced the young currency from autumn 2009 onwards. Moreover, the EUI has taken the decision, as part of its European vocation, to launch a **School of Banking and Finance** in autumn 2015. The School will engage in research, policy dialogue and executive training in this crucial field.

Banking Union, together with the European Stability Mechanism, have so far been the major responses to the crisis in terms of building institutions and policy instruments to ensure that the Eurozone is better prepared for future challenges. The salience of Banking Union is not surprising because the depth of financial integration and the interdependencies that this created proved to be the Achilles heel of the single currency. Although the architects of the Euro were fully aware of its limitations and understood that further integration would be necessary in the longer term, remarkably little concern was expressed at the creation of a single currency without centralised supervision of financial institutions. The dangers of that toxic link between sovereigns and banks, which was acknowledged by the European Council in June 2012, lent urgency to the quest for a centralised supervisory mechanism in the Eurozone. The pressure was also driven by the importance of banks for funding and liquidity in the real economy in Europe.

In normal times, the EU would only engage in deep institution building like this over a protracted time frame. Essentially there has been a major federalisation or Europeanization of power in the sphere of banking and finance. Many analysts and scholars have concluded that the Banking Union as presently constructed is incomplete, a partial banking union. There is much debate about the strength of the backstop and its ability to deal with a major crisis. The Banking Union has a set of infant institutions- still finding their feet, understanding their role and settling into a complex institutional environment within the European Central Bank (ECB), and with other institutions at the EU and national levels. The system is being built on the credibility of the ECB, a relatively young institution but one that proved its presence and power. How will Banking Union operate? How will it be tested and by whom? All we can say with any certainty is that it will be tested in the years ahead.

Let me again thank the conference organisers for their initiative and our distinguished guests who joined us at the European University Institute for what was a lively discussion on a new and important development in European integration.

Brigid Laffan Director Robert Schuman Centre for Advanced Studies

Rethinking Banking Supervision and the SSM Perspective

Speech by **Ignazio Angeloni** | Member of the Supervisory Board of the European Central Bank

Introduction: remembering TPS [1]

I am grateful to the organisers for inviting me to this conference, as it also gives me the opportunity to visit the European University Institute (EUI) one more time. Every return to the hills of Fiesole is pleasant and brings back memories. This time the memory is that of Tommaso Padoa-Schioppa: a long-time "friend of the EUI", as your website reads. Tommaso's association with EUI was a long one. In 1982 he met here Altiero Spinelli [2], whose professional and personal influence would become central to his life. After that, he came back regularly to lecture and give speeches; I am honoured to say that I joined him a few times. Following his untimely death in 2010, his personal archives were donated to the EUI and will be, in due course, available to scholars. Recently, the Institute has created a Chair named after him, which will help preserve his memory and continue his research.

15 years ago (in March 2000) Tommaso wrote an article that, though not being among his most cited ones, I always found remarkable. The title is "An institutional glossary of the Eurosystem". [3] The word "glossary" is an understatement, and refers to the dictionary-like form of the article. The ambition of the piece is no less than to review, for the newly created ECB, some of the foundations of central banking developed over 30 or more years of research and debates: things like central bank goals, independence, transparency, accountability, and so on. The semantic expedient is used to convey two implicit messages: first, that those notions

are not immutable but should be interpreted and applied according to the times and circumstances; second, that the euro and the ECB are such novel endeavours that in order to understand them one must, first and foremost, redefine the language.

This article came to my mind while we were preparing for the Single Supervisory Mechanism (SSM) and during its first year of activity. The crisis called into question many established wisdoms regarding financial policies: monetary policy strategies and operations, lending of last resort, banking regulation and supervision, crisis management, contagion control, state support to banking, and so on. The lessons are relevant especially for the euro area, which is, in fact, where the main institutional changes are taking place. As the dust settles, one feels the need for a systematic rethinking and redefinition of many of those common wisdoms that looked immutable to many of us until 2006. In the field of banking supervision, the SSM, newly created precisely to respond to some of those challenges, is ideally placed to put any new thinking into practice.

I do not plan to carry out a similar task in my intervention today. I lack the time, let alone the vision and the insight, to do for supervision what Tommaso did for monetary policy 15 years ago. I just want to offer some reflections triggered by our experience in starting the SSM, also in the light of the crisis and my earlier experiences in the ECB monetary policy function. The similarities and differences between the two policy areas are instructive. I will organise my arguments around a few main themes, starting with the scope of banking supervision, its goals or mission, then moving on to its independence, transparency and accountability, and concluding with the relation with its "host", the central bank.

Banking supervision: drawing the boundaries

Let's indulge, for once, in Tommaso's habit of starting a discussion on a topic by examining first the literal meaning of its name. The Webster online dictionary, under "supervision", refers to "watching and directing what someone does or how something is done". The Latin origin (super and visio) literally means "to view from above". The English terms "surveillance" and "oversight" are etymologically equivalent, though sometimes they acquire different meanings in economic policy practice. The German Aufsicht and the French supervision convey the same idea, while in the Italian vigilanza the etymology is lost.

What does "seeing from above" mean? I think it would be presumptuous to assume that those who exercise supervision are always "superior" to those being supervised, professionally, morally or in other senses. It doesn't hurt if they are, but we cannot count on this being always the case. The interpretation I favour is that, in order to watch and direct, the supervisor has to be in a position to observe the broader context in which the actions take place. It has recently become clear that this superior perspective is essential: it is impossible to gain a proper understanding of the "safety and soundness" of a bank, in any relevant case, if that picture does not include the links between that bank, other banks and the broader economic and financial environment. The banking system is nested in the broader global financial and economic system in a complex interconnected structure, with different layers. [4] Recently, for example, shadow banking is increasingly in focus, as are the potential risks from the insurance and pension funds sectors. The interconnection with banks should not be underestimated. Supervision focused only on the books and activities of individual banks is insufficient and potentially misleading. I will say something later on how the SSM tries to combine the micro- and macro-financial perspectives.

Observing supervisors at work, I have noticed a recurring tension in the way the limits between supervision and regulation are defined. In English, the term "banking regulation" encompasses both supervisory and regulatory functions, but in continental Europe we consider them distinct. Regulators (including lawmakers) are supposed to write the rules, while supervisors merely ensure they are observed. I have used this distinction myself at times, because it is easy to explain and to understand. But it is to some extent illusory, and there is a risk it may at times become a way to elude responsibilities. The line between the two functions has weakened further recently. Let's consider the European example. In 2011, three "supervisory agencies" were created; in fact, they are not supervisors – in the strict sense of monitoring compliance – but EU secondary regulators, tasked with ensuring that European laws are transposed into national law and applied consistently across all countries in the Union. In the area of banking, the European Banking Authority (EBA) does this by issuing implementation rules and technical standards that Member States (notably their supervisors and banks) are supposed to apply. Conversely, the EU supervisory authorities – meaning the SSM for 19 Member States and the respective national authorities for the remaining 9 – not only check compliance, but actively contribute to shaping the rules within the EBA's decision-making process.

More importantly, national and European banking laws and secondary regulations typically set minimum standards (for example, for capital and liquidity ratios), not specific levels that banks have to maintain. Nothing prevents banks from upholding standards above those minima, and supervisors in fact typically require sizeable additional margins as part of their so-called Pillar 2 evaluation and intervention process. The Pillar 2 process consists in examining all sources of risks to banks, in addition to those inherent in the determination of minimum solvency criteria; this includes other balance sheet features, like liquidity and maturity transformation, plus internal organisation, governance, controls, the sustainability of the bank's business model in different economic scenarios, and so on. The Pillar 2 process includes also macro-prudential elements, according to European legislation (CDRIV and CRR), though it rarely plays a central part. Supervisors typically incorporate all these elements in a framework (we can call it the "supervisory model") to ensure consistency. The framework is to some extent quantified, by means of scoring methods, and allows margins of subjective judgement. [5] The end result is the determination of prudential add-ons to the minimum capital requirements, as well as the identification of other actions that banks are asked to undertake, depending on individual conditions.

There is a general tendency for Pillar 2 processes to become more articulated, systematic and codified, hence more transparent and convergent towards international best practices. The ECB has developed a methodology for its own evaluation process, starting from the experience of its constituent national authorities, that will be applied this year for the first time to the banks it supervises directly.

An important warning should be made here. While supervision becomes more rich and systematic, acquiring some regulatory characters, efficiency and simplicity constraints become more pressing. Supervision should never become a further regulatory overlay. The burden of compliance for the industry is already high and should be kept under control. This is especially important in the SSM area, where new authorities have been created.

Mission

Let's move one step further. If we regard supervisors/regulators as agents delegated by society to accomplish a mission, more questions arise. What is the goal of banking supervision and regulation, and who should set that goal?

As I am speaking in a university, let me say first that I am surprised to see so little research devoted to the goals of banking regulation. The comparable literature on monetary policy is endless; discussions on how to set, measure, pursue and justify the goals of monetary policy virtually never stop, acquiring new life at each turn of the economy – the latest crisis being no exception. In other policy domains, such as public budgets, taxation or labour markets, debates on the nature of the policy objectives are less intense, but still more active – it seems to me – than what we see happening in the field of prudential regulation and supervision.

I don't think this depends on the questions to be asked being trivial, or the answers unimportant. It probably has to do with certain complexities that discourage both the academic and the practitioner in tackling the subject head-on, and especially in entering into exchanges with one another. Between the banking supervisor and the theorist in the same field there is more distance and less understanding than between their homologues on the monetary policy side. The complexities have to do, in part, with the confidentiality of the subject and the vested interests involved. Supervisors deal with companies that compete on the market and are therefore reluctant to release information. As a result, the supervisory process takes place largely in the shadows, and this makes both scrutiny and independent analysis more difficult. Another factor is that the policy process itself is difficult to define, involving a multiplicity of instruments used to attain a continuum of generically defined objectives. We are very far from the simple one-instrument, one-target, one-transmission mechanism environment that most monetary policy scholars are familiar with.

Those complexities and that distance have costs. To begin with, it is more difficult for supervisors to communicate with public opinion or other non-specialists. The absence of explicit analytical frameworks and well-articulated policy objectives makes it more difficult to explain, in non-technical terms, what needs to be done and when, and why occasional policy failures occur. The activity of supervisors, not generally visible to outsiders, falls suddenly under the spotlight when banking crises occur; when that happens, the supervisor is usually found guilty without appeal. This lack of visibility may explain, incidentally, a somewhat lower perceived attractiveness of the supervisory profession relative, for example, to core central banking functions. The latter are – wrongly, I think – considered more "glamorous" because they appear to be more scientific and make the newspaper headlines more often. I want to note here, in passing, that this perception did not prevent the ECB, last year, from conducting a very successful recruitment for its supervisory structures, attracting high talents both from the supervisory community and from the market.

A consequence of this communication gap is a widely held public misperception of what supervision is supposed to achieve. Most non-specialists probably think banking policies should prevent bank failures in all circumstances. This expectation is unfounded, of course. Banks are subject to market discipline like other private firms. Their specific safety arrangements are meant to protect not their shareholders, but other stakeholders, including creditors and users of banking services that are regarded as public goods (like payments), and ultimately the general taxpayer, who acts as a backstop.

Is this extra degree of complexity and opacity an inherent feature of banking supervision, or is it the fruit of inherited working practices that can and should be changed? Views differ. I would agree with those who think that certain risks faced by banking supervisors, and them alone, require to be treated with particular caution in public communication. At the same time, I am also convinced that much more work can and should be done to make supervisory practices more transparent and better understood by all.

Let me return to the initial question now, concerning the goals of supervision. The Core Principles of the Basel Committee state that the primary objective for banking supervision is to promote the "safety and soundness" of banks. [6] However, the meaning of "safety and soundness" needs to be clarified. For sure, it does not mean riskless. Banks are risky by definition; they cannot conduct their business otherwise. [7] I think those terms mean, generally speaking, that the risks borne by the taxpayer and by the creditors of the bank are appropriately contained and transparently disclosed. The exact extent and distribution of those risks, however, needs to be determined more precisely. [8]

Hanson, Kashyap and Stein [9] have proposed a definition of the goals of micro- vs. macro-prudential supervision, assuming, in accordance with neoclassical logic, that public policy intervenes only to correct market failures. In their view, micro-prudential policy should correct the distortion towards risk taking created by the safety net. Conversely, macro-prudential policy is meant to correct for other market failures, also giving rise to undue risk taking, generated by "systemic externalities".

I find this argument useful but incomplete. If bank services provide positive externalities to society, then not all taxpayer risk should be removed. Over-regulation is also sub-optimal. At the same time, the correct balance between taxpayer risk and the involvement of other stakeholders (shareholders, creditors) depends on collective preferences. We are crossing the line between technical competence and politics. Political reasons help explain, for example, why after the recent crisis regulation has increasingly tended to protect the taxpayer at the expense of bank creditors. In Europe, the bail-in provisions of the Bank Recovery and Resolution Directive, which are particularly severe, are an illustration.

I draw three conclusions from this discussion.

First, regulation and supervision should aim at balancing the risks and benefits of banking, taking into account all externalities involved. The correct solution is not one in which all taxpayer risk is removed.

Second, society should be put in a position to express more explicitly its preference as to where that balance is located; at present this form of collective guidance is lacking almost everywhere. This requires appropriate public communication on the nature of banking, its risks and implications; difficult issues on which specialists are also divided.

Third, more research is needed. We need proxies for bank risk and stability, providing a yardstick for setting supervisory goals and measuring performance. More work is needed also on supervisory instruments, clarifying how they interact with each other and how they affect stability (the "transmission mechanism"). Finally, evidence is needed on the interconnections and feedbacks between banks and the economy. Advances have been made, especially by network and contagion analyses; important micro-data sets on interbank exposures are being developed. Supervisory practice should hopefully be able to make increasing use of those data.

Independence

In thinking about supervisory independence, drawing a parallel with central banking can be helpful.

It is generally accepted that, in order to be successful, monetary policy needs to be free from short-term political interference and delegated to a technically equipped agency, the central bank, formally bound to a clearly defined goal. To balance that independence, appropriate reporting obligations must exist ("accountability"), requiring the central bank to provide information on its actions ("transparency"). Delegation of complex policy tasks where time inconsistency problems arise has proved to be beneficial not only in monetary policy but also in other policy areas.

Now the question arises: does the same framework apply to banking supervision? Or is there something inherently different there that warrants specific arrangements? This question was not explored in detail until the late 1990s, when several countries (the United Kingdom being the most prominent example) decided to separate banking supervision from the central bank and entrust it to a separate agency. This is a bit surprising to me, because while differences exist between the two policy functions – as I shall argue – they are still relevant regardless of whether they are performed by the same institution or not.

I think that the criteria suggesting delegation to an independent agency suit banking supervision no less than monetary policy. First of all, banking supervision is highly technical and complex, requiring a mix of financial, accounting and legal expertise. Moreover, the potential conflict between short-term and long-term objectives (the time inconsistency problem) is likely to be relevant as well; for example, supervisory forbearance may help to protect confidence in individual institutions in the short run, if the supervisor enjoys a high degree of credibility, but is likely to be detrimental to such credibility – and to financial stability – over a longer horizon. In addition, banking supervision typically involves important vested interests, a further reason for separating policy from direct political control.

This notion has been recognised in recent years as a key component of bank supervisory practice. The Core Principles of the Basel Committee on Bank Supervision specifically mention the need for operational independence of supervisors without interference by government or industry. [10] The supervisor should have full discretion to decide when and if it needs to take action.

A high degree of transparency is especially suited to a new institution like the SSM, which has no track record. In particular, the EU Regulation establishing the SSM stipulates that the ECB should be bound in its decision-making process by Union rules and general principles on due process and transparency. In this context, the ECB is accountable towards the European Parliament and the Council. This includes regular reporting, and responding to questions by the European Parliament and the Eurogroup. [11]

Transparency and accountability

While the case for independence is relatively straightforward, specific circumstances make transparency and accountability in supervision especially delicate, requiring particular safeguards.

First, supervision is special in that it involves handling two types of information, one concerning the authority itself and its behaviour (proceedings, deliberations, internal thinking, strategy and methodologies, etc.), and the other concerning the supervised entities.

Second, supervisors typically obtain, in the exercise of their function, sensitive information about the situation of individual banks. Proprietary information generated within the bank may, if publicly known, affect its competitive position. The supervisor does not have the legal right to disclose such information; the obligation may fall on the banks, themselves, in certain cases. Banks typically trust that the supervisor will treat information confidentially, and this facilitates the flow of information between them. A similar situation is not typically seen in monetary policy.

Third, the supervisory process generates information on the soundness of individual banks – their solvency, liquidity, profitability, quality of internal governance, viability of business models, etc. Early disclosure, especially when the picture is not yet complete and any necessary countermeasures have still to be taken or planned, can be risky and counterproductive, endangering financial stability. This does not exclude, however, the publication of supervisory statistical data, along the lines of what is done in the United States, for example.

The supervisor in the central bank: cohabitation issues

I have to mention here an instance in which I disagreed with Tommaso. In an article written for an ECB conference, he argued that central banking and financial stability are linked because financial stability is in the "genetic code" of central banks. He referred to the historical role of central banks, in many countries, as guardian of stability. [12] At the time (2002), macro-prudential policies were not established yet, hence what he essentially meant was that central banks should be involved in banking supervision.

I objected, arguing that institutions evolve, just like biological species do (penguins was the example I used, that nowadays use their former wings as flippers); the habits of our ancestors should not impede that evolution when conditions change. My argument echoed the prevailing thinking of the time, with its preference for narrowly defined central banks disjoint from supervision. [13]

I felt rather happy about my objection at the time, but in fact events proved him right shortly after. The crisis produced a unification – or re-unification – of central banking and supervisory functions almost everywhere. The most documented case is probably that of the Bank of England, but the pattern is more general. Central banks that host supervisory functions normally are organised so as to maintain an orderly distinction between the two activities, in the form, for example, of separate decision making bodies, organograms, and a degree of attention and control over the extent and the modality in which information is exchanged.

The ECB is a case in point. The decision to locate the new single supervisor in the ECB was almost immediate. It was dictated by legal considerations but also by the will to strengthen the new authority from the outset with the experience and the established reputation of the ECB. At the same time, the legislators – notably the European Parliament – insisted that clear separation lines should be included in the charter.

The SSM Regulation specifically mentions that the supervisory tasks should be separated from the monetary policy function. Provisions are included in the SSM Regulation to bring this about. A separate Supervisory Board has been established, in which senior representatives from all participating Member States, four ECB representatives, and a Chair and Vice-Chair participate. This Board is responsible for planning and executing the supervisory tasks and for drafting all supervisory decisions. The Governing Council of the ECB formally adopts the decisions via a non-objection procedure. In the case that the Governing Council does object to a draft decision prepared by the Supervisory Board, an established mediation panel is activated to resolve the differences.

The operation of the Governing Council is completely differentiated as regards monetary and supervisory functions. Such differences include strictly separated meetings and agendas. Moreover, the supervisory units are organisationally distinct from and subject to separate reporting lines. The ECB has set up a formal "separation framework", in the form of internal arrangements to distinguish the two functions, in particular with respect to professional secrecy and the exchange of information, [14] while at the same time ensuring that the organisational and information synergies are exploited.

These arrangements are working. The clear statutory mandates of the Supervisory Board and the Governing Council make a blurring of responsibilities unlikely. The two bodies interact regularly, with the respective roles clearly delineated. Moreover, regular joint meetings are convened to discuss financial stability and macro-prudential issues, where central banking and supervisory interests intersect. [15]

Conclusion

This speech has already been long enough; moreover, its intent was to present elements for reflection, not firm policy statements. Hence no specific conclusions are needed.

To the prevailing academic audience, I would like to remind that the banking and financial regulatory/supervisory universe is in a state of rapid evolution everywhere, with consequences that are important for the society as a whole. There are many interesting and important issues that call for more research. Do not misinterpret the distance that exists, at present, between supervisors and academics as a sign that your work is uninteresting or unimportant. It is not. And that distance needs to be narrowed.

Thank you for your attention.

NOTES

[1]I am grateful to Cécile Meys for her excellent support and to Jakob Orthacker for useful comments.

[2]The episode is recorded in Spinelli's diaries, Vol. III, p. 813. I am grateful to Antonio Padoa-Schioppa for pointing this out to me.

[3]T. Padoa-Schioppa, "An institutional glossary of the Eurosystem", prepared for the conference on "The Constitution of the Eurosystem: the Views of the EP and the ECB", 8 March 2000 (http://www.ecb.europa.eu/press/key/date/2000/html/sp000308_1.en.html).

[4]A. Haldane: On microscopes and telescopes, Speech given at the Lorentz centre workshop on socio-economic complexity, Leiden 27 March 2015.

[5]More in detail, in the ECB the risk assessment system (RAS) supports supervisors' day-to-day supervisory work. It is used for evaluating banks' risk levels and controls, their business model, their internal governance, their capital adequacy and their liquidity adequacy on an ongoing basis. The outcome of the RAS is combined in the overall Supervisory review and evaluation process (SREP), which aims at ensuring that institutions have adequate arrangements, strategies, processes and mechanisms, as well as capital and liquidity to ensure a sound management and coverage of their risks.

[6]Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision, September 2012. Principle 1 states, inter alia, "The primary objective of banking supervision is to promote the safety and soundness of banks and the banking system. If the banking supervisor is assigned broader responsibilities, these are subordinate to the primary objective and do not conflict with it".

[7]D. Diamond and R. Rajan, December 1999, "Liquidity Risk, Liquidity Creation and Financial Fragility: A Theory of Banking", NBER Working Paper Series No 7430.

[8]The SSM Regulation (article 1) specifies that the stability of the

financial system is also an objective of the SSM (http://www.europarl.europa.eu/document/activities/cont/201311/20131104ATT73792/20131104ATT73792EN.pdf).

[9]See Hanson S. G., Kashyap A. K and Stein J. C., (2011), "A Macroprudential Approach to Financial Regulation", Journal of Economic Perspectives, 25(1), pp. 3-28.

[10]Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision, September 2012 (http://www.bis.org/publ/bcbs230.pdf).

[11]See Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (http://www.europarl.europa.eu/document/activities/cont/201311/20131104ATT73792/20131104ATT73792EN.pdf).

[12]T. Padoa-Schioppa, "Central banks and financial stability: exploring a land in between", in V. Gaspar, P. Hartmann and O. Sleijpen (eds.), The transformation of the European financial system. Second ECB Central banking conference, Frankfurt am Main, European Central Bank, 2003, pp. 269-310. He developed the argument as follows: "It was – and, I would be inclined to say, still is – an integral part or an inseparable component of the central bank as a bank, of its monopoly on ultimate liquidity, of its role as the bankers' bank, and of commercial banks as creators of money themselves".

[13]There is a very large literature on the pros and cons of centralising monetary policy and supervision in the same institution. Arguments favouring normally refer to the advantages that an insider knowledge of the banking sector entail for the conduct of monetary policy, especially when this takes the form of lending-of-last-resort in crisis times. There are also synergies between supervisors and other core central banking functions, such as the oversight of payment systems. Conversely, centralisation may give rise to conflicts of interest, as the fragility of the banking system may lead the central bank to pursue a more accommodating monetary policy stance than warranted for the pursuance of price stability. See, for example, C. Goodhart and

D. Schoenmaker (1995), "Should the Functions of Monetary Policy and Banking Supervision be Separated?", Oxford Economic Papers, Volume 40, pages 539-560.

[14] See the Decision of the European Central Bank of 17 September 2014 on the implementation of separation between the monetary policy and supervision functions of the European Central Bank (https://www.ecb.europa.eu/ecb/legal/pdf/en_ecb_2014_39_f_sign.pdf).

[15] At the ECB, the ultimate decision-maker regarding the activation of macro-prudential policies is the Governing Council, acting on a draft decision submitted by the Supervisory Board. In practice, the Governing Council interacts closely with the Supervisory Board, usually to strict deadlines. An effort is being made to combine micro-prudential and systemic considerations, against the background of the broader macro-financial situation. Every quarter, the Governing Council and the Supervisory Board convene in joint sessions to examine the macro-prudential situation. The Governing Council can also request the Supervisory Board to submit a proposal or to undertake studies concerning specific sources of vulnerabilities. At the ECB a Macro-Prudential Coordination Group has been established, comprising Board members and staff with the relevant expertise.

PART I

Is the Banking Union Stable and Resilient as it Looks?

The Banking Union and Beyond

Andrea Colombo and Mario Nava

The Banking Union represents one of the greatest economic and financial successes of the EU of the last *few* years. It brought back a much-needed stability, reassured markets, significantly contributed to further integration of European markets and gave them a sense of political direction and perspective. EU economic conditions and prospects are better than three years ago when the Banking Union was launched. However, both growth and job creation are still lower than their desired pace.

This note first analyses the Banking Union along three dimensions (institutional, financial and economic). Second, it argues the case for the next steps that Europe may need to take to restore economic growth and it shows how the Banking Union has made those steps possible.

1. The Banking Union: a successful story

There are several dimensions under which the Banking Union could be examined. We look hereafter at three of them and at their interrelationship: the legal and institutional foundations of the Banking Union (section 1.1), the impact of the Banking Union on private and public market financing conditions (section 1.2), and its impact on economic conditions (section 1.3).

1.1. Institutional and legal foundations

The Banking Union legal and institutional setting relies on three pillars: the Capital Requirement Directive and Regulation (CRD/CRR), which constitutes the main part of the Single Rulebook, the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), which be looked at in subsections a, b, and c, respectively.

a. The Single Rulebook: Capital Requirement Directive and Regulation

The (fourth) Capital Requirement Directive (CRD4) and the first Capital Requirement Regulation (CRR) constitute the most important and well-known piece of legislation composed of the Single Rulebook, along side the Deposit Guarantee Scheme Directive and the Bank Recovery and Resolution Directive (see c *infra*). The European Commission (from now on, *Commission*) issued its proposal for the CRD4/CRR in July 2011; the proposal obtained the Council General Approach in May 2012, under the Danish Presidency, and was finally politically adopted by the European Parliament (from now on, *Parliament*) and the Council of the European Union (from now on, *Council*) in March 2013, after 37 political and more than 100 technical trilogues between the three European institutions.

The CRD4/CRR is composed of more than 700 articles, is based on Art. 114 of the Treaty on the Functioning of the European Union (TFEU)[1]: it translates into European law the Basel 3 guidelines, complementing them with a number of prudential requirements regarding corporate governance and the prudential use of capital buffers, which go beyond the Basel 3 guidelines.

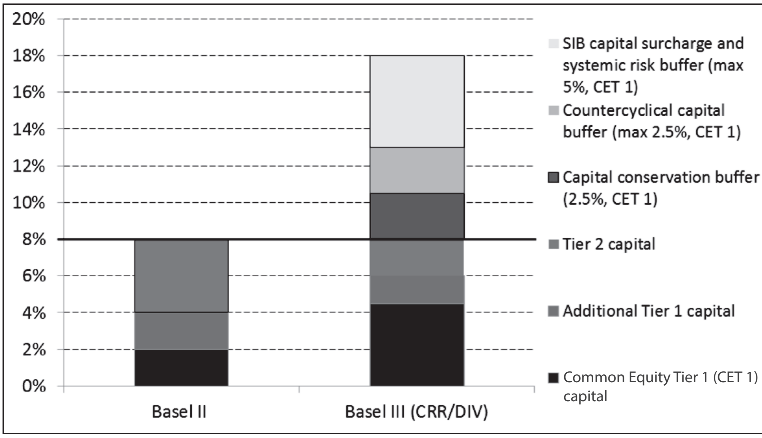
The CRD4/CRR package regulates through the Regulation (CRR) banks' liquidity, the quantity and quality of banks' minimum capital requirements, banks' leverage, banks' counterparty risks and national flexibilities. It also regulates through the Directive (CRD4) the ability of the supervisors to impose prudential buffers, corporate governance rules, harmonised sanctions and general enhanced supervision rules.

The Commission's choice of designing a regulation for capital requirements allowed for a harmonised and homogenous implementation of rules across the whole European Union.

This legislation provides for a minimum capital requirement of 7% of banks' Risk Weighted Assets (RWAs), for the top quality capital (CET1, essentially equity), compared to 2% of Risk Weighted Assets previously and an overall minimum capital requirement, for both first and second tier quality of capital, of at least 10.5%, more in many cases, especially for larger banks. The use of the Regulation, which is directly applicable to market operators, was essential to ensure market uniformity.

1 "The European Parliament and the Council shall, acting in accordance with the ordinary legislative procedure and after consulting the Economic and Social Committee, adopt the measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market." – Art. 114, TFEU.

Figure 1: Overview of the Basel 3 capital requirements, as implemented in the EU by the CRDIV package.



b. The Single Supervisory Mechanism (SSM)

On 29 June 2012, the Council of Heads of State and Government asked the Commission to put forward a proposal for the single supervision of the Euro Area banking sector "to break the vicious circle between banks and sovereigns", based on Art. 127.6 of the Treaty on the Functioning of the European Union[2]. Nine weeks later, on 12 September 2012, the Commission officially presented a proposal to the informal ECOFIN of Nicosia. One year later, the Council and the European Parliament adopted a regulation creating the Single Supervisory Mechanism (SSM), composed of the European Single Supervisory Board and the national authorities along the lines proposed by the Commission. The SSM applies to all the Euro Area countries and it is open to the participation of non-Euro Area countries[3].

At the time of the conception of the single currency, in the early Nineties, the issue of whether the single currency also needed single banking

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

3 At the time of writing, Denmark is the non-Euro Area country closest to joining the SSM.

supervision was already raised. It found, eventually, its solution in 2013 with the creation of SSM, which was both an economic and political act responding to political and economic challenges to the Euro Area[4].

Before its official start in November 2014, the SSM conducted the most detailed, rigorous and comprehensive assessment of financial institutions' capital and assets, ever implemented in Europe and possibly in the world. This assessment made banks' balance sheets more transparent. It simultaneously generated incentives for banks to call on the capital markets to improve their capital levels in order to reassure investors of their ability to face any adverse economic scenario.

c. Recovery and Resolution Rules and the Single Resolution Mechanism (SRB) for the SSM Banks

In June 2013, the European Commission adopted a proposal for a Bank Recovery and Resolution Directive (BRRD).

The BRRD provides a triple mechanism of taxpayers protection based on i) resolution plans; ii) bail-in of 8% of the liabilities of banks in need of resolution; iii) national resolution funds, each equal to 1% of the EU covered deposits (for more details see Huhtaniemi, Nava, Tornese, 2014). The institutionalisation of the bail-in will protect taxpayers from the possible collapse of fragile banks and their bail-out through public resources. The BRRD minimises the risk of moral hazard, introduces market discipline and forces banks to prepare a resolution plan, in order to limit as much as possible any contagion risk. It is no exaggeration to say that, thanks to the BRRD, Europe moved resolutely away from "bailing-out" towards "bailing-in" of any bank needing recovery and resolution.

We distinguish, broadly speaking, two possible models of "bail-in": a "broad bail-in" and a "narrow bail-in", where "broad" and "narrow" refer to the choice of liabilities that can be bailed-in in resolution. Europe chose a "broad bail-in" approach, applied to all EU banks from the smallest to

4 "We need to secure the economic recovery, reduce fragmentation in the euro area and continue the process of institutional and structural reform (…). Once the SSM is established, it offers a real possibility to take a new, European approach towards governance of the financial sector – and hence to reverse the harmful financial fragmentation we have seen during the crisis." – Mario Draghi, 22 November 2013.

the largest, whereby most liabilities[5] can be bailed-in following a precise hierarchy. Because of the "broad bail-in" approach, the BRRD empowers supervisors to decide, on a bank by bank basis, if, in order to comply with the requirements at the point of non-viability, some additional and identified bailinable instruments should be held while the bank is a going concern. The BRRD minimum bail-in requirements apply only at the bank's point of non-viability and of resolution. The bank's ability to meet them is monitored, by the supervisory authority, during the life of the bank.

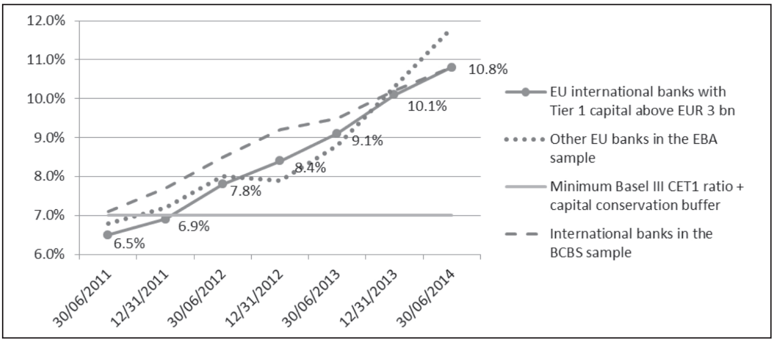
The US forthcoming legislation on bail-in takes a narrow approach whereby only some, ex-ante identified, liabilities can be bailed-in. In contrast to the BRRD, it imposes a minimum and permanently available amount of subordinated "bailinable" liabilities. As a consequence, the US approach envisages resolution-specific capital requirements, involving both equity and debt capital, to comply with during the entire life of the bank.

The two approaches reflect (and are best suited to) the different bank structures prevailing in the two continents and the set of banks to which they apply: in the EU, banks' liabilities are mostly deposits and senior debts with some junior subordinated debts, banks are very diverse and legislation applies to all of them. In the US, instead, banks' liabilities are mostly composed of subordinated debt and legislation applies only to the largest banks. The difference between the two approaches is particularly evident in the treatment of senior debt: in the EU the senior debt may be part of the resolution operation, but not in the US. While the two approaches are different, no empirical proof is (as of today) available to demonstrate which of the two approaches is more efficient and leads to less contagion. This distinction between broad and narrow bail-in is particularly relevant when discussing the case for further, equity and debt, capital requirements specific only to the Too-Big-Too-Fail banks, as is currently the case in international fora like the Financial Stability Board (FSB).

Within the Euro Area, and because of the existence of the Single Supervisory Mechanism, the national resolution funds provided by the BRRD became a single, progressively mutualised fund (named the

5 Liabilities excluded from the bail-in process are: deposits up to €100,000, covered by the Deposit Guarantee Scheme; secured liabilities including covered bonds; liabilities to employees of failing institutions, such as fixed salary and pension benefits; commercial claims relating to goods and services critical for the daily functioning of the institution; liabilities arising from a participation in payment systems which have a remaining maturity of less than seven days; inter-bank liabilities with an original maturity of less than seven days.

Figure 2: Results from BCSB and EBA Basel 3 monitoring exercise at June 2014. Evolution of the Common Equity TIER 1.



Source: FISMA own computation

Single Resolution Fund – SRF) for all the countries participating to the SSM (Euro Area countries only for the time being). The negotiations for its implementation required an Intergovernmental Agreement, following an Intergovernmental Conference, dealing with the progressive establishment and mutualisation of the SRF.

In April 2014, the European Parliament and the Council approved the BRRD and the Intergovernmental Agreement. The last step towards the completion of the Banking Union was taken, less than 22 months since the Council declaration of June 2012. Like the SSM, the SRM applies to all the Euro Area countries and it is open to participation from non-Euro Area countries.

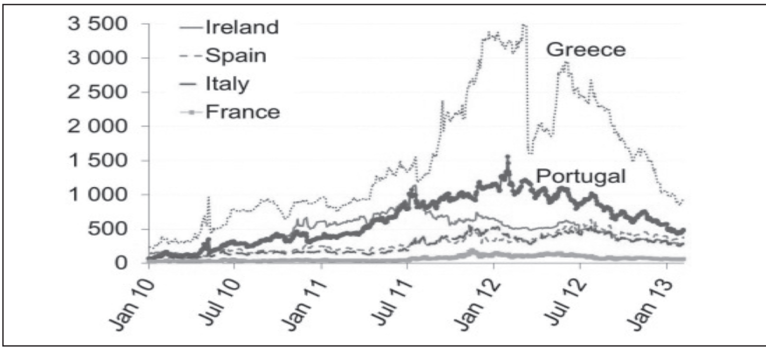
1.2. Financial impact of the Banking Union

The design of the Banking Union coincided with the highest peak of the financial crisis: spreads across sovereign bonds were mounting and confidence in the health of the banking system was at its minimum. Caught in a vicious circle, banks and sovereigns were weakening each other.

The Single Rulebook, its stringent rules and the credibility of its cross-country homogeneous implementation, created market pressures for banks to rapidly increase their capitalisation (Figure 2). In just a few years, the EU bank capitalisation and solidity reached a level comparable to that of the US[6].

6 According to the Federal Deposit Insurance Corporation, in the second quarter of 2013 leverage ratio for global systemically important banks in EU and USA were 3.86 and 4.30, respectively. TIER 1 Capital ratio, 12.49 and 12.73 respectively.

Figure 3: Performance of selected sovereign bonds with respect to German Bund (Source: Reuters – ECOWIN).



The announcements of the new, credible and reliable regulatory ratios, described in section 1.1.a *supra*, were immediately accepted by the markets. This meant, *de facto*, that financial institutions respected them well in advance of the timing provided by legislators and in so doing won back market confidence.

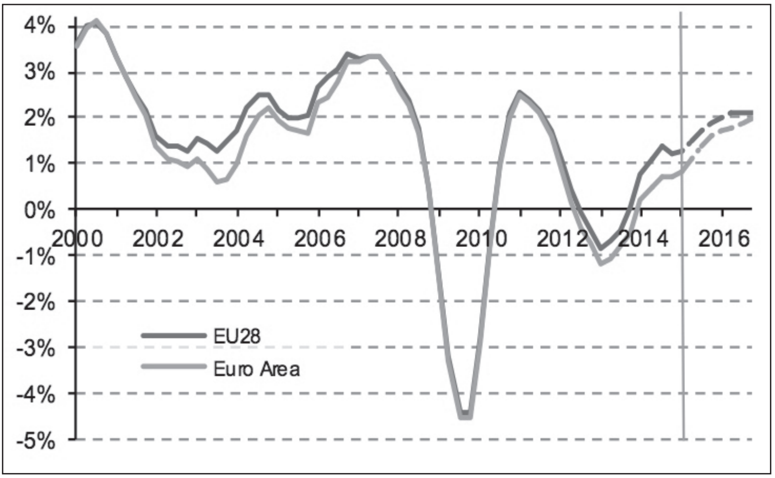
The regained market confidence in a stable banking system would have not necessarily translated into better financing conditions for sovereigns if markets had not been convinced that the link banks-sovereign was clearly broken. Since its conception, the markets have considered the European "bail-in" model introduced by the BRRD quite reliable, as shown by the significant sovereign spread reduction that took place during and after the design of the Banking Union (Figure 3).

1.3. Economic aspects

The Banking Union brought financial stability and reduced sovereign spreads. Consequently, access to finance was eased and the supply conditions of European corporates and governments improved. Banking union also made consumers more confident to invest cross-border due to the harmonisation of rules, controls and safety nets (Nouy, 2015), so it could give a boost on the demand side. Growth results in 2014 and prospects for 2015 and 2016 have improved (figure 4).

The Banking Union proved therefore to be an important element for stability and a necessary, but not sufficient, condition for Europe's return to growth. Banking Union is an important element of a more efficient supply side in Europe. However for growth to emerge again, policies on

Figure 4: Annual growth of GDP in EU28 and Euro Area



Source: Eurostat. National quarterly accounts, Commission forecast and own calculations)

both the supply and the demand side of the economy are needed. The next section will provide a review of the relevant initiatives recently put in place by the Commission.

2. Beyond Banking Union

This section discusses two areas of work, the Capital Markets Union and the European Investment Plan aimed at improving, respectively, the supply side and the demand side of the European economy.

2.1. The Capital Markets Union

The Capital Markets Union (CMU) builds on the new regulatory framework of the banking sector and extends its credit-supplying potential. Several existing challenges, such as heavy reliance on banks, differences in financing conditions, different market rules and practices, limited SME access to finance, make the development of a Capital Markets Union policy urgent. In February 2015, the European Commission published a green paper on the Capital Markets Union, which is a declared policy priority for the Juncker Commission.

Capital Markets Union has three main objectives: 1) to develop a more diversified financial system complementing bank financing with deeper capital markets; 2) to unlock the capital around Europe and put it to work for the economy in order to give savers, from within and also outside Europe, more investment choices in Europe; 3) to establish a genuine single capital markets in the EU where, on the one hand, investors are able to invest their funds without any cross-border hindrance and, on the other hand, businesses (SMEs and large companies alike) can raise funds from a diversified range of sources, irrespective of their geographical origin.

First: develop deeper EU capital markets. The European capital market activity (equity financing, corporate bonds or securitisation) increased significantly over the last two decades. Between 1992 and 2013, the total EU stock market capitalisation has progressed from €1.3 trillion (21.7% of GDP) to €8.4 trillion (64.5% of GDP). The total value of outstanding debt securities has grown from €4.7 trillion (74.4% of GDP) to €22.3 trillion (171.3% of GDP). Nevertheless, market financing is still in need of development (figure 5).

The US public equity markets are almost double in size (stock market capitalisation is 138% of GDP in the US vs. 64.5% in the EU in 2013). The US corporate (non-financial) debt securities markets are three times as large (total value of corporate non-financial debt outstanding is 40.7% of GDP in the US vs. 12.9% in the EU in 2013)[7]. The US venture capital market is about five times bigger (in terms of amounts invested). If European venture capital markets were as deep as in the US, an additional €90 billion of funds would have been available to finance companies during 2008 to 2013.

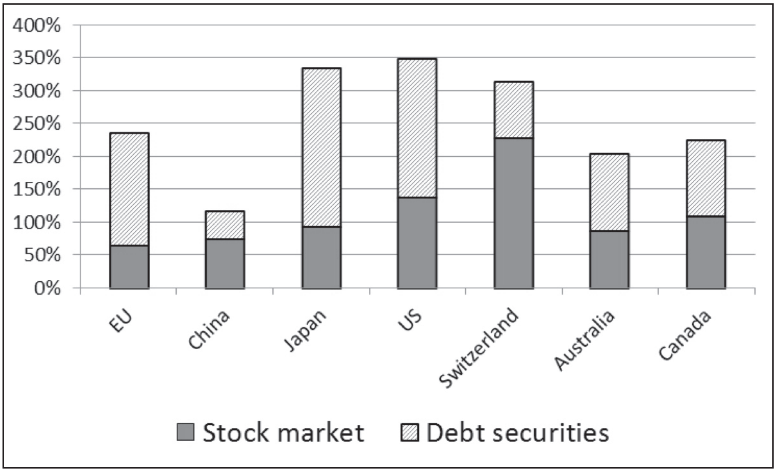
Second, unlock EU capital markets. Contrary to the US, 40 percent of EU households' financial wealth is held in the form of deposits (figure 6). This figure implies that most of the savings are directed towards low-risk, easily accessible and short-term investments, rather than EU companies.

In order to run their activities, EU companies rely heavily on credit supply by banks, which are incidentally also key players in financial intermediation in the EU. Having the European engine of growth[8], dependent mostly only on the banking sector as a principal source of financing is

7 Figures obtained from ECMI statistical package 2014.

8 It has been estimated that 65 percent of EU employment and more than 55 percent of EU value added is contributed by SMEs (European Commission, 2014).

Figure 5: Stock market capitalisation and debt securities as a percentage of GDP.



Source: ECMI statistical package, 2014

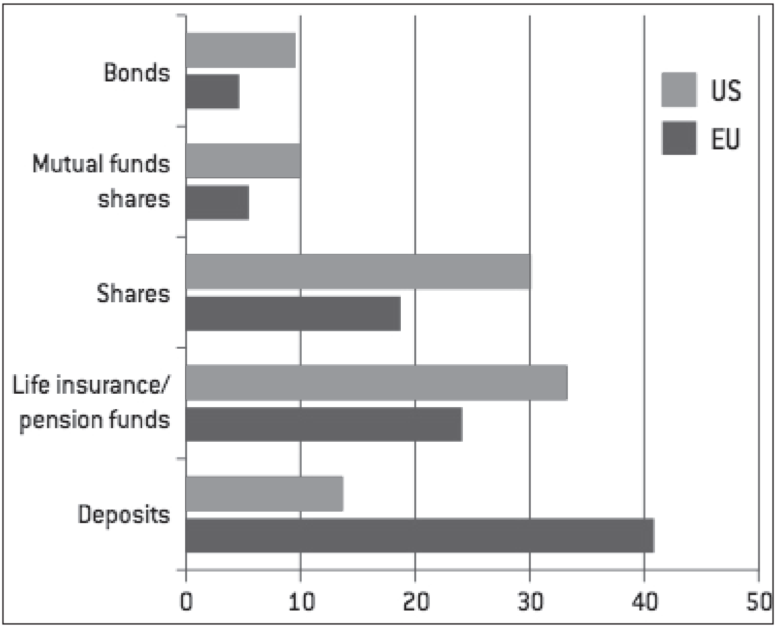
certainly sub-optimal and becomes a risk factor when economic and financial tensions emerge.

Third: greater cross-border integration of the EU equity and debt markets. Retail banking has remained national, while wholesale banking cross-border activities suffered from the crisis. While cross-border corporate bond holdings have recently recovered, in the equity market about two-thirds of EU equity holdings have domestic origins. Moreover, there is a wide variation in capital market development across EU Member states. For example, domestic stock market capitalisation in 2013 exceeded 121% of GDP in the UK, compared to less than 10% in Latvia, Cyprus and Lithuania. The CMU will address these issues by facilitating the creation of well-integrated and deep European capital markets, by freeing resources for the real sector, by spreading country- and region-specific risk and thus smoothing the impact of recessions on consumption, investments and banking sector activity.

Clearly there is not one single measure that will deliver a Capital Markets Union. There are many steps, some taken in the short term and some needing more time, which all together may lead to greater integration.

