OESTERREICHISCHE NATIONALBANK
EUROSYSTEM

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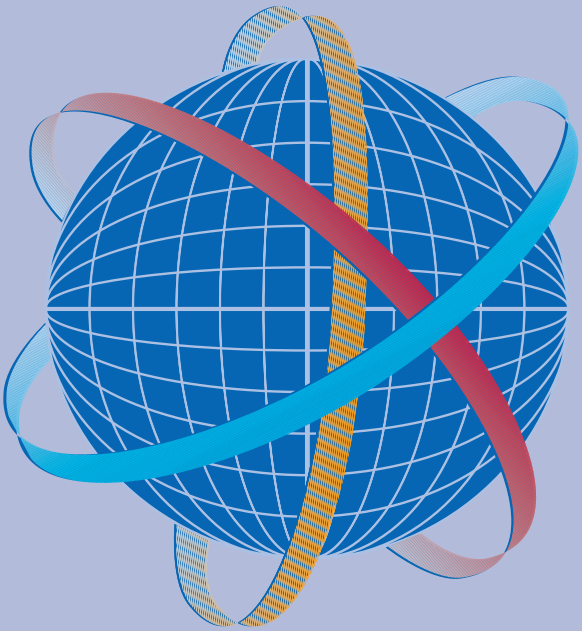
Toward a European Banking Union: Taking Stock



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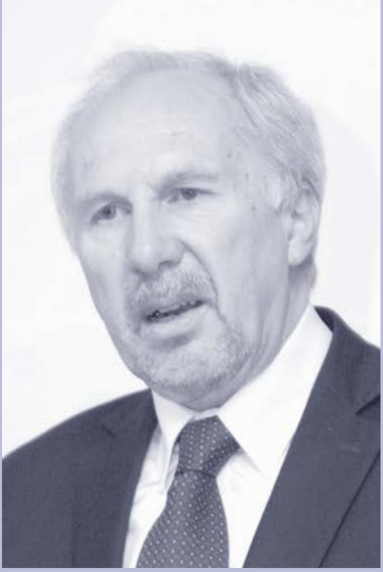

Opening Remarks

Ladies and gentlemen,
On behalf of the Oesterreichische Nationalbank (OeNB), I am very pleased to welcome all of you to the OeNB's 42nd Economics Conference here in Vienna.

I am especially honored to welcome Sonja Steßl, State Secretary in the Austrian Ministry of Finance, and this year's keynote speakers, Axel A. Weber, Chairman of the Board of Directors of UBS, and Vítor Constâncio, Vice President of the European Central Bank. We are once again fortunate to have a distinguished panel of speakers and discussants consisting of academics, policymakers from supervisory authorities and central banks as well as financial practitioners. Thank you for contributing your ideas and research to our conference. I would also like to take the opportunity to thank the staff members of the OeNB for their great efforts in organizing this event.

At last year's conference, we addressed the "changing role for central banks", and today and tomorrow we are going to follow up on this theme, so to speak, by taking stock of the progress we have made toward a European banking union. Central banks have assumed additional responsibilities in supervision, and conferring the role of single banking supervisor in the euro area on the European Central Bank is one of the cornerstones of the system of bank regulations that is commonly referred to as banking union. At this year's conference, we will not only assess the effects the upcoming banking union will have for central banks, but we will also examine the consequences for economic policy, for the banking sector and for the economy at large.

The term *banking union* has been coined in analogy to *monetary union* – and most likely also to *political union*, which continues to be an overarching aim in Europe. What does banking union stand for in a nutshell? It means that the *key instruments of banking policy are being centralized at the European level* with a view to strengthening and extending the supervision and the resolution of banks. The aim of the Single Supervisory Mechanism (SSM), designed to reduce the probability and severity of banking crises, is mainly *preventative*, whereas the Single Resolution Mechanism (SRM) and the Bank Recovery and Resolution Directive (BRRD) are primarily remedial, designed to protect national public finances from the consequences of bank failure.

Even if the banking union's setup may be deemed by many as being far from perfect – and we will have ample opportunity to discuss its flaws and imperfections in the next two days – the very fact that this project has been brought on track shows that European decision makers are *able to act*, and reach a consensus, on important matters *in a timely manner*. Creating the legal framework of banking union has taken less than two years: At the June 2012 EU summit, the heads of state or government announced their intention to transfer key instruments of banking policy to the European level, and last month, the European Parliament approved the SRM and thus the final pillar. Given the complexity of the matter, this has been rather swift, not only by European decision-making standards.