In the short-term, several measures can help achieve the three objectives mentioned above:

Figure 6: Financial portfolio of households in the EU and US, percentage of total financial assets (Veron and Wolff, 2015 based on OECD, 2011)



1) Lowering the barriers to accessing capital markets through a review of the Prospectus Directive[9],
2) More information on SMEs will be provided to creditors and banks will be encouraged to give feedback to SMEs whose credit has been declined. Asymmetric information, usually impeding demand and supply of credit to match, will therefore be minimised.
3) Building sustainable securitisation and fostering simple, transparent and standardised securitisation across the EU. Greater standardisation of corporate debt issuances will allow for the development of a more liquid secondary market for corporate bonds. Covered bond markets would also benefit from a greater integration, thus providing investors with safer and more liquid investment opportunities.
4) Boosting long term investment: Through the European Investment Project Pipeline (discussed in the next session), a dedicated website

9 The Directive 2003/71/EC regulates the prospectus to be published when securities are offered to the public or admitted to trading.

will be created to ease access to information for investors on infrastructure projects.

5) Developing European private placements markets

To ensure the success of the CMU, attraction of foreign savings to foster investment in the EU is also crucial. There is a wide scope for capturing additional equity and debt investment from third countries: in 2013, the EU attracted €5 trillion of portfolio investment, out of a global total of €25 trillion.

Economic literature points to the fact that in addition to the short term measures, the CMU's real potential can only be achieved with a long-term structural policy agenda dealing with areas such as more integrated accounting enforcement and supervision of audit firms, better corporate credit information, reliance of financial infrastructure, insolvency law, financial investment taxation, (Veron and Wolff 2015), collection and analysis of capillary data and building a comprehensive real-time European map of risk (Issing and Krahnen, 2009).

An effective CMU needs consistent regulation, of both financial products and financial intermediaries, which eliminates barriers to cross-border investments. As an example, the CMU would benefit from active and cross-border participation in the European capital markets of the insurance companies, whose solidity has been strengthened by the Solvency 2 regime and who have a long term horizon for investment.

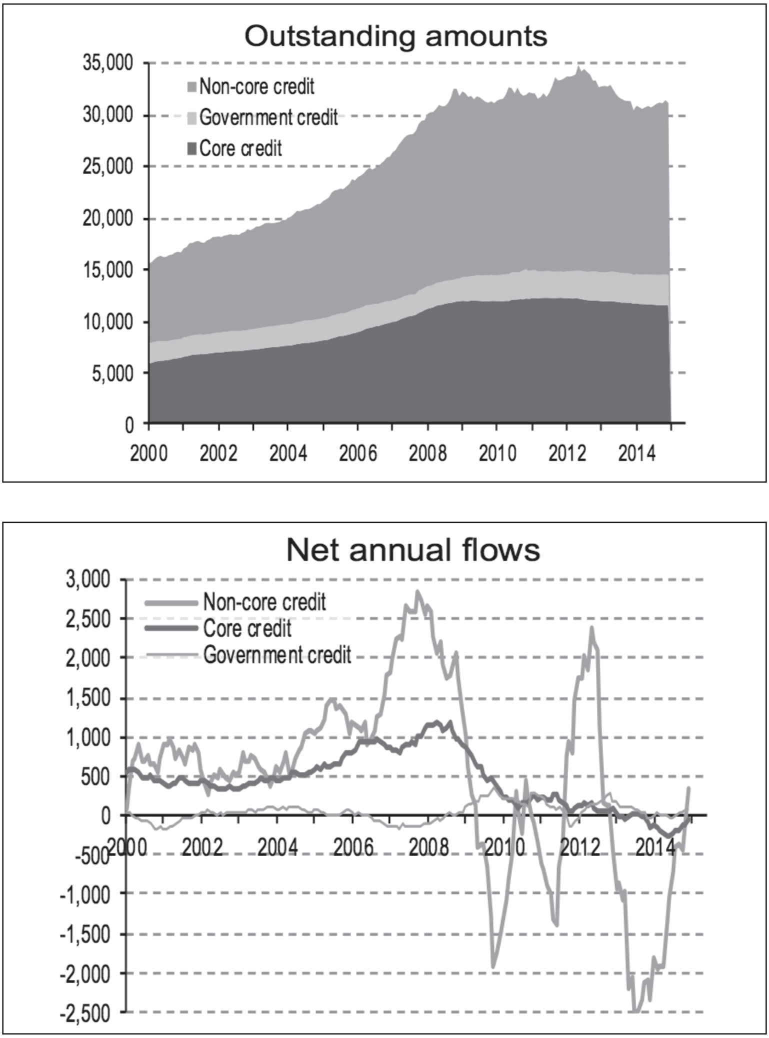
A lively discussion at EU and national level is currently ongoing and several workshops on technical issues and more general conferences on the CMU are taking place. A CMU Action Plan, which takes into account the wealth of the stakeholders' replies, is foreseen in early Autumn 2015, delineating short term and medium term actions needed for the period 2015-2019.

2.2. The European Investment Plan

While during the crisis the evolution of non-core financial credit has been particularly volatile, the evolution of core credit dropped during the crisis and has never recovered. Such a peculiar pattern suggests a structural drop in the amount of financial resources for the core credit as shown in Figure 7.

In other words, while the Banking Union succeeded in making banks stronger and resilient, it could not improve the amount of funds going to the core credit of the economy.

Figure 7: Core vs. non-core activities of banks, Euro area MFIs, € billion assets (ECB Statistical Data Warehouse).



Inevitably, this pattern has an effect on the availability of funds for investment. Any appropriate policy mix requires both a demand and a supply side component. Indeed, after three weeks in office, the Juncker Commission announced an Investment Plan aimed at reducing the EU investment gap that originated during the crisis and has widened since then. Since the budget of the EU is limited and in any case unsuitable for traditional demand policy, non-conventional ideas have to be put in place in order to ensure that investors can close an investment gap of €300 billion required to boost growth (figure 8).

The European Investment Plan is an innovative example of a "leveraged demand" policy, that is a demand policy which uses public money as a lever for private investment. Its goal is to create the right incentives for the market to invest in 3000 projects, by improving the project risk return balance. To do so, the European Investment Bank (EIB) and the European Union are expected to provide guarantees for €21 billion, channeled into the European Fund for Strategic Investments (EFSI). By leveraging 15 times on the EFSI, the European Commission expects to trigger around €240 billion of long-term investments and €75 billion of investments in small and medium enterprises and mid-cap firms between 2015 and 2017. Member states[10], on a voluntary basis, can also participate in the implementation of the EFSI thus increasing the fund's ability to reach the target financial amount for the identified projects.

The list of public and private projects (which currently totals €1300 billion) has been submitted to the Commission by every Member State, put forward by their promoters to the EIB and will be sorted individually by an ad hoc Investment Committee.

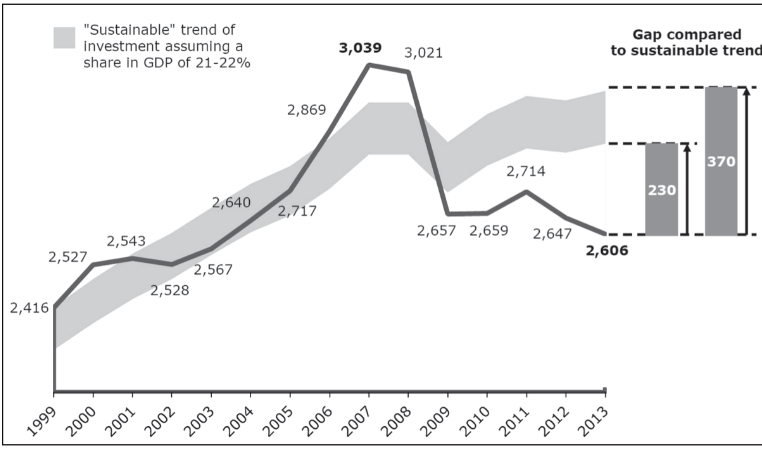
Next to it, a European Investment Advisory Hub (EIAH) is created to provide technical assistance to help promoters to structure and finance their projects better. The EIAH will further support the introduction of complex financial packages and the cooperation between the EIB and National Promotional Banks (NPB) and will act as a portal for all investors.

In May 2015, the European Commission, the Council and the European Parliament concluded the political discussion on the composition and the structure of the EIAH and the selection procedure of the projects to be financed.

The EFSI is an important tool to attract investments, but it should not be the only one. An investment-friendly environment at national and European level, opening to several and competing forms of finance, is vital. In this respect, the EU institution has indeed put forward a

10 As of May 2015, France, Germany and Italy contributed by €8 billion each to the EFSI through their respective National Promotional Bank, Caisse des Dépôts, KfW and Cassa Depositi e Prestiti. Spain contributed by €1.5 billion via the Istituto de Crédito Oficial.

Figure 8: Real Gross Fixed Capital formation



Source: Commission Services, 2014

harmonised, predictable and reliable regulatory framework of both the European banking sector (the Banking Union) and the Capital Markets Union enabling a smooth channelling of investments towards the real economy.

Conclusions

The 2007 financial crisis deeply affected the European economy and is having lasting effects for a series of concatenated reasons. The first reason is the financing side of the European economy, which is heavily reliant on banks, and in many countries, big banks. The second reason is that those banks have become very exposed to sovereigns during the crisis, and in particular to their own sovereign. This fed a vicious circle that eventually hindered credit supply, as banks were the main financing source of the economy, for both large corporates and SMEs alike.

The Banking Union was created to sever the bank-sovereign loop and provide a clear harmonised framework for financial regulation. Markets reacted rapidly and positively to the legislative requirements and accelerated a recapitalisation of banks sometimes well above the legal levels. While the EU banking sector is considered to be repaired, the challenges of creating incentives for banks to serve the real economy (supply of credit) and the access to credit in deep and liquid markets still remain.

The Capital Markets Union aims at responding to those needs on the supply side. It creates incentives for banks to be more active in the capital markets, by making markets more homogeneous, efficient and integrated cross-border. They will ultimately become, in this way, deeper and more liquid and therefore a credible alternative for any investment. The Banking Union asks for more equity investment in the banking sector; the Capital Markets Union makes sure that this equity investment is properly priced and that the credit multiplier originating from more stable banks is effective.

The European Investment Plan responds to a lack of investments on the demand side. A project pipeline, gathering selected projects in which any private investment will be backed up by the Commission, EIB and certain EU states, will be created. This is the only and most creative solution European institutions have to boost growth without relying on pure expansionary budget policies.

To conclude, the Banking Union is a necessary, but not sufficient condition for growth. The Capital Markets Union aims at further improving the economy's supply side. The European Investment Plan, instead, represents a stimulus to the demand side to close the investment gap provoked by the crisis.

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The Banking Union: State Guarantees and Defeasance Structures

Natacha Valla

1. Introduction

In 2014, the European Parliament adopted by a comfortable majority the legislative acts founding the Banking Union (BU). In the words of Michel Barnier, the then European Commissioner in charge of Competition and Financial Affairs, the legislation created a "truly European system to supervise all banks and to treat their potential failure".

The Banking Union indeed represents a significant landmark in European integration and should reduce the likelihood of a systemic banking crisis and help bring down financing costs.

However, as it currently stands, the BU suffers from three main shortcomings, as highlighted by the first real life test case, Hypo Alpe Adria (HAA). First, it does not explicitly address the issue of defeasance structures. Second, it fails to provide a proper doctrine on the use of public guarantees: given the sharp deterioration in the creditworthiness of sovereign borrowers, it may be ill advised not to take into account the risks associated with guarantees provided by national or infra-national entities. And third, there is a grey area as to the legality of decisions taken at the national level.

2. The core concepts of the Banking Union

Significant progress has been made in the setting-up of a banking union in Europe. The first pillar, the Single Supervisory Mechanism, under which the ECB takes responsibility for monitoring the financial stability of banks, came into effect in November 2014. Just prior to this, the ECB published its ground-breaking 'comprehensive assessment' of the banking sector (comprising stress tests and an asset quality review on the 130 largest banks) designed to give a transparent account of the current state of play and ensure a sound starting point for the Banking Union (Table 1). While the jury may still be out on whether having a single institution conduct monetary policy, fulfil the lender of last resort function and wear the supervisor's hat is optimal, the implementation of the SSM can be viewed as a significant achievement.

The second main pillar, the Single Resolution Mechanism, became operational on 1 January 2015 with a remit to ensure the efficient and centralised resolution of failing banks. The Single Resolution Board (SRB) was established to act at the main decision making body of the SRM. The Board started work swiftly on the development of resolution plans and related issues, but most of the provisions in the SRM Regulation will only apply from 1 January 2016 and beyond. A Single Resolution Fund (SRF) will be set up, financed by the banking sector itself and implemented according to the 'single resolution' principle. A few years will be necessary for the Fund to reach its full potential, but agreement has been reached on a target of €55bn (about 1% of covered deposits in the euro area).

While the SSM and the SRM are on track, the guarantee of bank deposits at the European level, meant to be a third pillar of the Banking Union, remains a thorny issue that still needs to be integrated into a common system.

Backing up the two main initiatives, is the "bail-in principle" whereby in the event of bank failure, banks' shareholders and creditors would first bear the cost, before taxpayers money is used to absorb losses. This is at the heart of the Bank Recovery and Resolution Directive (BRRD) that had to be implemented by all Member States by 1 January 2015.

Undoubtedly, the Banking Union is meeting success. Even Denmark, a notably Eurosceptic country, has expressed its wish to become a member and has started concrete negotiations with the European Commission. But, while its construction is sophisticated, it has not yet been fully tested in the field. The case of Hypo Alpe Adria (HAA) – still unfolding – might be the first reality check and has already highlighted some key shortcomings that need to be addressed.

3. Hypo Alpe Adria: the first real life test of the Banking Union

The slow descent of Hypo Alpe Adria (HAA)

HAA was a modestly sized *Landesbank* in the purest Germanic tradition, based in the small state of Carinthia, a mountainous region in the south of Austria. Between 1990 and 2000, it became closely linked with local political circles, leading to a policy of aggressive balance sheet expansion, with little attention paid to the riskiness of its investments. This catastrophic approach to risk management – notably in the Balkan region – quickly made the institution very fragile, but the state of Carinthia's (complacent) policy of granting public guarantees ensured very cheap market financing, with investors lured by the belief that the public authority would always back the bank if things went wrong. The Griss Report of 2015 established that "the quick expansion of the bank was only possible due to the liability of the Land of Carinthia, without the latter having been able to fulfil the respective obligations." By 2003, these guarantees had reached €23bn, more than ten times the size of Carinthia's own annual budget. By the end of 2008, the bank had become completely dependent on regional state aid, and by 2009, the situation had become so critical, the Austrian government injected €8bn (2.7% of GDP) worth of fresh capital in the bank, half its overall balance sheet size of €16bn. Before the end of the year, the bank had been nationalised in an emergency to avoid bankruptcy (Rechnungshof (2015)) and another €20bn of regional guarantees had been granted.

In September 2014, the government established with the approval of the European Commission a wind-down, or 'defeasance' structure (called HETA) for the orderly wind-down of HAA (the Hypo Act was enacted in July 2014 – see Bundesgesetzblatt (2014)). In line with European Union law, HETA may not itself conduct deposit banking nor may it hold equity interests in financial institutions.

In the course of setting up HETA the government already cancelled – unilaterally - the equivalent of €1.7bn worth of subordinated debt. But it is after October 2014, when the Banking Union really starts to take shape, that the story gets interesting. Austria implemented the Banking Union European principles ahead of the deadline of 2016, passing a law in January 2015 based on European Regulation 2014/59. And not long after, at the beginning of March, the Austrian Financial Market Authority (FMA) imposed a moratorium on HETA's debt payments. With only minor exceptions, HETA debt holders will not be paid any principal and interest before June 2016.

Winding down the wind-down structure

In imposing this moratorium on a defeasance structure, Austria has interpreted the Banking Union, in a way that, though strictly speaking correct, could be seen as contrary to its spirit. Having said that, in the months preceding the March 2015 moratorium, HETA had shown recurring signs of insolvency and no other alternative – either public or private – seemed available to avoid bankruptcy: winding down the wind-down structure through a (blunt version of) bail-in was thus judged to be in the public interest and resonates well with the idea of protecting – at last, after years of complacency – taxpayers' money.

The bail-in quotas to be applied to private bond holders will be fixed at the end of the moratorium in 2016 and based on the results of a thorough asset quality review (AQR) exercise conducted under the supervision of the FMA.

4. BU leaves the issue of defeasance structures unaddressed

The first lesson from HETA is that the Banking Union framework leaves the question of defeasance structures very much up in the air. It is clear that the European directives have been conceived and designed for up-and-running commercial banks. But where does this leave wind-down structures? Should they be subject to the same rules? Will the Single Resolution Fund (SRF) be called to the rescue for an ailing defeasance structure? And if so, will banks agree to put money in the common pot if they know that its resources run the risk of being eaten up by the 'bad banks' of others ?

This lack of clarity around the issue of 'bad banks' is all the more striking given the intense debate and thinking around analogous issues. Areas such as too-big-to-fail, related systemic risk, and specific macro-prudential requirements have all been reviewed. The European Commission has even presented a far reaching proposal for a Regulation on structural measures for EU credit institutions (EC (2014)) looking into the possibility of separating a bank's business activities into two separate entities. Why then have 'bad banks' been overlooked?

In terms of the role of the SRF, one could argue that its implementation will be so slow and gradual that by the time it is fully operational none of the 'bad banks' created by Member States in the wake of the crisis will still exist. Under an optimistic scenario, their assets might indeed be successfully wound down in less than a decade. But equally, a scenario of a long lasting deleveraging period is not unrealistic. The Banking Union would thus put the EU in a much safer position if it included contingency plans for when wind-down structures themselves run into difficulties.

Defeasance structures and commercial banks: Germany's DuessHyp…

HETA's role in the collapse of German bank Duesseldorfer Hypothekenbank (DuessHyp) highlights the underlying vulnerability of commercial banks that own liabilities issued (or even just borne) by 'bad banks'. DuessHyp seemingly collapsed as a result of a margin call (from Eurex) to post additional collateral in view of the need to write down (€348m) bonds inherited from HAA via HETA (DuessHyp was subsequently taken over by the Association of German Banks, see Moshinsky et al. (2015)). According to Bundesbank data as of April 2015, the German financial sector had about €7bn exposure to HETA, all dating from HAA times, and most held by banks. Whether or not those losses have a systemic dimension still remains subject to debate – and should for this very reason be taken seriously.

Defeasance structures and restructuring funds: Spain's Sareb

A further example highlighting the need for the Banking Union specifically to address defeasance structures, is Spain's Sareb. In 2013, Sareb posted a loss of over €260m as a result of writing off loans convertible into equity. In 2014, Sareb saw a loss of nearly €600m as the Bank of Spain instructed it to write off (and provision) unsecured credit to real estate developers undergoing bankruptcy proceedings (*Sareb (2015)*). The accounting regime under which Sareb, a mix of bank and real estate asset managers, must operate still needs to be approved. Normally, Sareb would have accrued its losses over 15 years, but the Bank of Spain specified they be frontloaded and compensated against tax credits. One motivation for this (cited by the paper *El Confidencial*) is the criticism by the European Commission of the original (under)valuations of the assets bought by Sareb, which could be seen as constituting state aid. As of early

2015, Sareb had a subscribed capital of about €5bn, 49% of which was owned by Spain's bank restructuring fund FROB.

To sum up, these cases underline that there are specific and deep rooted issues with defeasance structures that so far have been left unresolved by the Banking Union: what role should the SRF play, how to contain potential systemic risk to commercial banks; the (lack of) reliability of asset valuations when defeasance structures are set up and implied state aid when these are undervalued; and what accounting regime should they operate under, in particular the time span over which losses should be accrued.

5. The discretionary space left to Member States is still a grey area

The second lesson from HETA is how legally sound are decisions taken by member states in the discretionary space that has been left to them by the Banking Union? It is very likely that HETA creditors are currently working day and night to challenge the legal basis of both the debt cancellation and the moratorium, the latter being related to BU legislation.

The FMA's decision to impose a moratorium illustrates the considerable discretionary power that national supervisors still enjoy. Even though the Banking Union goes a long way in establishing centralised mechanisms for supervision and resolution, its mechanisms are layered on top of existing national institutions (IMF (2015)). Under the SSM, the ECB does not directly supervise, but simply oversees the supervision of less significant banks in the euro area by their respective national competent authorities. Likewise, under the Single Resolution Mechanism, the Single Resolution Board will "simply" oversee the resolution of banks by national resolution authorities.

This discretion at the national level is combined with a fair degree of centralisation of financial backstops: as of January 2016, the Board will start to have access to a common, industry-funded backstop to facilitate resolution if needed (the SRF, as mentioned above). Moreover, the European Stability Mechanism (ESM) can directly recapitalise banks under restructuring, acting as a kind of common fiscal backstop to the banking union. However, the hurdles for its use are very high (for example, bail-in must be exhausted), and the funding available is capped at €60 billion. This sum would be rapidly depleted in a systemic crisis.

Taken together, these centralised tools should eventually help minimise recourse to taxpayer-financed bailouts. But it is not clear whether they will be "mobilisable" if and when a decision taken at the national level entails the activation of financial backstops.

6. Public guarantees: ticking bomb or useful support to investment?

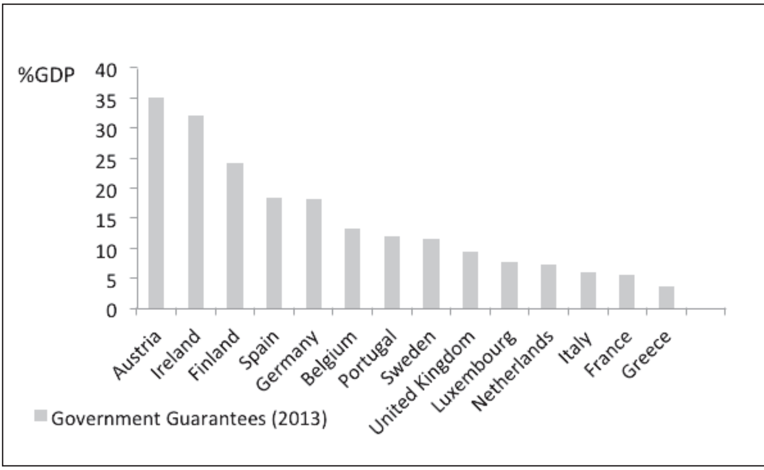
The third issue raised by the HETA case is that of public guarantees and their impact on public finances. The use of public guarantees intensified during the Great Recession, and their use seems to be growing even faster in the aftermath. Guarantees are often seen as a way to support investment by reducing funding costs. Or are they an 'open sesame' that allows anyone (including the ECB) to finance anything with their eyes half closed?

It must be remembered that a public guarantee is and will always remain a contingent liability. By definition, contingent liabilities are dormant and as such are difficult to manage, control, assess and value. As the Austrian federal government sadly learnt, they require dedicated monitoring and management. Public liabilities encompass both direct and indirect liabilities. Such liabilities are many and varied, but even the subset of contingent liabilities relevant to the Banking Union is more multidimensional than one might think. They can be explicit - entailing a legal obligation - or implicit - implying a social obligation (Houlihan Lokey (2012)).

Pricing guarantees has often proved difficult (Levy and Zaghini (2010)). And assuming that a hypothetical or off-balance sheet liability is not a genuine commitment is a fatal error. Consolidated figures for public guarantees extended by euro area member states are telling (Charts 1 and 2), and putting them in the broader context of contingent government liabilities is even more scary (Chart 3).

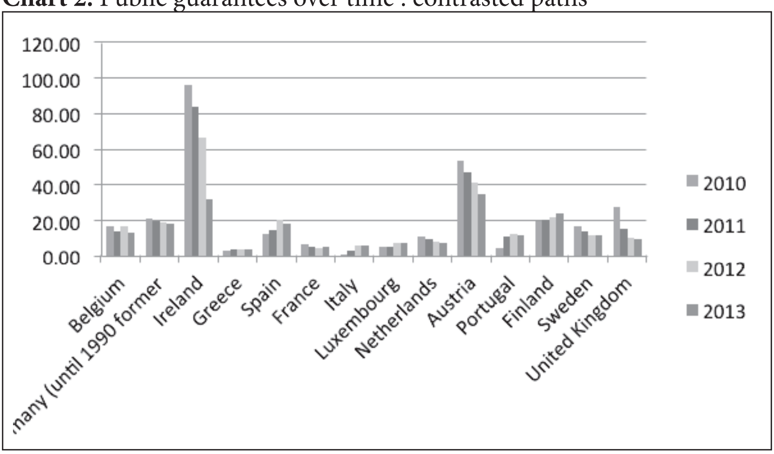
Among the contingent liabilities displayed in Chart 3, many are related to the banking sector: loan guarantees to public and private sector entities, umbrella guarantees, state deposit guarantee schemes – all of the former are explicit – and bail-outs related to the reversal of private capital flows (though this latter category should be quasi eliminated by the bail-in principle).

Chart 1: Public guarantees around of above 20% of GDP in five Member States



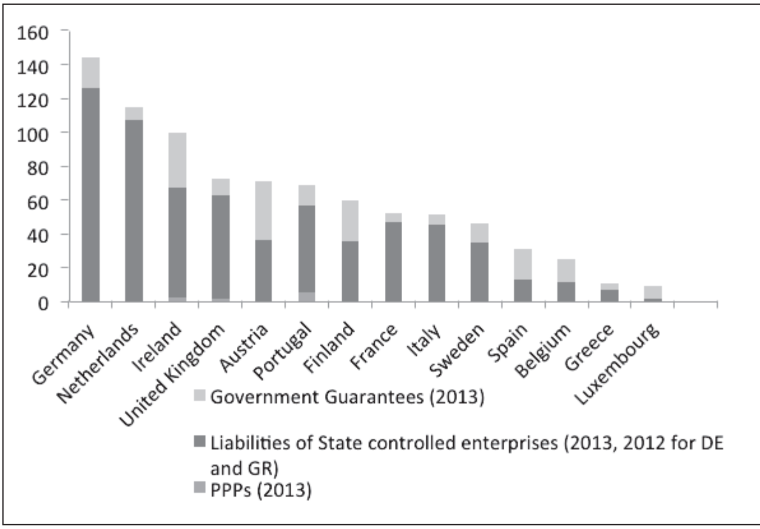
Source: Eurostat

Chart 2: Public guarantees over time : contrasted paths



Source: Eurostat

Chart 3: Contingent public liabilities might turn out problematic



Source: Eurostat

This rise in guarantees is puzzling. Market participants and policymakers have become more wary of imprudent liability management by governments, and one would have thought a holistic approach to public assets and liabilities would have become common wisdom following the sovereign debt crisis.

Local versus national government guarantees

Following the collective effort to harmonise accountability at the European level, guarantees granted to banks at the national level are now at least better identified and quantified. But what about guarantees granted at the infra-national level, such as regions or Länder? The Carinthian case has shown that there is a clear financial stability argument to supervise – or at least oversee – the financial activity of local governments associated with guarantees. Interestingly, in the case of Carinthia, the EC forbid as early as 2003 the extension of further public guarantees to banks on the basis of their being anti-competitive. A decision that was greatly challenged by local policy heroes relying on guarantees to finance their projects at low cost!

Effectiveness and distortions of public guarantees

Beyond their consequences on the sustainability of public finances, public guarantees also affect the propensity of banks to take risk, as the HAA case clearly illustrated. Gropp et al. (2010) show that in 2001, when government guarantees for savings banks were removed in Germany, the banks reduced their credit risk by cutting off credit to their riskiest borrowers. Grande et al. (2011) underline that there is a fine balance to strike between the positive impact of guarantees in kick-starting bank funding and the negative distortion caused in the cost of bank borrowing.

BU, guarantors and due diligence

The Austrian episode saw the state of Carinthia maintain its liability for the debts of the HAA group despite the bank's uncontrolled, rapid expansion abroad, without being equipped with the necessary risk management systems and control mechanisms. As the independent report concludes, it was "not apparent that the auditors, the bank supervision and the Land of Carinthia made sufficient use of the opportunities open to them in order to work towards limiting the risks." The Banking Union does not change the incentives for public guarantors to enact appropriate due diligence. But nor does it address the adverse incentive for politicians to lower financing costs through guarantees without caring about risks as long as they do not materialise during their own political mandate.

Overall, the HAA case raises the question of "who is the ultimate guarantor", and "what can decently be guaranteed". In the case of Carinthia, the Federal government, until recently, acted as if it were legally obliged to step in for the contingent liabilities incurred at the infra- national level, as illustrated by its decision to purchase all shares of HBint, a client of HAA. But as its more recent stance has shown, the solidarity between local and national government entities should not be taken for granted when it comes to fulfilling guarantee obligations. HAA creditors holding high yielding guaranteed bonds may find out their belief that a national bailout would automatically occur if the regional government entity could not service its debt may turn out be a fallacy.

It is regrettable that the Banking Union does not take any teleological position on public guarantees. The amounts at stake are considerable. In 2013, public guarantees were equivalent to more than 30% of GDP in Austria and Ireland, and equivalent to about 20% in Finland, Spain and Germany.

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Table 1: Overview of the ECB's AQR exercise

Rank	Banking Group	Country	Total assets			*Phased-in CET1*			*Fully-loaded CET1*			AQR results				
			16/03/2015	*end 2013 (AQR)*	*2015Q1(2014Q4)*	Capital	RWA	Ratio	Capital	RWA	Ratio	CET1 ratio	*AQR adj.CET1*	*Baseline (8%)*	*Adverse*	*Amount*
1	BNP Paribas	France	>1000	1 640 314	2 392	67	642	10,5%	66	645	10,3%	10,7%	10,5%	10,3%	8,1%	
2	Deutsche Bank AG	Germany	>1000	1 580 758	1 955	60	432	13,8%	48	431	11,1%	13,4%	13,3%	12,6%	8,8%	
3	Crédit Agricole S.A.	France	>1000	1 456 338	1 803	32	311	10,2%	32	311	10,2%	11,0%	10,8%	11,1%	8,8%	
4	Banco Santander	Spain	>1000	1 117 159	1 370	74	618	11,9%	60	618	9,7%	10,4%	10,3%	11,1%	9,0%	
5	Société Générale S.A.	France	>1000	1 141 579	1 429			10,5%	37	370	10,1%	10,9%	10,7%	10,6%	8,2%	
6	BPCE	France	>1000	1 065 430	1 239	48	399	12,1%	49			10,3%	10,0%	10,1%	7,0%	
7	ING Groep N.V.	The Netherlands	500-1000	786 504	1 053	43	308	14,0%	36	308	11,6%	10,4%	10,1%	10,4%	8,7%	
8	UniCredit S.p.A.	Italy	500-1000	849 993	901	43	421	10,1%	43	421	10,1%	9,8%	9,6%	9,5%	6,8%	
9	Nordea Bank Finland Plc	Finland	300-500	304 761	726	24	151	15,6%				14,1%	13,7%	14,2%	10,4%	
10	Intesa Sanpaolo S.p.A.	Italy	500-1000	536 620	682	37	280	13,0%				12,0%	11,7%	11,2%	8,3%	
11	Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A.	The Netherlands	500-1000	674 139	681	29	212	13,6%			11,8%	12,8%	12,0%	11,2%	8,4%	
12	Banco Bilbao Vizcaya Argentaria	Spain	500-1000	587 085	673	44	347	15,8%				10,8%	10,5%	10,2%	9,0%	
13	Commerzbank AG	Germany	500-1000	561 384	605	21	222	9,5%				11,4%	10,8%	11,4%	8,0%	
14	ABN AMRO Group N.V.	The Netherlands	300-500	369 752	438	16	113	14,1%				12,2%	12,1%	12,5%	9,2%	
15	DZ Bank AG Deutsche Zentral-Genossenschaftsbank	Germany	300-500	315 876	403	12	98	12,2%				9,2%	9,0%	8,7%	6,0%	
16	Caja de Ahorros y Pensiones de Barcelona	Spain	300-500	335 127	356	19	153	12,1%	17	150	11,5%	10,3%	10,2%	10,8%	9,3%	
17	Landesbank Baden-Württemberg	Germany	150-300	273 523	266	12	82	14,6%	11	82	13,6%	14,0%	13,5%	12,3%	7,4%	
18	KBC Group N.V.	Beligque	150-300	241 306	258	13	90	14,7%	14	92	14,9%	13,3%	12,7%	12,0%	8,3%	
19	Dexia NV	Beligque	150-300	222 936	268	8	57	14,3%				16,4%	15,8%	10,8%	5,0%	0,3
20	Bayerische Landesbank	Germany	150-300	255 836	239	10	75	12,9%	8	75	10,2%	14,0%	13,2%	12,4%	9,4%	
21	Banco Financiero y de Ahorros (Bankia)	Spain	150-300	266 491	232	11	88	12,5%			11,0%	10,7%	10,6%	12,3%	10,3%	
22	Erste Group Bank AG	Austria	150-300	197 639	203	11	102	10,5%	11	103	10,2%	11,2%	10,0%	10,1%	7,6%	
23	HSBC France	France	150-300	188 559	201	5	33	14,1%				12,9%	12,6%	11,2%	6,6%	
24	Norddeutsche Landesbank-Girozentrale	Germany	150-300	197 663	198	7	69	10,7%				10,6%	10,1%	10,9%	8,8%	
25	Belfius Banque S.A.	Beligque	150-300	161 072	194	7	50	14,7%				13,9%	13,5%	11,0%	7,3%	
26	Landesbank Hessen-Thüringen Girozentrale	Germany	150-300	176 999	179	7	54	13,4%			11,8%	12,5%	12,2%	11,4%	8,2%	
27	Banca Monte dei Paschi di Siena S.p.A.	Italy	150-300	199 106	188	6	76	8,1%				10,2%	7,0%	6,0%	**-0,1%**	4,2
28	Banco de Sabadell	Spain	150-300	161 544	167	9	75	11,8%			11,7%	10,3%	10,3%	10,2%	8,3%	
29	La Banque Postale	France	150-300	199 225	149	7	53	12,7%			14,0%	10,0%	10,0%	10,1%	9,1%	
30	Banco Popolare – Società Cooperativa	Italy	150-300	126 459	123	6	48	11,9%			11,6%	10,1%	7,9%	6,7%	**4,7%**	0,7
	Confédération Nationale du Crédit Mutuel	France	500-1000	539 007	not found						15,5%					

Note: Selection of top 30 european banks based on the list of supervised banks by the BCE as of16 March 2015, selection of banks that have been selected for supervision because of their size of total assets: https://www.bankingsupervision.europa.eu/banking/list/who/html/index.en.html

Financial Stability and Integration in the Banking Union

Christos Hadjiemmanuil

How stable and resilient is the euro area's Banking Union? The answer depends on the fundamentals of the euro area's financial sector as much as on the Banking Union's novel institutional and normative framework. The prospects for financial stability are thus contingent on the evolution of banks' portfolios, conditions of operation and industrial structure, as reshaped by the crisis (section 1). In particular, the degree of integration of financial markets and banking systems is a key factor: continuing fragmentation is bound to have negative implications also in terms of resilience (section 2).

Turning to public prudential regulation and crisis management, the establishment, as part of the Banking Union project, of streamlined decision-making mechanisms for the supervision and resolution of banks may not be enough; coherent and credible arrangements for the financing of resolution actions and, more generally, for the provision of a uniform and effective safety net are also needed. With a convincing and equitable set of burden-sharing arrangements, a future financial shock would be less destabilizing and a relapse to conditions of market fragmentation could be avoided (section 3).

It should be noted, however, that a proper appreciation of the situation regarding the safety net should take explicitly into account the close interactions between banking regulation and monetary policy. From this perspective, the ultimate question is, whether the Banking Union can provide simultaneously effective stabilization mechanisms and robust market discipline, through unwaveringly strict enforcement of prudential standards and banks' budgetary constraints (section 4).

1. The state of the banking sector in the aftermath of the crisis

The state of the euro area's banking sector is slowly improving (European Commission, 2015b: ch 1). The factual evidence suggests that significant steps towards increased safety have already been made.

To start with, some deleveraging has taken place. Thus, at the end of 2008, the total volume of banking assets in the euro area stood at € 33.5 trillion; five years later, assets were down to € 26.8 trillion (ECB, 2014b). The change is due to: balance-sheet repair and the write-down of bad assets; the divestment of non-core assets (in many cases, foreign operations); and to a very significant extent, the recalculation and scaling down of the derivative positions of large banks (thus potentially overstating the true extent of deleveraging).[1] However, as the financial recovery picks up, the deleveraging trend is likely to be reversed (unless, of course, further regulatory demands for capital items in an environment of low profitability put a more permanent break on credit extension by banks).

Changes in the composition of banks' balance sheets are also consistent with the hypothesis of increased safety. On the asset side, one can observe a modest shift towards traditional bank lending (loans and receivables) and away from trading assets. Of course, the situation is not uniform across banks and countries. Thus, trading assets represent a relatively higher proportion of total assets in the balance sheets of large, systemically important banks (19%) as well as banks based in large economies, such as Germany and France (25%). On the liability side, there has been a shift from wholesale to deposit funding. As a percentage of total funding, wholesale funding, which peaked in 2009 at 36%, has declined considerably subsequently, and is now down to 23%. With confidence growing and activity picking up in the interbank market, banks are now less dependent on central bank funding and excess liquidity in the system is being mopped up. In contrast, banks' reliance on deposit funding has modestly increased, with deposits now contributing over 50% of total funding.

Moreover, bank capitalization has improved markedly. At end of 2013, the ratio of Tier 1 capital to risk-weighted assets was about 13% for the median bank. Moreover, the ECB's comprehensive assessment of the

1 It should be noted that other financial enterprises (including insurance companies and pension funds, as well as 'shadow banks') have not been affected in the same way by the crisis. Indeed, within the wider financial sector (whose size has doubled over the past decade, reaching in 2013 a total volume of assets of € 57 trillion, or six times GDP) banks have lost relative ground: their share of the sector has gone down, from 59% to 52%.

condition of the euro area's large, systemically important banks, whose results were announced on 26 October 2014, did not unearth significant capital shortfalls (ECB, 2014a).[2]

In all these respects, today the situation of the average euro area bank (if such a thing exists) is much sounder than it was two or three years ago. Of course, there are still risks and weaknesses. Most significantly, bank profitability remains particularly sluggish (ESRB, 2015b: 29). This is due to a combination of factors, not all of which are likely to improve in the near future. Many banks are still hampered by the previous period's legacy of bad-asset problems, civil and regulatory liabilities and high restructuring costs. More generally, the macroeconomic environment, characterized by weak, uneven and fragile growth and low interest rates, is not conducive to strong profit performance and entails wider risks to the banking sector' recovery. Still, all in all significant repair has taken place at the firm level and the operating environment is better than before. On the ECB's assessment of the overall state of affairs, systemic risk is at a low level, with the indicators of systemic stress for euro area banks (as well as for most euro area sovereigns) returning to pre-crisis levels (ECB, 2014d; ECB, 2015b).

Nonetheless, a critical caveat is in order. It is not at all certain that the improvement is permanent and structural, rather than conjunctural or cyclical. If the latter, the situation could be easily reversed in case of a new destabilizing shock. The present environment of low stress is largely due to monetary-policy decisions. At some point, the situation may change, either due to a shift in the ECB's stance or because of a more profound real or financial shock. In any event, the current optimistic outlook does not necessarily guarantee the system's resilience in a future crisis. Thus, the true question is, not whether the banking system happens to enter a better phase, but whether it is now better equipped, from a structural as well as a regulatory viewpoint, to withstand a drastic deterioration of the economic, fiscal or financial environment.

A related question is, whether in a future crisis the banking system would be able to provide continuity of credit intermediation, smooth and uniform transmission of the monetary policy and efficient risk-sharing

2 The comprehensive assessment covered 130 banks, whose combined assets amounted to some € 22 trillion, thus representing over 80% of the euro area's total banking assets. It identified capital shortfalls in just 25 banks, whose combined shortfall at end-2013 was estimated at no more than €24.6 billion (ECB, 2014a: 6). By the time of completion of the comprehensive assessment, twelve banks had already covered the shortfall by issuing new capital. The rest presented their capital plans by end-2014.

across the Banking Union as a whole – something that it was patently unable to provide in recent years. In the euro area, the crisis was marked, not only by financial distress and banking failures, but also by a profound reversal of the substantial financial integration achieved since the introduction of the single currency, especially in the money and wholesale banking markets. Measures of financial integration peaked in 2008, but between 2009 and 2012 there was a complete break-down of cross-border financial flows and linkages. In the early phase of the crisis, the collapse of interbank lending was a major source of contagion. Subsequently, the unwinding of cross-border financial positions was followed by at times wide cross-country dispersion of nominal interest rates and attendant conditions of credit extension. The cost of money and, more generally, the monetary and credit environment came to diverge systematically between countries, despite the fact that the euro area is a monetary union, with a theoretically single monetary policy and unitary monetary conditions. For the private sector, location, as distinct from firm-specific performance and risk factors, came to dominate financing costs. In this sense, the fragmentation of the euro area into national financial islands was a primary cause of the economic troubles of peripheral economies. This experience underlines the significance of robust and non-reversible financial integration for monetary and financial stability in the Banking Union. Financial integration is a necessary condition for uniform monetary and credit conditions and the smooth transmission of monetary policy in the single currency area. It also facilitates stabilization by ensuring better risk-sharing. Conversely, any reversion to fragmentation can destabilize the banking system of particular economies and disrupt the credit intermediation function. For these reasons, ensuring permanent financial integration is not an independent objective, but a major stability concern in the Banking Union.

2. The limits of financial integration

More recently, cross-border financial activity in the euro area has resumed and there has been strong convergence of monetary and credit conditions across countries. Triggered by the endorsement of the Banking Union project in June 2012 and the announcement of the ECB's Outright Monetary Transactions (OMT) programme shortly afterwards, market confidence has improved greatly. The abatement of fears about the break-up of the euro area has almost eliminated redenomination risk for the countries in the euro area's periphery, with the exception of Greece. This has led to a remarkable narrowing of sovereign spreads. More generally, it has resulted in a marked increase in financial integration, with costs of funds converging rapidly across countries and volumes of cross-border activity gradually returning to pre-crisis levels. In its annual reports on financial integration, the ECB identifies a strongly positive trend in the period from mid-2012 onwards (ECB, 2014c; ECB, 2015a). This trend has affected all financial markets, albeit to a different extent. There is a resumption of activity in the money markets, especially in their secured segment. A decline in excess liquidity suggests that financial institutions are now more confident that the operation of wholesale markets will be smooth and uninterrupted. The situation in bond markets has improved, although integration indicators remain below their pre-crisis levels. Banking markets, on the other hand, show limited progress. Retail banking markets remain as deeply segmented along national lines as they have always been. Moreover, there is still dispersion in the borrowing costs faced by non-financial corporates in different countries – although this is not an incontrovertible sign of fragmentation, since the higher lending rates in distressed countries may also be explained by the riskier macroeconomic environment and increased prevalence of non-performing loans.

The real question, however, is not whether interest-rate levels have converged or whether the operation of interbank markets has normalized, but whether any apparent gains in integration will last. We should recall that the relatively high level of integration recorded in the European institutions' reports for 2008 (ECB, 2008; European Commission 2009) proved instantly reversible (ECB, 2009). The same could prove true of current reintegration trends, if the macroeconomic environment deteriorated.

For a proper evaluation of the situation, it would be useful to draw a distinction between convergence, as observed over the past two years, on the one hand, and integration, on the other. 'Integration' should denote the effective and permanent unification of financial systems. The euro area is not yet there! Presently, the convergence of monetary and financial conditions critically depends on macroeconomic, and in particular monetary, policy; it should, instead, be firmly grounded on structural factors, including more integrated bank ownership structures and an increased prevalence of cross-border banking groups. Furthermore, direct cross-border lending transactions are still rare, especially in the retail segment.

Cross-border lending intermediation in the euro area has always been fundamentally indirect and layered, with banks in surplus countries advancing to their counterparts in deficit countries wholesale funds, which the latter then on-lend domestically to commercial and consumer clients. All this suggests that, even though the prospect of an imminent catastrophe has now receded, fragmentation has not yet been addressed convincingly and permanently at the structural level and a future relapse is always possible.

Regarding the ownership structure and geographical segmentation of the banking industry, in particular, in certain respects the situation may have become intrinsically worse due to the pattern of recent restructuring developments. The crisis was followed by a wave of consolidation. At end-2013, 5948 credit institutions (including foreign branches) operated in the euro area; five years earlier, the number stood at 6690. The population of euro area-based banking groups has likewise declined from 2920 to 2609 groups (ECB, 2014b: 7–8). Significantly, however, consolidation has taken place mostly on a domestic, rather than cross-border, basis. In many cases, it involved intragroup transactions, as part of internal restructuring efforts. In contrast, the genuine M&A activity has been subdued in terms of both the number and the value of transactions (ECB, 2014b: 12–14). In particular, cross-border mergers remain few and far between. One result of this type of consolidation is increased market concentration at the national level, with relevant indices going up during the crisis years.

Of course, there is considerable variance across countries with regard to the size and concentration of the banking sector and the extent of domestic, as distinct from foreign, control of banking assets. In a few small member states, namely, Luxembourg, Malta, Ireland and Cyprus, which specialize in financial services and operate as financial entrepôts, the banking sector is unusually large in comparison to domestic GDP, although the ratios have declined substantially after the Irish and Cypriot debacles. In terms of assets, while in certain smaller countries (especially amongst the newer member-states) the market is dominated by banking groups based in other European countries, in most countries there is clear preponderance of the domestic banks. As for market concentration, banking systems in the large countries are much less concentrated than those in smaller countries (ECB, 2014b: 14–15). Overall, however, the developments suggest that in certain countries banking activity is increasingly concentrated in the hands of domestic systemically important banks.