The motion to set up a banking union has been an integral part of the response to the crisis. Consequently, banking union must be seen in the wider context of the new European financial architecture. The crisis exposed a host of *weaknesses in the banking sector*, ranging from a dramatic increase of nonperforming loans, which required banks to repair their balance sheets and triggered a process of deleveraging, to an impaired profitability that undermined the capacity of banks to retain earnings. This brought about a considerable loss of confidence within and into the banking system, and banks' refinancing conditions deteriorated severely as a result. Moreover, as these effects varied across euro area countries, the trend toward greater financial market integration that had been observed since the start of monetary union went into reverse, and market fragmentation increased again. The crisis also revealed *flaws in the institutional framework* of the European banking markets, which continued to be regulated at the national level despite the far-reaching integration of the euro area financial market.

From a short-term perspective, announcing the "banking union" project and taking steps toward its implementation have – together with other measures – already reassured markets, as can be seen for instance in the stark reduction of risk spreads over the past two years. However, the full benefits of this project will materialize only over the long term. While not "curing" the current crisis, the banking union will help prevent and mitigate future problems in the banking sector.

Banking union is aimed primarily at *breaking the nexus between government and banks* and to decouple sovereign creditworthiness from banks' creditworthiness in a given country. Under the current setup, when bank solvency is put into question, the looming restructuring implies a heavy financial burden for the sovereign, which increases doubt over the creditworthiness of this particular state. According to Eurostat data, public interventions in support of financial institutions, such as direct recapitalizations, overall fiscal support measures and the nationalization of banks, are reflected in a cumulative 5% of GDP increase in the national debt of euro area countries until 2013. However, this link between weak sovereigns and weak banks works both ways. As sovereign bonds account for a large share of bank assets, doubts about sovereign creditworthiness directly translate to a re-evaluation of banks' assets, and consequently to doubts about the solvency of these banks. In the future, the SRM will ensure that the costs of bank failure are borne first and foremost by the private sector, with sovereigns providing funds only in exceptional circumstances. The SRM structure is explicitly based on the principle that any losses are to be borne by shareholders and creditors and that any public assistance should only be transitory and be recouped by means of ex post levies on the banking sector. By improving private risk-sharing, the banking union will importantly sever the link between financial system instability and resulting threats to fiscal sustainability of individual euro area countries, especially smaller ones.

The high risk premiums some banks faced in refinancing markets meant that they did not benefit from the low interest-rate environment provided for by the accommodative monetary policy stance of the ECB. Consequently, they were not in a position to pass on these favorable interest rates to their customers. Therefore, in some countries, the low interest rates and unconventional measures did not feed through to the customer level. Decoupling the correlation between the cost of funding of euro area banks and that of their respective sovereigns will *remove an impediment to the proper functioning of monetary policy transmission* and will ease the fragmentation of banking markets. In a number of euro area countries under stress, not only had interest rates for loans remained elevated, but also volumes of bank loans had contracted during the crisis. When this contraction had been due to tighter credit standards as a result of banks' impaired access to market funding, breaking this link should benefit the private sector, and especially the corporate sector, in these countries. In Austria, loan developments had been less worrisome, and the corporate sector has not so far suffered from credit constraints witnessed in the euro area as a whole.

Banking union is expected to increase the *efficiency of financial intermediation by banks*. In a bank-based economy like the euro area, this is particularly relevant, because enterprises rely to a much greater extent on banks for funding than e.g. firms in the U.S.A. According to a recent ECB report, loans on bank balance sheets account for close to 50% of nonfinancial corporate debt in the euro area, but only 20% in the U.S.A. Therefore, strengthening the banking system is also essential for the real sectors of the economy, as more resilient banks are much more effective in *performing their vital functions vis-à-vis the real economy*. First of all, a credible and respected supervisor together with clear rules on bank resolution will reduce the uncertainty premiums that many European banks currently pay on their refinancing. As the ECB is set to be an exacting and respected supervisor, banks subjected to its supervision will enjoy high confidence, and this should result in a reduction of the uncertainty premiums. Moreover, the principle of bail-in in case of bank failures and the uniform cascade of liability as it is laid out in the Banking Recovery and Resolution Directive (BRRD) will help strengthen market discipline, although the ensuing effects on banks' funding costs will differ depending on the structure of their liabilities. In some cases, this may entail additional costs, as banking industry representatives have pointed out. For example, unsecured creditors that until now have almost always avoided a bail-in will demand higher risk premiums. At the same time, deposits can be expected to become less sticky, which again might exert upward pressure on funding costs (which will definitely be the case with the annual contributions to the Resolution Fund, scheduled at EUR 5.5 billion). But overall, banking union will result in a more stable refinancing structure of the banking sector and thus enable banks to better contribute to the economy.