At the same time, many larger banks are now more focused on their home market than they used to be. Occasionally, the increase in the share of domestic to total activities was due to mergers with other domestic banks, but frequently it reflected the divestment of foreign operations as part of post-crisis streamlining. Official responses to the crisis contributed to this trend. This applies, for instance, to the way in which certain large, multinational banking groups such as Dexia or ING were resolved at an early stage of the crisis by being split into separate national successor entities. In numerous other cases, national governments (especially in programme countries) merged failing banks into new, larger entities or transferred them forcibly to viable institutions.

The move towards banks of larger size, increased systemic importance and primarily domestic business focus is hardly beneficial in terms of systemic stability (cf Laeven et al., 2014). It increases the potential for country-specific financial shocks and renewed disruptions of cross-border financial activity and capital flows. Simultaneously, it worsens the systemic side-effects of failure at the national level, thus aggravating the 'too big to fail' ('TBTF') problem (Strahan, 2013). Compared to the very large reversal of cross-border investment flows and the extensive disruption of liquidity sharing experienced during the crisis, the decrease in the presence of foreign banks in national banking systems is rather limited. Nonetheless, a banking system's shape when exiting the crisis is bound to influence its further development for years to come. From this perspective, even a modest scale-back of foreign bank presence in certain jurisdictions can be significant, since it entrenches the structural segmentation of the European banking system into interacting, yet distinct national subsystems.

Of course, a financial system dominated by foreign banks is not devoid of risks for the host economy. While it can contribute to better risk-sharing and a smoother adjustment in the event of a local economic shock, it may be a problem if a financial crisis threatens the foreign banks in their home base: in the latter case, the banks may suddenly and abruptly decide to retrench their operations by scaling back their exposure to the host economy, thus acting as a primary channel of contagion. The experience of Eastern European member-states in 2008–09 proves the point (Allen, Jackowicz and Kowalewski, 2013). On the other hand, with supervision now centralized at the hands of the ECB, one can imagine that in future the supervisory response to a situation of this type will be more appropriate: rather than insisting on the ring-fencing of liquidity within the home jurisdiction, as some national supervisors did during the crisis (**Jones, 2013**), the ECB will probably insist on a balanced approach, seeking to maintain cross-border liquidity lines intact. There are other potential drawbacks of multinational bank dominance that must be considered, like the concentration of ownership power and managerial decision-making in a few national capitals, with potentially negative implications for other (smaller and/or peripheral) countries, which may find themselves at the bottom of the pyramid. Still, the interpenetration of national banking markets and the emergence of more broadly based banking groups would, in principle, result in more profound and irreversible integration and, other things being equal, in a more stable financial system.

A strategy for overcoming financial fragmentation was presented to ECOFIN in late 2013 by two experts from the Bruegel think-tank (Sapir and Wolff, 2013). In their view, financial integration and stability in the Banking Union should be pursued by way of a three-step process, involving: (a) an immediate, thorough and tough appraisal of the true capital needs of banks in the euro area, in the form of the ECB's 'comprehensive assessment' exercise (which at that point had yet to be conducted), followed by the recapitalization of undercapitalized but otherwise viable banks with private money; (b) aggressive resolution of problem banks, preferably by way of cross-border bank sales and mergers, so as to encourage the integration of retail banking markets and to break decisively the domestic bank-sovereign links; and, as a longer-term objective, (c) the development of genuinely cross-border securities markets, especially for equities and corporate bonds, through the extensive harmonization of corporate governance, insolvency and tax law. In particular, the shift to a more market-orientated financial system was considered essential, in order to reduce the heavy reliance of European economies on bank funding and to improve economic stability through better financial risk-sharing.

By underlying the significance of unified, efficient and deep capital markets for the future development of the financial system, this strategy effectively presaged the Juncker Commission's Capital Markets Union project (Juncker, 2014: 6; European Commission, 2015a; Hill, 2015), to which it may have served as an inspiration. However, the part which concerned the banking sector, and which should be applied first, has not been followed. To begin with, despite expectations to the contrary, the ECB's comprehensive assessment was not particularly tough; and in any event, it did not reveal significant problems, thus rendering redundant the suggestions regarding the preferable approach to repair and resolution. Moreover, up till now bank restructuring and resolution efforts have taken place on a predominantly domestic basis; and this tendency may well continue in the foreseeable future, since, on the one hand, so far there is no sign of a strong lobby for restructuring through cross-border mergers, while, on the other hand, national governments, which tend to prefer domestic consolidation, are likely to retain considerable influence over the engineering of resolution solutions as long as resolution funding arrangement have not been fully mutualized.

As for the hope that the Capital Markets Union might of itself transform the financial landscape, leading to a less-bank-centred and more structurally integrated financial sector, it is enough to observe that even its most enthusiastic proponents recognize that this is a long-term project. The concept may be worthy, but it clearly lacks the revolutionary, game-changing character and clear focus of the Banking Union. It comprises a multitude of partial objectives, many of which lack political visibility. Its success depends on the combined effect of a large number of legal, administrative and practical steps, some of which are full of thorns. It is not by coincidence, nor due to a lack of vision that, almost half a century after its appearance (EEC Commission, 1966), the Segré Report's plan for a truly pan-European and dynamic capital market remains largely unrealized. More recently, the Financial Services Action Plan (FSAP) set out an ambitious and very extensive legislative programme, which was predominantly directed to the development and integration of capital markets (European Commission, 1999), but this was also insufficient. This time too, one should not expect rapid and spectacular success. The Capital Markets Union can provide a frame and a theme for the European policy agenda for the non-bank financial sector; but it is unlikely to yield appreciable fruits any time soon – much less to relegate questions of banking policy to a secondary position in the political, legislative and regulatory agenda.

3. The new regulatory landscape

Beyond adjustments at the industry level, the robustness of the regulatory regime is also critical to the long-term stability banking sector. It is precisely on this plane that the most spectacular changes have been observed over the past few years. Both the norms and the organizational arrangements for prudential supervision and bank resolution have undergone radical transformations.

Regulatory requirements

In the wake of the Lehman Brothers debacle, Europe embarked on a major wave of prudential reregulation. The pre-existing system of prudential controls was revised and tightened considerably. The overhaul was pursued under the more general rubric of the development of a so-called 'single rulebook', comprising highly harmonized regulatory frameworks for the operation of European financial institutions and markets. Significantly, the rules of the single rulebook are not confined to the euro area, but apply uniformly across all member states. Relevant provisions are promulgated at two levels: the basic legislation (regulations or directives) is enacted by the European Parliament and the Council in accordance with the ordinary legislative procedure; this contains numerous enabling provisions, allowing for further elaboration of the rules by way of supplementary instruments (delegated and implementing acts), which are adopted in the form of Commission legislation. In the field of banking, the body responsible for the preparation of the supplementary instruments is the European Banking Authority (EBA).

The prudential framework is one of the two core components of the single rulebook for banks. In this area, the basic norms are now set out in the CRD IV/CRR legislative package (Directive 2013/36/EU, OJ 2013 L176/338; and Regulation (EU) No 575/2013, OJ 2013 L176/1). For the most part, this translates into European law the provisions of Basel III, the latest iteration of the Basel global capital adequacy framework, now reinforced with new liquidity and leverage components (BCBS 2011; BCBS 2013; and BCBS 2014). There is little doubt that the new capital requirements are much tighter than the previous system of bank capital adequacy. One could retort that these requirements are not exempt from certain serious defects inherent in the general conceptual approach and risk-weighting techniques of the Basel system of capital adequacy, whose apparent technical sophistication masks fundamental arbitrariness.[3]

3 An arbitrariness only made worse as a result of the labyrinthine and non-transparent provisions first introduced with Basel II, which enabled individual banks to choose how the general standards may apply in their own case, thus opening opportunities for gaming the system.

Nonetheless, regardless of one's views on the underlying methodology, it is clear that Basel III raises appreciably the capital ratios that banks must observe and, in particular, demands that these be covered predominantly with true shareholders' capital ('core Tier 1' capital items, such as common stock and disclosed reserves), as distinct from the hybrid capital items and subordinated debt instruments, which were admitted in the calculation to a much larger extent in the past. Furthermore, the assessment of capital positions now takes place on a less static basis, due to the periodic stress-testing of banks' portfolios; and it is possible to vary over time the standard (micro-prudential or bank-specific) capital requirements by imposing on a country's banks additional macro-prudential capital requirements, in order to counteract perceived macroeconomic imbalances and emerging systemic risks (Directive 2013/36, art 133 (1); Regulation 575/2013, art 458).[4] Last but not least, alongside the revamped risk-weighted capital requirements, the new prudential framework encompasses totally new elements of protection, including liquidity ratios and a non-risk-weighted leverage ratio.

The other core component of the single rulebook regulates the handling of bank failure. It is based on the recently enacted Bank Recovery and Resolution Directive (BRRD) (Directive 2014/59/EU, OJ 2014 L173/190). The BRRD establishes a special administrative regime for the resolution of distressed or failed credit institutions. This is a novelty, not only for European law, but also for the domestic law of many member states. In contrast with the *ad hoc* character of traditional bank-crisis management practices at the national level, the resolution process now becomes highly streamlined. Resolution actions will henceforth be supported by advance recovery and resolution planning, with individually produced plans for each and every significant bank or banking group. As for actual resolution-related decision-making, this will now be subject to openly proclaimed general principles and rather detailed procedural and substantive rules. Beyond enabling derogations from the general

4 As the relevant decisions can be taken by special bodies operating at the national level in cooperation with supranational bodies and institutions other than the ECB (ESRB and EBA, Commission and Council), macro-prudential regulation is partially decoupled from supervision, both horizontally and vertically (Constâncio, 2010; Constâncio, 2015). Moreover, even in so far as the ECB can impose macro-prudential requirements in the euro area, this function is exercised under special procedural rules, under which the primary decision-making role is reserved for the ECB's monetary policy-makers (Governing Council), and not for its supervisory wing (Regulation (EU) No 1024/2013, OJ 2013 L287/63, art 5; and ECB Rules of Procedure, art 13h, as inserted by Decision ECB/2014/1, OJ 2014 L95/56).

law, the BRRD delineates a structured approach to the management of bank failures and prioritizes particular solutions. Its norms are intended to eliminate TBTF concerns and to minimize the need for bailouts with taxpayers' funds, thus enhancing market discipline. For this reason, they include a specific burden-sharing cascade, which gives precedence to the private financing of a failed bank's restructuring. In particular, a failed bank's existing stakeholders –namely, its shareholders, junior creditors and, depending on the circumstances, even senior creditors and depositors with deposits in excess of the guaranteed amount of € 100,000– are required to contribute to the absorption of past losses and to the recapitalization of the bank by means of a write down of their equity and debt claims and/or conversion of their debt claims into equity; this is has been named 'the bail-in tool' (Directive 2014/59, arts 2(1)(57) and 43–55).

For reasons that will be hinted at later on (section 4), it is doubtful whether the new resolution regime will live up to its promise to eliminate TBTF and all but remove the need for public financing of bank bailouts. Still, it can contribute to the containment of risk, because it provides a more structured and predictable approach to resolution and contains provisions which partially improve the incentive structure of banks' shareholders. Less directly, resolution planning and other provisions on the structure of banking groups will precipitate organizational adaptations, while a pre-emptive reorganization of banks' internal and external relationships in view of the bail-in provisions may also be expected. From this perspective, one of the most significant elements of the new regime consists in the prospective imposition on systemically important banks, as part of their resolution planning, of a new financing constraint, the so-called 'MREL' (minimum requirement for own funds and eligible liabilities), requiring these banks to retain minimum ratio of total bail-inable liabilities (including eligible junior debt and bonds) to total liabilities (Directive 2014/59, art 45).[5] This is a second line of defence, whose scope goes far beyond traditional bank capital. When finalized and implemented, the MREL standards will result in a very substantial enhancement of the resilience of large banks; additionally, the constraint on their liability structure will set limits to their incentives for further growth.

The new regulatory arrangements have a less evident but very significant risk-reducing effect in the area of collateralized interbank lending.

5 More recently, the Financial Stability Board (FSB) has proposed the imposition on global systemically important banks (G-SIBs) of a broadly equivalent requirement for a minimum total loss-absorbing capacity ('TLAC') (FSB, 2014).

In the pre-crisis period, the existence of European legislation establishing insolvency 'safe harbours' in favour of the holders of financial collateral (Directive 98/26/EC, OJ 1998 L166/45; Directive 2002/47/EC, OJ 2002 L168/43) facilitated the development of conditions of excessive liquidity in interbank markets. In case of a debtor bank's insolvency, safe-harbour provisions protect creditors holding financial collateral by recognizing close-out netting and allowing them to enforce their claims separately from other creditors and with immediate effect; this is achieved by means of the unilateral liquidation of their collateral outside the collective proceedings. The avoidance of the insolvency moratorium and of the principle of pro-rata satisfaction is a strong inducement for the collateralization of wholesale lending and the development of related securities financing techniques (see Keller et al., 2014). In this manner, in normal times safe harbours boost considerably the availability of short-term interbank liquidity at low cost (Paech, 2015). However, there is a significant downside, in so far as the resulting liquidity exposures increase bank interconnectedness and systemic risk. In a crisis, collateralization provides protection to a failed bank's immediate wholesale creditors; but, at the same time, it encourages the immediate cessation of further credit extension, the rapid foreclosure and liquidation ('fire-sale') of existing collateral and, when this takes place on a large scale, the emergence of asset-price deflationary spirals, which can lead to the drying up, or even complete freezing, of interbank markets as the falling aggregate value of available collateral items can no longer support further liquidity-sharing across the whole system. This catastrophic dynamic made itself felt with particular force in autumn 2008. Even though the new regulatory norms leave the safe harbours intact, they partially mitigate the problem outlined above in two ways: firstly, the new prudential rules (e.g. Regulation (EU) 648/2012, OJ 2012 L201/1) establish a more cautious approach to securities financing and, in particular, to the multiple use of the same collateral, while requiring the intermediation of central counterparty mechanisms for certain positions; and secondly, the BRRD imposes a mandatory and automatic stay on individual enforcement actions during the resolution process, thus preventing the unwinding of collateral positions and the resulting collapse of the liquidity positions during the period when a failing bank's fate is still under administrative consideration (Directive 2014/59, arts 69–71). These developments partially address systemic risk in a market of critical importance, which also constitutes a primary interface between the formal banking industry (credit institutions) and 'shadow banks'.

All in all, the prudential framework is considerably more demanding today than it was before the crisis. Its general evolution reflects a shift away from the excessive reliance on current prices, credit ratings and the supposedly self-correcting market practices of the pre-crisis period. Instead, the emphasis is now being placed on externally imposed (that is, public), mandatory, more uniform and significantly stricter prudential standards. The presently relatively low capital ratios of many banks cannot belie this fact. Building up capital resources requires time and conducive macro-financial conditions; at this stage, however, we are just exiting a major crisis (which has naturally led to a depletion of bank capital positions, thus leading to a very low new starting point). The new regulatory standards are phased in only gradually; accordingly, current market weaknesses cannot be attributed to them. Moreover, an over-aggressive prudential stance could be counterproductive, since it could harm the rather timid recovery of the European economies.

Of course, this does not mean that all is good, or that there are no uncertainties and continuing problems. The long implementation horizon of the new prudential norms implies that during the transition the banking system will continue to operate below the projected levels of safety; and, what is more important, it provides banking interests with ample time for lobbying for the norms' relaxation or further postponement. Moreover, certain elements are not totally convincing. In particular, at 3%, the projected leverage ratio may be too low; and the specification of the new liquidity requirements is rather fuzzy and highly dependent on the technicalities of the final implementing instruments. The fate of the proposals on structural controls (European Commission, 2014) is also very uncertain. Last but not least, the question of limits on the public-debt exposures of credit institutions –an issue of primary importance for breaking the infamous bank-sovereign feedback loop, which reignited the financial crisis in 2012– has only recently brought into the official regulatory discussion (ESRB, 2015a). The effectiveness of the post-crisis regulatory settlement and its eventual impact on banking risk (and risk-taking incentives) thus hangs on a number of design choices which are still open for decision.

Organizational centralization of supervision and resolution

While the territorial field of application of the new regulatory norms is pan-European, the reform of the organizational structure concerns specifically (and, at least for the time being, exclusively) the countries of the euro area. Indeed, 'Banking Union' is but a label given to the euro area's new regulatory architecture. Its hallmark is the drastic centralization of the administrative responsibilities for prudential supervision and resolution through the establishment of two streamlined structures, the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), respectively. In these mechanisms, certain roles are assigned to the relevant national authorities; but the most important decisions are reserved for newly appointed European authorities.

Thus, in the SSM, the key responsibilities (including the direct ongoing supervision of 123 'significant', or systemic, banking groups) have been transferred to the ECB, but are performed separately from its monetary policy functions in an organizationally distinct supervisory wing, headed by a new organ, the Supervisory Board (Regulation (EU) No 1024/2013, OJ 2013 L287/63). The Supervisory Board includes centrally appointed officials as well as representatives of the national supervisory authorities.

There are reasons to expect that supervision will become more effective with the move to the SSM. The streamlining of supervisory practices, reporting requirements and lines of communication can play a positive role. There is also a hope that the ECB's assessments will be more broadly based and more rounded than those of national supervisors. In the case of cross-border groups, in particular, the new system may facilitate prudential assessments on a group-wide, single-enterprise basis, and may even lead to somewhat lower compliance and reporting costs, since all entities in a group will now be subject to a single set of supervisory demands.

Many observers, however, expect the greatest benefits to derive from the removal of certain perverse incentives affecting supervisory decision-making at the national level. The ECB is highly unlikely to share national supervisors' attachment to 'national champions' and dislike for cross-border M&As. In periods of market turbulence, it will not seek to ring-fence liquidity within national borders, as they did. More generally, the ECB will tend to be less amenable to influence, not to mention outright pressure, from national governments and banking interests. Finally, the ECB may be less beset by incentives for forbearance than the old national supervisors. Conceivably, however, a tendency towards relatively stricter enforcement might not operate in a fully consistent way. Strict enforcement towards middle-size banks, of primarily national significance, could go hand-in-hand with a propensity towards leniency and forbearance for very large banks of pan-European importance. If so, this tendency would both entrench the TBTF benefits of size and result in effective discrimination against the national banking industries of smaller and less wealthy peripheral states.

The rather odd distribution of responsibilities within the SSM gives rise to other and more immediate concerns. While the ECB is directly responsible for the supervision of large banks, the intention is that it will normally delegate to the national competent authorities the front-line supervisory tasks, including in relation to the collection of information and on-site inspections (Regulation 1024/2013, arts 4 and 6). When sanctions need to be imposed, the ECB may act autonomously only if these sanctions derive from directly applicable instruments of European law (regulations) and are directed to legal persons; in all other cases, the enforcement actions must be brought at the request of the ECB by the national authorities, in accordance with national law and procedure (Regulation 1024/2013, art 18). The ECB is also only indirectly responsible for the ongoing supervision of less significant credit institutions (albeit solely responsible for the grant and withdrawal of their authorisation); and it totally lacks competence in relation to regulatory matters of non-prudential nature (that is, for conduct-of-business and transactional banking regulation) (Regulation 1024/2013, arts 1, 4 and 6). In addition to being administratively inconvenient, this division of supervisory tasks is highly dependent on mutual trust. In theory, the close and faithful cooperation of the ECB and the national authorities should ensure effective coordination and help to avoid frictions; and in the event of disagreement, the system's hierarchical structure gives the final say to the ECB. However, such semi-strong centralization cannot preclude strategic behaviour on the part of national supervisors. For instance, these may choose to withhold information or delay its transmission, or sabotage the enforcement actions required by the ECB (Ferrarini, 2015). The risk that national supervisors will attempt to game the system in this manner may increase during crises, when the timeframe for decisions is condensed and the preferences of domestic and European decision-makers are more likely to diverge.

A specific criticism of the new regulatory architecture's variable geometry relates to the decoupling of regulation from supervision (Ferrarini, 2015). The individuation of the single rulebook is a matter for the EBA or, on numerous occasions where national discretions are still available, the national legislative and/or regulatory authorities. Thus, in its capacity as regional supervisory authority, the ECB is called to apply norms having either a wider (pan-European) or a narrower (domestic) territorial field of application. The current arrangements are, undoubtedly, complex and cumbersome. One wonders, however, whether the exercise of regulatory powers is an integral attribute of the supervisory function, as the critics claim. If anything, it makes sense to have a common rule-making process for the Internal Market as a whole, with the same rules applying to the euro area as elsewhere in the EU. As for the local variation and 'gold-plating' of the regulatory norms, rather than being transferred from the national to the euro area level, it should be discouraged altogether. Thus, for all the awkwardness and potential tensions, there are good reasons for splitting the regulatory from the supervisory responsibilities and leaving to the EBA the development of the single rulebook, which should apply uniformly across the Union. On the other hand, the EBA's internal decision-making arrangements are less than ideal (Regulation (EU) No 1022/2013, OJ 2013 L287/5). The creation of the Banking Union has led to a revised voting system in the EBA's Board of Supervisors, whereby decisions must be supported by majorities of both the Banking Union country representatives and those of non-participating countries. The representation of the Banking Union raises additional questions: the representatives of the national supervisory authorities of the participating countries sit as full members, while the ECB representative participates without voting rights. Participation in colleges of supervisors of cross-order banking groups also takes place by way of parallel representation. Time will tell, how solid and effective these arrangements are.

The supervisory responsibility of the ECB extends to the adoption of appropriate measures, when a bank meets the criteria for early intervention. When, however, a bank is found to be failing, its resolution will in future be carried out by the Banking Union's second mechanism, the SRM (Regulation (EU) No 806/2014, OJ 2014 L225/1). The SRM's administrative mechanism is backed by supranational financial arrangements in the form of a pre-funded Single Resolution Fund (SRF), which must be built up by the end of 2023 with contributions raised on a mandatory basis from the regulated credit institutions; and *in extremis* the ESM can serve as common fiscal backstop (Regulation 806/2014, arts 67–77; ESM Treaty, art. 15; ESM, 2014; Hadjiemmanuil, 2015: 26–34).

Within the SRM, the key decisions in relation to the resolution of ECB-supervised banks will be taken by a brand-new European agency, the Single Resolution Board (SRB), but the actual execution of the resolution scheme will be left to the national resolution authorities, acting in accordance to domestic company and insolvency law; the latter will also be primarily responsible for the resolution of less significant banks (Regulation

806/2014, art 7). To avoid agency problems and policy frictions, all actions of national responsibility will be subject to the SRB's reserve powers of intervention. Like the ECB's Supervisory Board, the SRB includes national representatives in addition to five centrally appointed members. Individual cases are considered either in a plenary session or in a truncated formation, the so-called 'executive session', which includes only the centrally appointed members and those national representatives who represent countries where the bank under consideration has a presence (headquarters, branches and/or subsidiaries). Resolution decisions are taken in executive session, except when the resolution scheme provides for support by the SRF in excess of € 5 billion or when the net accumulated use of the Fund in the last consecutive 12 months has exceeded the threshold of € 5 billion (Regulation 806/2014, arts 43, 49–55).

The resolution procedure is very complex, but exceptionally expeditious (Regulation 806/2014, art 18). In particular, upon notification from the ECB of a bank's actual or impending failure or on its own initiative, the SRB assesses the bank's condition and draws the resolution scheme, specifying the appropriate resolution tools and financing arrangements, including the extent to which the SRF may be used. To take effect, the resolution scheme proposed by the SRB requires the approval of the Commission or, when the Commission refers the matter to it, of the Council. In case of objection by either of them, the SRB must reconsider the situation and amend the resolution scheme in accordance with the reasons given for the objection. The various procedural steps must take place within very tight time limits, ensuring the completion of the whole procedure within no more than 32 hours – the length of the proverbial weekend.

Given the high stakes, very short timeframe and high administrative complexity of resolution proceedings, the separation of supervision from resolution may generate more significant practical challenges than that between regulation and supervision. The operating relationship between the ECB and the SRB is a potentially sensitive issue. It will be interesting to see, how the two organizations will coordinate their functions in relation to recovery and resolution planning. More significantly, the ECB retains responsibility for early intervention in weak banks; the SRB takes over only once a credit institution has been declared 'failing or likely to fail'. Since the relevant assessment can be initiated by either authority, the delimitation of their respective fields of action effectively becomes a matter for concurrent decision-making. This may be a significant source of frictions; and if a bank's failure appeared to be mishandled, it could provide grounds for playing the blame game.

It is not possible to delve here into every aspect of the Banking Union's institutional set-up. Certainly, the structure and operating modalities of the SSM and the SRM contain grey areas, some of which were mentioned above. Nonetheless, from a regulatory perspective, the creation of the two mechanisms signifies a major transition –a veritable regime change– whose overall impact on the effectiveness of supervisory control and the stability of the euro area's banking system will, in all likelihood, be beneficial. From another perspective, that of crisis management, on the other hand, the progress achieved so far has been rather timid.

Bank resolution and burden-sharing in the Banking Union

One should remember that the Banking Union was motivated, not by considerations of supervisory effectiveness,[6] but by concerns intimately linked to bank resolution and its financing. Indeed, the funding of the safety net constituted the primary cause of the Spanish crisis of early 2012, which set in motion the series of decisions leading to the Banking Union. The Spanish case provided a clear illustration of the perverse dynamics of the bank-sovereign feedback loop, whereby a state's financial weakness undermines the credibility of the (explicit or implicit) public guarantees in favour of domestic banks, thus leading to an erosion of these banks' ability to access market liquidity during a crisis, thus making all the more necessary the provision of public support, which, in its turn, leads to a further deterioration of the fiscal position, and so on. As these effects were not symmetrical across the euro area, but country-specific, the bank-sovereign loop produced a strong divergence in monetary and financial conditions between the weaker peripheral economies and those of the centre, which called into question the very survival of the single currency area. The absence of supranational burden-sharing arrangements for bank crisis management allowed this vicious circle to follow its course uninterrupted.

When the Banking Union project was initially announced in mid-2012, the key promise, which helped to soothe markets, was precisely

6 Just three years earlier, in February 2009, the de Larosière report, referring to proposals for the unification of the supervision of cross-border financial institutions at the pan-EU level, had expressed strong reservations about so bold a move, especially as long as the EU had not decided 'to move towards greater political integration' (de Larosière Group, 2009: 58).

that the funding of bank bailouts and resolution actions would henceforth be mutualized. This would be achieved through a single deposit guarantee scheme (DGS) and a common fiscal backstop (with the ESM performing the latter function). The only reason for which the centralization of the supervisory function was endorsed without much resistance, was that this was a prerequisite for the centralization of financing arrangements. This, however, did not happen or, at least, did not happen in a full and conclusive sense.

While the Banking Union eventually comprised single mechanisms and central institutions for both supervision and resolution, the resolution financing arrangements remain to a large extent fragmented. A uniform safety net (as envisaged, e.g., by ESRB, 2012: 14–18, 22–24) is still lacking. The original proposal for a single DGS, to complement the new integrated supervision and resolution mechanisms (Van Rompuy, 2012: 4–5), has been postponed *sine die*, if not altogether abandoned (European Commission, 2012: 4, 6 and 9). The ineffectual system of separate national DGSs will thus be retained, subject to rather unconvincing provisions enabling mutual borrowing between DGSs (Directive 2014/49/EU, OJ 2014 L173/149). As already mentioned, within the SRM, resolution actions can be supported by supranational financing arrangements, in the form of the SRF and, potentially, the ESM as common fiscal backstop. But any potential fiscal interventions will still be primarily based on the residual responsibility of a bank's home country (Hadjiemmanuil, 2015). Thus, in a potential crisis, nationality and the fiscal strength of the domestic sovereign may continue to be a significant risk-differentiating factor.

The abandonment of the original promise regarding the mutualization of bailout costs is partly due to transitional considerations, since countries of the euro area's centre such as Germany, Netherlands and Finland were adamant that banks' losses on pre-existing or 'legacy' assets should not be grandfathered into the Banking Union's resolution arrangements. A basic argument against burden-sharing in relation to legacy assets was that the countries which exercised *ex ante* supervisory control over the problem banks should be saddled *ex post* with the fiscal costs of rescuing them. Many commentators went so far as to blame the deficiencies of supervision at the national level for the crisis. In actual fact, however, during the crisis the weaker links in the chain proved to be, not countries with reputedly weak supervisory systems, but those which, due to limited fiscal capacity or very large banking sectors relative to GDP, displayed limited ability to finance a fully-fledged bailout effort. Be this as it may, now that supervisory control has passed from the national authorities to the ECB, this argument can no longer be invoked to justify the residual financial responsibility of national DGSs and governments.

Still, a more general tendency to avoid burden-sharing unless strictly necessary is clearly in evidence, especially when the resolution actions necessitate public financial support. The preferences of fiscally robust states (which, being confident that in a crisis they will be able to finance on their own the bailout of domestic banks, do not want to contribute to the rescue of foreign ones) combines with the BRRD's principal legal policy (which is to ensure that henceforth the taxpayer's contribution in the financing of resolution actions will be confined to the bare minimum) to transform subtly but profoundly the fundamental rationale of the Banking Union. Instead of focusing on the viability and symmetry of the resolution financing arrangements, the mode of thinking that eventually prevailed takes it for granted that aggressive bail-in, based on the principles of the BRRD, will take place in each and every case of resolution. According to this narrative, in future the full, or almost full, costs of resolution will fall on the private sector – that is, first on a failed bank's direct claimholders and then on the privately pre-funded stand-by resolution financing arrangements (namely, the relevant DGS and resolution fund). If so, there will rarely be need even for domestic public assistance, much less for supranational bailout arrangements! We have thus moved almost imperceptibly from the original intention, which envisaged the eventual mutualization of public safety nets in the Banking Union, to a system relying on the principle of robust and quasi-automatic private risk-sharing (cf Buch & Weigert, 2014). However, the belief that publicly financed bailouts have been relegated once and for all to the ash heap of history is most likely false. In a future systemic crisis, the extension of public guarantees can once more appear politically or economically unavoidable; then, the credibility of such guarantees will become yet again a critical factor, in terms both of re-establishing order in the market and of preserving equal conditions of operation across member states. This, indeed, was the intuition behind the original Banking Union approach.

Thus, the necessity of central financial arrangements and full burden-sharing currently rests on a number of considerations: the likelihood that, despite the new provisions on bail-in, bailouts of significant banks will continue to take place; the principle of alignment of supervisory control and liability, which, in the new environment of all but unified regulation and supervision, operates in favour of mutualization;

and the need to preserve the stability of the financial system and the equality of monetary and financial conditions across the euro area, both of which rest on flimsy grounds when the financial responsibility for bank resolution is divided along national lines and country-risk continues to plague banks (cf Herring, 2013). Less evidently, an additional argument for full burden-sharing relates to the incentives of the ECB, since in an environment of separate national financial arrangements the single supervisor may have an additional and idiosyncratic incentive for forbearance where a failing bank's home country (or the relevant DGS) is itself fiscally weak.

It is often said that the euro area's banks are 'European in life, but national in death'. However, due to the official and private responses to the recent crisis (including the ring-fencing of liquidity, the break-up of several large cross-border groups along national lines, the nationalization of many weak banks and the concentration of certain countries' public debt in the hands of domestic banks) market segmentation has increased, and banks are more likely today than before the crisis to be national both in life and death! Rather than reversing this development, the Banking Union's burden-sharing arrangements may actually entrench it!

At the same time, strong doubts have frequently been voiced about the sufficiency of the new resolution regime's pledged resources. Under the new arrangements:

- by mid-2024, the national DGSs must be pre-funded with at least 0.8% of their members' total covered deposits (Directive 2014/49, art 10(2)) – a level of pre-funding currently corresponding in absolute terms, according to estimations, to a pan-European total of about € 55 billion (as long as the DGSs remain nationally based, however, even this amount will not be freely available for any particular resolution action);
- with pre-funding gradually rising to 1% of covered deposits (Regulation 806/2014, art 69(1)), the SRF has a target level of approximately € 55 billion (based on the 2011 volume of covered deposits); and
- following political agreement in the Eurogroup, the direct recapitalization of banks by the ESM (as distinct from its provision of indirect assistance to national recapitalization programmes, through loans to the home country) is subject to an overall cap of € 60 billion (out of the ESM's total lending capacity of € 500 billion) (Dijsselbloem, 2014).

In practice, this means that the pre-funded part of the relevant financial instruments will possibly suffice to resolve even one of the largest European banking groups – subject, however, to the rather unrealistic assumption that this takes place in isolation, and not as part of a wider crisis! In view of the banking system's total size (with assets of € 26.8 trillion), the amounts are clearly insufficient to address a systemic crisis. If proof is needed, this is provided by the experience of the recent crisis: according to Commission estimates, between October 2008 and end-2012 the member states extended €591.9 billion of public funds –an amount equivalent to 4.6% of the Union's 2012 GDP– for the purpose of recapitalizing banks or providing asset relief; in addition, they provided guarantees and other forms of liquidity support in relation to transactions whose outstanding amount reached in 2009 a peak of € 906 billion – that is, an additional 7.78 % of the Union's 2012 GDP (European Commission, 2013). Thus, even when the prescribed target levels of the financial instruments will have been reached after several years, we will still be very far from a convincing level of readily available resources. Of course, the SRF can supplement the pre-committed amounts by borrowing, while the levying of *ex post* contributions from the banking sector is also possible. But the latter may be inadvisable in the midst of a crisis; accordingly, the primary use of *ex post* contributions may be to repay borrowings after the crisis has ended. And this brings one back to the perennial quandary of fiscal backstops and their mutualization!

A final concern in relation to the SRM relates to the possibility that the financially stronger countries may be able to exercise *ad hoc* influence over the resolution decision-making process. This is due to two institutional factors: firstly, the SRB is constructed, not as a purely European administration, but as a board where national resolution authorities are represented; and secondly, the ESM takes lending decision with unanimity, thus providing lender countries with an effective veto over the activation of the direct recapitalization instrument. These factors lessen the automaticity of the resolution process and open the road for the politicization of crisis management, thus reducing the predictability and credibility of the arrangements. Even worse, the proliferation of institutional actors and retention of national vetoes creates serious concerns regarding the management of major crises: the non-automatic access to fiscal resources is aggravated by the absence of a clearly identifiable institutional centre for relevant decisions, leaving open the question, who may decide (and on what basis) on a potential system-wide bailout.

4. The monetary policy nexus

As things currently stand, financial stability in the Banking Union would appear to depend more directly on monetary policy than on the arrangements for banking supervision and resolution. In particular, in the summer of 2012 the European Council's endorsement of the Banking Union project was swiftly followed, first by an uncharacteristically strongly-worded public commitment by ECB President Mario Draghi's 'to do whatever it takes to preserve the euro', and then by the announcement of the so-called 'outright monetary transactions' (OMT) programme. The latter allows, under certain conditions, the ECB to intervene in the secondary sovereign bond markets in order to stabilize prices, if a euro area country comes under extraordinary and, in the ECB's view, unjustified market pressure. These ECB announcements marked a turning point in the crisis, quelling turbulence and contributing to the steadying of sovereign bond prices, as reflected in a rapid and substantial convergence of countries' interest-rate spreads. Indeed, the OMT programme shaped market expectations so forcefully merely by being announced that its actual activation has proven unnecessary (cf Occhino, 2015).

More generally, since the eruption of the crisis the ECB has resorted to a wide range of unconventional monetary tools, in repeated attempts to reflate the economy and support the credit intermediation function. Not only has it kept its key policy rate (main refinancing operation rate) at record low levels, but has also relaxed its collateral eligibility standards. It has carried on extraordinary long-term refinancing operations (LTROs), including two operations of very long-term duration (with 36-month maturities), which provided ample liquidity to the banking system. More recently, it embarked on new asset-purchase programmes (ABSPP and CBPP3, involving the purchase of simple and transparent asset-backed securities and of a broad portfolio of euro-denominated covered bonds, respectively), with a view to facilitate credit provision to the economy. Finally, in March 2015 it put in operation a fully-fledged quantitative easing programme (Public Sector Purchase Programme, or PSPP), involving the purchase from European institutions and national agencies of € 60 billion worth of sovereign bonds and securities per month over a intended period of at least 20 months. Less directly, the Eurosystem has enabled the financing of countries' balance-of-payment deficits by permitting the automatic accumulation of very large-scale open debits by deficit national central banks as part of the operation of the TARGET cross-country wholesale payment system. And on a number of occasions it has authorized the extension of substantial amounts of emergency liquidity (ELA) by national central banks to credit institutions in distressed countries.

Through this wide range of tools, the Eurosystem has essentially turned into the euro area's ultimate and all-inclusive backstop, supporting the general macroeconomic situation, the banking system at both the currency area and national levels, the smooth operation of sovereign bond markets, the refinancing of cross-border payment imbalances, and even the resumption of activity in asset markets! The unconventional character and wide scope of the interventions have attracted two types of criticism. On the one hand, the ECB's broad and bold interpretation of its monetary functions has led to accusations that it overstretches its Treaty mandate and breaches the prohibition on the monetary financing of member states. The argument has been expressed vociferously, but eventually unsuccessfully, in litigation relating to the legality of the OMT programme (BVerfG, judgment of 14 January 2014, 2 BvR 2728/13; and CJEU, Case C-62/14, *Gauweiler*, judgment of 16 June 2015). On the other hand, the ECB is accused of following an overburdened monetary policy. In this context, some fear that the monetary policy will fail to achieve its goals; but others are more concerned about the longer-terms implications. The claim is made, in particular, that an ultra-loose monetary policy can encourage risk-taking, thus planting the seeds of future financial instability (see Claeys and Darvas, 2015).

The latter possibility points to an inherent ambiguity of central banking, and a resulting policy trade-off. Since Bagehot's seminal contribution (Bagehot, 1873), the standard prescription is that, in times of crisis, central banks must support the wider banking system by acting as lenders of last resort. The abject failure of 'liquidationist' policies during the Great Depression has reinforced this message. And the Keynesian paradigm has added the dimension of active demand management to macroeconomic thinking, with critical implications for the conduct of monetary policy. If, however, a highly accommodative monetary policy is needed in times of economic and/or banking crisis, this leads almost inexorably to the validation of legacy assets of questionable quality; by supporting their values, monetary policy subsidizes the asset-holders and thereby entrenches moral hazard. This is also true of the responses to the present crisis. For instance, the provision of support to the banking sector is typically accompanied by incantations of the classical recipe for lending of last resort (which requires the central bank to lend freely, to solvent banks, on good security, and at a penalty rate of interest). But this is pure rhetoric! In practice, of the classical recipe, only the first element (that is, to lend freely) is applied in all seriousness; as for the rest, the theory is honoured in the breach! Thus, lending is actually extended to banks with questionable asset portfolios, on the basis of relaxed collateral requirements and valuations which depend themselves on the central bank's interventions, and at exceptionally low rates, which do not truly reflect risks. Indeed, this being part of a reflationary strategy, it is in the nature of the interventions to flood the system with fiat money liquidity, rather than to price risk 'correctly'.

Recent experience is also inconsistent with the theory that the central bank provides a liquidity insurance service, allowing banks to under-invest in liquidity and free-ride on the common pool, but only to the extent it can mitigate this problem by (imperfectly) monitoring banks' asset choices (as in Bhattacharya and Gale, 1987). In reality, the relaxed, market-price-based supervisory attitude to asset quality of the pre-crisis period has given its place to a wholesale relaxation of liquidity conditions, as part of a highly accommodative monetary policy, which attenuates the need for immediate recognition and correction of debt overhang problems. At the same time, however, a remarkable hardening of the supervisory stance is in evidence. To a certain extent, the tough new capital adequacy requirements and related prudential norms, which seek to contain risk in particular transactional environments (e.g., securitization), put breaks on new lending and thus operate in opposite direction to the reflationary monetary programmes.

Interestingly, this amounts to reversal of a common assumption. Theoretically, it is the banking supervisory authority, not the central bank, which is characterized by incentives for forbearance. For this reason, in past debates relating to the institutional structure of financial supervision, one of the arguments against the combination of supervisory and monetary functions in the central bank was that this may lead to wrong monetary decisions. For example, in a macroeconomic situation which otherwise calls for a more restrictive monetary stance, if most banks are in bad shape, the central bank may be diverted from its price-stability objective and engage instead in loose bank refinancing. Since it knows that any ensuing increase in inflation will improve the position of the banks, by gradually effacing the value of their existing stock of bad assets, the central bank thus trades its monetary objective of price stability for bank survival. The use of monetary policy tools in support of this type of implicit bank bailout saves the supervisory credibility of the central bank, which does not want important banks to fail under its watch. This line of argument assumes, of course, that the central bank's incentives for forbearance are eliminated, when the supervisory functions are exercised by a separate authority. The experience of the recent crisis, however, proves that this is not necessarily so. In the present case, due to the prevailing deflationary conditions, a drastic relaxation of monetary policy was deemed to be beneficial in terms of both general macroeconomic management and banking stability. This, indeed, would appear to be the more probable scenario generally, because banks fail preponderantly in periods of economic distress (Goodhart, 2000: 21–23).

This, of course, raises a different question: Why has banking regulation become so much tighter precisely at the moment when economic conditions would call for a countercyclical relaxation of banking standards? If supervisors are more prone to forbearance than central bankers are, what is the source of their demands for rapid restoration of banks' capital positions and for the observance of more demanding risk-control standards, at a time when the banking industry is still ailing? This paradoxical situation indicates that it is misleading to describe the relationship between monetary and supervisory policy in terms of a putative conflict of interests, which could be avoided through their institutional separation. Instead, we should recognize that the more general problem concerns the trade-off between two discrete policy objectives (short-term stabilization *versus* long-term market discipline), both of which are integral to banking (as distinct from monetary) policy and whose interaction defines the overall regulatory position.

The actual policy mix changes over the financial cycle, because banking policy is subject to strong time-inconsistency for two reasons.

Firstly, banking prudential regulation is aimed at preventing bank bankruptcies. It thus shares certain properties with general insolvency law, including its propensity to vacillate between an *ex ante* (pre-failure) and an *ex post* perspective (cf Marinč and Vlahu, 2012: ch 2). *Ex ante*, there is insistence on hard budgetary constraints and on the principle of strict enforcement of claims, because this optimizes debtors' incentives and reinforces market discipline. *Ex post*, however, the situation appears in a different light. Due to the long time-delays, informational asymmetries and high administrative and transactional costs of the liquidation process, the termination of an insolvent enterprise will often appear more costly and inefficient, and thus value-destroying, when compared with the alternative of its continuation as a going concern, following some sort of debt restructuring. Thus, real insolvency actions tend to relax *ex post* the budgetary constraints and to treat debtor enterprises more leniently than what would be necessary in order to eliminate moral hazard. This shift in perspectives applies with a vengeance to bank failures – not to mention system-wide banking crises, when the incentives for forbearance are almost insurmountable! This is due to the overriding consideration that bank closures can cause exceptionally strong negative external effects. Of course, the resulting softening of the theoretically applicable norms creates moral hazard; but, all in all, the immediate external costs of strict enforcement may be so high (especially in the context of a systemic crisis) (Laeven, 2011: 23–28), that even a benevolent public decision-maker may consider it preferable to relax the supervisory standards, and even to use public moneys for a costly bailout.

Secondly, regulatory policy is governed by the 'regulatory sine curve' described by John Coffee, whereby, as a result of interest-group politics, the intensity of controls increases after a financial crisis, and then wanes, as market conditions return to normalcy (Coffee, 2012). This is due to the fact that in the wake of a crisis anti-banking-industry political entrepreneurs can find it easy to mobilize public support in favour of regulatory reform, but the effect is short-lived; once the situation improves, countervailing actions by the banking industry can be expected to produce a gradual relaxation of the norms, both by influencing their administrative implementation and by procuring legislative revisions favourable to the industry.

What is interesting about the current European situation is that regulatory policy is at the early phase of its cycle (or the upper point of the sine curve). Put another way, regulation now views the banking industry from a predominantly *ex ante* perspective; but this is only because it has externalized the management of inherited bank problems, first to the unprecedented public bailout programmes and more recently to the ECB's monetary policy, whose reflationary monetary goals coalesce with the objective of gradual banking repair.

At the end of the day, then, the key problem does not concern the static allocation of responsibilities to this or that institution, but the dynamic variation of the objectives of banking policy over time, also taking into account the close linkage of monetary and financial conditions. The necessary trade-offs are now largely internalized within the ECB. *Ex ante* (that is, under normal market conditions) the ECB in its various roles (monetary authority, banking supervisor and leading macro-prudential decision-maker) will need to prevent asset bubbles from building up, control interconnectedness in the financial sector (cf Alves et al., 2013) and, possibly, set limits on the excessive financialization of the economy (cf ESRB, 2014). But its actions in this direction are bound to entail positive regulatory costs for the regulated industry, which will accordingly have strong incentives to seek to neutralize the regulatory position. Moreover, from a policy perspective, the ECB will need to address the trade-off between long-term stability and resilience, on the one hand, and shorter-term efficiency and competitiveness, on the other. The dilemmas are significant, but well-known and inherent in any banking prudential regime – and, in more general form, in any system of precautionary risk-regulation.

In contrast, *ex post* decision-making in the Banking Union will be subject to novel and distinctive constraints, as a result of legal obligations introduced by the BRRD and the procedural interference of the SRM. Through its insistence on resolvability and prior resolution planning, the new resolution regime makes a very important step towards the reduction of the external costs of strict enforcement of insolvency norms; up to a point, this helps to contain moral hazard. Moreover, the BRRD now sets high legal barriers to certain forms of public intervention in favour of weak banks. But is this the end of supervisory forbearance? Will TBTF and moral hazard soon become dim memories from a bygone era? This is highly unlikely! The open-ended nature and temporal variation of the policy trade-off described above is unlikely to disappear in the Banking Union simply because of the new resolution principles in the BRRD. We should recall, in particular, that TBTF is not the sole cause of forbearance. The BRRD system is largely premised on the false assumption that banks fail individually, one at a time. In real life, the collapse of TBTF banks tends to occur in a context of wider distress. In this sense, resolvability cannot of itself ensure future systemic stability; it can indeed render more practicable the rapid recognition and write-off of bad debts, thus facilitating immediate deleveraging, but this can hardly be achieved without second-order harmful effects. It is equally unrealistic to believe that, in a future systemic crisis, bail-in will suffice to resolve failing banks;[7] and,

7 Time inconsistency may also affect the actual application of the BRRD's bail-in instrument. *Ex post*, full bail-in may not appear appropriate in every case. This is why in the relevant provisions the apparent automaticity of bail-in is watered down by allowing discretionary exemptions for particular classes of liabilities.

as discussed above, the total pre-funded resources of DGSs and the SRF are insufficient for system-wide recapitalization. More generally, during a major economic downturn, private finance for bank resolution will be no more forthcoming that it was during the recent crisis. This is precisely why the (broken) promise of a convincing fiscal backstop was so essential an aspect of the original Banking Union proposals.