Likewise, banking union will be a strong incentive for banks to improve their risk management. Yet, while it is certainly one of the central aims of banking union to make banks' lending policies more risk sensitive, supervisors will also have to bear in mind the impact their actions have on the real economy. Banks' *willingness and ability to share the risks of the real sectors of the economy* lies at the heart of the house bank principle that prevails in much of the euro area (and certainly in Austria). Close long-term relationships with their customers have so far enabled banks to continue financing enterprises and projects that are relevant to the economy also in times of less favorable cyclical conditions. Without doubt, the issue of forbearance has to be addressed properly; however, banks that immediately take action on the first signs of a customer's potential default do not fulfill their economic function properly. Vice versa, banks that persistently fail to take measures against nonperforming debtors would not fulfill their function as intended, either. Overall, even if this ability of banks to share risks with the nonfinancial sectors were to be preserved, it can be expected to diminish. Capital markets are likely to gain in importance for corporate finance. However, as this funding option is available primarily to larger companies, this leaves the issue of SME finance.

Let me now turn to the institutional design of banking union. For one thing, this project is also aimed at remedying political weaknesses in the supervision process. In regulation economics, the term *regulatory capture* refers to a phenomenon when regulators or supervisors end up identifying too strongly with the interest of those they were charged with regulating. I do not think that this theoretical concept is very relevant for the role of the Oesterreichische Nationalbank and can imagine that the Austrian bankers present in this room are not always too happy about that. But generally speaking, once supervision is elevated to the more remote European level, supervisors are expected to be less prone to *deal making* and forbearance might be less likely to occur –which could, of course, add to the increasingly pro-cyclical effects of the newly emerging supervisory structure in Europe. An entire session of the conference will be devoted to this aspect and we will be able to discuss these problems in more detail. Monetary policy making was centralized one and a half decades ago, and now banking supervision is about to follow suit, which can be regarded as a further decisive building block in completing economic and monetary union.

The course of events during the crisis has shown that safeguarding financial stability is a key theme for central banks. What is, however, less clear is the exact definition of the role central banks are supposed to play in this context. Just think of the microprudential versus the macroprudential aspects of supervision. There cannot be any doubt that macroprudential policy is a task for central banks. *Macroprudential policy*, aiming to identify, prevent and mitigate systemic risks, was recognized as an important instrument early on during the process of drawing lessons from the crisis. While not being directly part of banking union, macroprudential policy is a precondition for the proper functioning as macrosystem instability can put individual banks at peril. Therefore, the European Systemic Risk Board (ESRB) was established in 2010, well ahead of the SSM and SRM, to add a new systemic perspective to supervision. Nevertheless, when we talk about the microprudential supervision of individual banks, the role for central banks is less clear cut. The SSM was established under the responsibility of the

ECB in order to avoid changes to the EU treaties. The legal basis for the banking union reform was Article 127(6) of the Treaty on the Functioning of the European Union, which allows for conferring specific tasks concerning policies relating to the prudential supervision of credit institutions upon the ECB.

Let me note in this context that the *supervision of individual banks is not an overly attractive task*. When it works well, nobody will notice, but if not, it entails considerable reputation risks. Moreover, there might be conflicts of interest between banking and financial system stability and the price stability objective of the central bank (something we discussed at our last year's conference). While political economy considerations explain why, at this point in the euro area's history, the SSM needs to be hosted by the ECB, we should nevertheless always bear these risks and potential conflicts in mind. Having said this, there is a strong argument for keeping the Resolution Agency clearly separate from the ECB.

Frictions may arise between national and European supervisors, between the various supervisory institutions at the European level or within the resolution regime, where the tasks to be solved are complex and the intricacy of the decision-making process is especially pronounced. These complexities might give rise to operational concerns and therefore need to be properly addressed right from the start as only the most stringent implementation and enforcement can restore confidence in the banking system and the institutional framework.