To strictly enforce the regulatory covenants, or to tolerate slippages and even provide support to failing banks, thereby entrenching moral hazard, is a perennial dilemma of banking policy, which we cannot simply wish away. But here, it is not only the formal supervisory and resolution process that counts. The possibility of broad state guarantees and/or of highly accommodative monetary interventions (for instance, in the form of system-wide refinancing operations, price-supporting purchases of assets or cheap lending of last resort) must also be considered, since these can offer temporary relief, and eventually salvation, to weak bank before the resolution threshold has been formally crossed! This is an alternative path to forbearance, which has been very much in evidence recently, and which remains open in the Banking Union. Especially in times of crisis, incentives to salvage all and sundry will most probably continue to dominate policy decisions. Conceivably, in such circumstances, the central bank's interventions may suffice to stem turbulence by supporting asset values. For all the immediate benefits, such a policy distorts the market participant's *ex ante* incentives for the next period and entrenches moral hazard, in a manner strictly comparable to a direct bailout. The 'efficiency' of potential central bank interventions thus acquires a different, less positive meaning, when one takes into account the elements of implicit subsidization and the indirect validation of past financial claims, which would otherwise turn sour. From this perspective, what counts is not banking regulation alone, but the overall monetary, fiscal and regulatory mix, which defines the contours of the safety net. The move to the Banking Union does not change this reality; it simply shifts it to a higher level and largely internalizes the relevant policy choices within the ECB.

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Is the Banking Union as Stable and Resilient as it Looks?

Viral V. Acharya and Sascha Steffen

1. Motivation

On 29 June 2012, the European Council and euro group member states agreed to establish a "Banking Union" (BU) as a *centralized* system of banking supervision and resolution. Europe was mired in financial crises since mid-2008. The crisis that started in the mortgage markets in the U.S. reached a global scale and triggered a series of national crisis responses in Europe. These responses, however, were driven by national interests to protect their banking system and characterized by means of forbearance and massive government bailouts of failing institutions. EU specific regulatory and institutional reforms that followed during the 2009 to 2012 period, however, kept a largely decentralized structure of national supervision.[1]

While some countries entered the financial crisis with already high debt-to-GDP ratios, other countries increased their debt levels substantially given the costs of bank bailouts and economic recovery programs. Bank and sovereign health is highly entangled as sovereigns provide a (implicit) fiscal backstop for banks. Banks, in turn, are the largest domestic sovereign bond investors. If the economy is weak, the ability of debt-ridden sovereigns to provide necessary fiscal backstops might be questioned leading to a destructive feedback loop between bank stability

1 Recommendations to keep the decentralized structure were documented in the "De Larosière Report", a high-level report on financial supervision in the EU. Based on this report, the European System of Financial Supervisors (ESFS) was established in 2011, which created new institutions at the European level such as the European Systemic Risk Board (ESRB) or the European Banking Authority (EBA) as well as several others. These institutions, however, had only limited supervisory power.

and sovereign risk.[2] Moreover, European banks' cross-country holdings of sovereign debt due to, for example, moral hazard and regulatory arbitrage incentives, facilitate contagion of sovereign risk across the euro area.[3]

The EU responded with various support programs targeted at member states with strained budgets such as the EFSF and the successor, the European Stability Mechanism (ESM). Greece, Ireland, Portugal, Spain and Cyprus all received financial support through these programs. Importantly, the countries received funds from these programs, which further increased their debt-to-GDP-ratios, and might then use funds to recapitalize their banking sector. The EFSF and ESM were not allowed to refinance banks directly. That is, support programs did not address the feedback loop between banks and sovereigns at this point.

The Banking Union is supposed to break the bank-sovereign linkages, make shareholders and bondholders of banks responsible for losses ("bail-in") and eventually lead to sustainable growth. To achieve these goals, the Banking Union has three pillars: (1) a single supervisory mechanism (SSM) that includes a single rule book for harmonized banking supervision, (2) a single resolution mechanism (SRM) and (3) a deposit guarantee scheme (DGS). Most core European countries oppose a mutualized deposit insurance system, and we thus focus on the SSM and SRM in our discussion.

However, the Banking Union and the centralized approach to banking supervision and resolution is supposed to prevent *future* banking crisis and shield taxpayers from losses from supporting struggling banks. Core European countries such as Germany made clear that mutualizing losses due to legacy assets had to be avoided. Before the official start of the banking union with the start of the SSM, the ECB conducted a comprehensive assessment to evaluate the strength and resilience of the banking sector and to demand measures to recapitalize weak banks. Funds to recapitalize the banking systems after the comprehensive had to come from the national governments subject to state-aid rules (ECB,

2 Major transmission channels include the exposure of banks to home as well as cross-border sovereign debt, possible write-downs of sovereign debt if sovereign ratings decline, loss in value of collateral, short-term wholesale investor pre-emptive runs and bank downgrades due to weakening sovereigns (e.g. Acharya, Drechsler and Schnable, 2014; Acharya and Steffen, 2015).

3 Banks have reduced cross-country holdings of sovereign bonds since 2011 but the linkages between banks and domestic sovereigns have increased in Greece, Ireland, Italy, Portugal and Spain as banks purchased increasingly these bonds (e.g. with the ECB's Long-Term-Refinancing-Operations (LTRO) in 2011 and 2012) as documented in Acharya and Steffen (2015).

2014). The comprehensive assessment comprised two key elements, an Asset Quality Review and Comprehensive Assessment (AQR), in which bank portfolios were evaluated using a single supervisory manual and a stress test to test the resilience of banks against various shock scenarios (EBA, 2014). Ideally, the comprehensive assessment would stop forbearance, identify problem loans and increase equity such that the ECB can take over a sound banking system as single supervisor. A weak banking system might pose a threat to the resilience of the Banking Union right from the start and pose also substantial reputational risks for the ECB as central bank as well as regulator.[4]

In November 2014, the European Central Bank (ECB) published the official results based on the AQR and stress test. In this article, we assess the stability of the euro area banking system. We conduct our own stress test analysis and compare our results with the outcome of the 2014 comprehensive assessment.[5] Using data for all publicly listed banks that participated in the comprehensive assessment as of 31 December 2013, we calculate a capital shortfall of €450 billion for the publicly listed banks that participated in the comprehensive assessment using a stress test approach similar to the EBA/ECB stress tests. We then compare our estimates to the official capital shortfall estimates from the EBA/ECB. Surprisingly, the two estimates are *negatively* correlated. This article argues that this striking divergence can be explained by the continued reliance on static risk-weights in the regulatory assessment. In fact, using the projected losses in the adverse scenario employed by the ECB and applying a different (non risk-weights based, i.e., simple) leverage ratio gives results much closer to ours.

Our analysis has several implications regarding the resilience of the Banking Union. The (still) weak banking system might pose a challenge

4 There are other uncertainties surrounding the BU. In particular, given the focus on euro-area institutions, what are the implications with regard to the consistency of EU bank regulation? What are the risks associated with effective EU bank governance? Moreover, banking supervision is not fully de-nationalized in BU. The ECB needs to coordinate supervision in the Single Supervisory Mechanism (SSM) with National Competent Authorities (NCA). National incentives of NCA were an important factor contributing to the euro crisis. Does this supervisory model increase efficiencies in banking supervision or make the SSM less resilient? These important questions are outside the scope of this article.

5 In an earlier assessment (Acharya and Steffen, 2014), we provided estimates that the capital shortfall of European banks might be as high as €750 billion using a bank's stock market valuation to measure leverage and by estimating losses to market value of equity in a global shock as severe as the 2008-2009 financial crisis.

to sustainable growth in Europe as well as the reputation of the ECB as a central bank and single supervisor. The non-standard policy measures of the ECB and the associated asset price inflation incentivizes banks to shift portfolios into these securities, which crowds out real sector lending and makes these securities systemically important. There are also institutional aspects that might prove challenging. For example, supervision is not fully centralized and the ECB depends on information provided by national regulators. Moreover, it is unclear whether the resolution framework envisioned in the SRM will effectively remove the bank-sovereign linkages. Overall, despite significant reform progress, several risks for the stability of the Banking Union remain.

Our article proceeds as follows. Section 2 introduces our stress test approach and compares the results to the official EBA/ECB outcomes. Section 3 documents implications of our analysis with respect to the stability of the banking union.

2. Analysis

2.1. Data and Sample

To investigate the strength of European banks we select all 41 publicly listed banks that participated in the 2014 comprehensive assessment for which market as well as financial statement data is available.[6] We collect stock prices from Bloomberg and financial statement information from SNL Financial as of 31. December 2013, which is the balance sheet date used in the EBA/ECB stress tests.

Table 1 shows descriptive statistics. Countries are sorted by market capitalization of banks (MarketCap). The total market capitalization of publicly listed banks is €539 billion. The average market equity divided by total assets (Market Equity/Assets) is 4.27% and the average book equity divided by total assets (Equity/Assets) is 5.27%. Market-to-Book ratios are, on average, 0.75 ranging from 0.57 (Cyprus) to 1.58 (Malta). There is substantial cross-sectional heterogeneity in terms of risk-weighted assets (RWA/Assets) among European banks, ranging from 23% of total assets (Germany) to 69% (Cyprus). Interestingly, banks in France and Germany are among those with the lowest RWA/Asset ratios and Market-to-Book (MTB) ratios.

6 A list of these banks is provided in Appendix I.

Table 1: Descriptive Statistics

Country	Market Equity/Assets	Equity/ Assets	Market-to-Book	RWA/Assets	MarketCap
Spain	7.05%	7.22%	1	0.48	146,082
France	3.23%	4.24%	0.68	0.26	127,696
Italy	4.29%	6.49%	0.61	0.48	83,000
Germany	2.19%	3.83%	0.61	0.23	50,570
Greece	8.26%	8.27%	0.95	0.58	26,945
Belgium	6.89%	4.00%	1.18	0.31	17,305
Austria	5.31%	7.24%	0.72	0.49	11,453
Ireland	6.11%	6.05%	0.98	0.43	9,816
Portugal	4.03%	4.48%	0.91	0.51	4,978
Malta	11.97%	7.70%	1.58	0.49	1,557
Slovakia	9.20%	11.94%	0.7	0.59	964
Cyprus	3.75%	6.25%	0.57	0.69	229
Total	4.27%	5.27%	0.75	0.35	539,083

2.2. Stress Test Analysis & Comparison with EBA/ECB Official Results

2.2.1. Shortfall measures

We compare two measures of capital shortfall, the "Regulatory Shortfall Measure" as used by the ECB and "SRISK" as calculated by NYU Stern School of Business Volatility Lab. Both concepts are conceptually similar as they estimate losses in a stress scenario and determine the capital shortfall between a prudential capital requirement and the remaining equity after losses.

Regulatory shortfall measure: The stress scenario is the adverse scenario as described in ESRB (2014) at the end of 2016. The regulatory benchmark is the Common Equity Tier 1 (CET1) ratio that is defined as CET1 capital divided by risk-weighted assets (RWA). The ECB applies a hurdle rate of 5.5% in the adverse scenario. Note that the CET1/RWA ratio is the only benchmark (or leverage) ratio that has been applied in the comprehensive assessment of the ECB.

SRISK: The stress scenario is a systemic financial crisis with a global stock market decline of 40%. SRISK is our measure for a bank's capital shortfall in this scenario, assuming a 5.5% prudential capital ratio with losses estimated using the VLAB methodology to estimate the downside

Table 2: Shortfall estimates

Country	SRISK	ECB Shortfall Adverse Scenario
Spain	37,914	0
France	189,042	0
Italy	76,287	7,640
Germany	102,406	0
Greece	4,360	8,721
Belgium	26,616	339
Austria	6,677	865
Ireland	3,053	855
Portugal	3,821	1,137
Malta	0	0
Slovakia	0	0
Cyprus	167	277
Total	450,343	19,834

risk of bank stock returns.[7] This scenario and the resulting SRISK measure use market data and market equity (instead of book equity) in determining leverage.

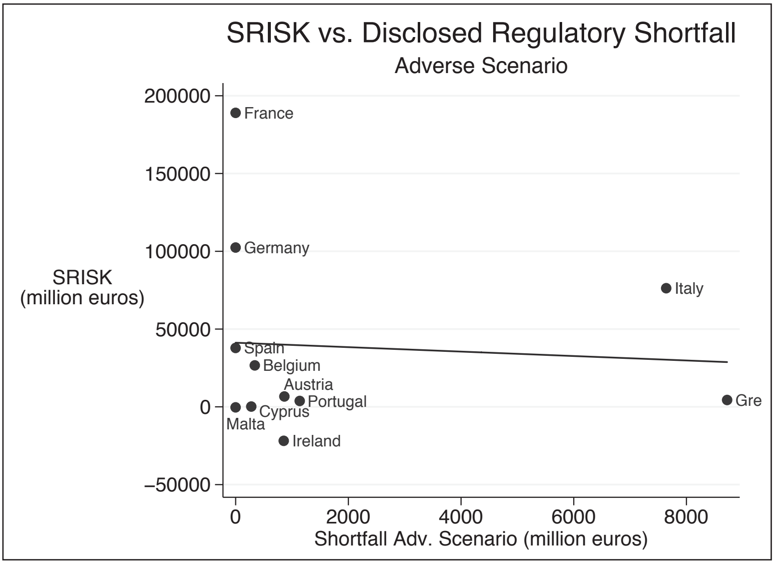
2.2.2. Comparison of Shortfall measures

Table 2 reports both shortfall measures aggregated across each country. SRISK suggests that the capital shortfall of the 41 publicly listed banks is about €450 billion while the official capital shortfall as calculated by the EBA/ECB is about €20 billion.

The following graphs always show SRISK (in million euros) on the vertical axis. Any changes are thus due to changes in the metric displayed on the horizontal axis. We use aggregate data at the country level, adding up the estimated shortfalls across all banks within each country. Our results are qualitatively similar if these graphs are displayed at individual bank level.

7 This capital shortfall measure has been implemented based on Acharya, Engle and Richardson (2012) and Brownlees and Engle (2013) and. The data are provided by New York University's VLAB (http://vlab.stern.nyu.edu/welcome/risk/). The theoretical motivation for the measure can be found in Acharya et al. (2010).

Fig.1a: SRISK vs. Regulatory shortfall measure



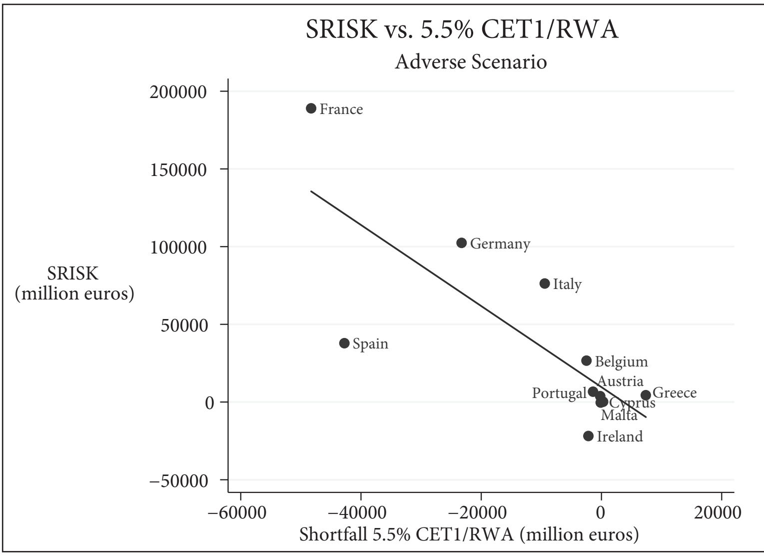
SRISK vs. Regulatory shortfall measure

Fig.1a plots SRISK against regulatory capital shortfalls from the 2014 comprehensive assessment. There is no correlation (in fact, the correlation is slightly negative) between the two capital shortfall estimates. Large banks in countries such as Germany, France or Spain had zero shortfalls in the regulatory assessment but show high SRISK.

As can be seen in Fig.1a, there is a lower bound of zero associated with regulatory capital shortfalls. We effectively remove this lower bound by comparing SRISK with the *un-truncated* shortfall calculated using the CET1/RWA benchmark and a hurdle rate of 5.5% that has been applied in the adverse scenario. We use CET1 capital and RWA as of December 31, 2016.

Fig.1b plots the results. Banks in France and Germany now have even large negative shortfalls that can be interpreted as "surplus capital". The correlation between SRISK and regulatory capital shortfalls now is large and negative. That is, those banks that have the highest SRISK also have the highest surplus capital under the regulatory capital framework.

Fig.1b: SRISK vs. CET1/RWA



SRISK vs. Total Losses

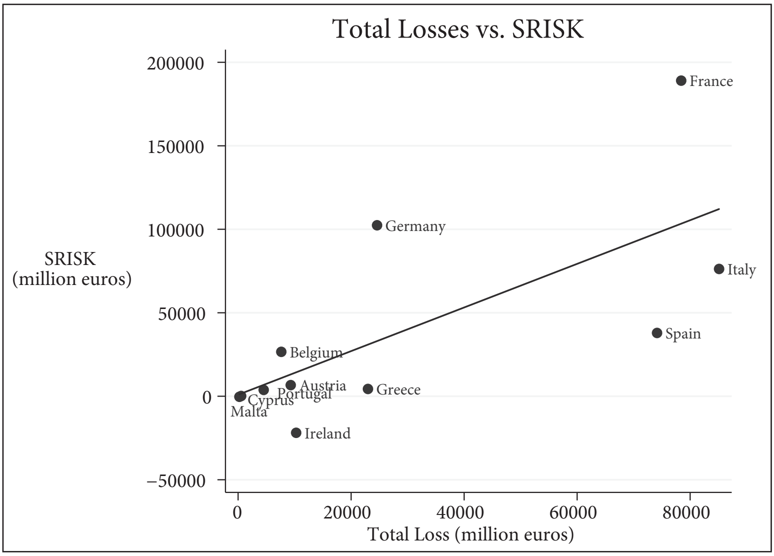
We find that it is not necessarily the design of the adverse scenario and the associated losses that explain the negative correlation between our results and those of the ECB.[8] To see this, we calculate total losses in the adverse scenario as the sum of losses in the banking and trading book and plot SRISK against these losses (again on the country level) in Fig.2.

SRISK is positively correlated with total losses incurred by banks in the adverse scenario. This result is reassuring given that regulatory losses are estimated with bottom-up asset-level loss calculations applied to book value of equity whereas VLAB losses that feature in SRISK calculation are estimated using a measure of downside risk of market value of equity in a market-wide equity downturn.

This suggests that it is not the actual losses but rather different ways of specifying prudential capital requirements that must be driving the negative correlation between SRISK and the results of the ECB. An important difference between the leverage ratio used in SRISK and the regulatory

8 In fact, the scenarios might even be more severe and comprise more risk factors compared to European Banking Authority (EBA) stress test of 2011. And even in 2011, reported losses were positively correlated with SRISK (Acharya, Engle and Pierret, 2014).

Fig.2: SRISK vs. Total Losses



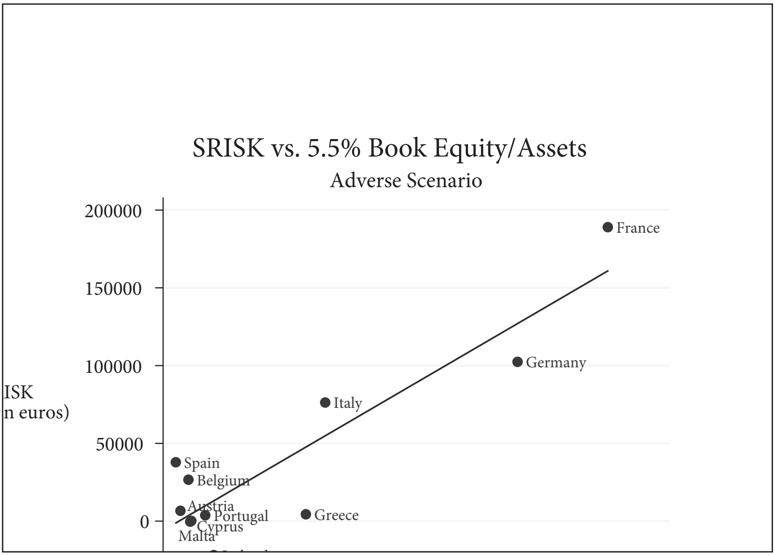
leverage ratio is the use of risk weights in the latter. These are static for banks using the standardized approach. But most banks, especially the large banks, use the internal ratings based approach (IRB) and calculate risk weights themselves. For example, Table 1 suggests that the average risk-weighted balance sheet of large German and French banks is only about 25% of its original size (measured by total assets).

SRISK vs. Book Equity/Assets LVG ratio

To make this point more explicit, we now use a different prudential capital requirement in the adverse scenario of ECB stress test after losses have been accounted for and that does not rely on risk-weighted assets. We calculate the realized Book Equity / Assets ratio in the adverse scenario (using the same losses that have been used by the ECB) and estimate shortfalls using a 5.5% benchmark. This capital requirement is akin to the 5.5% simple leverage ratio required by the Dodd Frank Act in the United States. We plot SRISK against this new shortfall measure in Fig.3.

The result is striking. We find a high and positive correlation between SRISK and shortfalls based on this leverage ratio. In other words, it is the

Fig.3: SRISK vs. Book Equity/Asset



use of risk weights in the regulatory benchmark that explains the shortfall differential between our and the ECB's assessment.

3. Implications for Banking Union

A crucial weakness of the previous stress tests in Europe has not been addressed in the comprehensive assessment, which might impair the resilience of the Banking Union. In particular, the use of a single regulatory benchmark for capital adequacy that is based on static risk weights to assess the financial stability of the European banking system. Similar to 2011, the question whether a bank is adequately capitalized has two different answers using the same loss scenario but two different leverage ratios, a risk-weights based one and the non risk-based one. The latter corresponds to market-based estimates closely, highlighting that market assessments of risk are high precisely for those asset classes for which risk weights are zero (such as sovereign bonds in Eurozone) or low (such as residential mortgages and residential mortgage-backed securities).

Future stress tests should incorporate a robust approach that does not rely exclusively on risk-weighted assets but adopts multiple approaches (such as the simple leverage ratio and the one proposed in this column). A major problem with the Basel risk-weight approach is that risk weights are static and do not reflect changes in risk over time. Moreover, large banks use an internal modeling approach (IRB-approach), which provides them substantial leeway for gaming risk weights.[9] Banks that do well on risk-weighted capital adequacy but poorly on other approaches are likely “arbitraging” the static nature of risk weights to lever up using zero or low risk-weight assets. On average, large banks have 25% of RWA/Asset ratios and thus have done very well in all stress tests since 2010, as they have never been subject to a simple leverage ratio. Overall, European regulators have asked for very little capital as of now.

The reform progress that has been made in the euro area did not include a decisive recapitalization of the banking sector in contrast to what we have observed in the U.S. This might be an important factor in explaining the differential development as to credit and economic growth. While the U.S. has experienced both an increase in real sector lending and GDP growth, these indicators are both stagnating (if not decreasing) in the euro area. Moreover, comparing the development of SRISK as measure of banking sector under-capitalization since summer 2007 and between the U.S. and Europe, we observe a decrease in SRISK to pre-crisis levels, while SRISK and, thus, the vulnerability of the banking sector, are still high in Europe.

Most reform effort to increase the stability of the euro area came from the ECB with an attempt to increase asset prices (e.g. of government bonds) through various non-standard monetary policy measures such as LTROs, changes in the collateral framework, or quantitative easing. Naturally, banks have incentives to purchase those assets that are favored by the ECB and that they can pledge as collateral in case of a future funding crisis. This, however, has two effects. First, while inflated assets prices increase the valuation of banks and make them look better, these asset classes become systemic and could adversely affect the euro area banking sector if there is a significant drop in asset prices. Second, banks, that have limited balance sheet capacity to begin with, purchase those assets for which they have to hold little economic capital and that are purchased by the ECB, which crowds out lending to the real sector. Data in the Eurozone (see e.g. Acharya and Steffen, 2015) suggest that lending to non-financial firms and households decreased dramatically as banks started

9 Behn at al. (2014) also highlight the negative consequences of the complexity associated with model-based regulation.

buying domestic sovereign debt, particularly in the peripheral countries. Worse, banks might provide further funding to firms whose solvency can be questioned to preserve their own scarce capital. The weakness of the financial sector thus likely impedes sustainable growth in the euro area.

Overall, the comprehensive assessment that preceded the start of the banking union might not have been successful in strengthening European banks' balance sheets. National regulators from countries with strained budgets as well as the ECB operating without a common fiscal backstop might have had incentives to avoid uncovering large capital shortfalls. Large recapitalization requirements would have had further strengthened the feedback loop between banks and sovereigns instead of weakening this link. The Banking Union is supposed to break this link with a common supervision (SSM) as well as common resolution system (SRM). However, there are further risks surrounding the Banking Union that might attenuate the common supervisory and resolution objective.

First, bank supervision is not full de-nationalized and the ECB depends on information generated by national regulators. Ultimately, it has to be seen whether this supervisory model increases the efficiency of banking supervision or make the SSM less resilient.

Second, a "single rule book" does not (yet) apply to all banks. There are still differences e.g. as to the calculation of CET 1 capital (which is an important factor in assessing regulatory capital requirements) as well as the treatment of deferred tax assets (DTA). While these differences are transitory in nature, they make a common supervisory approach more difficult, at least as of today.

Third, while the SRM (that becomes fully operational as of January 1st, 2016) focuses on restructuring banks without using taxpayer funds by including a bail-in of investors, a restructuring fund set-up by bank levy's as well as the possibility to use funds from the ESM, it is still unclear whether this will eventually break the bank-sovereign linkages. Several questions remain unanswered: How much bail-in capital is actually available? Is the size of the restructuring fund sufficient if there is a severe financial crisis? Moreover, the ESM can only recapitalize banks directly if an indirect recapitalization (in which the national sovereign borrows from the ESM and uses the funds to recapitalize its banking sector) is not possible. Overall, the Banking Union might not provide the common fiscal backstop that is necessary to break the sovereign-bank linkages.

Finally, our results also have implications for burden sharing in the Banking Union and the question how burden sharing should be designed.

If differences in bank capitalization determine potential shortfalls, then a bank levy should reflect that.

To conclude, a lot of progress has been made over the last years that ultimately strengthens the financial system and this progress should not be diminished. However, several risks remain as documented in this short article. How the euro area deals with these risks going forward will eventually determine the resilience of the Banking Union.

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Appendix I

List of public banks

Bank	Country
Erste Group Bank	Austria
Österreichische Volksbanken	Austria
Dexia	Belgium
KBC Group	Belgium
Hellenic Bank	Cyprus
BNP Paribas	France
Crédit Agricole SA	France
Société Générale	France
Aareal Bank	Germany
Commerzbank	Germany
Deutsche Bank	Germany
Alpha Bank	Greece
Eurobank Ergasias	Greece
National Bank of Greece	Greece
Piraeus Bank	Greece
Allied Irish Banks	Ireland
Bank of Ireland	Ireland
Permanent TSB Group Hldgs Plc	Ireland
Banca Carige	Italy
Banca Monte dei Paschi	Italy
Banca Popolare di Milano	Italy
Banca Popolare di Sondrio	Italy
Banca popolare dell'Emilia	Italy
Banco Popolare	Italy
Credito Emiliano	Italy
Intesa Sanpaolo	Italy
Mediobanca	Italy
UBI Banca	Italy

UniCredit	Italy
Bank of Valletta	Malta
HSBC Bank Malta	Malta
Banco BPI	Portugal
Millennium BCP	Portugal
VUB banka	Slovakia
BBVA	Spain
BFA Sociedad Tenedora Acciones	Spain
Banco Popular Español	Spain
Banco Santander	Spain
Banco de Sabadell	Spain
Bankinter	Spain

PART II

Is a Capital Market Union Needed?

A Capital Market Union: A Few Thoughts

Giovanni Dell'Ariccia

The recent financial crisis and the subsequent lackluster recovery have rekindled the debate on the role of intermediated finance versus capital markets in the European Union. Some have argued that the crisis was a manifestation of vulnerabilities and pitfalls of a mostly bank-centered system. In particular, the inadequacy of alternative channels to funnel funds from savers to small and medium enterprises has come under scrutiny (and, related, the excessive role of debt versus equity). These concerns represent the economic rationale for the "Capital Market Union" (CMU) sketched in a recent Green Paper by the European Commission.

The main objectives that the proposed CMU seeks to address are: "improving access to financing for all businesses across Europe and investment projects, in particular start-ups, SMEs and long-term projects; increasing and diversifying the sources of funding from investors in the EU and all over the world; and making the markets work more effectively so that the connections between investors and those who need funding are more efficient and effective, both within Member States and cross-border."

These are worthy objectives which, if reached, would undoubtedly make the European financial system more efficient and resilient. Yet, whether the CMU can be effective in achieving them depends on what prevents the efficient working of the system in the status quo. I explore this point in greater detail in the following notes.

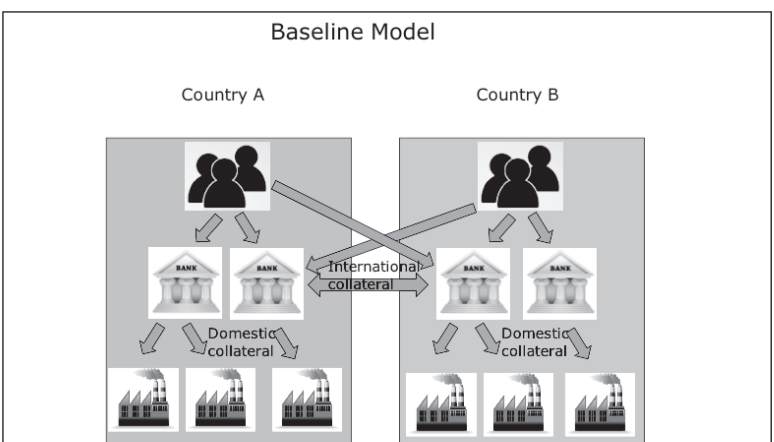
Implicit Theoretical Background

The Green Paper presents two sets of arguments in favor of the development of deeper and more integrated capital markets in Europe. The first is cyclical. The current lack of growth is seen, at least to some extent, as the result of banks' distress and the associated inability/unwillingness to lend. In that context, the CMU is portrayed as a vehicle to provide an alternative source of external finance for SMEs. The second set of arguments is structural. Deeper and more efficient capital markets would reduce the system's vulnerability to future crises. Should banks fall again in distress, stronger capital markets could prevent or at least weaken the vicious bank/real-sector/sovereign spirals that played a critical role during the recent crisis. The CMU is also seen as a complement to the Banking Union as it would favor the creation of uniform standards for securitization, collateral, etc. Finally, more efficient capital markets are seen as a precondition to reduce the centrality of debt instruments as a source of external funding.

There is an implicit theoretical background associated with these arguments:

First, there need to be economically meaningful financial frictions that constrain firms' and banks' ability to borrow. These are easily justified under a variety of corporate finance models (see Freixas and Rochet, 2008 for extensive references). For instance, under limited liability, moral hazard concerns associated with excessive leverage will limit equilibrium lending through collateral constraints. A similar result can be obtained through hidden borrower quality and adverse selection.

Second, the model has to involve some degree of financial market fragmentation. In particular, one has to assume that only banks (in particular large ones) and large firms are able to borrow from foreign lenders

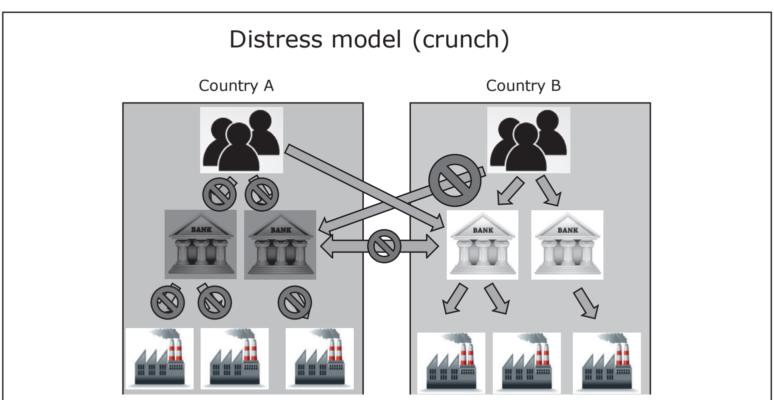


(banks or direct capital markets). Small and medium enterprises and households can, instead, borrow only from local banks. For instance, one could assume that the type of assets available to small firms and households are not accepted as collateral by international lenders (Caballero and Krishnamurthy (2001) present a model with some of these features.) One also needs the additional assumption that, at least in the short-run, barriers to entry (legal or economic) prevent foreign banks from entering the local banking market.

In this kind of model, in tranquil times, the segmentation of international financial markets has little impact on economic activity. As long as banks have sufficient international collateral and borrowers have sufficient domestic collateral, the system operates efficiently. Banks will intermediate any saving-investment imbalance by borrowing/lending across borders through the interbank market and/or the collection of foreign deposits. It follows that, in tranquil times, the benefits from CMU would be limited.

Obviously, to the extent that deeper capital markets relax borrowing constraints, the CMU might bring benefits such as greater access to credit and venture capital. However, these are benefits that in principle could be obtained even in autarky and it is unclear (at least for larger EU countries) that they are closely intertwined with the development of CMU. That said, to the extent that the CMU would bring greater competition among banks and other investors, it could be beneficial even in tranquil times.

However, it is in times of crisis that, in a model as described above, the CMU could bring major benefits. Given the assumed barriers and segmentation, distress in local banking systems translates easily into a credit crunch. Local banks cease to be able to intermediate S-I imbalances, as



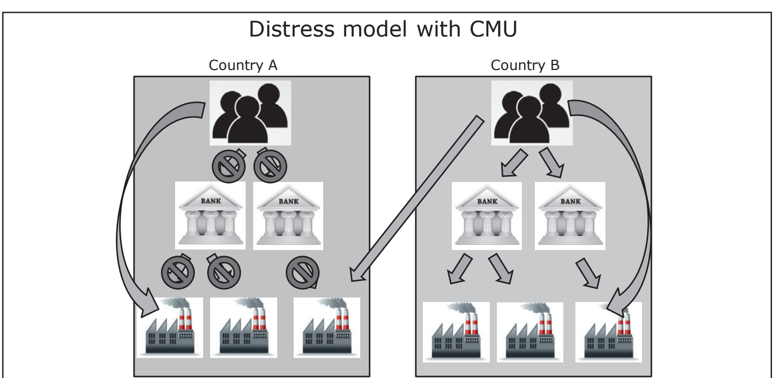
they are unable to borrow sufficient funds from abroad. In addition, their local intermediation function might also be compromised. Hence, the real sector's demand for funds remains unmet. This in turn leads to a compression in economic activity, which exacerbates bank distress. And so on. The CMU would help break these vicious spirals.

Essentially, the CMU would help intermediate S-I imbalances across countries, which local banks cannot absorb because in distress. Foreign banks and individual investors would be able to funnel funds directly to firms, even when a country's banks were in distress. This would mitigate the real effect of the banking crisis by preventing the credit crunch and the associated feedback on the banks themselves.

Under these conditions, the benefits from the CMU can be significant. Further, if one believed that the CMU is a precondition for the development of local capital markets (for instance, because of economies of scale and scope), benefits would include allowing domestic investors to by-pass local banks and provide funding directly to entrepreneurs. Obviously, this analysis relies on the assumption that the bottleneck in financial intermediation resides with the banks and not the borrowers. Should the credit crunch be the results of impaired firm balance sheets, repairing cross-border arbitrage conditions through the CMU would do little to alleviate the crisis.

Relationship with the Banking Union

The development of a CMU has elements of both a substitute and a complement to the nascent European banking union.



It will reduce the need for a banking union to the extent that by allowing for direct cross-border funding of non-financial firms and improving cross-border capital allocation, it will weaken the sovereign-bank spirals that have characterized this crisis. In particular, by making it easier to allow for the resolution (and liquidation) of distressed banks, it could prove a partial substitute for the (still missing) common fiscal backstop that several observers consider an essential element of the banking union (see, for instance, Goyal et al. 2013).

Similarly, the CMU might improve the monetary policy transmission mechanism through the development of market determined reference rates not directly subject to bank balance sheet. Again, this would play through the ability of foreign investors to fund non-financial firms directly, severing the weakening the country-level link between the funding conditions for banks and borrowers.

At the same time, however, the CMU might strengthen the functioning of the banking union. The SSM and uniform resolution rules will help promote cross-border investment in banking systems under the CMU. And greater cross-border ownership would allow for easier recap of weak banks and limit effects of local crises. Similarly, the CMU by easing bank funding pressures, through access to foreign equity, securitization etc., would contribute to the smooth functioning of interbank markets.

Finally, since even in autarky there seems to be a rationale to bypass sick banks, the development of a CMU seems advisable independently of the banking union.

Potential unintended consequences

As for any regulatory reform, the CMU carries risks associated with its potential side effects. Here are a few, but the list can be most likely be extended.

First, as direct funding becomes cheaper and more widely available, more transparent firms (those with fewer informational barriers and agency problems) will find it profitable to migrate outside of the banking system. Banks may, then, retrench into the least transparent segments of the market in a sort of "flight to captivity" (Dell'Ariccia and Marquez, 2004). This will allow for the benefit from the CMU to extend to these less transparent firms as banks will reallocate their portfolios in their direction.

However, the move comes with risks both at the cyclical and structural level. First, on impact, the competition with newly developed capital markets will compress bank profitability. This may complicate the exit from the crisis in countries with capital-depleted banking systems (see Hoshi and Kashyap, 1999, for the experience of Japan with capital market development). At the structural level, to the extent that there is cross-subsidization of credit across market segments, opaque borrowers might be worse off once margins on lending to transparent borrowers are compressed (the empirical evidence on this effect is mixed. See Gormley, 2014). More critically, if borrower opaqueness is correlated with risk, banks retrenching on opaque will be left with riskier loan portfolios.

Finally, the Green Paper rightly highlights that an efficient "plumbing" (the proper reform and implementation of several micro-level elements of the reform) is critical to ensure that transactions cost do not overwhelm the gains from more developed and integrated capital markets. Among these elements: More harmonized tax and resolution regimes: Uniform securitization standards; Credit bureaus (access, standards); "European passport" for financial assets to ensure equal treatment; Support for VC (possibly though a more favorable tax treatment). But the list goes on.

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Does Europe Need a Capital Market Union? And How Would We Get There?

Thorsten Beck

After the less than complete construction of the Banking Union, Europe's policy makers have found a new policy target in the financial system – the construction of a Capital Market Union. This initiative is based on the observation that Europe's financial systems are mostly bank-based and were missing the spare tire of market finance during the recent banking crisis. This column discusses the rationale for such an initiative, based on the theoretical and empirical literature on optimal financial structures and the factors driving financial structures, and explores the policy agenda awaiting Europe's policy makers.

Optimal financial structure - what does the literature tell us?

The financial system consists of a large array of intermediaries and markets. While there has been an increasing consensus that a more efficient financial system can have positive repercussions for economic development, though with important non-linearities, the discussion on whether a stronger reliance on intermediaries or on markets is more conducive for economic growth is far from being settled.

First of all, it is important to note that financial institutions, most prominently banks, and financial markets overcome the agency problem between lender and borrower in different ways. Financial institutions create private information, which helps them reduce information asymmetries. Financial markets, on the other hand, create public information, aggregated into prices. Similarly, there are differences in the mechanisms through which financial institutions and markets exercise corporate governance. Banks can help improve corporate governance directly through loan covenants and direct influence on firm policy and indirectly through reducing the amount of free cash flows senior management has available. Financial markets can help improve corporate governance by linking payment of senior management to performance, through voting structures, and the threat of takeover if the stock price falls below a value that is seen below fair value. Finally, there are different ways financial institutions and markets help diversify risks. Banks offer better intertemporal risk diversification tools, whereas markets are better in diversifying risk cross-sectionally. Markets are better in offering standardized products, and banks are better in offering customized solutions for risk management and diversification. However, banks and markets can also be complementary through instruments such as securitization, allowing exit strategies for venture capitalists, and by providing competition to each other.[1]

However, there are also important arguments of why banks are better than markets and vice versa. In liquid markets, investors can inexpensively and quickly sell their shares and consequently have fewer incentives to expend resources monitoring managers (Bhide, 1993; Stiglitz, 1985). Bank-based systems mitigate this problem because banks reveal less information in public markets (Boot, Greenbaum, and Thakor, 1993). Also, efficient markets can reduce the effectiveness of takeovers as a disciplining tool, as atomistic shareholders have incentives to capture the benefits from a takeover by holding their shares instead of selling them, thus making takeover attempts less profitable (Grossman and Hart, 1980). On the other hand, proponents of the market-based view emphasize that powerful banks frequently stymie innovation by extracting informational rents and protecting established firms (Hellwig, 1991). The banks' market power then reduces firms' incentives to undertake profitable projects because banks extract a large share of the profits (Rajan, 1992). Also, banks—as debt issuers—have an inherent bias toward conservative investments, so that bank-based systems might stymie innovation and growth (Weinstein and Yafeh, 1998; Morck and Nakamura, 1999). Finally, bank credit is more cyclical than market finance, given the important role of asset values and wealth constraints in lending decisions.

Initial cross-country comparisons have not provided evidence for either view. Evidence on the aggregate cross-country level, on the cross-country

1 See Stulz (2001) for an overview. See Allen and Gale (1999) for a comprehensive treatment of different theories on the different functioning of banks and markets.

cross-industry level, and on the cross-country firm level have not found any evidence that countries, industries, or firms grow faster in countries with either more bank-based or more market-based financial systems (Levine 2002; Beck and Levine, 2002; Demirgüç-Kunt and Maksimovic, 2002). Rather, the overall level of financial development, not structure, explains cross-country variation in economic growth. This is consistent with the financial services view, which focuses on the delivery of financial services and less on who delivers them. However, it is also consistent with the view that the optimal financial structure changes as financial systems develop, consistent with theoretical models to this effect (Boyd and Smith, 1998). It is also consistent with findings on different income elasticities of different segments of the financial system. The development of contractual savings institutions and capital markets is much more income-elastic than the development of the banking system (Beck et al., 2008). This finding is consistent with the observation that most low-income countries have more bank-based financial systems, while capital markets emerge at more advanced income levels.

More recent research, however, has given more nuanced results. Specifically, these studies suggest that for less developed countries, development of banking systems is more important, while for more developed countries, markets seem more important (Demirgüç-Kunt, Feyen und Levine, 2013, Cull und Xu, 2013). Capital market development enhances firm innovation (as measured by patents) while banking sector development might actually be damaging (Hsu, Tian und Xu, 2014). And finally, countries with bank-based financial system have lower growth rates, especially during crisis times and their banks pose higher systemic risk (Langfield und Pagano, 2015).

There is one important caveat to add here. Most empirical analyses have focused exclusively on the banking sector and equity markets, given data availability. While these two segments are of critical importance, such a focus ignores other critical elements, including corporate bond markets, private debt and equity markets (including equity funds and venture capitalists) as well as institutional investors. Traditional financial structure measure do not fully capture the variety and richness of financial landscapes across countries, including the interlinkages between different segments, Given this rather limited empirical focus, it is also not clear whether the indicators of financial structure pick up differences between bank- and market-based financial systems, or rather between equity finance and debt finance, given that traditional measures of financial intermediary development focus on banks (and thus debt), ignoring private equity, and traditional measures of capital market development focus on equity markets, ignoring bond markets.

Before jumping to any conclusions on the optimality of a specific financial structure, let me add that the empirical finance and growth literature has shown independent positive effects of both financial intermediary and equity market development (Levine and Zervos, 1998; Beck and Levine, 2004). We can interpret this evidence as suggesting that a more complete financial system, with its different segments well developed is growth-enhancing. Recent evidence, however, has also shown that an oversized financial system – most likely due to regulatory subsidies and a credit bubble – can have negative growth effects (Arcand, Berkes, and Panizza, 2015). One does therefore not have to target a specific financial structure to justify policies aiming at a smaller banking system and the development of non-bank segments of the financial system.

Why is Europe bank-based?

Numerous studies have documented the bank-based nature of Europe's financial systems, if not a bank bias. Langfield and Pagano (2015) report that EU's banking system assets amounted to 334% of GDP in 2013, while the U.S. banking system amounts to only 115% of its GDP. Even in Japan-often cited as the archetype of a bank-based system – total bank assets amount to "only" 196% of GDP. How did Europe become such a bank-based financial system? There are different hypotheses for this, referring to deep historic factors and persistence and more recent events. On the one hand, European countries has had a tradition towards strong banks, favouring the universal banking model, compared to the U.S. which has seen a long-standing hostility vis-à-vis large banks. The law and finance literature observes that most European countries are of Civil Code legal tradition, which favours large and powerful banks relative to disperse and atomistic capital markets. Related to this, there has been a tendency across Europe to focus on national banking champions. While all of this can explain oversized banking systems, there are also factors that explain relatively less developed capital markets and other non-bank segments of the financial system. Dispersed stock exchanges across Europe do not allow for the necessary network and scale economies and create information rents for market participants in individual markets. Dispersion of regulatory regimes for non-bank finance (including private equity) makes scale economies in the financial system segments difficult.