Another point of criticism is that banking union *only covers deposit-taking institutions*. Apart from competitive aspects, this contradicts the lessons from the financial crisis of 2007/08, which exposed risks to financial stability that resided outside the traditional banking sector. Thus, there is a danger that intensified regulation in the banking sector might cause important and risky business activities to be shifted into less regulated areas such as shadow banking entities.

Competitive distortions could also arise from a failure to establish a genuine Single Rule Book and from the discretion that national authorities maintain regarding, for example, the implementation of macroprudential tools. Notable national differences in supervision might therefore remain in place; in other words, the playing field would then not be completely level. On the other hand, it may be argued that there should be scope for *some degree of differentiation below the euro area level*. After all, different cultures and languages will continue to exist within the euro area. In the same vein, the question remains if the new supervisory system is apt to address national problems properly. For instance, there will still be national or local financial cycles, as has been the case for business cycles to this day. As small banks will remain within the remit of national supervisory authorities, there will in any case be the need for a two-tier supervisory regime.

Banking union will not only affect relationships among the various players within the euro area, but also *relationships with players outside the euro area*. The fact that banking union currently only covers the euro area may give rise to competitive concerns. To be sure, all EU Member States can be expected to benefit indirectly from banking union via a more stable financial system in the participating countries. But let me stress here that it would be in the interest of all if as many countries as possible decided to join. Banks domiciled in countries that opt to join will enjoy the reputational gains from being subject to the same supervisory standards as their euro area peers, which might for instance dampen risk premiums on their debt. Obviously, this might encourage a number of Central, Eastern and Southeastern European countries which are not (yet) part of the euro area to join banking union.

To conclude, centralizing banking policy at the European level undoubtedly constitutes a milestone in deepening and completing the euro area's economic and institutional integration. At the same time, banking union is of course *no panacea*, and in itself does not solve the problems surrounding banks. Furthermore, the problems of the banking sector were by no means the only reason behind weak growth, rising government debt or fragmentation in the euro area. Banking union can therefore only be one – albeit an important – element in the overall set of measures which are instrumental in putting the future development of the euro area on a more sound economic and institutional footing.

Ladies and gentlemen,

I hope one thing has become obvious from my short remarks: the European banking union, while being an important step, will require a lot of work in its implementation and in the process will require a lot of further thinking, creative problem solving and persistent work. I am confident that today's and tomorrow's distinguished lineup of speakers will shed light on a number of challenges that have yet to be tackled on the road toward full banking union. I very much look forward to two days of lively discussions with all of you, given the multitude of perspectives represented here. I hope you will find our conference useful and insightful.

Sonja Steßl

State Secretary
Federal Ministry of Finance

Opening Address

Dear Governor,
Ladies and gentlemen,
It is a pleasure to welcome you in Vienna as State Secretary of Finance, also on behalf of Federal Chancellor Faymann, who sends his greetings. I am glad to speak today at this conference on the European banking union, a topic of major importance not only for central bankers but also for us in the ministry of finance.

Since the start of the EU's common market we have seen significant progress in European financial integration, enhanced by regulatory reforms targeted towards the creation of an ever deeper union. The increasing volume of cross border banking was one of the signs of this deeper integration. From the very beginning, it was clear that deeper financial integration has many advantages, but also bears some risks. And whereas the advantages like more efficient capital allocation have been emphasized many times, the risks were often neglected.

A substantial risk has materialized in the crisis when negative developments in one country lead to major problems in others. Bursting housing bubbles in some peripheral Member States all of a sudden created financial tensions in the hubs of the European financial system. One might ask whether the financing of a housing bubble in Spain or Ireland was really the most efficient use for German or French capital. The unguided financial integration seemed to contain the seed of its own destruction.

The EU has reacted to the crisis by establishing a banking union. Let me just briefly mention some features of the banking union which I consider especially important from a Ministry of Finance point of view:

- The independence of supervision which enhances crisis prevention: once the Single Supervisory Mechanism (SSM) has effectively taken over the supervision of banks in the euro area, there will be much less scope for interventions at the national level and banks in distress and their owners will be held responsible at an earlier stage, which should diminish the risk of a banking crisis in the first place.
- Even more important is the breaking of the vicious cycle between banks and sovereigns that some have called even a "doom loop" for the euro area. Until recently, states were forced to bail-out failing, but only systemically relevant banks in the interest of financial stability; the very definition of systemic relevance seemed to be a moving target at times. Under the banking union, newly founded bail-in instruments and backstops funded by the banking sector itself should prevent future involvement of governments in rescue operations when a bank fails.