Using cross-country comparisons, Demirguc-Kunt and Laeven (2001) point to several regulatory and institutional factors that can explain why financial systems are more bank- or more market-based. Specifically, they show that countries with a strong protection of shareholder rights and good accounting regulations tend to have market-based financial systems. However, many of these institutional characteristics are strongly correlated with the historic and political factors discussed above. These different analyses suggest that the financial structure of countries might be a rather persistent phenomenon and not easy and quickly to change. It suggests that the agenda aiming at shifting the balance within Europe's financial system towards more non-bank finance is a long-term one.

Where to go from here?

Strengthening the relatively underdeveloped financial segments across Europe has two main dimensions. Completing the banking union might contribute to reducing the power of banks and thus give sufficient space for the development of the non-bank segments of the financial system. On the other hand, there is an array of policies and institutions that can help enhance the development of the non-banking part of Europe's financial system and some of which have been laid out in the recent Green Paper by the European Commission. They include (i) the revival of securitisation markets (including the creation of standards; creation of platforms; and the important interaction with liquidity requirements under the new Basel III regulatory regime); (ii) increase in liquidity by linking corporate bond markets – where segmented insolvency laws are one major barrier; (iii)) creating linkages between different stock exchanges to increase liquidity, while maintaining competition, and (iv) creating a EU-wide second tier capital market/private placement market. There are also important demand-side policies, aiming at getting more firms to accept market finance, which includes corporate governance reforms, but also reducing cost barriers, as e.g. lowering prospectus costs.

It is important to understand, however, that these policies and institutions cannot work over night. They are rather policies and institutions that are aimed at long-term structural changes in the financial system. They certainly will not contribute to leading Europe out of the current crisis, but might contribute to a long-term higher sustainable growth rate through more efficient resource allocation.

The discussion around a capital market union is often seen as a follow-up to the discussion and design of the banking union. However, there are critical differences. The banking union project has been primarily designed to construct a supra-national financial safety to help revive an efficient and stable Single Market in Banking. The capital market union project, on the other hand, is more targeted at a large number of many small reforms across different non-bank segments of the European financial system. While stability concerns are certainly not to be ignored, they are not at the centre of attention as in the case of the banking union. Critically, while the different segments of the banking union (often referred to as the three pillars) are closely interlinked, it is not obvious that this is necessarily the case for the different reforms captured under the heading of Capital Market Union. While they certainly might reinforce each other, they do not show the same interdependence as in the case of the banking union. In addition, the banking union project is mainly a Eurozone project (given that the externalities are primarily though not only within the monetary union), while the capital market union project is aimed at the whole European Union.

In summary, the capital market union is a worthwhile economic policy goal, not so much to change the financial structure of Europe, but to close gaps in Europe's financial sector. It is a long-term goal that requires deep structural reforms that will change the relative power positions of players within the corporate and financial systems of Europe.

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Evaluating the 2013 Euro CAC Experiment

Elena Carletti, Paolo Colla and Mitu Gulati

1. Introduction

The subject of this volume is "The New Financial Architecture in the Eurozone". As one might expect, since this is about the "new architecture", most of the essays in this volume are forward looking in terms of talking about pieces of the architecture yet to be put in place. Our essay is instead backward looking. It looks at one of the pieces of this architecture that was put in place two years ago, in January 2013; the Euro CAC. There may be lessons to be learned from this Euro CAC experiment in terms of what to do (or not to do) going forward.

On January 1, 2013, it became mandatory that every new sovereign bond issued by a member of the European Monetary Union include a new contract clause called a Collective Action Clause or CAC.[1] This, we believe, constituted the biggest one-time change to the terms of sovereign debt contracts in history, impacting a market of many trillions of euros. And it was not just that the change was big in terms of the size of the market it impacted; it was big in terms of its impact on the documentation of each individual Euro area sovereign bond contract. To illustrate,

1 There was an exception for bonds of maturities under a year and bonds being tapped from bond issuance programs already in place. The latter exception, however, could only be used to a limited extent and had to be gradually phased out.

prior to January 1, 2013, all of the terms of a local-law Irish sovereign bond fitted on about a page and a half; the full document was about three pages long. After January 1, 2013, the document was twenty pages long; almost all of that space taken by the new CAC term. It was a big change. But did it do anything? And, more importantly, did it do what it was intended to do?

The Euro CAC initiative was put in place in the wake of the sovereign debt crisis that hit the Euro area in late 2009. The goal, as announced by the Euro area finance ministers on November 28, 2010, was to "safeguard financial stability".[2] The task of designing this Euro CAC and implementing the initiative was delegated to what is called the "Bonds and Bills Committee", a committee comprised of the debt managers of all the EU area countries that meets regularly in Brussels to discuss matters of common concern. Under the leadership of the head of the French Treasury, and with an eminent US law firm advising it, this committee took somewhere between a year and two years of regular meetings (once a month in Brussels, typically) to design their clauses (Gelpern & Gulati 2013). It is hard to estimate exactly how much time and effort went into the production of these new Euro CACs, but with at least eighteen countries at the negotiating table on a monthly basis, each of which would have probably had multiple bureaucrats and lawyers working on preparing for the meetings and then attending, it must have been thousands of man hours that went into this project. Roughly two years after the initiative was put into place, we can begin evaluating its impact. Did the initiative achieve what it was aimed at?

That then raises the question of what the initiative was aimed at achieving. The announcement of the Euro area finance ministers in November 2010, said that the initiative was meant to "safeguard financial stability". But that is too vague to evaluate. If we dig deeper into what policy makers seem to have intended at the time though, it seems clear that their original intent was to send a message to the markets that there would be "PSI" or "private sector involvement" in restructurings in the future. That is, that in the future all of the burdens of a sovereign debt failure in the Euro area would not be put on the taxpayers via bailouts; instead taxpayers private investors would have to take a hit if the countries they invested in got into serious debt problems. Putting in provisions into the bonds that detailed precisely how these future restructurings would

2 *See* http://europa.eu/efc/sub_committee/cac/cac_2012/final_-_cac_public_report.pdf

take place was a clear way of sending such a message. For example, an Irish investors holding an twenty-page post-2013 Irish bond that had more than a dozen pages detailing how a restructuring of his bonds would take place would surely notice the difference between that and the three-page pre-2013 Irish bond that said nothing about a restructuring. In the latter, he would be hard pressed to claim that he had not had notice that a restructuring of his debt was a possibility.

The question to ask then is: Did the markets get the message that was intended? Did they see these post 2013 bonds, with their new CAC terms, are more likely to be restructured than their pre 2013 non-CAC compatriots.

The case we make in this essay is that, at least based on preliminary indications, there is reason to be concerned that the policy goals of the Euro CAC project (regardless of whether they were laudable ones) were not achieved. If so, then the question that should be asked by policy makers is why not? Or, put differently, what should have been done differently?

2. CACs: Some Background

Collective Action Clauses or CACs are easily the most studied contract provisions in sovereign bonds; they may well be the most studied contract provision in any setting whatsoever. The reason they have garnered so much attention is that on multiple occasions over the past few decades, they have been seen as providing a solution to global financial crises that hit the sovereign debt markets. The standard in sovereign bonds for much of the past century was that if a debtor wanted to get a reduction in its obligations, that reduction had to be individually approved by each bondholder. In practical terms, a large scale restructuring of a bond with many thousands of dispersed holders was near impossible. The end result then, for a sovereign in default, would be either that the Official Sector, fearing the contagion that might occur from a protracted default, would provide a bailout (e.g., Mexico in 1995) or the sovereign would be mired in years of litigation (e.g., Argentina over the past decade). Neither outcome was viewed as good.

CACs are provisions that make it easier for a sovereign debtor to do a debt workout, by allowing a supermajority of creditors to accept a deal for the entire creditor group (a contractual cram down of dissenting creditors)

(Portes 2004). At least three times over the past century, policy makers ranging from expert committees of the League of Nations in the 1920s, to the authors of the Rey Report in 1995 all the way to Angela Merkel and Nicholas Sarkozy taking a beach walk in Deauville in October 2010, have proposed the introduction of CACs as a way to fix problems with the sovereign debt market (Weidemaier & Gulati 2013). In every instance, an immediate response to the policy proposal from market actors has been the query: "But won't the introduction of these new terms raise the cost of capital?"

The first initiative, that of the League of Nations in the 1920s, did not come to fruition, with the CAC proposal not even making it to the final report of the League Committee in charge of proposing changes. The second CAC initiative, that began roughly in 1995, was aimed at foreign-law emerging market sovereign bonds issued primarily in New York. This initiative, starting in 2003, was an enormous success in terms of the rate of voluntary adoption of the CACs proposed by a G10 committee of experts (almost 100%). And dozens of academic papers were written, both before and after the 2003 initiative, analyzing the question of whether the new terms would (or have) increased or reduced the cost of capital.

We will not get into the details of the prior academic work, both for reasons of space and because the Euro CAC experiment turned out to be quite different than the one undertaken a decade prior in the New York market for emerging markets sovereign issuers. The focus of the prior studies was foreign-law governed bonds whose terms typically already required a high vote for them to be altered (typically, unanimous approval). The CACs that were being put in place in these foreign-law emerging market bonds were going to make restructurings easier in moving from a high vote requirement (usually, unanimity) to a lower one (usually 75%). The Euro CAC initiative was different in that it was taking local-law governed bonds that had no CACs and putting in CACs (with a vote between 66.67% and 75%). As we will explain in more detail below, using the context of the Greek restructuring of 2012, it is not at all clear from the outset that inserting a CAC into a local-law bond will make restructuring easier. The reason being that "local law" bonds can arguably altered at whim by the local government. In such a context, why would one expect a CAC to have any effect at all?

3. The Euro CACs

The sovereign debt crisis that hit the Euro area nations in 2010-2013 went through a number of stages. Initially, there were big bailouts with transfers of funds from the richer nations to the poorer ones. And later, there was a brutal restructuring in one country, Greece. To say that there was political and economic fallout from the crisis and the missteps that were taken in trying to fix it is to put it mildly. As a result, the Euro area policy makers put in place a number of policy measures aimed at ensuring that the resolution of future sovereign debt crises would not be quite so costly to the Eurosystem. The initiative that most directly impacted the sovereign debt market was the imposition of an identical debt restructuring mechanism, via contract, in all Euro area sovereign bonds that were issued after January 1, 2013.

In constructing the Euro CAC initiative, Euro area policy makers had borrowed from a US Treasury Department initiative from roughly a decade prior, in 2002-03. That initiative, constructed in the wake of the sovereign bailouts of the mid 1990s and the default of Argentina in 2001, was focused on emerging market issuers (mostly Latin American) who were issuing sovereign bonds to mostly foreign investors under New York law. The Euro area version of the initiative, however, was significantly more ambitious than the emerging market version in three ways. The size was larger (it applied to a multi trillion dollar market as compared to one that was a in the tens of billion), the scope was wider (applied via the local laws of eighteen different Euro member nations as opposed to one foreign law (New York)), and the CAC provisions in question were more powerful (applying in an aggregated fashion across a full set of a nation's bonds, as opposed to on a bond by bond basis). As noted at the outset, the Euro CAC initiative of 2013 engineered, at one blow, the single biggest change to sovereign bond contract terms ever – and this is a market that has been around for at least five centuries, if not more.

CACs, as noted, are contract provisions that allow for a majority of creditors in a single bond, or sometimes even across an issuer's full series bonds, bonds, to vote to modify the payment obligations to the debtor (with the permission of the debtor). Put simply, they are a mechanism that allows for the debtor in crisis and a majority of creditors (usually a supermajority, between 66.67% and 75%) to agree to a restructuring of obligations that the debtor owes in a fashion that forces the deal on a minority of dissenting creditors (holdouts). Prior to January 2013, the overwhelming majority of bonds of Euro area countries (over 95% of a market of upwards of $10 trillion in outstanding bonds) contained no such contract provisions. If these had been foreign-law governed bonds, a Euro area sovereign wanting to restructure them would have had to go to each individual bondholder and ask her to voluntarily take a haircut; an impossible task. But these were local-law governed bonds; meaning that the local legislature could write new terms into them. As a result, Greece, prior to its March 2012 restructuring, was able to legislatively impose a specially designed set of CACs on its local-law bonds and then conduct its restructuring.

4. The Euro CACs: Predictions

What was the predicted impact of the Euro CAC policy move? Looking back through the policy briefs, press reports and academic articles written at the time tells us that there was variation in terms of what policy makers expected from the Euro CAC initiative.

Initially, and before the Greek restructuring of 2012, there were those (perhaps the majority) who saw the Euro CAC move as profoundly anti-creditor; and particularly so vis-à-vis the holders of bonds of the weaker Euro area nations. Certainly, this was the intended message of the Franco-German announcement on October 18, 2010 (made after the infamous Deauville beach walk). Private creditors were now forewarned that they could be restructured (Gelpern & Gulati 2013). If there was a sovereign crisis in the future, private creditors could no longer expect to be bailed out (in Greece, at least for the first few years of the crisis, the private creditors were bailed out in full). Under this view, one might predict that the CAC bonds would be perceived as riskier than the non-CAC ones; after all, the CAC ones were the ones where bondholders were told explicitly that a restructuring was possible in the future.

The Euro CAC initiative, as some policy makers have explained to us, initially had a dual purpose. The hope was to both produce the effect of assuring current bondholders (in non-CAC local-law bonds) that they were safe (because CACs would only be put in place after Jan 1, 2013) and also to assuage the concerns of taxpayers (who were worried, in late 2010, that they would be repeatedly on the hook for providing repeated bailouts to the weakest nations of the Euro area). As it turned out though, bondholders did not believe the message. The announcement of the CAC initiative in late 2010 did not calm the markets; if anything, investors may have taken the announcement as a sign that restructurings were coming, and soon (Gelpern & Gulati 2013). Within a year, the markets were proved right in that it was announced that Greece would be pursuing a restructuring of its bonds. In March 2012, that announcement was implemented in brutal fashion via a retroactive legislative imposition of a special set of CACs on all Greek local-law bonds (Zettelmeyer, Trebesch & Gulati 2014).[3]

One might ask at this stage, after the Greek restructuring in 2012, whether there was any more need for the Euro CAC initiative. After all, the fact that the message that non-CAC local law bonds were safer than CAC bonds could no longer be sent (the March 2012 restructuring by Greece arguably put an end to that). But the Euro CAC initiative did not get abandoned. Perhaps policy makers thought that the markets would believe their repeated assertions that Greece restructuring was "unique and exceptional".

Some of the policy makers who were interviewed about the foregoing put forward a more nuanced explanation for why the Euro CAC initiative went forward. The new story justifying the Euro CAC initiative, these policy makers asserted, was that the initiative would send a pro-creditor message. Instead of telling creditors that restructurings would be more likely in the future, the new story was that CACs were a commitment not to do a Greek retroactive change in the law in the future. The Greek restructuring was, to reiterate, was "unique and exceptional." Unlike with Greece, where the sovereign had retroactively imposed a vote requirement on its bonds after it had figured out how many votes it had (or so we suspect), thereby making it near impossible for bondholders to hold out against deals they thought were unsatisfactory, the vote requirements would now be clear and uniform for everyone from the start. The prediction, under this pro creditor story then is the opposite of that under the first story: the local-law bonds with CACs here should have lower yields than their non-CAC counterparts because the CAC bonds, in the case of a restructuring, would be assured an orderly restructuring process where the rules of the game would be known in advance (unlike with Greece and unlike with the non-CAC local law bonds).

The question in evaluating the CAC initiative then is whether it resulted in assuring the markets that CAC bonds would fare better (or worse) in

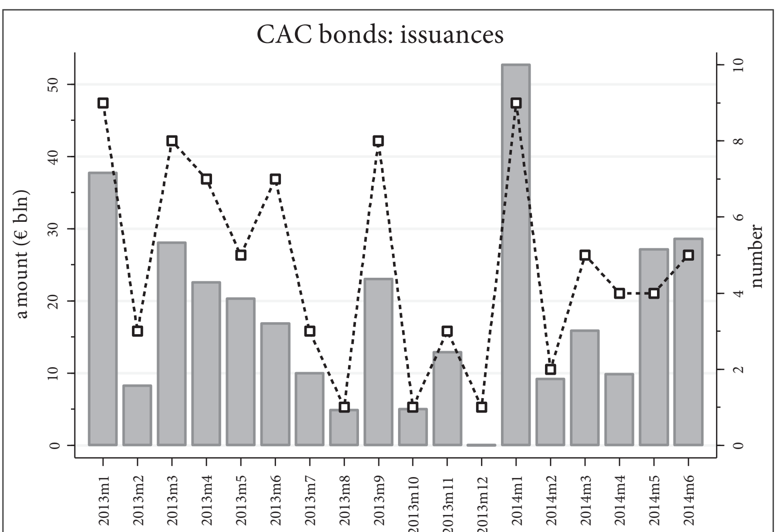
3 There was an exception made for a subset of bonds held by Euro area official sector institutions such as the European Central Bank.

future restructurings than the non-CAC ones. Prior to implementation, policy makers seem to have made predictions going both ways.

5. Some Preliminary Insights

The dataset we utilize is drawn from a variety of sources (Bloomberg, Dealogic, and Thomson One Banker). It is made up of 85 CAC bonds for 13 Eurozone sovereigns issued between January 1, 2013 and June 31, 2014 with maturity larger than one year (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxemburg, the Netherlands, Portugal, Slovakia, Slovenia, Spain). All bonds are either zero coupon or have a fixed coupon. Figure 1 displays the issuance activity of CAC bonds in our sample, over time. By the end of the first quarter of 2013 all countries had issued at least one bond with a CAC. Figure 2 plots the time-series of the amount outstanding (the sum of original issues and further tap issues)[4] of CAC bonds in Eurozone countries, both in absolute terms and relative to

Fig. 1. CAC bonds issuances. Monthly time series of CAC bonds issuances by aggregate amount (grey bars, left vertical axis) and by number of issuances (squares, right vertical axis).



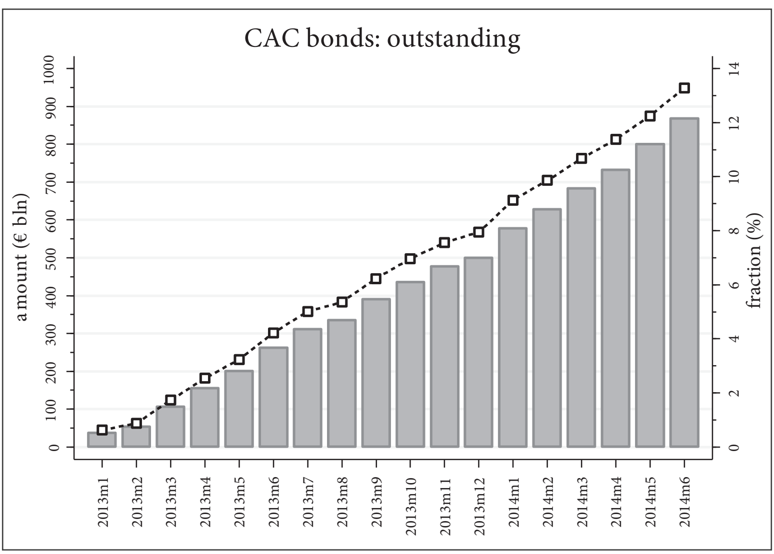
4 After issuing a new bond, governments can raise additional debt by reopening already existing securities (so-called tap issues).

the overall amount of long-term government debt.[5] Figure 2 shows that at the end of June 2014 about 13% of long-term bonds included the new Euro CAC provision.

The joint message of Figures 1 and 2 is that CAC bonds are becoming more and more important in the context of Eurozone sovereign debt markets. We now turn to the question at the heart of the inquiry: Do markets see the bonds with CACs as being different from those without them in terms of the risk of being restructured?

To gather preliminary evidence on this matter, we select four CAC bonds with five years maturity issued by different countries (Austria, Finland, France, and Spain). We pair each of these bonds with a non-CAC bond issued before January 1, 2013 by the same issuer, with the same currency and roughly the same residual maturity, and then compare the daily yields of CAC and non-CAC bonds.

Fig. 2. CAC bonds outstanding. Monthly time series of CAC bonds outstanding by aggregate amount (grey bars, left vertical axis) and by fraction of total long-term government outstanding (squares, right vertical axis).



5 Data for long-term government debt outstanding are sourced from the ECB Statistical Data Warehouse. For each country, we consider long-term government debt as the sum of long-term residual maturities (over 1 year) and short-term residual maturities (up to 1 year), in all currencies.

In Figure 3 we plot the yields of our bonds. We do not find that our CAC bonds consistently have higher yields than their non-CAC counterparts for the four countries under consideration.[6] Nor, for that matter, do we find the converse. For instance, the 5 year bonds issued by Austria and Finland enjoy, on average, yields lower by, respectively, 7.5bps and 15.8bps than non-CAC bonds with similar maturity. On the other hand, for France and Spain we observe larger yields of CAC versus non-CAC bonds. Although in economic terms these yield differentials may seem small, they are all statistically significant. At first cut then, the evidence suggests that CACs did not have their intended effects. Indeed, the effects seem to sometimes go in one direction and at other times in the opposite direction.

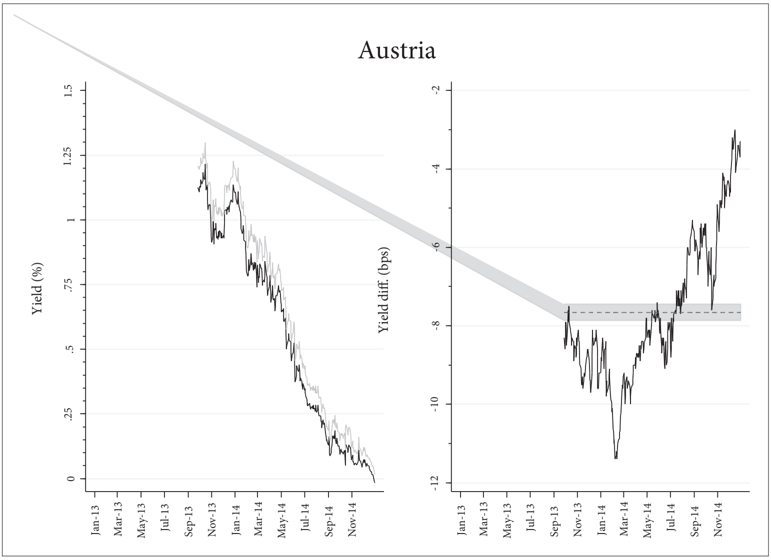
Further, they seem to have had some explicitly unintended effects. The reason we say that is that the CAC initiative was explicitly intended — as per the directives of the treaty - to operate in the same fashion across all the Euro area countries.[7] Put differently, while the individual effects in particular countries might have been expected to be different (with stronger effects in the weaker countries than in the stronger ones), the effects were all supposed to go in the same direction. But that is not what we see. The question is why.

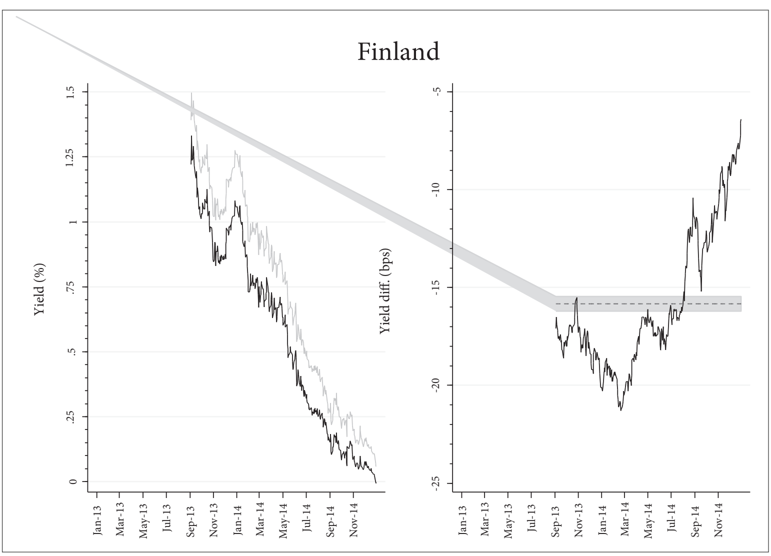
Fig. 3: Yield and yield differential between CAC and non-CAC bonds. For each country, the left panel plots yields (in percentage) on CAC bonds (black line) issued with 5 yrs maturity and those of matched non-CAC bonds (grey line). The right panel plots the yield differential (CAC minus non-CAC bond, in bps) for each bond pair, together with the average yield differential (dashed black line) and its 95% confidence interval. For Austria we consider the 1.15% bond with maturity Oct 2018 (ISIN: AT0000A12B06) and the 4.35% bond with maturity Mar 2019 (AT0000A08968); for Finland we consider the 1.125% bond with maturity Sep 2018 (FI4000068663) and the 4.375% bond with maturity Jul 2019 (FI0001006306); for France we consider the 1% bond with maturity Nov 2018 (FR0011523257) and the 4.25% bond with maturity Oct 2018

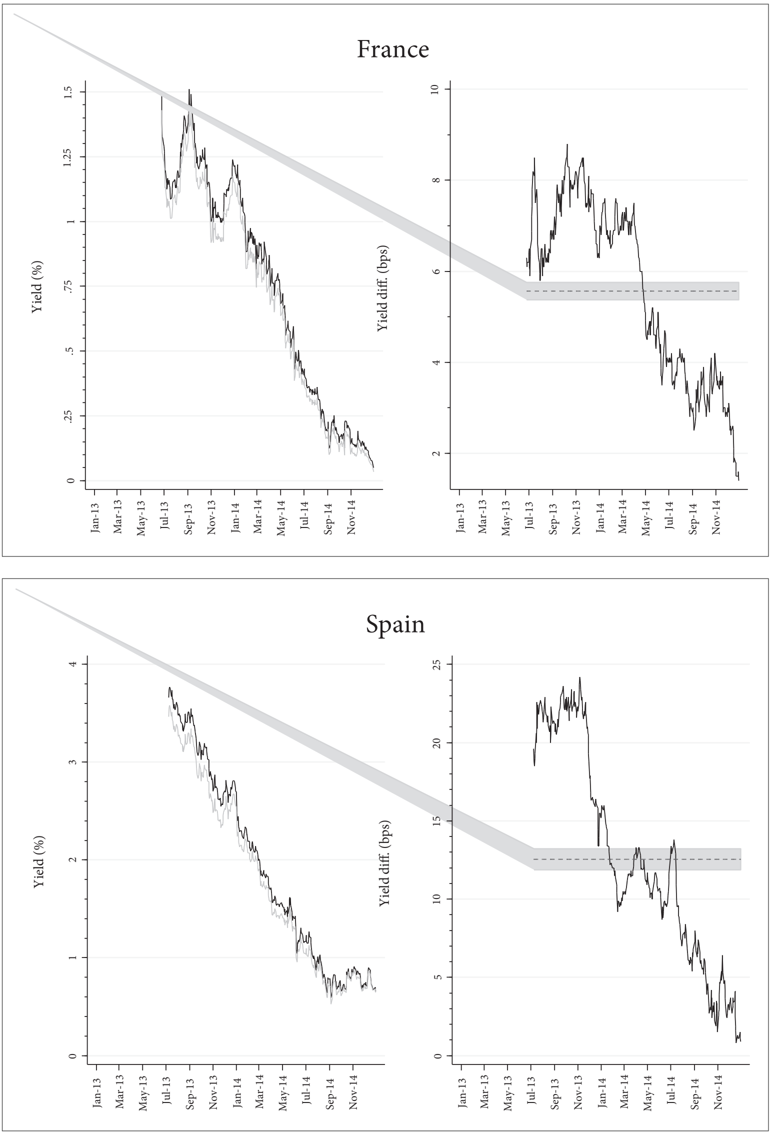
6 A recent DIW Economic Bulletin report also looks at the relative yields for Euro area CAC and non CAC bonds, observes the differences to be quite minimal, and asks the question of why this reform (particularly in the local law bond context) was embarked on in the first place (Steffen & Schumacher 2014).

7 Article 12(3) of the ESM Treaty stated:
Collective Action Clauses shall be included, as of January 1, 2013, in all new euro area government securities with maturity above one year, in a way that ensures that their legal impact is identical.

(FR0010670737); for Spain we consider the 3.75% bond with maturity Oct 2018 (ES00000124B7) and the 4.1% bond with maturity Jul 2019 (ES00000121A5).






France
Yield (%)
Yield diff. (bps)
Spain
Yield (%)
Yield diff. (bps)
Jan-13
Mar-13
May-13
Jul-13
Sep-13
Nov-13
Jan-14
Mar-14
May-14
Jul-14
Sep-14
Nov-14

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Capital Markets Union and Small and Medium-Sized Enterprises (SMEs): A Preliminary Assessment

Pierre Schammo

Abstract

The Capital Markets Union is the European Commission's latest policy initiative in the capital markets field. It is a project in the making. Much of it remains to be spelled out and fleshed out. However, the first elements of a future CMU are slowly beginning to emerge. The aim of this paper is to discuss these elements and to offer a first assessment. In particular, this paper aims to discuss the relationship between the CMU and one of its key objectives which has proved elusive in the past: that is, of facilitating access to finance for SMEs. In this process, the paper offers a number of suggestions on how to make progress on this crucial issue. Among other things, it advocates a form of supply side driven matchmaking as a means to improve information issues affecting SMEs in the SME funding market.

1. Introduction

The Capital Markets Union (CMU) is the European Commission's latest policy initiative in the capital markets field. It is a project in the making. Much of it remains to be spelled out and fleshed out. However, as soon as the idea of a CMU was proposed, it attracted almost instant attention and interest. This paper offers a first assessment of the CMU initiative. It begins with a set of observations. Firstly, unlike the CMU's 'closest cousin' – the Banking Union (BU) – the proposal for a CMU appears so far to have proved remarkably uncontroversial among Member States. It has benefited from broad support, including from the UK which is resolutely against joining a BU and which, one would expect, looks with suspicion at attempts to establish 'unions' within the Union.[1] Secondly, the CMU is not only about a single capital market. To an extent, the latter is only a means to realise the CMU's other objectives. In particular, the European Commission has been keen to stress the benefits of a CMU for small and medium sized enterprises (SMEs) in a post-crisis world. Thus, one of the ambitions of the proposed CMU is to offer SMEs better access to finance. It is a key objective of the CMU, but one which has proved to be elusive and fraud with difficulties in the past.

Against this background, the aim of this paper is twofold: firstly, to assess and reflect on the first elements of a CMU; secondly, to investigate the relationship between the CMU and SMEs. More specifically, the aim is to show why the relationship between SMEs and a future CMU is a complex one and in this process to consider ways to make the latter more relevant to the former. To this effect, this paper will make a number of suggestions. These suggestions focus on the SME funding market and especially on how to address information problems affecting SMEs in this market. Among other things, this paper recommends a type of supply side driven matchmaking via pan-EU finance platforms as a means to improve information issues for SMEs. It will draw for this purpose on proposals that have recently been adopted in the UK.

The paper proceeds as follows. Section 2 starts by discussing first elements of the proposed CMU. Section 3 turns to the access-to-finance problematic for SMEs. Section 4 concludes.

2. The CMU: first elements

This section begins by examining first elements of a future CMU. Based on policy documents and the Commission's Green Paper on building a CMU,[2] it will show that the CMU can currently be described as an ambiguous concept (a.), which is underpinned by suggestions on a short-term programme in areas where there is broad support, and by broad/vague

1 The idea of establishing discrete 'unions' appears certainly to be in the trend. There is of course the BU and the CMU, but the term has also been used to describe an Energy Union or even a Derivatives Union. Regarding the latter see Maijoor (2015).

2 European Commission, (2015b).

ideas on potential actions for the longer term (b.). The concept and its potential programme are held together by objectives which are largely uncontroversial (c.). After discussing each of these elements, I will reflect on the prospect of a CMU in a more holistic manner (d.).

a. An ambiguous notion

The concept of a Capital Markets Union is an inherently ambiguous notion. On the one hand, the use of the term 'union' might appear to suggest that the CMU is supposed to mark a new stage in capital markets integration with presumably further institutional integration and consolidation at EU level. On the other hand, however, save for the word itself and what it brings to one's mind (e.g., in terms of an 'ever closer union'),[3] little is known about the meaning to be ascribed to the CMU. Unlike the Banking Union (BU), which was right from the beginning tied to a heavy institutional and integrationist agenda, the CMU concept was largely left unspecified when first put forward by the Commission. Its origins can be traced back to President Juncker's July 2014 speech before the European Parliament and his political guidelines for the next Commission which state that:

> 'Over time, I believe we should complement the new European rules for banks with a Capital Markets Union. To improve the financing of our economy, we should further develop and integrate capital markets. This would cut the cost of raising capital, notably for SMEs, and help reduce our very high dependence on bank funding. This would also increase the attractiveness of Europe as a place to invest'.[4]

Beyond this brief statement, Juncker did not offer details on the content of a CMU or on any future building blocks. Juncker's November 2014 mission letter to Lord Hill, the Commissioner for Financial Stability, Financial Services and Capital Markets Union, also offered few clues, except that the letter specified that the CMU was supposed to be in place by 2019 and that it was meant to include all the Member States.[5] The latter point was also highlighted repeatedly by Lord Hill during his first hearing before the European Parliament in October 2014. However,

3 Art 1 TEU.

4 Juncker, (2014a).

5 Juncker, (2014b).

Hill provided few details on the CMU initiative during his first hearing. Asked on the CMU, Hill noted:

> 'As I was saying just now, I think the first step – which sounds very prosaic (but I am a practical, pragmatic person) – is to identify, first of all, what the obstacles currently are standing in the way of the free flow of capital. I do not want to start with a grandiose vision. It is a little over two weeks since I was nominated, and I think you would collectively think I had taken leave of my senses if, after two weeks, I were to come to you and say 'this is everything we are going to be doing over the next five years'. So I am, I think, clear in my mind that I want to take this step by step, starting with the analysis. … So I would have to urge you to be a little patient, because I think to rush and make a mistake would be a mistake….'[6]

As already noted, the beginnings of the CMU are in marked contrast with the BU. Not only is the latter mainly a Eurozone construct, but the BU was from the beginning more clearly circumscribed. Thus, when calling for a BU in June 2012, (former) Commission President Barroso added that the BU would be one of the building blocks of a Genuine Economic and Monetary Union and that it should include 'single European banking supervision and a common deposit insurance and resolution framework'.[7] Admittedly, this degree of clarity did not serve the BU especially well. Indeed, as finally agreed, the BU looks quite different. The idea of a single deposit insurance scheme had for better or worse to be dropped.[8] In any event, the notion of a capital markets *union* has no particular constitutional significance. It has no place in the treaties, unlike the concept of a single market or the European Economic and Monetary Union. The CMU will however become part of the EU's 'nomenclature'

6 First hearing of Jonathan Hill before the European Parliament (Brussels, 1 October 2015), 15-16 available at http://www.elections2014.eu/resources/library/media/20141022RES75902/20141022RES75902.pdf. Hill provided some details during his second hearing (see Hearing of Jonathan Hill (Brussels, 7 October 2014) 13 available at http://www.elections2014.eu/resources/library/media/20141022RES75902/20141022RES75902.pdf. See also Reply to supplementary questions addressed by ECON to Commissioner-designate Hill, available at http://www.elections2014.eu/resources/library/media/20141006RES73040/20141006RES73040.pdf.

7 Barroso, (2012). See also European Council, The President, (2012); European Commission, (2012a).

8 House of Lords, European Union Committee, (2014), p. 45.

in the financial and banking fields. This includes the Lamfalussy four-level approach, the European System of Financial Supervision, the single supervisory and resolution mechanisms and of course the BU. [9]

The fact that the CMU concept lacks clarity has been widely acknowledged among commentators. It has left the door open for very different interpretations.[10] Verena Ross, the Executive Director of ESMA, put it well when giving evidence before the House of Lords at the end of October 2014: '[i]f you ask 10 people, they will give you 10 different answers as to what capital markets union means'. [11]

Perhaps unsurprisingly, the meaning ascribed to a future CMU has tended to differ according to the interests and/or role conceptions of CMU commentators. Moreover, among these commentators the issue of a possible transfer of supervisory powers to the EU level has been a recurring theme. For example, for Yves Mersch, a member of the ECB's Executive Board, the CMU has a role to play in helping the ECB to implement its monetary policy.[12] However, Mersch also pointed out that it was time for policy-makers to consider if it was still appropriate for Member States to be in charge of day-to-day supervision. [13] Meanwhile, Steven Maijoor, ESMA's chairman, has repeatedly stressed the need to ensure investor protection when designing a CMU.[14] However, on the issue of day-to-day supervision, Maijoor treaded carefully. Given that the decision-makers within ESMA are national competent authorities, it was perhaps not surprising that he stayed clear of pleading for transferring day-to-day supervisory powers to ESMA.[15] Member States too contribute views to the debate. In the UK, for instance, the proposal for a CMU is viewed as an opportunity to promote capital markets integration and

9 One should be forgiven for thinking that this nomenclature – from levels to a union – was intended to reflect stages in an increasingly integrated institutional structure. It is not the outcome of some grand scheme, but the outcome of reforms which were often put in motion by exogenous factors (e.g. the financial and sovereign debt crises).

10 See also Mersch, (2014b); Lannoo (2015) p. 1.

11 House of Lords, EU Economic and Financial Affairs Sub-Committee, (2014), p. 421.

12 Mersch, (2014a); Mersch, (2014b).

13 Mersch, (2015).

14 Maijoor, (2014b); Maijoor, (2014a); Maijoor, (2015).

15 Ibid.

hence the City of London.[16] However, the UK Government has also been keen to stress that a CMU did not require consolidation of day-to-day supervision at EU level.[17] The latter reflects a long-held position in the UK which sees supervision as a matter for Member States. This position is given support by the argument that if fiscal responsibility is a national matter, supervisory decisions should be as well.[18]

Over the coming months and years, it can be expected that the CMU will gain more concrete shape, possibly – even though not necessarily – with a consensus emerging around a set of building blocks.[19] For the time being and despite the ambiguity of the term, the notion of a CMU nevertheless offers actors a 'focal point'[20] to promote cooperation on a wide range of possible issues.[21] The European Commission has begun to spell out these issues in its Green Paper on a Capital Markets Union. I turn to the Green Paper next.

b. A short-term programme in areas where there is broad support; and broad/vague ideas on potential actions for the longer term

The European Commission published its Green Paper on Building a Capital Markets Union in February 2015.[22] As a green paper, it aims to generate debate and discussion on possible areas for action. First and foremost, it offers an opportunity for feedback. In addition to the green paper, the Commission also consults on revising the Prospectus Directive and on a framework for securitisation.[23] Both consultations are part of the Commission's effort to develop a CMU.

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16 See e.g. House of Lords, European Union Committee, (2015a), p. 94, noting that the CMU offers 'a golden opportunity for the UK to promote the importance of capital markets, as an alternative to bank funding, in the functioning of the EU economy'.

17 See House of Lords, European Union Committee, (2015b) p. 29.

18 Schammo, (2012), pp. 780-781.

19 Note that in the Commission consultation document on a framework for simple, transparent and standardised securitisation, the Commission notes that developing high-quality securitisation is one of the building blocks of the CMU. See European Commission, (2015e) p. 2.

20 Goldstein and Keohane, (1993).

21 cf. Mersch, (2014b), who talks of the CMU as a 'connector and label', noting further '[t]o operate with this term will help to raise awareness, to define overall objectives, to prioritise resources and to ensure consistency of the individual measures'.

22 European Commission, (2015b).

23 European Commission, (2015d); European Commission, (2015e).

Even if only a green paper, it is nevertheless noteworthy that the Green Paper on building a CMU contributes little to clarifying the concept which is at the core of it: that is the CMU.[24] Thus, it does not specify the meaning of a CMU and remains silent on even a working version of the building blocks of a future CMU.[25]

Regarding the relationship between the CMU and the BU, the Green Paper notes that the former will benefit from the fact that the latter offers stability.[26] It also states that a

> 'Capital Markets Union will differ from Banking Union: deepening capital markets requires *steps* that will be distinct from the key elements of Banking Union'.[27] (emphasis added)

However, we are left in the dark about the distinct steps (institutional, substantive?) which the Commission has in mind. On a brighter note, the Green Paper reaffirms the Commission's intention to ensure that the CMU is an EU project and not just a Eurozone project.[28] The Commission is also keen to stress the importance of consultations, economic analysis and impact assessments whilst underlining that legislative action is only one among a series of possible courses of action.[29] While these statements are welcomed, they should not be overestimated. They are mostly 'better regulation' platitudes.

These observations aside, the possible reform or review suggestions that are listed in the Green Paper provide nevertheless some useful insight on the possible future content of a CMU. The Commission differentiates between possible actions that might be pursued in the future and a number of priority areas that are singled out for early action. Regarding the latter, the measures include a review of the Prospectus Directive,[30]

24 Admittedly, the Green Paper does specify the broad objectives of the CMU. I will return to these below.

25 Instead it notes that the feedback which the Commission will receive following the green paper will help it to 'put in place the building blocks for a fully functioning Capital Markets Union by 2019'. See European Commission, (2015b), p. 3.

26 Ibid, p. 5.

27 Ibid.

28 Ibid.

29 Ibid.

30 Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC [2003] OJ L345/64.

work on securitisation, as well as possible actions in the areas of SME credit information, the European Long-Term Investments Funds and the private placement market.[31] As noted, the Commission consults separately on the review of the Prospectus Directive and has launched a consultation on 'simple, transparent and standardised securitisation'. [32]

In selecting these areas, the Commission treaded carefully. Deciding to review the Prospectus Directive was unlikely to prove controversial. The Commission merely brought forward a review which was supposed to take place by 1 January 2016.[33] More generally, it is worth noting that there was already a wide consensus on the need for some sort of action in many of the selected areas, before the launch of the CMU project. For instance, much has been said on the need to revive the securitisation market in the wake of the financial crisis. Influential papers were published on the topic, notably by the Bank of England and the European Central Bank.[34] Discussions on reviving securitisation, but also on the need to work on SME credit information[35] and on private placements (or, covered bonds for that matter) have also taken place at the level of the OECD.[36] Suggestions for action in these (and other) areas have also been presented in industry reports.[37] The Commission also stayed clear of advocating possibly contentious measures in these areas. Thus, where industry-led action had already resulted in tangible outcomes (see the work on private placements), the Commission acknowledged and welcomed it.[38]

31 See also European Commission, (2014c), p. 8.

32 See supra (n 23).

33 European Commission, (2015d), p. 3.

34 European Central Bank and Bank of England, (2014a); European Central Bank and Bank of England, (2014b). See also European Banking Authority, (2014); European Commission, (2013b) p. 12.

35 On credit reporting, see also World Bank, (2014); AFME, (2013), p. 50, suggesting to 'create centralized pan-European and/or national SME information and rating databases…'.

36 Kaousar Nassr and Wehinger, (2014).

37 eg Ares & Co, (2013); AFME, (2015).

38 On private placements, see Charter for Euro Private Placements (Euro PP): industry guidance document commissioned by the Banque de France and the Paris IDF Chamber of Commerce and Industry (March 2014), available at http://www.fbf.fr/en/files/9HLKDR/Charter-for-Euro-PP-March-2014.pdf; ICMA, (2015). The Commission also treads carefully when asking stakeholders if any action by the EU is needed 'other than supporting market-led efforts to agree common standards?' (see European Commission, (2015b), p. 12.

Turning to the Commission's thoughts on potential areas for action in the longer term, the Commission clearly chose breadth over depth of thinking. Thus, a most striking aspect of the Green Paper is the sheer range of areas and ideas put forward for consideration. Areas include financial and securities regulation (including crowdfunding and venture capital), but also insurance and pension provision, supervision, company law, insolvency, accounting, taxation, actions in the technology area and public measures. In fact, the Commission invites contributions on any issues which 'require action to achieve a Capital Markets Union'.[39]

In relation to matters such as market supervision, which in all likelihood will matter for defining the future institutional shape of the CMU, the Green Paper strikes one as ambiguous.[40] While the Commission stops short of pleading for a transfer of day-to-day supervisory competence to the ESAs, the Green Power does not explicitly rule out additional transfers of powers in the supervisory field either. Hence, as far as pan-European supervision is concerned, the glass is either half-full or half-empty depending on whom you ask.

The Commission also remained somewhat circumspect on the issue of promoting cross-border mobility of companies. Promoting company mobility has proved to be an intractable problem for the EU. Legislative action on the topic has been sluggish. Initiatives such as a 14th Company Law directive, which could have facilitated the transfer of the registered office of a company, have never been adopted. Here too, the Commission is cautious when noting that '[f]urther reforms to company law may be helpful in overcoming barriers to cross-border establishment and operation of companies'.[41]

Hence, much of the content of a future CMU remains to be specified and is a priori open to proposals from stakeholders. However, the Green Paper does provide some clarity on one aspect of the proposed CMU – that is, the CMU's objectives. I will turn to these objectives now.

39 European Commission, (2015b), p. 26.

40 The Green Paper notes that '[f]urther consideration could be given to the role played by the ESAs in this context. To the extent that national supervisory regimes may result in differing investor protection levels, barriers to cross-border operations and discouraging companies seeking financing in other Member States, there may be a further role for the ESAs to play in increasing convergence' (see European Commission, (2015b) p. 22). The Commission goes on to ask: 'Do you think that the powers of the ESAs to ensure consistent supervision are sufficient? What additional measures relating to EU level supervision would materially contribute to developing a capital markets union?' (European Commission, (2015b), p. 26).

41 Ibid., p. 24.

c. Wide consensus on underlying objectives

It is apparent that the CMU initiative is about realising a single capital market where capital can flow freely across borders. But to an extent this objective is only a means to realise the CMU's other objectives. Thus, the CMU is also meant to reduce Europe's reliance on bank finance; to help the real economy – especially SMEs – to gain access to capital; and to help investors to gain access to a wider range of investment opportunities. These objectives reflect the Commission's attempt at fostering jobs, growth and entrepreneurship in a post financial crisis era – a core priority of the Juncker Commission[42] – and at addressing the risks for Europe's businesses and economies of mainly relying on banks for external funding, especially in times where banks tighten their lending policy.

The CMU's objectives provide the glue between the CMU concept and a yet largely unspecified agenda for realising it. However, it is also apparent that by defining these objectives, the Commission did not venture onto unfamiliar ground. Free movement of capital is a Treaty enshrined objective.[43] Meanwhile, facilitating access to finance for SMEs is a chronic EU hangover from past reform rounds. In its 1998 Risk Capital Action Plan, the Commission noted for example that it was essential that European entrepreneurs were 'able to access the right financing, at the right price, at the right place and at the right time to develop their companies and their ideas'.[44] Facilitating access to finance has been a theme in many other Commission communications, white or green papers.[45] The EU legislature too has sought to address the issue in various ways.[46]

42 Juncker, (2014a).

43 See generally Moloney, (2014); Payne and Howell, (2015).

44 European Commission, (1998), p. 2.

45 e.g. European Commission, (2008); European Commission, (2011c); European Commission, (2013a); European Commission, (2012b); European Commission, (2011a); European Commission, (2013b).

46 e.g. see Rec (132) and Art 33 of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU [2014] OJ L 173/349; Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds [2013] OJ L115/1; Rec (44) and Art 501 of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 [2013] OJ L176/1; Regulation (EU) No 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds [2013] OJ L115/18; Regulation (EU) No 1287/2013 of the European Parliament and of the Council of 11 December 2013 establishing a Programme for the Competitiveness of Enterprises and small and medium-sized enterprises (COSME) (2014 - 2020) and repealing Decision No 1639/2006/EC [2013] OJ L347/33.

The Commission's other main ambition – that is, of diversifying sources of funding in order to reduce reliance on the banking sector – is not an unfamiliar objective either, even though it is more closely tied to the financial crisis and its aftermath.[47]

The objectives that underpin the CMU initiative are unlikely to cause controversy, even among actors with potentially very different integrationist preferences. The point is obvious with respect to the Commission's ambition to complete a single capital market: it is a constitutionally preserved goal. But there is also a wide international consensus on the need to improve access to finance for SMEs – not least because of their contribution to national economies and to growth – and to reduce businesses excessive dependence on the banking sector, especially in the wake of the financial crisis. That said, the Commission clearly did not intend to make the banking sector feel excluded from the CMU project. The Green Paper highlights banks' crucial place within a future CMU and their key role within European economies.[48]

d. The CMU: first thoughts on first elements

So far, I have argued that the notion of a CMU is ambiguous; that the Commission in its Green Paper chose breadth over depth of thinking; that there was already broad support for some sort of action in those areas which the Commission selected for early action; and finally that the potential programme and the CMU concept are glued together by uncontroversial objectives which are recurring in EU initiatives, but which sit well with the (potentially) varying integrationist preferences of Member States.

Admittedly, the fact that the Commission remains vague on the CMU and on possible future actions is not necessarily worthy of criticism. After all, green papers are about generating feedback and testing the water. I also noted earlier that the CMU – for all its ambiguity – currently offered a focal point for promoting cooperation on a wide range of issues. Moreover, being ambiguous or vague can be a useful strategy for dealing with potentially conflicting policy preferences. Focusing on how to avoid deadlock in EU policy-making, Héritier for example notes that one strategy is to settle for a framework decision, 'phrased in such vague terms as to allow actors with diverging views to interpret it according to

47 See e.g. European Commission, (2013b).

48 European Commission, (2015b) p. 4. See also European Commission, (2015c).

their individual interests'.[49] The point resonates with the notion of 'constructive ambiguity'. Hoffmann notes:

> 'There has always been most progress when the Europeans were able to preserve a penumbra of ambiguity around their enterprise, so as to keep each one hoping that the final shape would be closest to its own ideal, and to permit broad coalitions to support the next moves'.[50]

Focussing on the policy proposal stage, Jegen and Mérand see constructive ambiguity as a strategy that 'coalesces around a "floating signifier"'.[51] They contend that it can serve 'political entrepreneurs to communicate with their audiences to push for a policy initiative'.[52] Thus, for them, ambiguity can be useful for communicating proposals: '[t]he intuitive advantage of ambiguity … is that it does not offend those who hold the power to support or block a proposal'.[53] Meanwhile, for Rayroux ambiguity can be useful in allowing Member States to claim domestically that their preferences and discourse are congruent with EU policy.[54]

Seen in this light, the fact that the CMU initiative lacks clarity, even substance, may actually serve it well: it makes space for differing interpretations congruent with potentially differing preferences for the future shape of a CMU. Recall in this context that the BU, whose agenda was set out with much greater clarity, proved controversial right from the beginning. It meant that the Commission was forced to shed one of its original BU pillars early on (ie, the single deposit insurance scheme). Unlike the BU, the loose CMU concept and agenda do not appear so far to have caused upset among Member States. Even the UK,[55] which has been highly critical of efforts aimed at closer integration – whether in the context of the BU or elsewhere[56] – sees the CMU as an opportunity more than anything else. The CMU thus appears, so far at least, to have

49 Héritier, (1999) p. 17.

50 Hoffmann, (1995), cited in Rayroux, (2014), p. 388.

51 Jegen and Mérand, (2014), p. 185.

52 Ibid, p. 183.

53 Ibid

54 Rayroux, (2014), p. 401.

55 See in the context, House of Lords, European Union Committee, (2015b), p. 12, citing Lord Hill as stating that there was '"a strong wind of support" among Member States for Capital Markets Union'. In this sense, see also Strupczewski (2015).

56 e.g. in relation to closer cooperation on a transaction tax.

successfully bridged the divide between Member States which are part of the BU and the most vocal non-participating Member State: the UK.[57]

However, whether a lack of clarity is a conscious political strategy is unclear.[58] At any rate, constructive ambiguity might well 'go wrong' once clarifications are needed.[59] Hence, as far as the CMU is concerned, the devil is likely to be in the detail: that is, in the agenda once it is set and in the specific proposals once they are brought forward. Whether the CMU's objectives will offer sufficient 'coalitional glue' if interests and preferences begin to differ markedly remains to be seen.[60] Moreover, it is a fact that the CMU lacks the sense of urgency of past EU endeavours – think of the European System of Financial Supervision or the Banking Union for that matter.[61] The point is noteworthy, since a sense of urgency can help to generate momentum and improve the odds of successful reforms in Brussels. In final analysis, however, it might well be that what proves crucial for improving the odds of the CMU reform agenda are the skills of the person who was tasked with delivering it – Jonathan Hill – especially when it comes to bridging a potential future divide between the UK and the BU Member States.

3. The CMU and SMEs

In this section, I will try to put flesh on the bones of the CMU project. I will begin with a few general observations. First of all, it is worth recalling that the CMU's objectives are wide, but also overlapping. A key objective such as 'better access to finance for SMEs' is merely emphasising the potential benefits of a single capital markets for SMEs. It is also plain that the CMU is supposed to benefit a variety of actors on both the demand side and the supply side: e.g. businesses, especially

57 See in this context, Ringe, (2015).

58 Whether much serious thought was given to the choice of CMU language is questionable. See Davies, (2015), noting that '[t]he capital-markets union actually began as a slogan, coined by one of EU Commission President Jean-Claude Juncker's acolytes'. See also Jegen and Mérand, (2014), p. 183 who note that ambiguity is rarely a 'conscious strategy'.

59 Jegen and Mérand, (2014) p. 183.

60 Arguably, the fact that a single capital market where movement is seamless has yet to fully materialise and that SMEs still face obstacles when seeking access to capital does not offer much support for the power of such objectives (ideas) over interests.

61 See Fuentes, (2015), citing David Wright, Secretary General of IOSCO, as noting that 'Europe always works best with deadlines. 2019 is a long term deadline …'.

SMEs, but also investors, insurance companies, pensions funds, banks, or other financial participants. Different actors have different profiles; they have different financial needs or resources, different levels of financial literacy, different levels of access to relevant information, etc. Thus, when assessing the CMU and what it offers each group (and sub-group) of actors, a multitude of factors need consideration. For the present purposes, the point is that the sheer number of factors complicates an appraisal of the CMU. Hence, rather than to attempt to formulate general and abstract proposals, I will attempt to make suggestions in relation to one group of actors – SMEs – and one of the CMU's objectives: that is, helping SMEs to gain better access to external finance. I will start by identifying the problematic (a.), after which I will reflect on possible solutions (b.).

a. Pathology

To properly appreciate the 'access to finance' problematic for SMEs, I will begin by highlighting a number of key issues. I will focus mainly on issues which affect the demand side: that is SMEs.[62]

'SME' is an umbrella term which lacks a single definition

As noted above, my aim is to make progress on designing a CMU by focussing on SMEs only. This task is complicated by the fact that there is no single definition of SME's.[63] The Prospectus Directive (PD), for instance, provides that SMEs are companies:

> '… which, according to their last annual or consolidated accounts, meet at least two of the following three criteria: an average number of employees during the financial year of less than 250, a total balance sheet not exceeding EUR 43 000 000 and an annual net turnover not exceeding EUR 50 000 000'.[64]

62 However, it is understood that there are obstacles on the supply side as well, which will further complicate access to finance for SMEs (in the area of insolvency, securities law, etc.).

63 See also in this context, House of Lords, European Union Committee, (2015b), at para 80; AFME, (2015), p. 30.

64 PD Art 2(1)(f).

By defining SMEs in this manner, the PD draws on a standard EU definition of SMEs.[65] MiFID II, however, defines SMEs as companies which 'had an average market capitalisation of less than EUR 200 000 000 on the basis of end-year quotes for the previous three calendar years'.[66] There are other definitions. According to the World Bank, for example, many banks define SMEs as businesses with sales of less than USD 2 500 000 and USD 10 000 000, respectively.[67] Other definitions focus on other figures (e.g. an annual turnover of up to GBP 25 000 000).[68] In other cases, it is the size of the funding sought which serves as a proxy for determining whether a business is small, medium or large.[69]

Besides definitional issues, there are other serious complications. Particularly problematic is the fact that 'SME' is an umbrella term. As a result, the range of businesses that are treated as 'SMEs' tends to be very broad. These businesses might often have little in common.[70] Thus, besides size, SMEs will vary along various dimensions: industry and sector, level of innovation, business ambitions, growth ambitions, etc. Variation may then become especially problematic when trying to diagnose problems and defining solutions.

Using capital markets is often considered uneconomical

Even if we overlook definitional issues, there are a number of other problems which require consideration. One such consideration concerns the size of funding which SMEs require. Specifically, the point is that the

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65 Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized entreprises [2003] OJ L124/36. Note that according to the Commission Recommendation, SMEs are enterprises 'which employ fewer than 250 persons and which have an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million'.

66 MiFID 2, Art 4(1)(13). The EUR 200 000 000 figure in MiFID 2 is still well above the figure which is included in the PD's definition of companies with 'reduced capitalization' (PD Art 2(1)(t)), which are companies listed on a regulated market and which had 'an average market capitalisation of less than EUR 100 000 000 on the basis of end-year quotes for the previous three calendar years'.

67 World Bank, (2014), p. 3.

68 See House of Commons, Treasury Committee, (2015) p. 3.

69 World Bank, (2014), p. 3.

70 There may also be relevant geographical differences. For example, the 2014 SAFE Survey reports that the proportion of SMEs which sees access to finance as the most pressing issue is largest in Cyprus, Greece and Slovenia whereas the relative lowest number are located in the Czech Republic, Austria and Slovakia. See European Commission, (2014b), p. 142.

amount of external finance which SMEs require will generally not be on the same scale as other (ie, large) businesses. At the same time, because of variation within the SME group (e.g. in terms of size), the amount of funding that SMEs may require is also likely to differ markedly.[71] For example, the 2014 SAFE survey reported:

> SMEs across EU-28 that were expecting growth were asked to indicate what amount of financing they would like to obtain. In 2014, most SMEs expecting growth would aim at obtaining financing between 25,000 Euro and 99,999 Euro (25% […]). 13% of SMEs would aim at obtaining less than 25,000 Euro, 19% would aim at obtaining between 100,000 Euro and 249,999 Euro, 18% would aim at obtaining between 250,000 Euro and 1 million Euro and 14% would aim at obtaining more than 1 million Euro to finance their growth ambitions. Between 2013 and 2014 there were no major changes in the amount of financing SMEs obtain.[72]

To this one must add that the cost involved with raising capital on stock markets is substantial. Expenses include due diligence costs, the cost of complying with disclosure requirements (initial and ongoing) and other regulatory requirements. Hence, because of the size of funding sought and the cost associated with raising capital on stock markets – or perhaps better, because of cost relative to funding size – many SMEs will consider capital markets a profoundly uneconomical route for raising funds.[73] Moreover, instead of measures aimed at facilitating equity investment (e.g. venture capital or business angels),

71 Ibid, p. 61, noting that 'there is a positive correlation between enterprise size and financing: larger enterprises more often apply for external finance than smaller ones. The same holds for innovative enterprises in comparison with non-innovative enterprises'. See also BMG Research and Department of Business, Innovation and Skills, (2013) p. 27.

72 European Commission, (2014b), p. 85. The remaining 11% were reported as na/dk ('no answer/don't know'). Note that the survey defines SMEs as enterprises with 1-249 employees (see fn 1, p. 9). For the UK, see also BMG Research and Department of Business, Innovation and Skills, (2013), p. 27.

73 Figures are difficult to find, but see tentatively, Zeidler, (2014), noting that raising funding on capital markets only makes sense for business with yearly turnaround of at least EUR 50 Million; AFME, (2013), p. 29, noting that '[f]or many corporates, particularly smaller firms, vanilla bank lending (including both term loans and credit facilities), is the main source of finance. The cost and ticket size required for capital markets issuance by corporates is typically prohibitive for transaction sizes below €500 million'.

many SMEs view public measures as a core driver for their future financing.[74]

However, all this is not meant to suggest that one should not attempt to improve access to different sources of finance. Recall in this context that the Commission has also launched a consultation on the Prospectus Directive (PD).[75] The directive requires an issuer to publish a prospectus in case where a company seeks to raise capital by making a public offer or where it seeks admission to trading of securities on a regulated market. It also requires each prospectus to be approved by the relevant competent authority. Because of its importance for the CMU, it is worth briefly considering the Commission consultation on the PD.

The PD is arguably a key measure for delivering a successful CMU. To be effective, its requirements must be properly calibrated. They must strike a proper balance between the different interests at stake. This also implies that the regime must be properly circumscribed. In its consultation, the Commission seeks feedback on *inter alia* the scope of the prospectus regime and on various exemptions from the obligation to publish a prospectus. Together these provisions determine the outer limits of the prospectus regime: they contribute to determining when an offer can be considered a private placement and whether there is room outside the prospectus regime for other forms of funding: e.g., investment based crowd funding. Specifically, the PD includes a number of thresholds, which contribute to determining whether the directive applies and, if it applies, whether a securities issue can be exempted from its key requirements. Among the former is Article 1(2)(h) which excludes from the PD's scope 'small offers', that is offers of securities with a total consideration in the EU of less than EUR 5 Million.[76] Among the latter is Article 3(2) which includes a list of exemptions which apply to offers that would otherwise be treated as public offers (e.g. an offer made to less than 150 persons per Member States or an offer of securities with a total consideration in the EU of less than EUR 100 000).

Besides consulting on the PD's scope, the consultation also seeks views on how to deal with compliance costs for SMEs in case where the directive's disclosure provisions do apply. Among other things, the Commission seeks feedback on the directive's 'proportionate disclosure regime'. The latter is meant to offer SMEs and companies with reduced

74 European Commission, (2014b), p. 88.

75 European Commission, (2015d).

76 PD Art 1(2)(h).

market capitalisation a lighter prospectus regime. However, the regime is thought to be ineffective.[77] The Commission also consults and on a possible prospectus regime for SME growth markets, a new category of multilateral trading facilities under MiFID 2.[78] In this context, the Commission considers whether it should introduce a 'bespoke prospectus regime' for SMEs (or for companies with reduced market capitalisation).[79] The consultation also opens the door for significant changes to the prospectus approval system under which each prospectus must be approved by a competent authority before it can be published.

Admittedly, there are other areas under consideration, which I will not discuss here. Instead I will limit myself to a few comments. First of all, it remains to be seen whether the EUR 5 Million threshold under Article 1(2)(h) is in and of itself problematic for many SMEs.[80] A more likely problem with Article 1(2)(h) is that Member States are left with discretion to unilaterally determine the treatment of offers that are below the EUR 5 Million threshold. They are thus able to define onerous prospectus requirements for offers that fall outside the scope of the directive.[81] Regarding SME Growth Markets, these markets might well prove popular with a portion of SMEs. A simplified prospectus for SMEs which list on these markets could be a way to make progress and

77 European Commission, (2015d), p. 13.

78 See MiFID 2, Art 33.

79 European Commission, (2015d), p. 14.

80 The figures quoted above (see supra, text to n 72) suggest that the funding needs of a majority of SMEs are well below the 5 Million threshold. Moreover, SMEs that wish to raise capital in excess of 5 Million on a stock market are currently able to access MTFs (eg AIM). MTF are not currently covered by the PD (although the Commission is now consulting on the matter). SMEs which contemplate listing on these markets will therefore not – currently – have to comply with the requirements of the directive, provided that they do not seek funding from the public (and if they are, are unable to rely on one of the exemptions of Art 3(2)). With regard to crowd-funding, note that the general EUR 5 Million is still far greater than the USD 1 million threshold which is the upper limit on the offering amount under the crowd-funding exemption of section 4(6) of the US Securities Act of 1933.

81 To be fair, the point did not escape the attention of the Commission which noted that investment-based crowd funding might be discouraged in Member States where the prospectus requirements are applied below the EUR 5 Million threshold (see European Commission, (2015d), p. 6). Note that the PD includes a very small offers *exemption* in Article 3(2) which exempts offers of securities 'with a total consideration in the Union of less than EUR 100 000'. Because of the interplay between Art 1(2)(h) and Art 3(2), Member States are unable to require publication of a prospectus for offers of less than EUR 100 000. However, for offers above this threshold, but below the EUR 5 Million threshold of Art 1(2)(h), they are left with discretion.

accommodate SMEs, provided however that information asymmetries, which have tended to be significant in the SME funding market, are also dealt with. But it is not obvious that the PD is the right instrument for addressing the concerns of SMEs/SME Growth Markets. In particular, it is not obvious that the PD is especially well suited for striking the right balance between (i) the concerns of SMEs/SME Growth Markets – in terms of reducing compliance costs[82] and allowing for flexibility[83] – and (ii) the needs of investors. The PD has proved to be quite an inflexible piece of legislation which is especially concerned with levelling the playing field between Member States. This is obvious as far as disclosure requirements are concerned (principle of maximum harmonisation as a general rule), but also as far as prospectus approval is concerned (*ex ante* review of each and every prospectus).

To be sure, the Commission has long acknowledged the importance of taking the needs of SMEs into account.[84] However, the PD has not been very effective at reducing compliance costs for SMEs. Thus, reducing 'administrative costs' was a core theme of the 2010 Prospectus Amending Directive.[85] In order to meet this objective, the Commission proposed, when bringing forward the proposal for an amending directive: the establishment of a proportionate disclosure regime, to abolish restrictions which prevent issuers of certain types of non-equity securities from choosing between a limited number of different competent authorities, and to facilitate offers of securities to employees under employee share schemes.[86] However, the outcome of these reform proposals was rather mixed. As already noted, the Commission is currently consulting

82 See also MiFID 2, Rec (132).

83 The need for preserving an 'appropriate degree of flexibility' in relation to SME growth markets was acknowledged by ESMA when advising the Commission on possible subordinate measures for MiFID 2/MIFIR. See European Securities and Markets Authority, (2014), p. 352, noting that '… among existing markets with a focus on SMEs, a broad spectrum of approaches exists in relation to the setting and application of issuer admission and disclosure requirements. Given this level of diversity, the preservation of an appropriate degree of flexibility for market operators under the supervision of NCAs, at member state level, is a central them of ESMA's advice'.

84 e.g. European Commission, (2008).

85 Directive 2010/73/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market [2010] OJ L327/1, recitals (1)-(4).

86 See European Commission, (2009b); European Commission, (2009a).

on reforming the proportionate disclosure regime which it says is 'perceived as too burdensome'.[87] It also contemplates further changes to the rules governing employee share schemes, which it sees as possibly failing to encourage third country issuers from offering securities to their EU employees.[88] The Commission is also consulting – again – on the issue of the determination of the competent authority for issuers of non-equity securities, its initial proposal having been rejected by the EU legislature.

Hence, attempting to undo the PD in order to accommodate SMEs might not be the best way forward. A more promising way would be to deal with SMEs in a separate directive which does not come with the 'baggage' of the PD (both in terms of its underlying approach and in terms of its underlying politics). Admittedly, it remains to be seen whether there is effectively a need for EU action in this area. But if so, a directive dedicated to SMEs might be more effective at balancing the needs of SMEs and those of investors, thereby hopefully contributing to creating the conditions for SMEs to grow and to achieve the scale needed to raise capital on the main market of a stock exchange.

SMEs face information problems

Offering SMEs better access to finance is not only a problem of the economics of lending or investing. It also depends on proper information. There is a wide consensus among public and private actors that information problems affect the prospect of SMEs attracting external finance. On the supply side, investors/lenders face information asymmetries which affect their ability to assess the creditworthiness of SMEs and the risks involved with SME businesses. Unsurprisingly, the Commission in its Green Paper, identifies work on SME credit information as an area for early action.[89] However, information problems also affect the demand side (SMEs). The Green Paper has less to say about these information problems. The Commission notes:

> '[i]n Europe, most SMEs only approach banks when seeking finance. … Although banks sometimes refer SMEs on to alternative finance providers, this does not always work: sometimes, neither banks nor SMEs are sufficiently aware of the existence of alternatives'.[90]

87 European Commission, (2015d), p. 13.

88 Ibid, p. 11.

89 European Commission, (2015b), p. 10.

90 Ibid, p. 14.

In fact, informational problems are pervasive on the demand side. They affect SMEs ability to identify financing options and to choose the most appropriate one. They are widely acknowledged. Thus, in its 1998 Risk Capital Action Plan, the Commission highlighted the 'general lack of understanding and awareness of financing options' among SMEs.[91] Financial market actors have been keen to highlight the issue too.[92]

Responding to such failures is not merely a matter of improving the flow of information between borrowers and potential lenders/investors. The problem has an educational dimension. Identifying the most appropriate financing option requires basic understanding of corporate finance, including knowledge of salient differences between debt and equity finance, their implications for the management and control of the business, etc. Education also matters for other reasons: successfully attracting external funding requires business owners to meet the expectations of finance providers: for example, in terms of developing and presenting solid business plans.

Given the needs and characteristics of SMEs, banks have particular advantages

So far I highlighted a number of key aspects of the 'access-to-finance' problematic of SMEs. Specifically, I referred to the (comparatively limited) size of funding which most SMEs require; the cost of raising capital on stock markets; and the information problems which investors/lenders *and* SMEs face. All this contributes to explaining why bank finance is the preferred source of external finance for SMEs in Europe. To be sure, the fact that bank finance is so prevalent in Europe has also to do with the fact that in comparison to the US, Europe has many more

91 European Commission, (1998), p. 18. In the UK, see also BMG Research and Department of Business, Innovation and Skills, (2013), noting that '[w]hilst the vast majority of SMEs are aware of finance from a bank, awareness of other sources of finance is lower. For instance, 53 per cent of SMEs were aware of venture capitalists, and 52 per cent were aware of asset based finance. However, less than a third were aware of business angels, export/import finance, peer to peer lending, and less that 12 per cent were aware of crowd sourcing or mezzanine finance. Fewer businesses were actually aware of specific suppliers for these non-bank types of finance'.

92 eg AFME, (2015), p. 30, noting that 'SMEs often feel lost when trying to identify alternative sources of funding'.

small businesses.[93] Given their size, they will not, in general, have access to capital markets. But even so, banks have in comparison to other providers of finance, a number of key advantages to offer. At the risk of simplifying a more complex and diverse picture, banks' business models are better suited for small scale lending. They have the necessary infrastructure and expertise to engage in SME lending.[94] Importantly, they benefit from an ongoing relationship with SME customers. Thus, in comparison to other finance providers, a bank is often more actively involved with the SME business and will be able to offer SMEs a wider range of services. The relationship aspect of SMEs and their banks is widely seen as important in explaining SMEs' behavior when seeking external finance. For example, a 2013 BIS/BMG research study notes:

> 'Most SMEs do not shop around when they need finance. They typically approach just their main bank within a week of needing the finance. This is because they have an existing relationship with their bank, and view the application process to their bank to be easier'.[95]

Because of their close involvement with SMEs, banks also tend to have better information about their SME customers. They will therefore be able to better assess the SME business and the risks that are involved.

Last but not least, because of banks' pivotal role, it is hardly surprising that SMEs are more confident in dealing with banks than with other finance providers. The 2014 SAFE survey thus notes:

> '[t]here exist considerable differences in the confidence among SMEs regarding talking about financing and obtaining the desired results with either banks on the one hand, and equity investors and venture

93 See Goldman Sachs, (2015), p. 4, noting that '[t]he high level of bank-dependence in the Euro area also reflects the importance of small and medium-sized enterprises (SMEs) in the European corporate sector. In the EU, half of all workers are employed by firms with fewer than 50 employees, whereas in the US that proportion is only around one-quarter … As a rule, small businesses cannot issue directly on publicly-traded securities markets, since insufficient information is available for investors to assess corporate performance and creditworthiness. SMEs are therefore more likely to rely on banks'.

94 e.g. European Central Bank and Bank of England, (2014b), p. 8, noting that '… for certain types of lending, such as loans to SMEs and residential and commercial property lending, banks are arguably better placed to extend credit given their branch network, credit assessment expertise and their operational capabilities').

95 BMG Research and Department of Business, Innovation and Skills, (2013), p. 1.

capital enterprises on the other hand, even within countries. It holds for each country that SMEs find the latter to be more intimidating …'.[96]

Access to external finance is not the most pressing issue for many SMEs

Last but not least, it is worth remembering that while access to finance is a significant issue, it is not the most pressing issue for many SMEs. For instance, the 2014 SAFE survey reports that

> 'In 2013 and 2014, the most pressing problem amongst SMEs in EU-28 was finding customers. From the items in the questionnaire, SMEs on average rated access to finance as the fifth most pressing problem they faced; it is mentioned by 14% of the SMEs as the most pressing problem'.[97]

Likewise, the ECB notes on the issue of access to finance of SMEs in the euro area that finding customers 'remained the dominant concern for euro area SMEs' during the surveyed period, with access to finance 'somewhat less of a concern'.[98]

b. Solutions

In the preceding part, I highlighted a number of issues which contribute to explaining the access-to-finance problematic for SMEs. In this final part, I will discuss ways to deal with this pathology. I will first return to the Commission's Green Paper and examine it in light of what I have said so far about SMEs (i), after which I will make a number of suggestions on a future CMU agenda (ii).

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96 European Commission, (2014b), p. 116, noting further that '[t]he difference is, however, relatively smaller for countries such as Denmark, Malta, Hungary and Greece. The difference is particularly large in the Czech Republic and Slovakia'.

97 Ibid, p. 141. However, there is variation among Member States. The survey notes: 'SMEs experience the problem of access to finance the most pressing in Cyprus, Greece and Slovenia; and the least pressing in the Czech Republic, Austria and Slovakia. Comparing across different types of enterprises, SMEs in construction considered the problem of access to finance the most pressing. Micro enterprises consider the problem of access to finance the most pressing, whereas large enterprises find it least pressing. More innovative enterprises experience more access to finance problems than less innovative enterprises'.

98 European Central Bank, (2014), p. 4. Like the 2014 SAFE survey, the ECB reports significant variation among Member States (see ibid, pp. 4-5).

(i) Thoughts on the Green Paper's first thoughts

Looking at the Commission's Green Paper in light of the pathology described above, the following points can be made:

First of all, it is plain that because of the issues highlighted above,[99] banks will need to continue playing a pivotal role in the SME funding market in Europe. The fact that the Commission has singled out work on high quality securitisation as an area for early action is therefore clearly important. It is hoped that if banks can free up their balance sheets by using securitisation (hence reducing the capital that banks must hold against these loans), securitisation will enable banks to increase their lending to SMEs.[100] Secondly, even if capital markets are likely to play a more indirect role for many SMEs, attempting to diversify sources of funding for SMEs is an objective which the Commission is right in pursuing. Large SMEs might thus be able to reap benefits of any future work on a pan-EU private placement market. Work in the area of venture capital or peer-to-peer lending/crowd-funding might also benefit a portion of SMEs (e.g., start-ups). The Commission is also right to consider other areas for action. As already noted, attempting to deal with information asymmetries in the SME funding market is important and should be welcomed. Meanwhile, progress in fields such as insolvency, taxation or securities law may prove to be crucial for stimulating cross-border investment. The Commission is also clearly not oblivious to the role that public measures can play in terms of facilitating access to finance for SMEs.[101] The fact that the Green Paper considers action on ancillary fronts (e.g. cross-border mobility or restructuring) is useful too. As noted earlier, access to finance is an important, but not necessarily the most pressing issue for many SMEs. Cutting red tape and trying to improve the

99 e.g. the small scale funding needs of a large proportion of SMEs and the larger proportion of small businesses in the EU in comparison to the US.

100 see e.g. European Central Bank and Bank of England, (2014b), p. 8, noting that '[b]y potentially enabling banks to lend without committing too much capital and other sources of funding, securitisation could provide indirect market access to certain borrowers, such as SMEs, who are otherwise unable to access markets directly'. See also House of Lords, European Union Committee (2015b), para 29; AFME, (2014), p. 11.

101 European Commission, (2015b), pp. 1 and 18. Regarding public measures, see especially the Regulation (EU) No 1287/2013 of the European Parliament and of the Council of 11 December 2013 establishing a Programme for the Competitiveness of Enterprises and small and medium-sized enterprises (COSME) (2014 - 2020) and repealing Decision No 1639/2006/EC [2013] OJ L347/33. See also European Commission, (2014a); European Commission, (2015a).

general regulatory and legal environment for SMEs is important, independently of the funding problematic. As far as the CMU is concerned, it is reasonable to assume that any measure which directly or indirectly contributes to fostering growth, will also improve the odds of a business gaining access to a wider range of funding sources: for example, on the main markets of stock exchanges which are currently not accessible to many SMEs.

Hence, the Green Paper and its ideas on areas of possible action should be welcomed. However, much remains to be spelled out and fleshed out and it is likely that the devil is going to be in the detail: that is, in the specific proposals once they are brought forward. That said, more thought needs to be spent on how to address information problems in the SME funding market. Specifically, the Commission in its Green Paper appears to lack imagination when thinking of possible measures for addressing information problems on the demand side – that is, information problems which affect SMEs when seeking funding. In order to address the latter, the Green Paper notes that

> '[b]anks could be encouraged to provide better feedback to SMEs whose credit applications are declined and to raise awareness about alternative financing opportunities for SMEs whose credit was declined'.[102]

These suggestions prompt a number of comments. Firstly, the reference to banks being 'encouraged' appears to be a nod to self-regulation. In fact however the Capital Requirements Regulation (CRR) already includes a 'feedback' provision on credit decisions by banks. Thus, regarding loan applications, Article 431(4) CRR requires banks, if requested, to explain their rating decisions to SMEs.[103] Secondly, concerning the Commission's other suggestion – ie, to encourage banks to 'raise awareness about alternative finance opportunities' for SMEs – it is worth noting that this approach has already been tried out at the national

102 European Commission, (2015b), p. 14.

103 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 [2013] OJ L176/1, art 431(4) which states that '[i]nstitutions shall, if requested, explain their rating decisions to SMEs and other corporate applicants for loans, providing an explanation in writing when asked. The administrative costs of the explanation shall be proportionate to the size of the loan'.

level. Thus, in 2010 major UK high street banks committed to a number of measures with a view to help businesses in search of finance. These commitments were set out in a taskforce report. With respect to information problems, the report concluded:

> 'Customers need to know what to do, and where to go, if the bank declines a credit application or offers an alternative finance solution. The Taskforce banks have agreed to commit to providing proactive and clear information on what alternative sources of finance and other help might be available. … Our signpost initiative sets out the minimum standard of service customers will get, either verbally or in writing. If their loan application is unsuccessful, they will be told why and they will then be guided to alternative sources of help and advice, including how to improve their creditworthiness. …'.[104]

However, these commitments appear to have largely failed to deliver results. The 2014 SME Finance Monitor reported in relation to businesses, whose loan applications had been declined, that only 9% had been offered an alternative form of funding or suggested alternative sources of external finance by the bank.[105] On the quality of the advice that these applicants received, it noted that:

> 'Two thirds (61%) thought that the advice their lender had offered at that stage had been poor, 14% thought it had been good while 9% had not been offered any advice'.[106]

Finally, according to the Finance Monitor, only 11% of unsuccessful applicants had been referred to 'any other sources of help or advice' by the bank.[107]

It is this sort of finding which the UK government highlighted when proposing legislation in this area.[108] Following the adoption of the Small Business, Enterprise and Employment Act 2015, section 5 of the act now

104 Report of the Business Finance Taskforce, (2010). Supporting UK business. (October), p. 42, available at https://www.betterbusinessfinance.co.uk/images/pdfs/Business_Finance_Taskforce_report.pdf.

105 BDRC Continental, (2015), p. 148.

106 Ibid. According to the survey, these results represented some progress in comparison to previous years.

107 Ibid.

108 See in this context, HM Treasury, (2014), pp. 5-6.

authorizes the Treasury to establish a mandatory referral system by way of regulations. Under this system, designated banks will be required to refer certain information about their SME customers and the latter's funding needs to so-called 'finance platforms'. The information in question relates inter alia to the amount and type of funding sought, the length for which the SME has been operating and receiving income, information regarding contact details, legal structure and the funding timetable.[109] The finance platforms are supposed to function as an access point and connect other finance providers with SMEs.[110] As noted, this mechanism requires separate regulations to be made by the Treasury. The regulations are at the time of writing only available in draft form.[111] For the present purposes, suffice to say that the transfer of the relevant information to a finance platform is subject to the SME's consent.[112] Crucially, a designated bank is only required to transfer information about its SME customer if the latter's application for a loan or for another credit facility from the bank is considered to be 'unsuccessful'.[113] 'Unsuccessful' is a term which is defined in the draft regulations.[114] It covers the case where a designated bank decides to simply reject its customer's application. It also covers the situation where the bank offers its SME customer a finance facility 'on a different basis', which the latter goes on to reject for reasons which do *not* concern the fees or interests that the bank wishes to charge its customer.

Given these limitations, it remains to be seen whether these new finance platforms, once the relevant regulations are made, will be effective in improving competition in the SME funding market. However, they might well prove useful in helping SMEs to gain access to alternative sources of finance. One advantage of the scheme is that SMEs will not have to actively search for alternative sources of funding. Instead of being

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109 Note that the Small Business, Enterprise and Employment Act 2015 leaves the duty to specify relevant information to the Treasury. The relevant regulations are currently only available in draft form. See the draft schedule of the Small and Medium Sized Business (Finance Platforms) Regulations 2015, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/389210/The_Small_and_Medium_Sized_Business__Finance_Platforms__Regulations_2015_Regulations_draft_statutory_instrument.pdf.

110 s. 5 of the Small Business, Enterprise and Employment Act 2015.

111 See supra (n 109).

112 s. 5(2)(a) of the Small Business, Enterprise and Employment Act 2015.

113 s. 5(1).

114 Draft regulation 2(2) of the Small and Medium Sized Business (Finance Platforms) Regulations 2015.

in an active mode,[115] they will be put in a reactive mode: matchmaking is primarily meant to be supply side driven via finance platforms.[116] However, it is plain that robust rules will need to be put in place in order to protect SMEs throughout the process, notably from untrustworthy finance providers.[117] Moreover, in order to prevent a lemons market from developing,[118] credit information on SMEs will need to be easily available to finance providers.[119]

(ii) Thoughts on a future Commission White Paper on building a CMU

At the time of writing, the Commission's consultation on the Green Paper is ongoing. Once the consultation is closed, it can be expected that the Commission will come forward with more specific proposals for action at EU level – presumably in a White Paper on building a CMU. Hereinafter, I will make some suggestions on areas for future action. In line with what I said earlier, I will proceed on the premise that bank finance will continue to prove crucial for many SMEs, but that seeking to improve access to finance for SMEs, by diversifying funding choices, is an objective that should be pursued vigorously. Moreover, from what I have said so far, it is plain that addressing information problems on the demand (for funding) side should be as much a priority as dealing with information problems affecting the supply (of funding) side. The latter area has been singled out for early action in the Green Paper; the former not.

Hereinafter, I will focus on how to address information problems affecting SMEs on the demand side. I proceed on the premise that improving access to finance for SMEs is not merely a question of improving the flow of information. As noted earlier, SMEs need more than raw information: they need advice, education and support. I will

115 See e.g. platforms such as http://www.betterbusinessfinance.co.uk/, http://europa.eu/youreurope/business/funding-grants/access-to-finance/.

116 Note that under draft regulations, a business that does not agree to its information being provided to a finance platform, will nevertheless be offered generic information by its bank on finance platforms, including on how it can refer itself to designated finance platforms (draft regulation 4(3)).

117 See in this context, HM Treasury and Department for Business Innovation & Skills, (2014).

118 Akerlof, (1970).

119 See in this context, s 4 of the Small Business, Enterprise and Employment Act 2015 which seeks to facilitate a better flow of credit information on SMEs via Credit Reference Agencies.

begin by examining the issue of improving the flow of information, after which I will turn to the issue of support (broadly defined).

Facilitating the flow of information

Before setting out substantive ideas, it is worth briefly considering the legal justification for EU action in this field. As already noted, a proper flow of information between SMEs and potential lenders/investors is crucial for improving the prospect of SMEs gaining access to finance. However, from an internal market perspective, improving the flow of information is clearly also important for ensuring that a single market for capital can function properly. Moreover, it is reasonable to assume that information asymmetries which affect the SME funding market at the domestic level will be even more severe at a pan-EU level. Addressing information problems in the SME funding market has thus a clear internal market rationale. The more difficult question is how best to address the issue on a pan-EU basis. As noted, the Commission in its Green Paper offers little in terms of an initial reflection on how to address information problems on the demand side. To make progress on the matter, I will suggest that supply side driven matchmaking via private sector finance platforms might be the way forward. One could thus imagine pan-EU finance platforms similar to the ones that are likely to emerge in the UK once the relevant regulations are made. Like in the UK, the crux of such an arrangement would be a system of mandatory referrals from designated banks to pan-EU finance platforms. Like in the UK, the subject matter of the referral would be information: that is, information concerning the funding needs of an SME customer. The aim of this new mandatory referral system would be to connect SMEs across the EU with finance providers (including with competing banks) by relying on pan-EU finance platforms as an information access point.

To be sure, there is a need for a deeper reflection on how a mandatory referral system could effectively work on a pan-EU basis; what safeguards would need to be put in place in order to protect the interests of SMEs as well as the interests of investors/lenders; what role finance platforms could play in relation to raising awareness of public measures; to what extent their role should extend to advice and support; and what type of funding model would be appropriate for a pan-EU finance platform.[120]

120 Note that under draft regulation 6(7) of the UK draft regulations, finance platforms cannot charge fees to SMEs. See also in this context the literature on two-sided markets, e.g., Rochet and Tirole, (2003); Evans, (2011).

However, as in the case of UK finance platforms, there are two obvious bottom lines. First, any transfer of information to a pan-EU finance platform would presuppose that the SME to which the information pertains, gives its consent. Once the information is transferred, rules will need to be in place in order to ensure that the SME remains in control of the process, including in control of information which allows it to be identified.[121] These safeguards will be important in order to protect against cold calling, a practice that would undermine confidence in the operation of pan-EU finance platforms and undermine the CMU's objectives. Secondly, it is plain that information asymmetries, which might prevent lenders/investors from assessing the creditworthiness of an SME business, would have to be addressed in order to deal with the 'lemons market' problematic.

With these safeguards in place, further thought should be given to the costs and benefits of going beyond the UK arrangements. Recall that according to section 5 of the Small Business, Enterprise and Employment Act 2015, a designated bank is only required to transfer specified information about its SME customers to finance platforms if the request for bank funding is 'unsuccessful'. Recall also that under the current draft regulations, a request for funding will *not* be considered to be unsuccessful if an SME customer is offered a finance facility on a 'different basis' and the latter rejects the offer for reasons having to do with the fees or interest to be charged by the bank.[122] Given the objectives of the CMU and the nature of the problem – especially, the need to address information problems on a pan-EU scale and the fact that SMEs do no tend to actively shop around for funding – there is a need for a deeper reflection on the circumstances which justify a transfer of information to a finance platform. Specifically, thought should be given to the question of whether a mandatory referral system should also apply in case where a bank offers its SME customer a finance facility, but the latter rejects the offer because of the fees or interest which the bank wishes to charge. Such a measure would not only contribute to improving access to finance; it would also ensure more effective competition in the SME funding market. Moreover, the additional burden that such a system would impose on banks can *a priori* be justified. Indeed, it is not unreasonable to assume that banks will

121 See generally, HM Treasury and Department for Business Innovation & Skills, (2014).

122 Draft regulation 2(2) of the Small and Medium Sized Business (Finance Platforms) Regulations 2015.

be able to benefit from a mandatory referral system if they themselves decide to join finance platforms in order to bid for business from SMEs which bank with their competitors. It is also worth noting in this context that the information that banks would be required to refer is unlikely to be proprietary information. In the case of the UK, for example, the information in question is basic information about the SME and its funding request.[123] In fact, given the nature of the information that is referred, one might well imagine actors other than banks referring information about SMEs to pan-EU finance platforms. Accountants could play such a role.[124] However, imposing a mandatory referral obligation on accountants would *a priori* be a step too far: the cost involved in establishing systems to ensure a transfer of information would likely be disproportionate to the benefits (if any) of such a system for accountants. This is not to say that accountants (or other professionals for that matter) could not be encouraged to offer SME customers the option of transferring information regarding their funding needs to pan-EU finance platforms. However, such a system, whilst voluntary, would need to be subject to the same safeguards as a mandatory system.

Advice, education and support

As noted above, SMEs not only need raw information about funding opportunities. They need advice, education and support. These different services can be regrouped under 'information provision', but for the sake of convenience, I will group them together under the umbrella term of 'business support' initiatives. The CMU offers an opportunity to reflect on how best to meet the needs of SMEs in this area.

It is apparent that business support can be offered on a commercial basis or as part of a commercial activity. It is conceivable that pan-EU finance platforms could play a significant role in this area too. However, in the remainder of this paper, I will focus on SME business support that is offered on a not-for-profit basis by public actors or through public schemes. It is worth beginning by highlighting a number of considerations.

123 See the draft schedule of the Small and Medium Sized Business (Finance Platforms) Regulations 2015.

124 See in this context, BMG Research and Department of Business, Innovation and Skills, (2013), p. 52, noting that survey results showed that '[a]ccountants were the most trusted source of advice, by 86 per cent of those likely to use advice in future if they had difficulties raising finance…'.

First of all, there is much to be said in favour of a 'one-stop shop' mechanism in this field: by concentrating a number of business support services in a physical or virtual place, a one-stop shop mechanism can be a useful practical solution for helping SMEs to get support, advice and generally to gain access to information, including regarding public measures. However, secondly, to be effective a one-stop shop mechanism must be sufficiently visible. Pleading for visibility is then arguably pleading against too much diversity in this field and in favour of more integration or at least a more integrated strategy. However, in fact there appears to be a good degree of diversity in this field, with Member State and EU schemes co-existing. The Enterprise Europe Network (EEN) is the EU's response to SME business support. The EEN is a one-stop shop.[125] It has, according to the Commission, a particularly important role to play in 'overcoming information asymmetries faced by SMEs and alleviating transaction costs associated with cross-border activities'.[126] It operates at national level through its member organisations. [127]

Despite – or perhaps more fittingly, because of – existing schemes at Member State and EU level, some see the US Small Business Administration (SBA) as a more effective example of a one-stop shop mechanism.[128]

125 Rec (17) of Regulation (EU) No 1287/2013 of the European Parliament and of the Council of 11 December 2013 establishing a Programme for the Competitiveness of Enterprises and small and medium-sized enterprises (COSME) (2014 - 2020) and repealing Decision No 1639/2006/EC [2013] OJ L347/33.

126 European Commission, (2011b), p. 6.

127 Article 10 of Regulation (EU) No 1287/2013 sets out the actions which the EEN may undertake: '(a) provision of information and advisory services on Union initiatives and law; support for the enhancement of management capacities to increase the competitiveness of SMEs; support aimed at improving SMEs' financial knowledge, including information and advisory services on funding opportunities, access to finance and related coaching and mentoring schemes; measures to increase SME access to energy efficiency, climate and environmental expertise; and promotion of Union funding programmes and financial instruments …; (b) facilitation of cross-border business cooperation, R&D, technology and knowledge transfer and technology and innovation partnerships'. In addition, the network is meant serve as a 'communication channel' between the Commission and SMEs and may serve to deliver services on behalf of other Union programmes, 'including dedicated advisory services encouraging SME participation in other Union programmes'.