During the recent crisis, these instruments were not available, and bank bail-outs and other support measures have increased the public debt in almost all EU Member States and thereby imposed a heavy burden on taxpayers; according to the European Commission the EU Member States provided

EUR 590 billion of capital support to the financial sector up to end-2012. These funds have been invested to safeguard financial stability and to stabilize investors' confidence; thus preventing the crisis from spreading across the whole banking sector. Therefore, I think it is justified that the banks will contribute to the reduction of our debt stock for the foreseeable future. We in Austria expect revenues of about EUR 3 billion over the current legislative period from the bank fee.

Another sensible approach to reduce the heightened debt level is a shift in the tax burden. A reduction of taxes on labour, especially for persons with lower earnings who have a high propensity to consume, would help to boost demand and growth. Such a growth stimulating measure could be financed by higher taxes on property and inheritance, in particular in Austria, where taxes on these items are among the lowest within the EU and the OECD. This is exactly in line with the EU's country specific recommendations which stated last year that Austria should *"reduce the effective tax and social security burden on labour for low-income earners in a budget-neutral way by relying more on other sources of taxation less detrimental to growth, such as recurrent property taxes."* The IMF and the OECD have recently also published research findings that emphasize the appropriateness of wealth taxes in the current setting. Unfortunately, there is still political opposition against these proposals in Austria but we only started the discussion and the topic will remain on top of the list as the government agreed on implementing a tax reform commission.

I would like to add that a shift in taxation from low income earners to wealthy households would also introduce an additional degree of fairness in our economies because the distribution of wealth has become more and more uneven over the last decades as was shown impressively in the recently published book by Thomas Piketty[1]. It is important to emphasize that the laws of capital accumulation that he refers to in his book are not laws of nature, but are man-made and therefore can also be changed by men or women.

Enhancing fairness and raising additional revenues are also the aims of our activities to curb tax evasion and profit shifting. Some corporations have abused the tax arbitrage opportunities under the existing legal framework within the EU and thereby eroded the tax base in all Member States. We are determined to punish tax fraud in Austria more severely in order to increase the incentives for all citizens to pay their due share; these measures should also increase public revenues significantly.

Another source of additional funding to recoup partially the cost of the crisis could be the Financial Transac-

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[1] *Piketty, T. 2014. Capital in the twenty-first century. Harvard University Press.*

tion Tax (FTT). The very low tax rates of the FTT would not harm the real economy but could have a positive incentive effect by reducing the profitability of merely speculative trading and hence contribute positively to financial stability. In its currently proposed form the FTT would mostly target stocks and some derivatives, but I am positive that within reasonable time we can broaden the base of the tax and I also hope that we can increase the number of countries which are willing to introduce the FTT.

Let me conclude by stressing that these measures in combination with a strong and credible banking union provide the right policy mix to counter the negative effects of the last crisis and help to prevent the occurrence of the next. The banking union is a fundamental ingredient in our economic strategy forward and is featured prominently in our government's work agenda. I would like to thank the OeNB for hosting this timely and topical conference and wish you all two days of inspiring presentations and lively debates.

Axel A. Weber

Chairman of the Board of Directors
UBS

The Role of the European Banking Union in European Integration

Since the beginning of the European debt crisis, the future architecture of the European Economic and Monetary Union has been discussed often and widely. The crisis has shown that an economic and monetary union cannot function well without a further integration of the participating countries' banking sectors.

Monetary union implies that the euro area countries share the same money, the euro. Sharing the same money implies that one euro should be the same across all member countries. If we define money as M1, then money can take two shapes – either it comes in the form of banknotes or in the form of deposits at a commercial bank. If markets start to differentiate between banknotes or between euros deposited at different commercial banks, the monetary union is at risk. A monetary union therefore requires a certain degree of integration and unification of the banking system.

Consequently, I see it as a positive and necessary development that we are now building a banking union, and I am convinced it will contribute to financial stability and economic prosperity. It should mitigate the link between banks and sovereign governments, curb financial fragmentation, enable banks to rebuild trust and focus again on their role in society, that is, supplying credit to the real economy. But it is also a project with many remaining challenges. Also, there is a risk that it may reduce pressure on other items on the political and economic reform agenda.

Three Key Issues

To start with, I would like to focus on three key issues of the banking union that in my view are especially important from an economic perspective. First, the banking union will make monetary policy more effective. Second, the uncertainties regarding implementation of the banking union; this is an exercise with many elements that need to operate cohesively for the whole project to be a success. And third, looking beyond the banking union, further structural reforms are necessary to stabilize Europe.

Let me start with the important relationship between the banking union and monetary policy. The banking union will make monetary policy more effective. Let me add here that effective monetary policy also requires integrated euro area financial markets beyond banking. Both should be top priorities on the political agenda.

To be more specific, a banking union is very much in the interest of monetary policy, for several reasons:

- First of all, it is important to mitigate the link between sovereign governments and banks and thus unburden monetary policy from fiscal concerns, from the responsibilities that have been assumed in the crisis, and from some of the "too big to fail" considerations. The different links between sovereigns and banks during the crisis created a negative feedback-

- loop that induced financial fragmentation and contributed to impairing the credit channel and the transmission of monetary policy. The need to sever this bank-sovereign nexus was one of the reasons for establishing the banking union. The Single Resolution Mechanism (SRM), in combination with the Single Resolution Fund (SRF), is supposed to address this issue. With the ECB in charge of the resolution of significant banks under the SRM, sovereigns will in the future have less ability to intervene in failing banks, enabling better separation of bank and sovereign risk.
- Please note that I said "mitigating" the link and not "breaking" the link between banks and sovereigns. Breaking the link is, in my view, illusory. Despite the banking union, the link will not be broken entirely. Links between a sovereign and its banks will always remain. For example, banks are usually the largest buyers of government bonds. Their balance sheets will therefore reflect the quality of their sovereign's bonds. Furthermore, banks and their sovereigns are subject to the same national business cycles. Besides, the deposit insurance remains national, representing another strong link between the sovereign and its banks.

- A second plus for monetary policy is that the banking union will contribute to harmonizing monetary conditions and reducing financial market fragmentation. A single supervisor should enhance transparency and lead to a convergence of rules and standards. The common principles embedded in the comprehensive assessment in preparation for the Single Supervisory Mechanism (SSM) should also create more homogeneity and thus increase trust in cross-border lending.
- And thirdly, a strong banking union can unclog the transmission mechanism of monetary policy. In the euro area, banks have traditionally played an important role in financing the real economy. Bank loans account for most household borrowing and for around 50% of non-financial firms' external financing, in contrast to the U.S.A, where 75% of firms' financing comes from capital markets.
  - The crisis disrupted lending processes in many European countries. The recent ECB report on financial integration in Europe and the ECB survey on the access to finance of SMEs in the euro area, for example, show that today there is still a large divergence in financing conditions and access to finance for SMEs in different parts of the euro area. In countries like Germany and Finland, some 80% of SMEs can fulfill their financing needs through bank loans, whereas in Greece or Ireland, this rate is only 30%. National governments first and foremost have a role to play in improving this situation.
  - The ongoing state of fragmentation in banking has become a serious obstacle to SMEs' access to financing, with implications for the eco-

> nomic recovery in distressed countries. Throughout the crisis the ECB tried to repair the transmission of monetary policy and restore the credit channel. And recently, global market developments have also contributed to an inflow of capital into the European periphery, but the problem is not solved yet. Governments need to act decisively to use these tailwinds to improve the situation before markets become more skeptical again.

The steps taken toward the banking union will establish conditions necessary for a transparent, competitive and stable banking sector. And they will help monetary policy to regain traction across the euro area and be more effective. Ultimately, however, it is up to policy makers to ensure that the banking system is restored to health. And, needless to say, the banks themselves play a decisive role in improving the situation.

Remaining Uncertainties

However, I also have some concerns regarding the implementation of the banking union. The set-up and implementation of the banking union is a tremendous undertaking with consequences in many areas. For this exercise to be successful, many building blocks must fit and work together, and conditions must fall in place.

The banks that are going to be supervised directly by the ECB under the SSM from November onwards are currently preparing for the transition of supervision and are undergoing the AQR and the stress test. Like a doctor, the ECB would like to have a full health check of any new patients. A doctor would put new patients on an exercise bike in order to test their resilience to stress. However, if the patient just came back from the intensive care unit, it is less obvious how such an exercise would be health-enhancing.

The Comprehensive Assessment is an important but delicate preparatory exercise. Many people are wondering if the outcome could trigger another crisis. The ECB has recently announced the details of how it expects failing banks to recapitalize.