128 See AFME, (2015), p. 30, noting that '[i]nterviewees also highlighted that SMEs' historical reliance on banks meant that SMEs often feel lost when trying to identify alternative sources of funding. This is not helped by the plethora of government and non-government schemes set up to support SMEs in recent times. The US Small Business Administration was identified by both bank and non-bank sources as a good example of a "one-stop-shop" for SMEs in need of both advice and funding'. See also House of Lords, European Union Committee, (2015b), p. 31.

The SBA is a federal agency. It was set up in 1953 by the US Congress in order to 'aid, counsel, and protect the interests of the nation's small business community'.[129] Its range of services includes (inter alia) information provision, advice, education, and financial support through various programs.[130] It also helps to uphold the interests of small businesses in the award of government contracts.[131]

It might well be that the US SBA is an example of a one-stop shop which is worth emulating. However, considering a more integrated one-stop shop solution akin to the US SBA would prove to be problematic in the EU: not only as a matter of political reality, but also as a matter of constitutional law. This is because SME business support is closely linked to industrial policy under the EU Treaties and the EU only has supporting competence in this area. That is, it can only take action in order to 'support, coordinate or supplement' Member State actions.[132]

Hence, the CMU faces arguably some political and constitutional limitations which might come to affect its ability to deliver one of its key objectives. However, this is not to say that the existing EEN should not be part of a discussion on a future CMU. There might be room to improve existing EEN arrangements within existing boundaries: for example, in terms of the visibility of the mechanism or the depth and quality of services provided at national level.[133] Hence my final proposal concerns the scope of the CMU initiative. Fragmentation of policy initiatives is unlikely to serve SMEs well. The Commission did not mention the EEN in its Green Paper on the CMU. Given the emphasis placed on access to finance for SMEs and the range of areas under consideration in the Green Paper, this omission is noteworthy.

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129 U.S. Securities and Exchange Commission, Small Business and the SEC: a guide for small businesses on raising capital and complying with the federal securities laws, available at http://www.sec.gov/info/smallbus/qasbsec.htm.

130 For details, see U.S. Small Business Administration, (2014).

131 Ibid.

132 Article 6 TFEU. Thus, Regulation (EU) No 1287/2013, which specifies the EEN's actions, is based on Articles 173 TFEU (industrial policy) and Article 195 TFEU (tourism). The COSME Regulation was not intended to replace national initiatives. See European Commission, (2011b), p. 11.

133 See in this context Art 10(3) of Regulation (EU) No 1287/2013 which states that the Commission shall assess the Network 'in terms of its effectiveness, governance and provisions of high-quality services across the Union'.

4. Conclusion

The aim of this paper was to assess the CMU initiative, as it is emerging at the time of writing. The paper attempted to gather first elements regarding the shape and content of the CMU by relying on policy documents and especially on the Commission's Green Paper on a CMU. Ultimately, this paper sought to investigate the relationship between the CMU and SMEs and make proposals on how to make the former more relevant to the latter.

By way of conclusion, it is worth considering two final issues. They have to do with the CMU or with the proposals that I made in this paper. Firstly, critics of the CMU initiative might seek to dismiss it as just another example of European gobbledygook. However, this criticism largely fails to do justice to the project. As noted earlier, for all its ambiguity, the notion of a CMU offers currently a focal point for promoting cooperation on a wide range of issues. Moreover, the CMU offers an opportunity to make progress on some long-standing issues. The second issue concerns the proposal for pan-EU finance platforms and for rolling out a mandatory referral system on an EU wide basis. The idea of finance platforms bridges a (somewhat artificial) divide between capital and banking markets. It is reasonable to assume that banks will be interested in being members of pan-EU platforms and as such be interested in competing for business alongside alternative finance providers. Critics might point out that such a system would do little to address Europe's bank bias: that is Europe's dependence on the banking sector. However, such a criticism is artificial and largely unwarranted. The EU would be pursuing an unrealistic strategy if it believed that banks would simply stop playing a role in the SME funding market as a result of the establishment of a CMU. To be successful, the CMU should not be about imposing a choice between banks and other finance providers. Instead, it should be about offering greater choice. Banks will continue to matter in the SME funding market. The Commission is right not to exclude them from the CMU initiative.

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PART III

Single Market versus Eurozone

Single Market vs. Eurozone: Financial Stability and Macroprudential Policies

Carmelo Salleo

The financial crisis which started in 2007 was the most severe in decades. It affected deeply some of the most advanced economies, in particular the US and the EU, and elicited strong responses. Policy makers focused along two lines of action:

- Conjunctural measures, aimed at avoiding the freefall of the economy and possibly elicit a quick comeback. Fiscal, monetary and prudential measures were taken in the heat of the moment, possibly with mixed results.
- Structural measures, devised to combine into a new analytical and institutional framework aimed at strengthening the resilience of the financial sector and at fostering a comprehensive approach to financial stability.

In this short essay I will look cursorily at the policy reactions of policy makers in the US, UK and EU to see what stylized facts can be drawn (with no pretence of science), then describe the new institutional setup in the EU and what challenges it poses to an area which can be broadly partitioned into three: the euro area (EA), the UK and CEE[1].

1. Conjunctural responses to the crisis

I will first look at fiscal, monetary and prudential policies across the US, UK and EU, then assess their collective impact on the three economies

1 As this volume also contains a submission which brings in the Swedish perspective I will defer to its author for further thoughts on the impact of the new framework on countries which do not fall in the three clusters I discuss here.

and draw tentative conclusions – figures are rounded up and not all definitions are exactly consistent with each other, but this intended to be a bird's eye view of the main trends. The EA will be looked at in terms of averages, even though responses were heterogeneous across countries – but the goal here is to give an overall perspective across the three economies and not to analyse in detail how the crisis played out within a monetary union.

a. Fiscal policy

The pattern of the fiscal policy response has been relatively similar across all three economies: an increase in 2008-10, then a decrease, but the orders of magnitude were quite different (Fig. 1).

In the US the government deficit had been around 2 per cent of GDP before the crisis; it jumped to about 9 per cent for the years 2008-10, then decreased again over the following years to about 3 per cent. If we take 2 per cent as a sort of long-term average, the US government injected more than 25 p.p. of GDP into the economy in just four years.

In the UK the government deficit was also hovering around 3 per cent before the crisis; it then jumped above 10 per cent in 2009 and came down relatively quickly but was still close to 5 per cent in 2014. Over 6 years the UK government injected into its economy more than 25 p.p. of GDP.

In the EA the weighted average of government deficits was less than 2 per cent of GDP before the crisis, it rose above 6 per cent in 2009-10 but was back to 3 per cent in 2013. If we take as long-term average 2 per cent, the extra resources pumped into the economy by EA governments was less than 15 per cent over 5 years. This might of course be due also to the fact that the EA lacks a central fiscal authority which could take decisive action in a short time-span, while national governments might try to free-ride on each other's expansion.

Over-simplifying a bit, the US went for a sharp boost, the UK for a more steady approach, the EA had overall a smaller fiscal response.

b. Monetary policy

As the impact of fiscal policy is powerful but takes time to feed into the economy, central banks went quickly into easing monetary policy, bringing reference rates to close to zero in order to counter deflationary pressures. However the impact on real rates was different, reflecting differences in the structure of the economy and perhaps about inflation expectations (fig. 2.1).

In the US policy rates dropped to (almost) zero in 2009 and real rates[2] stayed a little above minus 2 per cent, starting to pick up only in mid-2014. This means that for about five years those willing to invest or consume were effectively subsidised by their creditors at a steady rate.

In the UK policy rates also dropped to (almost) zero in 2009 but real rates went all the way to almost minus 5 per cent towards end-2011 then climbed up to zero at the end of 2014. Somehow inflation expectations (or perhaps expectations about the UK economy as a whole and about its performance relative to the global economy) have been volatile over the past few years, and might have been turning more pessimistic over the latter period.[3]

In the EA policy rates dropped more slowly – below 2 per cent only towards the end of 2009 and below 1 per cent in 2014. Real rates got close to zero only towards the end of 2010 and have stayed broadly there since. Hence the monetary stimulus for investment and consumption has been less pronounced than in the US or the UK, probably due to a pessimistic outlook on the performance of the EA economy (which would be consistent with expectations of very low inflation).

So conventional monetary policy had to grapple with the zero lower bound problem: once there, policy rates' influence on the economy depends on variables that are generally beyond the grasp of central banks. But central banks didn't confine themselves to manoeuvring prices (interest rates), they also engaged in non-conventional measures, by using quantities (expanding their balance sheets) (fig. 2.2).

The Fed increased the size of its balance sheet from about 6 per cent of GDP in 2007 to more than 15 per cent already in 2008 and around 23 per cent in 2013. Its purchases of government bonds were about 20 per cent of the federal deficit in 2009-10, more than 50 per cent in 2011 and 2014, close to 80 per cent in 2013 (fig. 2.3). In this indirect form of cooperation between the government and the central bank, in which the central bank through its purchases effectively ensured that fiscal expansion would not

2 Calculated ex-post, with all the limitations of such an approach.

3 For a given nominal rate a higher real rate implies lower inflation expectations – this could be either due to more faith that the Bank of England will keep inflation under control compared to what investors thought in the earlier years of the crisis, or more pessimistic expectations about the performance of the UK economy over the next few years – hence lower inflation expectations.

raise interest rates and crowd out private investment, monetary expansion accompanied fiscal expansion at its peak (the first few years) and provided some form of support for the government's debt management program.

The Bank of England followed a similar expansion path for its balance sheet, from 7 per cent of GDP in 2007 to15 per cent in 2008 and more than 20 per cent already in 2012. It purchased large amounts of government bonds (relative to government deficit) in 2010, 2012 and 2013. The central bank expanded its balance sheet together with the first round of fiscal stimulus, then again when the government deficit was about to shrink.

The ECB's balance sheet expanded from 18 per cent of the area's GDP in 2007 to 24 per cent in 2008, to close to 34 per cent in 2012 then decreased to 26 per cent in 2014. Its purchases of government bonds issued by EA governments over the years 2010-2013 were less than 8 per cent of their deficits.

The maximum expansion of central banks' balance sheets compared to 2007 is similar across the three economies (a little above 15 per cent of respective GDP), but the ECB purchased a much smaller fraction of government deficit, thus letting governments finance themselves on financial markets as usual.[4]

c. Prudential policies

Fiscal and monetary policies are the classical conjunctural tools, but there is also a whole set of instruments which affect the supply (and sometimes demand) of credit and which can be put under the broad umbrella of prudential policies that affect the economy as a whole. Furthermore, given that the crisis was mainly a financial one at least at the beginning, and that there was broad consensus about the need to reduce a debt overhang in the economy and strengthen the banking system to reduce moral hazard (the too-big-to-fail problem) and cost for taxpayers, prudential polices have been just as important a tool.

I will focus in this section on measures aimed at increasing the resilience of the banking sector via increases in capital because of their conjunctural impact. Other measures were undertaken (such as the creation

4 On the general issue of the effects of quantitative easing, see e.g. "The Effects of Quantitative Easing on Interest Rates: Channels and Implications for Policy", Brookings Papers on Economic Activity, Fall 2011, by Arvind Krishnamurthy and Annette Vissing-Jorgensen and "ECB Policies Involving Government Bond Purchases: Impact and Channels" (2014 WP), by Arvind Krishnamurthy, Stefan Nagel and Annette Vissing-Jorgensen.

of asset management companies or of resolution funds in some countries, government guarantees on bank bonds, bank workouts, etc.) but from a conjunctural perspective they are perhaps less relevant.

Broadly speaking, regulators and supervisors realised that banks were undercapitalised either already ex ante, holding too little capital for the risks they underwrote, or ex post after having had to absorb severe losses. Banks were therefore requested to increase substantially their capital ratios to ensure a sufficiently comfortable buffer for absorbing potential additional losses, and they had the choice between raising equity (not easy in difficult market conditions), retain earnings (not easy with a weak economy) or deleverage (not good for a fragile economy).

I will look in turn at risk-weighted capital ratios (fig. 3.1), which are informative about banks' risk-taking capacity ex ante[5], and at leverage ratios (fig. 3.2), which are informative about banks' resilience in case of a shock.[6]

The general set of rules to be adopted was decided collectively within the Basel framework, but national authorities can exert some moral suasion to accelerate the adoption of measures or even adopt more stringent requirements.

The Tier 1 ratio of US banks was below 10 per cent in 2008, and went above 12 per cent already in 2009. Their leverage declined slightly from assets being 10 times equity in 2008 to a ratio of around 9 in 2010. US banks, which are a much smaller part of the financial system than in the EA, strengthened quickly their capital positions in terms of ex ante risk but left their resilience to shocks broadly unchanged. The improvements were mainly due to increases in capital, as the weight of banks' total assets to GDP actually increased from 70 to 85% between 2007 and 2014 (fig. 3.3).

UK banks started below 8 per cent of Tier 1 ratio and increased it continuously to above 13 per cent by 2014. Their leverage ratio decreased from 27 to 17. UK banks increased significantly both their risk taking capacity and their resilience to shocks, and they did it by increasing capital but also by deleveraging a bit, as their total assets to GDP ratio fell from 460 to 400 per cent. These data reflect also the fact that the large UK banks are also global players, so maybe this last figure is only relatively meaningful.

5 Higher ratios mean that banks' probability of default is lower – assuming the mapping from risk to capital is correct of course.

6 As losses are in nominal terms and not weighted, low levels of capital in the system mean it is more fragile in case of another crisis.

As for EA banks, they increased their Tier 1 ratio from 8 to 12 per cent, and their leverage ratio decreased from 25 to 17. On the whole this was achieved mainly via capital increases, as their share of total assets over GDP fell only slightly from 340 to 310 per cent.

Overall all three banking systems have similar risk taking capacity, US banks have much smaller balance sheets so their resilience is higher – but of course one should look at a broader set of financial institutions to assess the resilience of the industry as a whole. It seems that in the end deleveraging was contained – from a macroeconomic perspective the credit supply seems to have been marginally affected by banks' massive recapitalization efforts, although of course portfolio allocations might have shifted towards assets with lower risk weights, such as government related securities, displacing credit to the economy.

d. Outcomes

I will look at the combined effect of fiscal, monetary and prudential policies on the economies of the US, UK and EA by describing trends in the financial sector (total debt over GDP,), the economy (GDP per capita and unemployment) and macroeconomic imbalances (the current account position).

The US – total debt in the economy was at 270 per cent of GDP in 2007; it shrank a little at the beginning then actually rose, to almost 300 per cent in 2014 (fig. 4.1). The private sector's share decreased a little, from 205 to 195 per cent, and the government's share increased from 65 to 100 per cent. The private sector deleveraged a bit but the public sector more than compensated for it. If debt overhang was a problem, the only possible benefit has been a shift to the government's balance sheet, which is probably more solid that the private sector's, but the overall magnitude of the problem has actually increased.

Real GDP per capita stayed broadly constant – at first it decreased slightly, then it increased; in 2014 it was 2 per cent higher than in 2007. The unemployment rate on the other hand reached a high of almost 10 per cent in 2010, the dropped to 6 per cent in 2014, still higher than before the crisis when it was below 5 per cent. The current account deficit was halved between 2007 and 2014, to 2.4 per cent of GDP, possibly also thanks to exchange rate effects induced by the ultra-lax monetary policy.

The policy mix chosen by US policy makers can be described as a combined loosening of fiscal and monetary policy, of significant magnitude and apparently with some synchronization in timing, and a relative tightening of prudential policies. It stabilised the economy, brought back unemployment, reduced the current account deficit and debt in the private sector, strengthened the banks but at the cost of much higher public debt and larger central bank balance sheet.

Of course one would need a counterfactual to see where the US economy would be had policies been more conservative. If fiscal multipliers are close to one and given that extra low rates decreased the cost of servicing debt, the fact that real GDP per capita stayed broadly constant indicates that the economy might have deteriorated significantly without such policies.

One might wonder whether, if another crisis of similar magnitude hits the US economy, there is enough space for a repeat of such a policy performance. The challenge is then to make sure that these policies were actually conjunctural, i.e. that they can be at least partially reversed to create room for possible future interventions.

The UK – total debt in the economy rose from 220 to 250 per cent of GDP (fig. 4.2). The private sector's share shrank, from 185 to 160 per cent and the government's share increased from 50 to 90 per cent. Just as in the US, the private sector's deleveraging was more than compensated by a massive increase of government debt. The UK's banks simultaneous increase in Tier 1 ratio, deleveraging and shrinking of their balance sheets indicates that they didn't shift much towards holding government bonds, but they might have constrained the supply of credit to the private sector.

Real GDP per capita dropped during the crisis, and was still slightly lower in 2014 than in 2007. The unemployment rate rose to 8 per cent in 2011 and was back to almost pre-crisis levels in 2014, at 6 per cent. The current account deficit on the other hand increased, from 1.5 to 4.3 per cent of GDP. The new jobs created after the through of the crisis were probably not high-paying ones and in non-tradable sectors.

The UK policy mix was of very loose fiscal and monetary policies and quite tight prudential policies. It was followed by a stagnant economy, deleveraging of the private sector but a deterioration of the current account position; banks became much more resilient.

Again, the challenge is to re-create room for possible future interventions by reducing the government's deficit (which is part of the program of the recently re-elected conservative government); the complication with respect to the US is a less vibrant economy and higher real rates. If there isn't a pickup in global demand UK policy makers might find themselves in a difficult situation, with few instruments at their disposal.

The EA – total debt in the economy has grown from 230 to 250 per cent of the economy (fig. 4.3). The private sector's exposure stayed broadly constant around 160 per cent of GDP, while the public sector's grew from 70 to 90 per cent. There was no deleveraging in the private sector but it had started out with low levels compared with the US for example, while the public sector on the whole is reaching high levels.

Real GDP per capita was 3 per cent lower in 2014 than in 2008, and unemployment is above 11 per cent and 4 p.p. higher than in 2008. The current account went from a deficit of 1.6 per cent of GDP in 2008 to a surplus of 2.4 of cent in 2014. This is all consistent with a contraction of output.

The policy mix in the EA was obviously affected by the lack of a central fiscal policy maker which could work in tandem with monetary policy, as happened implicitly or explicitly in the US and the UK. In the end fiscal policy was on the whole moderately loose, while monetary policy was more aggressive, in particular with its non-conventional measures. Prudential policies were tighter than in the US but looser than in the UK. The EA's economy fared the worst of the three, with a slightly lower increase in public debt (but starting also from higher levels), a weaker economy, banks that are not in better shape than the others and only an improved current account (but probably due more to the recession and terms of trade effects than to increased productivity).

The challenge as for the UK is to reduce governments' deficits in the face of weak growth; the task is complicated by the fact that government debt is higher in the weaker countries, and by more cumbersome decision-making processes which impose additional costs in terms of delays and compromises.

e. The bottom-line

Almost 6 years after the collapse of Lehman Brothers the economies of the US, UK and EA have not really fully recovered to where they would have been without the crisis. If one assumes a trend growth of 1 per cent for real GDP per capita (lower than GDP because of ageing populations, immigration, etc.) then it is lower by 3 to 6 p.p. compared to what it would be.[7] Unemployment is still higher than before, in particular in

7 For a comparison with the great Depression see also "The Current Financial Crisis: What Should We Learn from the Great Depressions of the Twentieth Century?" (2009), by Gonzalo Fernandez de Cordoba andTimothy Kehoe, mimeo.

the EA. Total debt is still high due to the expansion of government debt, central banks are in uncharted territories. The only bright spots are lower private sector debt and more resilient banks.

This being said, the stylized facts described above suggest some lessons in terms of responses to a financial crisis, and some challenges.

Fiscal policy is very powerful, especially in coordination with an aggressive monetary policy; together they can compensate for private sector deleveraging and seem to work well in reducing unemployment, less so in promoting growth.[8]

Non-conventional monetary policy measures can play a role when policy rates hit the zero lower bound. Their impact, and the effects of central banks buying large amounts of government bonds should be further explored.

Prudential policies should be seen as part of the broader policy mix. They can be tighter when fiscal and monetary policy are looser, otherwise they risk spurring excessive deleveraging in the private sector and delay a possible upturn of the economy.

The main challenge is how to reduce the public sector's balance sheets without derailing a fragile recovery. Just as coordination within an economy improves the effectiveness of each policy, perhaps international coordination of the three policy domains could create economies of scale and scope. Of course one would need to integrate in the picture the other key players in the global economy – Japan, China, the other emerging markets – but the description of such strategic interactions goes well beyond the scope of this paper.

2. Structural measures

While policy makers dealt with the crisis by manoeuvring fiscal, monetary and prudential policies, together with regulators they also set out to amend the old framework and design a new one which would address some issues which the crisis highlighted as key to preserve financial stability.

Most measures affect banks, and therefore were designed and agreed upon within the Basel framework (the so-called Basel 3 agreement), then they were adopted in the EU regulatory framework with the CDRD IV/CRR in 2013. This new set of regulations updates and upgrades the

8 On private sector deleveraging and fiscal policy see "Balance Sheet recession as the Other Half of Macroeconomics", (2012), Richard Koo, mimeo.

microprudential framework which had shown many weaknesses, and it formally introduces the concept of macroprudential regulation, aimed at preserving financial stability.

a. The instruments

Without getting into the details of the new tools created to reduce systemic risk, here's a quick summary of the main instruments which are now at the disposal of macroprudential authorities.[9]

To address the pro-cyclicality of the financial system, the main tool is the counter-cyclical capital buffer. Banks are supposed to fill the buffer in good times (defined as: when the credit-to-GDP gap is above some threshold, which is in turn linked to the probability of a crisis), so that when there is a downturn they can decumulate them thus not constraining the credit supply. The idea is that the buffer increases the resilience of banks to shocks, softens the impact of a downturn and possibly also curbs risk-taking during the boom phase by increasing the cost of credit since equity is more expensive than debt (this last effect rests implicitly on the assumption that Modigliani-Miller does not apply to banks).

To address the risk of contagion across the banking system, more capital buffers were devised so that banks can absorb higher losses, which decreases counterparty risk. Furthermore limits to large exposures can be imposed to reduce interconnectedness. Sectoral risk weights can also induce banks to reduce common exposures and thus the risk of generalized losses.

To deal with the related risk of firesales, which were one of the amplifying mechanisms of the crisis, the new framework adds to the toolbox two liquidity ratios which should ensure on the one hand that banks have a balanced structure of assets and liabilities in terms of maturities, and on the other hand that they have enough cash to finance their operations for a month without having to start selling assets of lesser liquidity – which could trigger widespread firesales.

Finally, to address moral hazard induced by banks that are too big to fail, systemic institutions are required to hold extra buffers so as to reduce the impact of their possible demise. They are also required to have high levels of bail-in-able liabilities to protect depositors and taxpayers

9 For a more detailed description of instruments available in the EU, see The ESRB Handbook on Operationalising Macroprudential Policy in the Banking Sector (2014).

(so-called TLAC requirements), and they must also issue contingent convertible bonds (CoCos) which convert to equity or absorb losses when regulatory capital dips below a certain threshold which is still way above resolution levels. This instrument should provide an additional layer of protection to debt-holders and is cheaper than equity as long as the coupon is tax-deductible (which it is generally in Europe but so far not in the US so US banks are not issuing CoCos yet).

Many of these instruments are meant to preserve financial stability but they also affect the safety and soundness of individual institutions and have therefore also a microprudential dimension. This raises complicated issues of governance: how should the two sets of prudential policies coordinate, what kind of conflicts could arise (e.g. in a downturn the macroprudential angle would suggest a release of buffers to sustain the credit supply while the microprudential perspective would be more conservative given the heightened risk of debtors), how does this all interact with the other macroeconomic policies are all issues that have found different solutions at the national and EA level.

b. The institutions

As the crisis hit the EA particularly hard, it became clear that its banking system was fragmented and therefore also had difficulties transmitting evenly monetary policy impulses. It was therefore decided to create a Banking Union, which would ultimately rest on three pillars; a common supervision, a common resolution scheme and a common deposit insurance.

The construction started by setting up a common banking supervision function, the Single Supervisory Mechanism (SSM), entrusted to the ECB. The governance of the SSM is complicated, as the ECB's Governing Council decides upon input of a Supervisory Board which does not have the same exact composition, but for the purpose of macroprudential policies the key result is that the ECB can use all and only the instruments detailed in the CRD IV/CRR, and only to tighten them. The rationale was probably that while national authorities might be hesitant to tighten during a boom and risking bringing it to a premature end, in a downturn there would be no inaction bias in loosening. The other key point is that national authorities can not only also use the same instruments (in both directions), they can also use any other instrument which is not contemplated by the CRD IV/CRR, such as Loan-to-Value, Debt-to-Income or

Loan-to-Deposit ratios, which are considered to be rather effective tools. National authorities play an important role in the macroprudential setting of the EA also because in a monetary union with non-synchronous financial cycles macroprudential policy often needs to be tailored to the specific situations of individual countries. This complex setup means that within the EA macroprudential policy is a coordinated effort between microprudential and macroprudential perspectives on one hand, and between national and EA-wide perspectives on the other.

The Single Resolution Mechanism (SRM) provides a framework for the orderly resolution of banks in the SSM space, and is especially important for banks with significant cross-border activities. It ensures that to the maximum extent possible taxpayers are shielded from the cost associated with bank failures and it has access to a resolution fund to help cover the cost of bank resolution. This way there is an appropriate degree of burden sharing across countries and the costs of bank failures are spread to avoid what happened during the crisis, namely that widespread bankruptcies in some countries had systemic effects on the economy. The SRM complements the SSM in that now that banks are supervised by a single entity with common standards it also makes sense that resolution is dealt with within a unified framework.

The last pillar of the Banking Union, a common deposit insurance is still in the works. Once it will be in place the EA will have a consistent, integrated framework to deal with issues pertaining to the banking sector and to a large extent to financial stability since banks are still the dominant players in the EA's financial system.

The other EU countries adopted a variety of governance structures to deal with the new framework for banking regulation and macroprudential supervision. In the UK all powers were given to the central bank, which is therefore responsible for monetary policy, microprudential and macroprudential supervision. In Sweden the banking supervision authority is also in charge of macroprudential supervision. In Denmark macroprudential supervision is performed by a committee chaired by the Treasury. In principle given the complementarities and trade-offs involved among the three policy domains (fiscal, monetary and prudential) many governance structures might make sense. The key issue of course is to ensure proper accountability of choices and a decision-making process which is effective within its institutional framework. In the EA, in which there is no overall fiscal policy and in which banks are by far the most relevant actors in the financial system, it makes sense to have the ECB at the center of the framework, albeit with shared responsibilities with national authorities and with the recognition of the independence of its monetary policy function from the other policy domains.

The key difference between the EA and the other EU countries is that in the EA there is no central fiscal policy, which as seen in the previous section is an important element of macroeoconomic stabilization. So in the EA it is particularly difficult to reap the benefits of a synchronized action of fiscal, monetary and prudential policies.

c. The challenges within the EU

The EU economy can (simplistically) be seen as an economic space organised around three poles: the EA, the UK and Central and Eastern Europe (CEE), which is not a homogeneous economy but a set of countries that share some common traits (fig. 5). The differences in economic, financial and institutional structures among these three areas mean that their interaction creates some challenges for policy makers when it comes to preserving financial stability in the EU.

The EA and CEE

Most CEE countries pegged their currency to the euro, therefore their monetary policies are heavily influenced by ECB decisions. In terms of using monetary policy for financial stability purposes, if their financial cycles are not aligned with the euro areas this means that there is little leeway, and actually they could be importing instability if for example in order to preserve the exchange rate they have to implement a monetary policy which is looser than what local conditions would suggest.

A second issue is that most CEE banking systems are part-owned by EA banks, which in many cases actually collectively have a significant or even majority market share. This means that CEE banking supervisors are host authorities and have little scope for an independent prudential stance. Home supervisors might fail to take into due consideration the issues of host supervisors, and cross-border banking groups might have strategies which transcend any specific local market. How banks manage their consolidated balance sheets across subsidiaries and what overall stance home supervisors think is appropriate determine in large part the dynamics of local banking markets and therefore the financial cycle.

This leaves CEE countries with fiscal policy as a financial stability tool, but this is obviously sub-optimal given the many other objectives and constraints faced by fiscal policy makers. This assessment is rather gloomy in principle but how relevant are these issues in practice?

On one hand, business cycles of CEE and EA countries are not too divergent, probably because the EA is by far the major trading partner for most CEE economies, and in most cases exchange rates can be adjusted on a one-off basis to correct for imbalances before they build up too much.

On the other hand some countries are entering in "close cooperation" with the SSM, which in essence means that over time they might join the banking union and become "co-home supervisors" of their own banks. This way they will be able to bring their perspective to the core of the new supervisory decision making process rather than having to interact on the basis of decisions taken entirely elsewhere.

For macroprudential issues the ESRB provides a forum in which to discuss and coordinate macroprudential stances and policies so there is scope for at least ample information sharing.

Finally, being part of the EU ensures that CEE countries will participate in the common development of new tools and frameworks, such as the Capital Markets Union project, and the further integration of financial infrastructures. More integration across the whole EU and a role in the governance mechanism should foster convergence and decrease the risk for a country of finding itself at odds with the rest but with little tools which can be used effectively.

The EU and the UK

The UK has an independent monetary policy[10] and therefore it is more in control of its business and financial cycle. Linkages with the EA are mostly due to cross-border flows and common exposures. Therefore coordination of macro-and micro-prudential policies would be beneficial to both economies, although even measured in terms of financial assets the EA is a much more important partner for the UK than vice-versa. Also in this case coordination can be achieved by having open discussions at the ESRB on respective goals and policy stances.

One issue is that both economies vie for a top role as financial centers in the world, and policy makers might be tempted to use prudential

10 To the extent that monetary policy can be truly independent, in particular of other monetary policies: on the global financial cycle see Rey, H (2013) "Dilemma not Trilemma: The global financial cycle and monetary policy independence", paper presented at the Jackson Hole Symposium, August 2013.

policies as competitive tools. Before the crisis there were fears of a race to the bottom in order to help national champions compete in the global area, and to reduce the local cost of business in a bid to attract market share. After the crisis some claim that prudential policy is still used for competitive purposes, this time around by gold plating common European regulations in order to attract business by claiming a higher level of resilience. Whether this is true or not, it is important that prudential policies are not diverted from their main goal, as using them for competitive purposes basically negates their basic aim which is to de-risk the sector and improve its resilience.

There is still a structural problem, which is the different role played by banks and markets in the EA and the UK. Banks are dominant in the EA, while markets play a much more important role in the UK. This leads to different policy perspectives as instruments are different, and different policy stances as market reactions are much more pro-cyclical and swift than banks', not to mention that markets are more integrated internationally. Taking this into account means that although intentions might be the same in the EA and the UK in terms of overall goals (e.g. increase the resilience of banks) the instruments chosen and timing might be different, e.g. UK authorities might favour a quick increase in straight equity to assuage investors while EA authorities might be comfortable with a build-up over time. This could lead to frictions as banks in both economies compete with each other and this different treatment might affect their business choices, even though it can be perfectly rational and optimal from a systemic perspective.

One final issue which might affect the interplay of prudential policies is the possibility that the UK exits the EU. If this were to be the case, what would be the implications for financial stability and macro-prudential policies? Perhaps not much, since the above discussion does not seem to depend much on the UK being part of the EU framework, but such a momentous event would definitely have many unforeseen consequences.

Summing up

The governance of different policy domains and their interplay among the main EU economies will shape the European way towards financial stability.

The key role of fiscal policy also for financial stability cannot be ignored. Within the EA this calls for much greater cooperation and coordination also in the fiscal dimension.

The relationship between the EA and CEE is a story of increasingly deep real and financial integration. The (semi-)fixed exchange rate regime and strong presence of EA banks in the CEE make the two regions very interdependent also from a financial stability perspective. This calls for more integration of prudential policies.

The relationship between the EA and the UK seems sufficiently loose and with enough degrees of freedom that differences in financial cycles should have little spill-overs if properly managed.

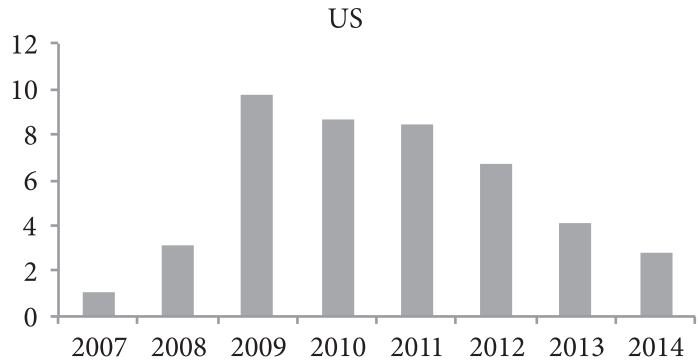
Conclusions

All in all, perhaps the main lesson of the crisis is that neither countries nor policies should be looked at in isolation – this is true in general and even more so when dealing with such an elusive and multi-dimensional concept as systemic risk.

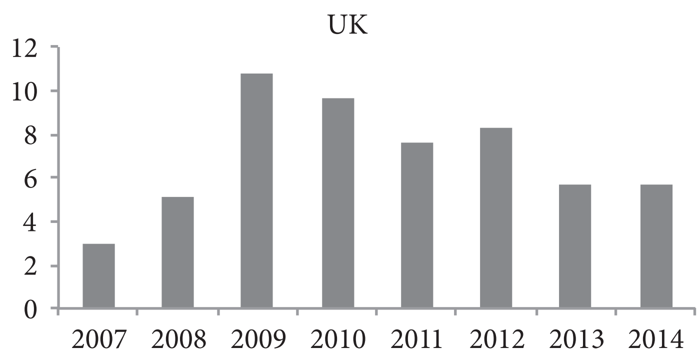
We need a true general equilibrium approach to preserve financial stability in the EU and in the world, which puts together fiscal, monetary and prudential policies. Whether we will be able to achieve a sufficient degree of cooperation across sectors, policy domains, countries and governance structures is the greatest challenge ahead. In the European Union we are working towards further integration of markets and institutional frameworks, streamlining of decision-making processes and cooperation within and across policy domains.

Figures

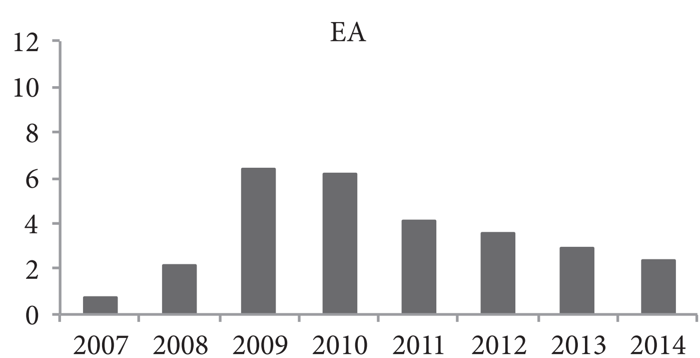
Figure 1: Government budget deficit (% GDP)



Source: *US Fed*

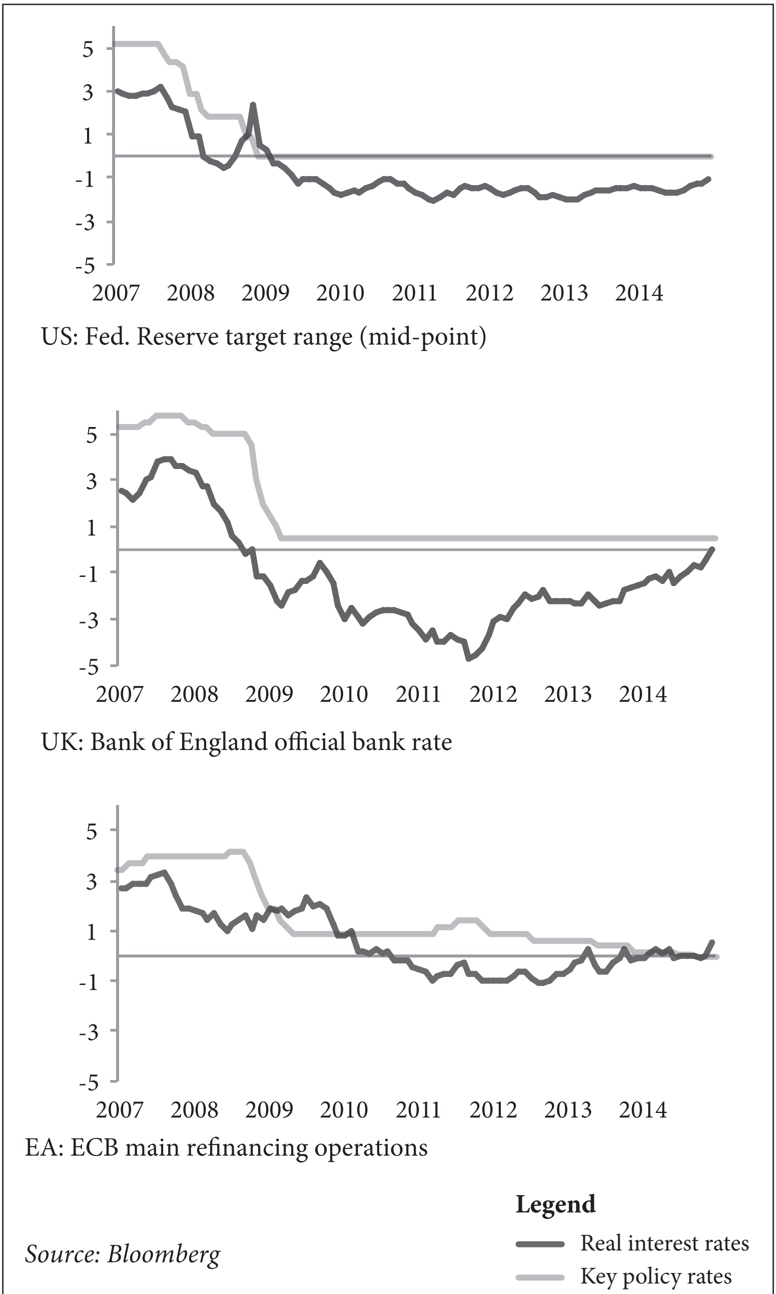


Source: *ECB*



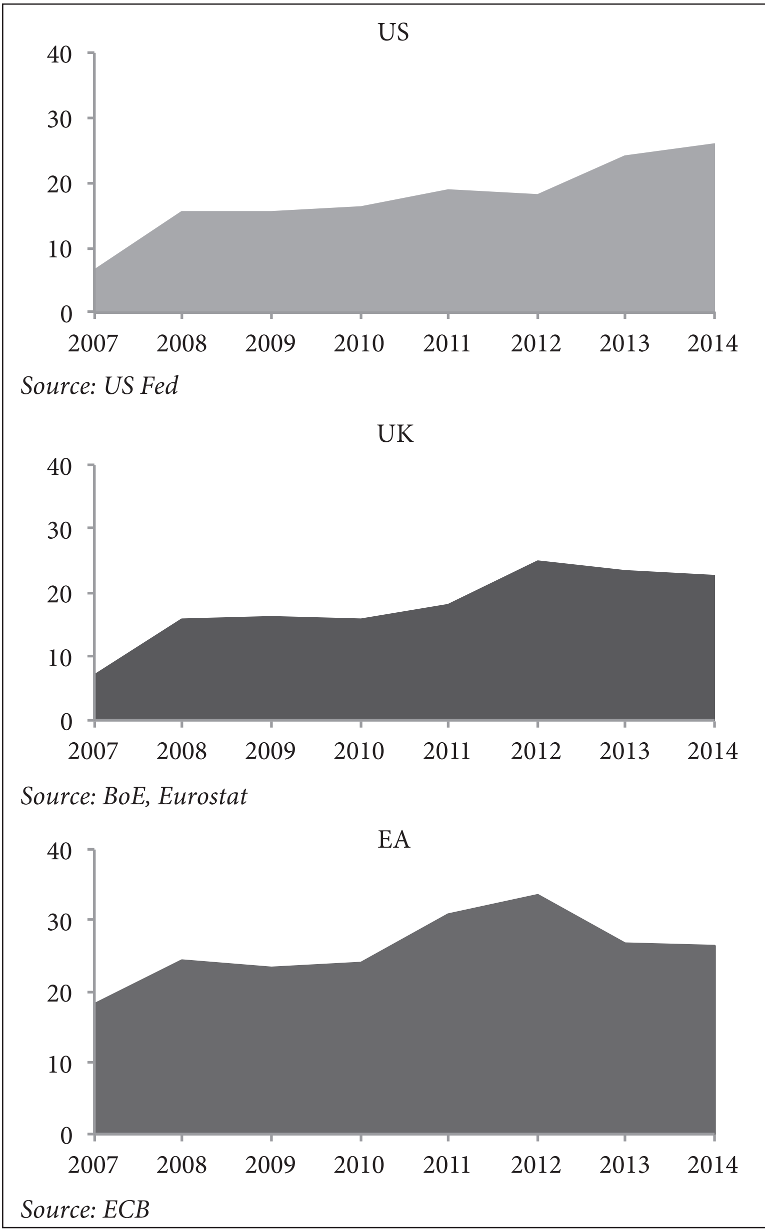
Source: *ECB*

Figure 2.1: Nominal and real interest rates (%)



Source: Bloomberg

Figure 2.2: Size of central banks' balance sheet (% GDP)



Source: US Fed

Source: *BoE, Eurostat*

Source: *ECB*

Figure 2.3: Purchases of government securities by central banks (% deficit)

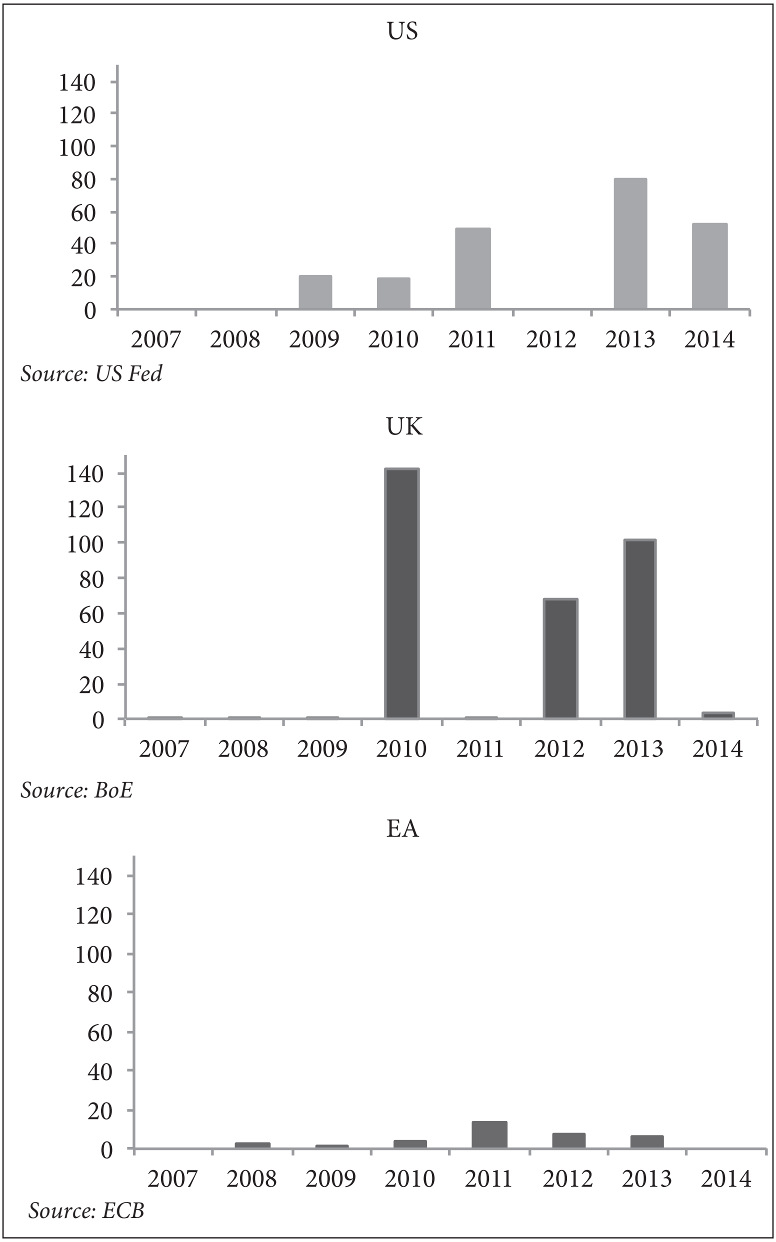
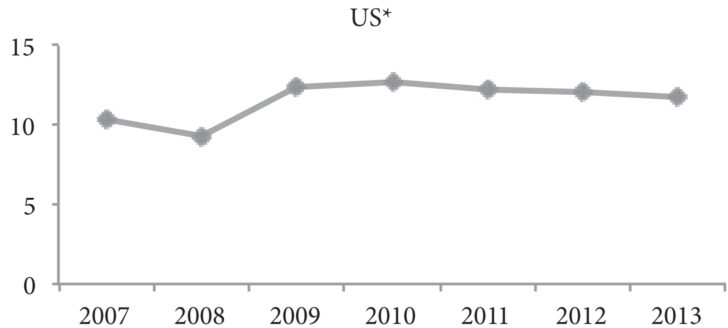
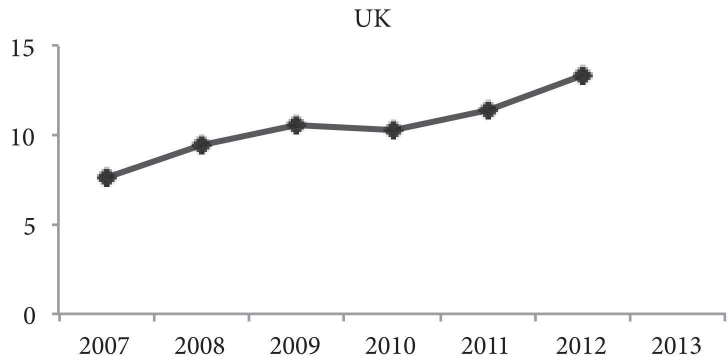


Figure 3.1: Tier 1 capital ratio (%)