I also wish to emphasize the importance of clear communication and transparency. Timely and transparent management of the market's understanding of the comprehensive assessment is important, in particular with respect to the impact of its outcome on individual countries and institutions. Where possible, the competent authorities should take mitigating actions.

Any downside surprise could make the capital raising efforts much more difficult for banks that are just implementing their plans to cope with tighter Basel III capital requirements, and therefore potentially trigger further deleveraging with consequences for lending and the economy.

Let me give you just a few examples to illustrate my concerns:

- First of all, to mitigate the bank-sovereign nexus, the SRM and the SRF are important building blocks of the banking union. Looking at the recently approved SRM, I find that the processes are complicated, as there are many parties involved in the decision making, a process that needs to be fast. Also the SRM needs unanimity and the overall concept is not tested.
- Furthermore, the Bank Resolution and Recovery Directive (BRRD), an important partner to the SRM and SRF, will only be enacted in 2016. This time gap may lead to potential complications in 2015 as some countries have no national law or legal ability to implement burden sharing

ahead of the entry into force of the BRRD. Also, the BRRD diverges in several aspects, such as in funding periods and the use of resolution funds, from the SRM and SRF.

- Another concern is the national deposit insurance, which is a weak link in my view. We need to find the optimal balance between national responsibilities and pan-European systems.

- Furthermore, I see potential conflicts of interest between the ECB as the supervisor and the ECB as the monetary policy authority. I am of the opinion that one needs to make a clear separation between supervision and monetary policy and I believe the current set-up, although with the best intentions, is a delicate one. For the 130 largest banks, the ECB is the “lender of last resort”, determines deposit and refinancing rates, enforces liquidity and leverage ratios, sets capital buffers, and on top of that it should also ensure price stability in the euro area. Truly a conflict of interest minefield!
- Last, but not least, I would like to add a general note of caution. The banking union will fundamentally alter incentives for many market participants. While regulation is always well-intentioned, it often has unexpected secondary effects. Given the importance and vast size of the European banking sector and the complexity of the project, one needs to be alert to recognize adverse developments and to react in time, if necessary.

So a lot of work remains to be done and further efforts are needed to address the concerns I mentioned. It is important to ensure the success of the banking union. But the banking union alone is not enough to restore stability. Policy makers have a large role to play in the stabilization of Europe.

Further Reforms are Needed

The European countries, in the core and in the periphery, need ongoing efforts at structural reforms to restore stability and return to a solid growth path. For example, labor costs remain high in Europe and 46% of SMEs in the euro area even reported increasing labor costs over the past six months. Unemployment, and especially youth unemployment, is a burning issue in many European countries. Red tape is still abundant and regarding fiscal consolidation, there is still a long way to go.

The banking union is not a financial panacea. Factors such as rigid labor markets, lack of competitiveness or bad fiscal discipline also contribute to the ongoing European problems. A banking union will not address these issues. The current loose monetary policy stance of the ECB may also lead to new imbalances, this time in core euro area countries. Again, a banking union will not prevent this.

The U.S. Federal Reserve System has decided to normalize its monetary policy and gradually taper its asset purchases, because it considers that the U.S. economy is improving and that recovery is sound. But recovery in the euro area is lagging that of the U.S.A. and the impact of the normalization in the U.S.A. is substantial, especially for the European periphery.

One could interpret the recent decline in Spanish, Greek and Italian sovereign rates as an indication that international investors have confidence in the reform dynamics in these countries. I don't consider this to be so – the market is probably too benign. But even if it were not, the current level of these rates would only be justified if the reforms are carried out as planned. And it is here that I have doubts. Therefore, with market pressure for reforms declining, the political pressure on these countries to deliver on their promises needs to stay high. It is the combination of further structural reforms and completion of European initiatives, such as the banking union, that will lead to more stability and trust.

Conclusions

The banking union is a historic, fascinating and ambitious development. It is an important step forward in complementing the Monetary Union. It is also a project with vast consequences for European integration. It is not a silver bullet, however, and more efforts are needed on the national as well as on the European levels to stabilize the financial sector. To put Europe back on a sustainable growth path, structural reforms and more and better cooperation between financial sector and regulatory and political decision makers are needed.