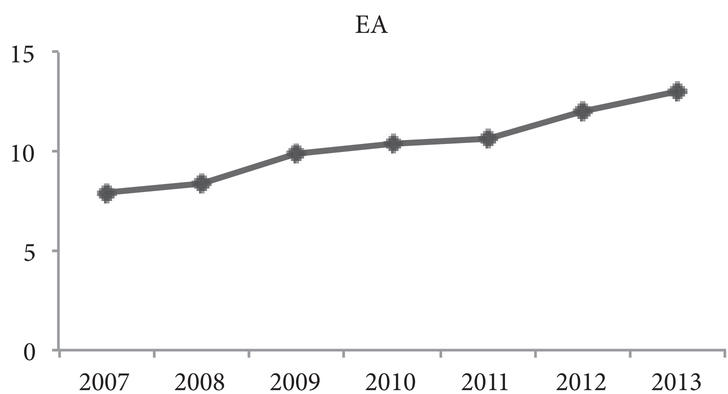


* Bank capital to assets ratio (%)

Source: World bank

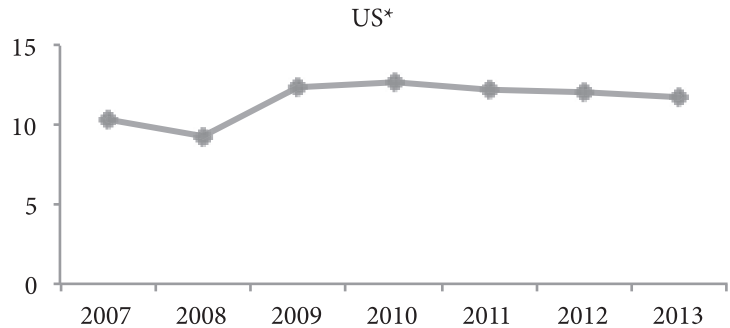


Source: ECB



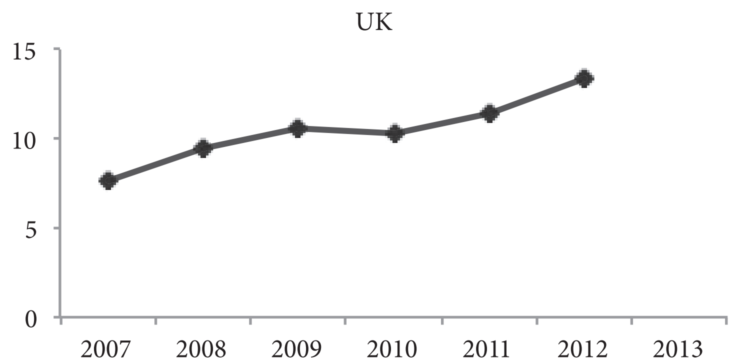
Source: ECB

Figure 3.2: Leverage ratio (%)

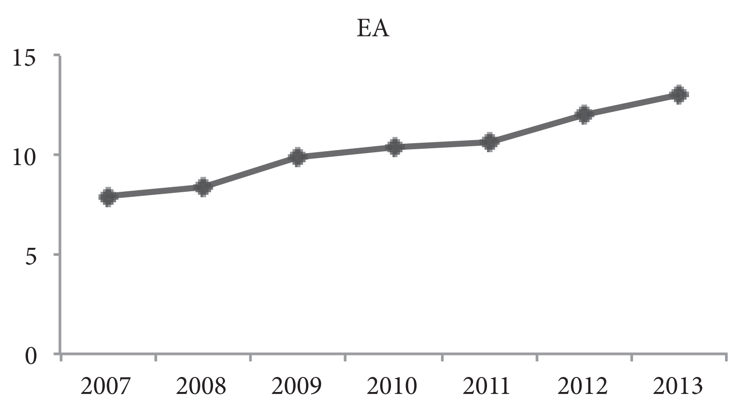


* Bank capital to assets ratio (%)

Source: World bank

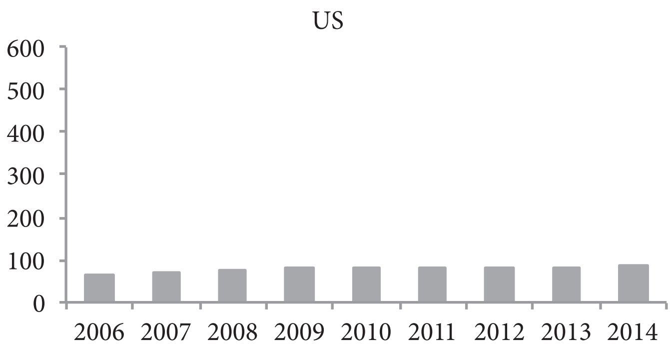


Source: ECB

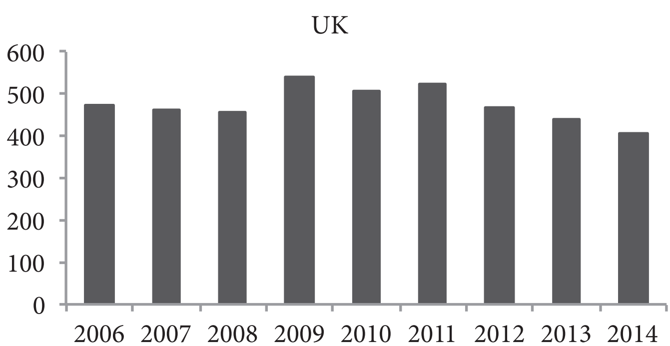


Source: ECB

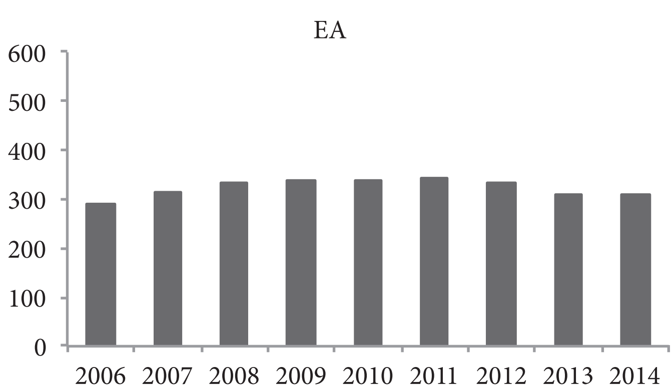
Figure 3.3: Total banking assets (% GDP)



Source: US Fed



Source: ECB



Source: ECB

Figure 4.1: Outcomes UK

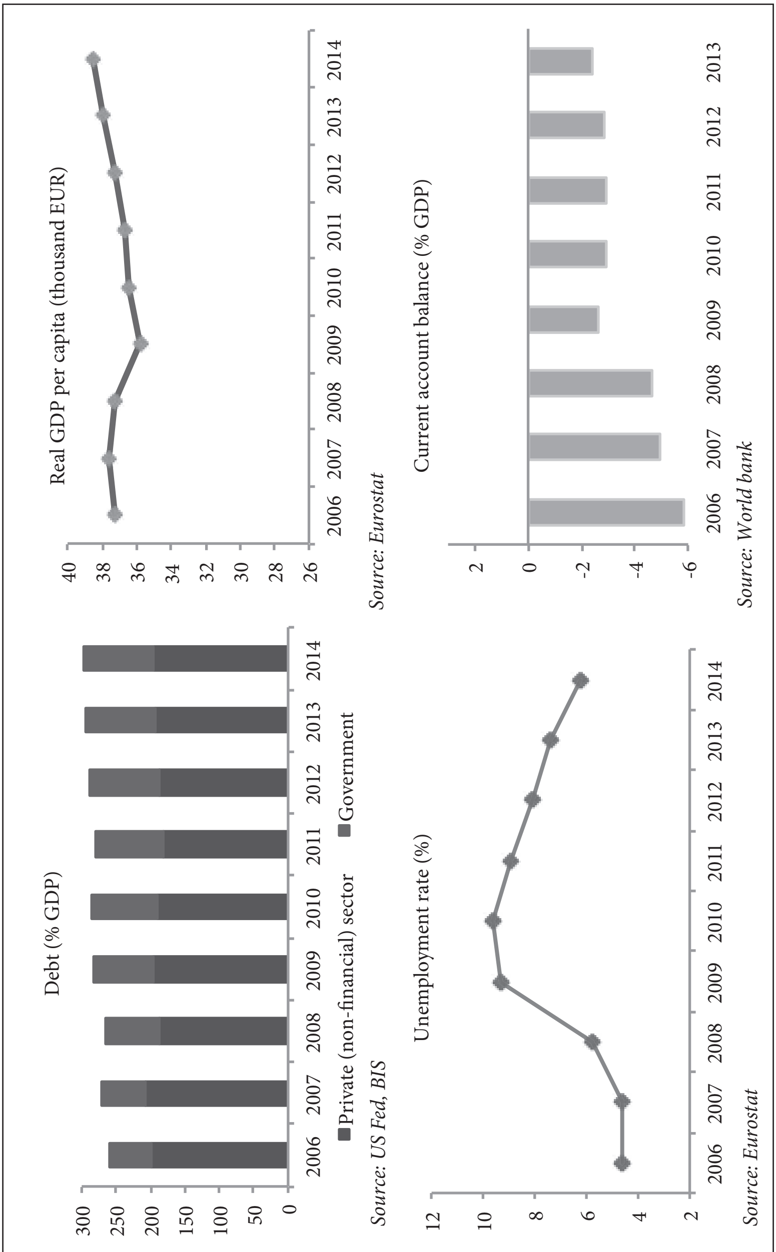


Figure 4.2: Outcomes US

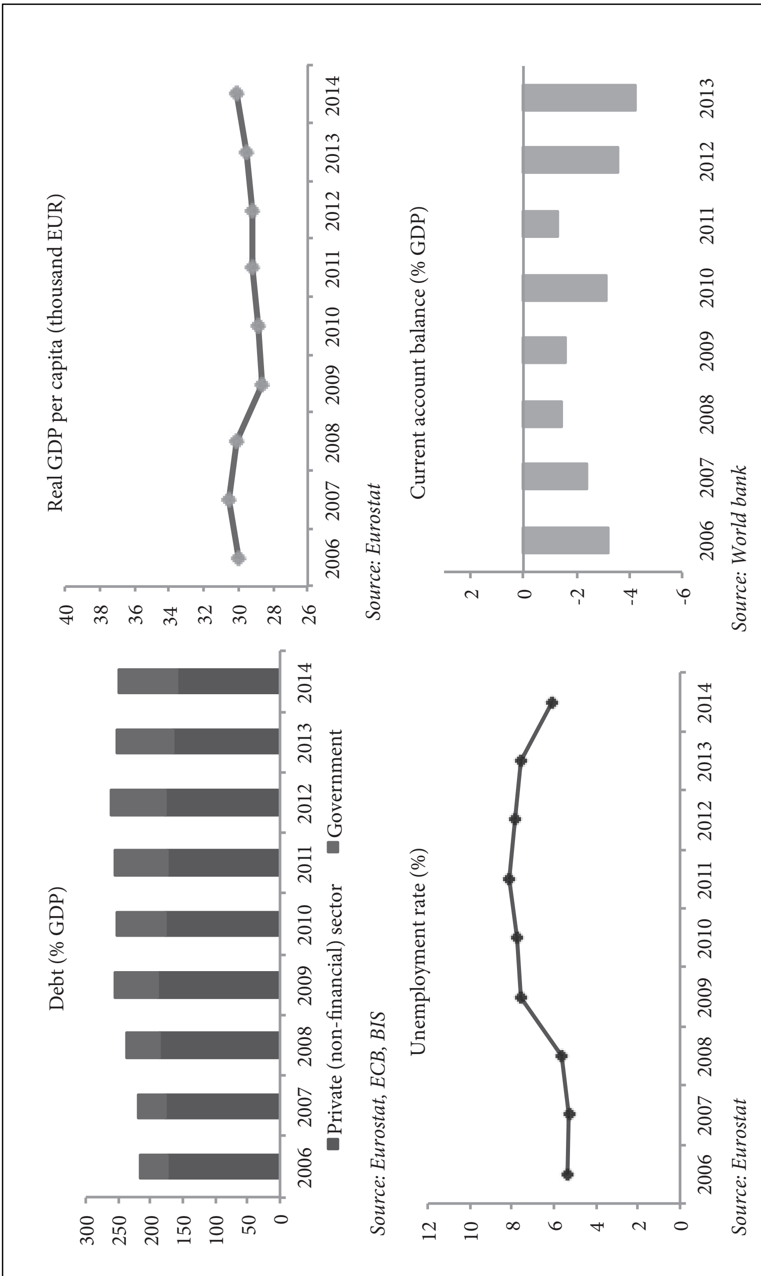


Figure 4.3: Outcomes EA

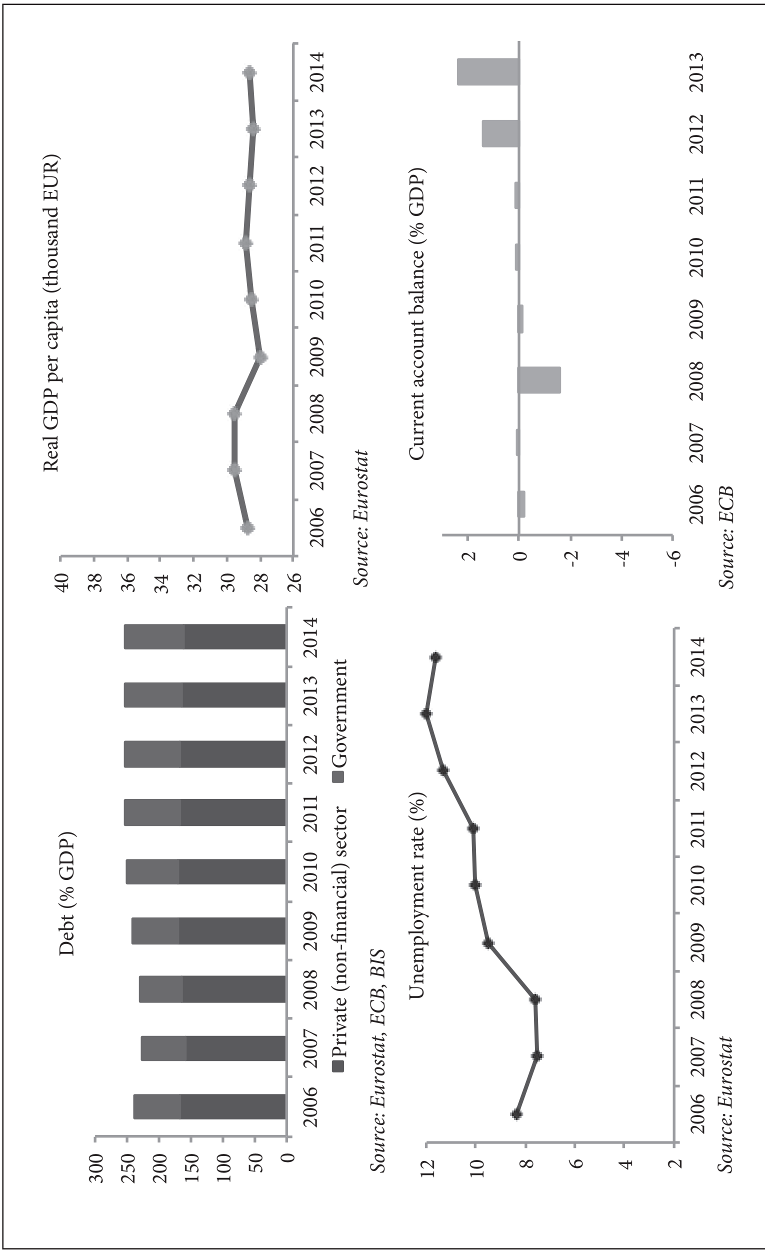
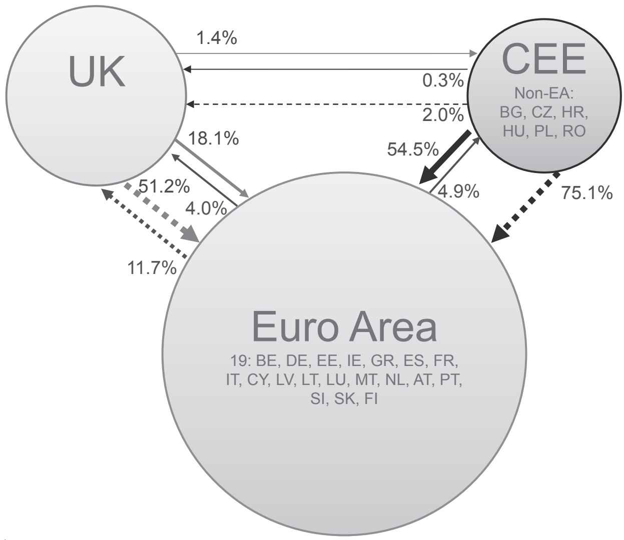


Figure 5: Real and financial relationships within the EUI



Notes:

Full lines represent trade to GDP ratio (i.e. bilateral X+M /GDP)
Dashed lines represent claims by banks vis-à-vis other
EU regions as a % of total foreign claims (where available).

Source: UN Comtrade, BIS Consolidated International Banking Statistics

The Banking Union from an Outside Perspective[1]

Kasper Roszbach

1. Introduction

This chapter contains some reflections on the achievements the EU banking union as seen from outside and its key challenges for the near future. I will touch upon four aspects of the banking union, without any ambition of completely covering all the arguments involved, mainly focusing on the supervisory aspects of the union. First, in Section 2, I will discuss the geographical and institutional setting of the banking union. Next, Section 3 deals with the rationale behind the Banking Union and describes what I consider important costs and benefits. In Section 4, I list some considerations that may have contributed to some countries, deciding to opt out from the Single Supervisory Mechanism (SSM). Finally, in Section 5, I discuss what implications SSM has had for non-participating EU countries so far and identify some of the challenges I believe lie ahead.

2. Geographical and institutional dimensions of banking union

For a proper assessment of the Single Supervisory Mechanism it is important to take into consideration its need to communicate with national authorities and institutions that are not subject to the SSM rulebook.

1 Disclaimer: The comments in this chapter are the author's own views and do not necessarily reflect the opinions of the Executive Board of Sveriges Riksbank. I am grateful to Reimo Juks, Mattias Hector and Christina Nordh-Berntsson for suggestions and comments on a draft of the conference presentation. All remaining errors are mine.

So what does the landscape look like outside the banking union? Currently, nine out of 28 EU member states, Bulgaria, Croatia, the Czech Republic, Denmark, Hungary, Poland, Romania, Sweden and the UK, participate in neither the Euro nor the SSM. These nine countries host, among others, six of the 15 globally systemically important banks (G-SIBs) designated by the Financial Stability Board that the EU hosts. These six G-SIBS have substantial activities through both subsidiaries and branches inside the SSM that play an important role in the economies of some SSM members.

The cross-border activities of large international banks can give rise to several situations. A parent bank outside the banking union can have subsidiaries inside. Swedish banks, for example, hold large markets shares in Finland and the Baltics, and banks with their domicile in Denmark as well as in the UK also have a substantial foreign business that plays an important role in the economies of some SSM member states. Many of these subsidiaries are supervised by the ECB because they meet one of the five "significance" criteria that can trigger direct supervision by the ECB. Another possibility is that a parent inside the banking union has subsidiaries outside. Austrian, Italian and German banks in particular have substantial networks in Central and Eastern Europe. These subsidiaries are supervised by non-SSM authorities.

Because of these financial linkages that cross the banking union "borders", in order to achieve an effective regulation and supervision of EU banks it is important that the banking union will facilitate an effective coordination of microprudential, macroprudential, resolution and crisis prevention policies.

3. Rationale for a banking union

Before I get to my "outsider's" view of the banking union I want to comment briefly on some of the principal arguments for and against creating a banking union. In doing so I will draw selectively on what I consider important research insights.

Acharya (2003) captured early on why a joint regulatory framework and a common supervisory standard will limit excessive risk-taking by bank, provided that regulatory standards are high. Acharya also argued that this reduces the risk for regulatory capture and the need to use tax money or state guarantees for bailouts of institutions that are deemed too big to fail (TBTF).

Empirical work has shown that a single supervisory standard may not only limit the risk for differences in supervisory standards or regulatory implementation but also reduce the risk of negative regulatory spillovers between countries. Ongena, Popov and Udell (2013) found that more competition in home markets and tighter business restrictions in domestic markets are historically associated with laxer bank lending standards abroad. Firstly, they found that lower barriers to entry in domestic markets (proxied by a regulatory environment that permits more bank competition), results in lower lending standards (proxied by more lending to ex-ante risky firms) by cross-border banks in local host-country markets. Secondly, tighter restrictions on non-core bank activities, like banks' involvement in securities markets, insurance, real estate, ownership of non-financial firms, et cetera, also result in lower lending standards by cross-border banks in local host-country markets. Ongena et al. found that both types of cross-border spill-over effects are stronger when banks are less efficiently supervised at home.

Creating a common level-playing field thus facilitates a better risk-sharing and diversification by banks across home and host countries. Such improved risk-sharing and diversification may in addition reduce the systemic importance of banks, since the diversity and loss absorbing capacity of the banking sector would increase.

Creating a single standard for banking regulation and supervision can also be associated with inefficiencies, both smaller and larger. As Acharya (2003) argued, if a joint regulatory and supervisory standard is based on the "lowest" or a "lower" common denominator, then a "one size fits all" approach may not generate the above mentioned benefits.

Other risks a banking union may need to deal with are of a more endogenous, second-round, nature. Better opportunities to engage in risk-sharing and diversification across countries are likely to lead to a change in the pattern of contagion between financial institutions. A preparedness to look more at inter-linkages is necessary. International contagion's basic workings were well illustrated by the events in 2008-2009, when stress in funding markets spilled over from the United States and contagion on the asset side occurred from the Baltics for Swedish banks.

In research related to that of Peek and Rosengren (2000), who found that the Japanese banking crisis had a negative impact on construction in the U.S. commercial real estate market, De Haas and van Horen (2012) provide deeper evidence on the mechanism through which more risk-sharing can lead to a stronger transmission of potentially a broader range of foreign shocks. Their work shows that, following the failure of Lehman, banks reduced credit less to markets (i) that were geographically close banks, (ii) where they were more experienced, (iii) where they operated a subsidiary (iv) and where they were integrated into a network of domestic co-lenders. Ongena, Peydro and Van Horen (2013) offer further evidence of the challenges that international linkages create. They find that, during the 2007-2008 financial crisis, internationally-borrowing banks[2] contracted their credit more than domestic banks that are funded only locally did. As a result, firms that were dependent on credit and at the same time had a relationship with an internationally-borrowing domestic or a foreign bank, as compared to a locally-funded domestic bank, suffered more in their financing and real performance.

The above pattern of transmission of financial shocks implies that financial globalization and internationalization of banking services can have substantial real consequences if not properly addressed by policy. This line of research thus suggests that banks that expand abroad and do so further away from their home markets, at least in an initial stage, may transmit shocks to their host countries more forcefully. Because research in this field is both new and scarce, we do not know with enough certainty how robust these effects are, whether they will disappear over time and what the costs associated with a transition to a new equilibrium with European banks in a truly European banking market will be.

4. What conditions may have contributed to countries opting out?

So far, only members of the Euro Area have joined the SSM, with Denmark considering joining (Jacobsen, 2015). What factors are likely to have contributed to non-Euro countries deciding to opt out of the SSM - for the time being?

Foremost, the design of the SSM created a governance structure that leans heavily on the ECB and is highly integrated with that of the Euro area, thereby reducing the influence of non-euro member states. Since non-Euro Area countries cannot gain a seat or voting right in the ECB's Governing Council (GC), this institutional construction created an opening for situations where the GC can overrule decisions by the

2 This applies to both domestic - and foreign-owned banks.

Supervisory Board, where non-Euro members of the SSM would get a seat and a say.

At the time of the negotiations, Denmark's Parliament, in correspondence with the European Commissioner (Folketinget, 2012) argued that "further integration between Euro Area Member States must not be allowed to undermine cooperation in EU28. […]" Furthermore, "during the negotiations on the SSM, several non-Euro Area Member States, including Denmark, attached great importance to ensuring that non-Euro Area Member States that choose to join the SSM can participate on balanced conditions in relation to Euro Area Member States. This is particularly relevant in terms of the voting rules that apply to the Supervisory Board and relations to the Governing Council of the ECB." The UK House of Lords (2012) argued along similar lines that the "main bone of contention for Member States such as Sweden, Poland and Hungary has been how to ensure that they would have a full and equal role in the decision-making process. The ECB statutes make clear that only Euro area Member States have a vote on [KR: supervisory decisions by] the Governing Council." In fact "the Swedish finance minister, Anders Borg, was reported as stating that 'either you must change the treaty so it's clear that every member is treated equitably or you need to move it outside of the ECB'" (House of Lords, 2012). The above arguments make clear that, going forward, it will be a challenge for the EU to balance the practical advantages of building new institutions on existing institutions that involve only a subset of EU nations, like the ECB, against the need to create EU-wide institutions that involve all member states.

5. Challenges associated with the Single Supervisory Mechanism

What particular challenges does the start of the banking union bring about for EU countries, either collectively or individually? In this chapter I briefly discuss four challenges associated with the SSM, without any pretense of either completeness or representativeness.

First, the occurrence of banks based in non-SSM countries with substantial banking activities within the SSM "borders" creates a challenge in the stress tests. For example, in the asset quality review and stress tests of 2014, the ECB was responsible for stress testing the Finnish subsidiary of Nordea, while Sweden's FSA stress tested the Swedish business. Such shared responsibility between the ECB and non-SSM supervisors when stress-testing cross-SSM-border banks particularly creates challenges for the consistency in testing methodology and the interpretation of partial results.

Secondly, the creation of the SSM creates a number of challenges for existing cross-border cooperation structures. The Nordic-Baltic countries are all relatively small and were early movers in creating cross-border institutions. Long-standing supervisory colleges for Nordic banking groups have been involved in the coordination of supervisory plans, the regular exchange of information on risks, liquidity and capital adequacy, joint inspections and - risk assessments and decision making process, for example as an input to EBA guidelines and work on colleges in the EU or joint supervisory teams in the SSM. They have also had a well-established Nordic-Baltic cooperation structure for macroprudential and financial stability issues. The Nordic-Baltic Macroprudential Forum (NBMF), set up in 2011, has regularly brought together central bank governors and heads of supervisory authorities to discuss macro-prudential policy issues. The Nordic-Baltic Cross-Border Stability Group (NBSG) is based on a memorandum of understanding on crisis coordination signed in 2010 and was set up in 2011 as a multilateral cooperation structure between Nordic and Baltic central banks, ministries of finance and supervisory authorities and concentrates on strengthening financial crisis management.

With the creation of the SSM, the ECB will become an important player in the supervisory colleges and the likely successor of the NBSG. With the BRRD still being implemented in national law, new cooperation structures and institutions are still in the process of being worked out. Changing asymmetries in the home-host relationship will be part of these transitions, as for example Nordic and Baltic subsidiaries are often of strategic importance to of non-SSM banks, but tiny from an SSM perspective. The third challenge concerns the role of the ESRB with the European supervisory architecture. Macro-prudential policy in SSM member states is a shared responsibility between the ECB and competent national authorities; in non-SSM countries only the respective national authority is responsible. As a result the ESRB through its ATC and the ECB through its FSC have closely related and sometimes partially overlapping responsibilities. The ESRB is the only EU-wide institution that includes the European supervisory authorities and identifies and analyzes systemic risk issues and can make recommendations or give warnings.

Through its Advisory Scientific Committee the ESRB has some built-in guarantees against the risk of politicization of policy. Moreover, while SSM covers the banking industry, the ESRB also covers the insurance industry, shadow banks, financial markets and financial infrastructure. The ESRB has also been highly involved in developing a macroprudential framework and toolbox that all EU countries can work with. However, the ESRB is currently quite dependent on the resources and management attention of the ECB. It has therefore been suggested that the ESRB should be further strengthened, for example by becoming more independent through the appointment of a managing director and that the ECB and ESRB coordinate their work in their respective committees. Finally, the earlier mentioned issue of cross-border sharing of supervisory responsibility has implications for the flow of supervisory information to central banks and raises some questions how the availability of important supervisory data can be guaranteed in, for example, crisis situations when a central bank needs to exercise its role as emergency liquidity provider. Parent-subsidiary relations may also lead to fluctuations in the availability of high-quality pledgeable collateral, thereby affecting the ability of central banks to provide liquidity assistance

6. Concluding remarks

The introduction of the Single Supervisory Mechanism raises a number of important questions. First, how can mechanisms be established that ensure a high standard of supervision and regulation in the SSM. Second, how can it be accomplished that the success of the banking union does not solidify the separation between Euro and non-Euro countries. Third, how will the cyclicality of credit across countries change as banks become more European and how effective will the policy tools we have to address be? Fourth, existing cross-border fora for the coordination of prudential policies and crisis prevention should be used where this is productive. Finally, the role of the ESRB should be strengthened so that it can act as a vehicle to assess risks across the whole EU and all branches of finance.

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The EU and the Eurozone

Harold James

The uncertainty about the outcome of the 2015 British election – which if it results in a Conservative victory is likely to produce a vote on EU membership that may well bring Britain out of the Union – combined with the increasingly likelihood of a Greek default and a partial or grey exit from the Euro raises in a suddenly acute form the question of the relationship of the EU and the Eurozone.

The Maastricht Treaty basically assumes that all EU member countries will satisfy the membership criteria for the currency union and stipulates that they are then obliged to join. The exceptions (opt outs) only relate to the UK and Denmark. The UK has been in a paradoxical position of championing the rather abstract case (with which probably a majority of economists agree) that a currency union requires a greater measure of fiscal integration than the EU or the Eurozone currently possesses. US policy-makers made very similar points. But on the other hand, the UK made it clear that it did not want to participate in that greater fiscal integration; and (with the Czech Republic) voted in January 2012 not to accept the fiscal compact treaty (on "legal grounds").

Brexit may thus in theory make a move to greater fiscal integration easier. At the time of the Maastricht discussions, many European policy makers, like the influential Commission President Jacques Delors, simply assumed that the EU share of the budget would rise to about 3 percent of GDP (by coincidence, that was about the share in peacetime of the US federal budget during the nineteenth century).[1] Instead, the figure remained stuck at just over 1 percent (it has actually declined slightly since the 1990s). Denmark on its own is unlikely to want to remain an outlier, especially since the management of the currency since the GFC has been rather

1 See James (2012), p. 253.

precarious. There is a similarly strong case why Sweden might want to end its anomalous "out" position – for the same kind of reasons as Norway and Switzerland are finding it very hard to live with an independent currency and to devise an appropriate set of monetary and exchange rate policies.

But at the same time the contemporary Greek experience should be a warning against thinking that there might be a new political equilibrium that shifts towards an obvious acceptance of greater fiscal federalism.

In justifying the "no" in 2012, Prime Minister Cameron explicitly played the idea of the common free market out against the Eurozone, with its fiscal promises: "They must not take measures that in any way undermine the EU single market. We'll be watching like a hawk." In this spirit, here are some suggestions for how the single market can be made to work better:

1. Currency Innovation: The Meaning of Currency Union

The debate about currencies within the EU should include a greater willingness to think about alternatives. In 1992-3, the EMS crises almost destroyed the path to the Euro, but the crisis was resolved by instituting greater flexibility: through wider (15 percent) margins in the exchange rate bands. The modern equivalent to the band widening of 1993 would be keeping the Euro for all members of the Eurozone but also allowing some of them (in principle all of them) to issue – if they needed it – national currencies. The countries that did that would find that their new currencies immediately trading at what would probably be a heavy discount. California adopted a similar approach at the height of the recent financial crisis, issuing IOUs when faced by the impossibility of access to funding. The success of stabilization efforts could then be read off from the price of the new currency. If the objectives were met, and fiscal stabilization occurred and growth resumed, the discount would disappear. In the same way, after 1993, in a good policy setting, the French franc initially diverged from its old level the band but then converged back within the band. Such a course would not require the redenomination of bank assets or liabilities, and hence would not be subject to the multiple legal challenges that a more radical alternative would encounter. There would also be the possibility that the convergence did not occur. The two parallel currencies could then coexist for a very much longer time period. This is not a novel thought. It was one of the possibilities that was raised in the discussions on monetary union in the early 1990s, that there might be a common currency but not necessarily a single currency.

2. Minimizing Financial Vulnerability: Banking Union

The debate on banking union also needs to be recast. What is now termed a banking union – that is common European regulation with some fiscal capacity for resolution in the case of failed banks – is a very belated but necessary completion of the monetary union. Even this step is only partial, and has excited a great deal of opposition from Germans who do not want to bailout south European banks. Thus while there is European supervision, the resolution process is predominantly national. Critics have correctly identified the problem, that some sort of permanent fiscal mechanism is required in order to pay for the bailouts and thus in fact implies a move to a real political union which regularly redistributes resources. But there is also a legitimate worry that the creation of an extended banking union would involve very large insurance commitments, that Europe's citizens are not necessarily already willing to take on. The current discussion – as set out for instance in the very helpful Four Presidents' Report of December 2012 - is set out very much in terms of an "insurance type mechanism": but it is important to remember that insurance mechanisms are not suited to make long term one way transfers, rather they have to represent a genuine sharing of risk (ie of conditions which at the time of making the insurance contract cannot be anticipated).

In a recent extended analysis of political economy trilemmas, the analysis of financial vulnerability provided the key linkage by which instability is transferred from the primarily technical domain of currency arrangements to the large fundamentally political problems of democracy and the international order.[2] Taking the fangs out of a dangerous financial system – for instance moving along the path from a bank-based system to a greater orientation toward capital markets – is thus an important element in rectifying flaws. The critical issue is to find innovative institutional paths to allow small and medium sized enterprises – that are traditionally at the core of economic dynamism in Mediterranean countries, but also in German and in Baltic Europe.

Securitization, which is often especially in the US presented as the villain of the 2008 crisis because of the centrality of problems in the

2 Bordo and James (2015).

securitized mortgage market, may be the most hopeful solution. Combining and repackaging small enterprise loans – from different regions and from different kinds of economic activity – is an obvious step to risk diversification. Of course, there can still be shocks that produce coordinated and generalized slowdowns, and that require macro-economic responses; One of the problems of bank lending in many countries (in the US but also in Europe) has been that it was increasingly directed toward property lending – and just served in consequence to drive up real estate prices and in this way accounted for probably the major source of increased wealth inequality in modern societies.[3]

3. Becoming more American: The Capital Markets Union

Part of the transformation of Europe's economy consequently should lie in a reduction of the role of banks in financing business activity and an increase in the access to capital markets, especially for SMEs. This has become part of the official European agenda for the capital markets union, sketched out in the green paper. Creating a genuine capital union will also require steps to ensure compatibility for products across national frontier, and provisions for greater transparency, including credit registries and credit ratings for SMEs. Up to now, small enterprise credit rating is handled in a very different manner in different countries: by private providers in some cases while in others central banks still play a major role in maintaining. The Banque de France created its major credit register in 1946; Germany has had a tradition of private associations, such as Creditreform established in 1879, and which then internationaliuzed their activity. There is also a requirement for convergence on legal procedures, notably bankruptcy: the idea of integrating capital markets thus requires really quite considerable steps in political and legal integration.

4. Shifting the Tax Base: Tax Union

Fourth, the debate about fiscal consolidation is in deed of rethinking. One of the great controversies of the nineteenth century U.S. revolved around Henry George's proposal for a land tax.[4] He explained that a great part of

3 See Ronglie (2015).

4 See George (1873).

the gains from productivity were captured through rents of monopolists or land-owners. Competition policy – the limiting of monopoly power – has from the beginning been a core task of the European Economic Community / European Union. But the land-owning issue has not been the subject of thought or debate – until very recently.

The recent story of Europe has been a process of learning lessons about the appropriate character of the tax base. In the 1970s, with increased capital integration, many European countries discovered that they could not tax capital highly – as large companies would otherwise move their operations. Capital was too mobile, and especially smaller European countries adopted low rates of corporate taxation which contributed to stronger and more dynamic economic performance. With increased mobility of people, the same limits are being reached for personal tax: as President Hollande found when he introduced a tax on the super-rich (over one million euros), which brought unexpectedly little revenue, and which he was obliged to scrap. The threat of the tax just precipitated the move of high-earning French residents to other countries, with lower tax environments. One solution – a common European tax rate – is hardly likely to lead to greater dynamism, and is incompatible with the principle of national democratic choice.

Taxing land more effectively has many obvious advantages. It isn't easy to conceal land, and it's impossible to move it. Taxing under-utilized land (empty, neglected and decaying houses) imposes a cost on the owners that they will try to avoid by selling their property to others who can make better use of it. Taxing urban land is an effective counter to the substantial rents that are created by planning restrictions in densely populated urban settings.

5. Transfers without Politics: Welfare Union

Problems of transfers in a large unit are at the heart of the political process of building federations or federalism. The better way of discussing transfers within a large and diverse political order is to think of them as individualized or personalized. In particular, a European-wide social security system would not only be a logical completion of the labor mobility requirements of the single European market.[5] It would indicate that the insurance principle is not just one which it is appropriate to

5 For an extended discussion, see Dullien (2014), also Andor (2014).

apply to financial institutions. It would provide an important buffer in that booming areas would pay in more, and shrinking areas would draw out more – without these payments going through government bodies and appearing as transfers from North to South – whether in a country such as Italy or in the whole of the European area. Defusing the political problem requires less statehood, rather than necessarily requiring the erection of a European super-state. But like the problem of designing better bank insurance, it also depends on making more adaptable labor markets so that the threat of large-scale unemployment swamping and destroying the insurance system is minimized.

6. Common Projects: Energy Union

The argument in favour of a European energy union – a genuine common energy market with common regulation – may even be stronger than the case that was successfully made in the 1980s and 1990s for a monetary union. Security concerns and worries about the extent of risk generate considerable pressure to implement dirigiste measures that may be counter-productive and harmful.

A coordinated approach to energy needs to address equally obvious problems that are often not recognised explicitly. Just as in the case of the European Union's overall "growth, stability, and cohesion" objectives, the 1996 Internal Energy Market directive's goals of (1) secure, (2) environmentally compatible, and (3) competitive energy sources are in conflict with each other: renewable energy may be environmentally sound, but is neither secure nor inexpensive; foreign supplies of oil and gas may be inexpensive at a point in time, but are subject to geo-political risks. Policy choices need to provide a framework to guide the myriad choices of market participants, producers and consumers, through a pricing mechanism that is accepted as fair and transparent. An economic argument can be made for security-oriented policies like renewable energy subsidies that increase both current costs and self-sufficiency.

The difficulty in formulating a forward-looking energy policy arises from the difficulty in comparing different types of risk and drawing appropriate policy lessons. There are at least four different perceptions of risk, and while all are clearly present, they tend to be seen in quite contrasting ways in different European countries, and consequently produce varied and mutually incompatible responses from national political authorities: in CO2 emissions and global warming; in nuclear energy; in security dependence on imported gas and oil; and in the vulnerability of grid delivery systems to periodic breakdown. Each of these threats is treated in very different ways. Since public debate is often driven by single headlines, a nuclear accident such as Fukushima produces a greater sense of danger than the vaguer (but more certain) long-term threat of climate change. The risk of system breakdown only enters the political debate after a concrete instance. Politics thus tends to respond too late to threats.

A fundamental philosophical division is discernible in energy discussions, around the choice between long-term planning or fixing of prices in order to generate certainty about future signals on the one hand, and a response to short-term and noisy market signals on the other. The debate is most pronounced in the case of the two environmentally and politically most sensitive issues: gas pricing, and nuclear energy. The greater the diversity of supply, and the more market alternatives exist (including different forms of energy), the more resilient the energy economy becomes against unanticipated events, including attempts to blackmail energy users. In other words, diversity of supply limits the power of the resource providers. Marketization can thus also provide a substantial impetus to improve political conditions in other parts of the world, and reduce the monopoly rents that corrupt politicians extract in resource-rich countries.

There is a geographical divide in Europe between those countries that rely on spot markets and those that use long-term oil-indexed contracts to purchase and receive their natural gas supplies. Northwest Europe has spot markets, with LNG import facilities and hubs. Oil-indexed contract markets predominate in Central, Eastern, and Southern European countries, where only one or two suppliers provide gas to domestic markets and there is little gas supply diversification.[6] The geopolitical strategy of President Putin is based around a pipeline view of the world, rather than a LNG vision. One result of the Ukraine-Russia crisis of 2014 may be a greater awareness of the security threat, an enhanced willingness to construct LNG facilities, and an expansion of the market principle of spot pricing as a result, rather than long-term indexation to other energy products.

Flexibilisation is an important principle in wholesale markets; but it can also play a major part in promoting domestic energy efficiency. From a consumer point of view, a move to flexible pricing may be an increasingly attractive way of steering demand away from peak times, at which

6 See Melling (2010); and European Economic Advisory Group (2015).

the production costs/marginal costs are high. Reducing extreme peaks of demand (and consequently of pricing) in an energy supply network that is pushing against capacity restraints requires a better linkage of supply systems that are still not fully integrated. The same is true for the potentially even bigger problem of smoothing peaks in green energy supply. If the national smoothing capacity becomes exhausted thanks to the closure of conventional power plants, as is regularly the case in Germany, there is a case for selling the excess electricity to other national energy markets and use their smoothing capacity.

Further improving the linkage requires a substantial investment in transmission systems. One response to the financial and debt crisis, which is also a crisis of European growth, is to demand higher levels of investment – both public and private – in Europe. The problem is that in the past, much public sector investment has been misdirected as a result of the political bargaining processes. However, private investment has also been misdirected (above all in large construction booms). Investment in energy networks may offer appropriate incentives to private producers looking at innovative ways of producing new clean energy sources. Since the search for funding also coincides with a widespread sentiment that Europe should investigate large infrastructure investment projects, it may be conceivable to fund the new energy transmission channels, both electricity gridlines and gas pipelines, with public or a mixture of public and private funding. A security levy on energy supply might be an appropriate way of ensuring the fiscal sustainability of such investment.

7. Common Projects: People Union

One of the gravest security crises currently facing Europe is the outcome of the disintegration of neighboring regions: North Africa and the Middle East in the wake of the so-called Arab Spring; and more recently the crisis in eastern Ukraine. Europe is confronting a humanitarian crisis as a consequence of the flight of refugees from civil war in Libya and Syria. ISIS is indeed trying to use the threat of further expulsions as a weapon against Europe.

The countries that are today on the front line of Europe's humanitarian struggle are by chance also the worst affected by the financial crisis: Greece, Italy, Spain. Responding to the distress of refugees is a European task, and the financial consequences of the refugee crisis cannot be left to the crisis-struck states, in which there is an inevitable political feeling that resources devoted to accommodating and even potentially integrating refugee populations can only come at the expense of citizens. Any adequate solution to the refugee challenge involves including or integrating them in a constructive way, at least for some time, into the host societies. It would necessarily involve substantial financial injections from Europe as a whole into the countries at the forefront of the refugee crisis. That could also be a source of new dynamism, and an answer to the problem of European ageing and decline.

At the same time, ensuring that people can move with dignity also requires the elaboration of a precise political program to stabilize the neighborhood of Europe. Europe cannot be an island in a sea of a humanitarian disaster. It needs to act effectively to end the chaos that is driving despairing people by the millions to a European safe haven.

8. Common Projects: Military Union

At the outset of the 1990s, many European leaders in the face of the new security challenge created by the collapse of communism and the Soviet Union emphasized that they needed to find a way to permanently secure European peace. Even at the time, it was not quite obvious that a currency union was the best way to do this (it was rather a question of the central bankers having plans for a currency union in their draws). Would not a common European army be a better course? In the nineteenth century, many people made the argument that universal military service was a central part of the project of nation-building. Jean-Claude Juncker recently triggered a storm of controversy when he made this suggestion, and critics emphasized the difficulty of expecting military sacrifice without a much further deepening of political community. On the other hand, common defense organization and procurement would certainly involve major savings, generate a more effective capacity to project power, and might well indeed make a wider group of young people realize that they are Europeans.

9. Common Projects: Youth Union

But a similar argument could be made for encouraging other sorts of organized movement: a common social year (in a different country), but also cross-national apprenticeship schemes: indeed this is an area that some German companies have tried, with considerable success.[7] Fostering youth mobility is probably a better way of moving to an integration of outlooks and attitudes, but also to a dissemination of best practice across Europe. Countries with high levels of out-migration at some point in the last (Ireland and Poland are the most striking examples) found that the return of you migrants who had increased their skill levels represented a major source of dynamism. In that sense, if the current crisis is promoting higher migration, it should not simply be a source of worry: in the long-run, it may have a strengthening effect.

10. Thinking Globally: Global Union

The management of cross-national problems and the containment of nationalistic quarrels certainly require technical fixes. But it also needs more. The fatal loops that tie badly managed currencies to the destruction of the international economic and political order inevitably conjure up memories of the disasters of the 1930s, the Great Depression and the drive to war. Currency wars are now making their reappearance. The rise in the exchange rate risks choking off an incipient strong US recovery. Unusually, Federal Reserve officials now sound worried about the currency. The unpleasantness created by the strong dollar additionally interacts with the vulnerabilities of the political system with a President committed to a significant trade agenda faced by a hostile and increasingly obstructionist Congress. The fierce debates about dispute settlement in the Trans Pacific Partnership as well as in the Transatlantic Trade and Investment Partnership play into the hands of trade skeptics. We should remember that there can be global disaster, as well as merely European disaster.

A politically legitimate mechanism for solving the problem of international adjustment was the unsolved problem of the twentieth century. In Europe and elsewhere it generated enormous conflict. There is an urgent need for ways of constructing currency stability that go beyond the narrow framework suggested by the OCA literature. Fixing this issue is a European but also a global agenda for the twenty-first century.

7 For a more developed suggestion, see Guardian (2012).

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