Vítor Constâncio

Vice-President of the ECB

Banking Union and European Integration

Ladies and gentlemen,

I thank the Oesterreichische Nationalbank for inviting me to Vienna to make this address on the banking union and European integration at the occasion of one more of its prestigious economics conferences. As Vice-President of the ECB, I have been involved in the banking union project from the start and it is with great pleasure that I now see it beginning to come into place. By the start of next year, we will have an operational Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM). It is undoubtedly the more important and far reaching reform in the European Union since the creation of the euro.

As many other European institutional innovations, the project was born in connection with the crisis management effort of trying to sever the bank-sovereign nexus that was contributing to financial fragmentation. The idea of launching the SSM emerged during the June 2012 European Council meeting. It was a consequence of the decision that the ESM could directly recapitalise weak banks, thus taking some fiscal pressure off sovereigns. But if the European level were to assume liability for European banks, it also logically had to assume control: hence the need for a European supervisor. It was only later that the concept of a fully-fledged banking union emerged, which would contain a SRM and a possible Deposit Guarantee Scheme, which has meanwhile been postponed.

Rationale and Objectives of Banking Union

The absence of European supervision and resolution had however already been identified by many analysts as an initial design flaw of monetary union. As the crisis developed, this became clear. The high degree of interconnectedness, in the euro area in particular, implies that the impact of supervision affects not only the domestic banking sector but also, as an externality, other countries. This has been captured by the so-called "financial trilemma". The concept of the trilemma illustrates the impossibility of achieving simultaneously three objectives in an environment with linked financial markets. These objectives are financial stability and financial integration while preserving supervision at national level.[1]

The reasoning behind this is the following: with increasing financial integration, pursuing national financial policies will generally not lead to financial stability, because national policies seek to benefit national welfare, while not taking into account externalities of national supervisory practices in other countries.[2] This leads to an under-pro-

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[1] *Schoenmaker, D. 2011. The Financial Trilemma. Forthcoming in Economics Letters.*

[2] *Holthausen, C. and T. Ronde. 2004. Cooperation in international banking supervision. ECB Working Paper 245.*

vision of financial stability as a public good.[3] A correction of this flaw addresses the first objective of banking union.

A second objective for banking union[4] stems from the evidence that keeping supervision at national level in both creditor and debtor countries contributed to the large imbalances that developed before the crisis. Without unified supervision, it was impossible to contain the build-up of such imbalances in the pre-crisis period. National supervisors had to respect the single market rules and lacked the macroprudential tools to offset the effects of large capital inflows. As I have often underlined, private debt intermediated by the banks, more than public indebtedness, was at the heart of developments in peripheral countries.[5] By introducing supervision at the European level, the banking union now offers a possibility to better pre-empt such developments in the future – and therefore to better protect the real economy and financial stability in the whole area.

A third objective of the banking union is the contribution it can provide to financial integration, by separating banks' robustness from sovereigns and consequently reduce markets' fragmentation.

The fourth objective is closely connected with the third one. Imperfect financial integration in a currency union directly complicates the task of the central bank. It becomes harder to achieve a smooth transmission channel of monetary policy and to ensure similar levels of interest rates across countries. Thus, the tendency towards less financial integration induced by both the financial crisis and institutional shortcomings has undesirable effects also for the conduct of monetary policy.

A final objective of banking union is to increase the efficiency of the banking system which is the dominant source of finance for the European economy. This will be achieved in different ways. First, the SSM will be a strong and independent supervisor, enforcing supervision consistently across the participating Member States. With supervision at a European level, the focus of supervisory activities will be aligned with the activities of cross-bor-

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[3] *On financial stability as a public good, see for instance Beck et al. 2010. Bailing out the Banks: Reconciling Stability and Competition. An analysis of state-supported schemes for financial institutions.*

[4] *Banking union and the future of banking, speech by Vítor Constâncio, Vice-President of the ECB, at the IIEA Conference on "The Future of Banking in Europe", Dublin, 2 December 2013; Towards the Banking Union, speech by Vítor Constâncio, Vice-President of the ECB, at the 2nd FIN-FSA Conference on EU Regulation and Supervision "Banking and Supervision under Transformation" organised by the Financial Supervisory Authority, Helsinki, 12 February 2013; Towards a European Banking Union, speech by Vítor Constâncio, Vice-President of the ECB, Lecture held at the start of the academic year of the Duisenberg School of Finance, Amsterdam, 7 September 2012 (ECB website).*

[5] *See "The European Crisis and the role of the financial system", speech by Vítor Constâncio, Vice-President of the ECB, at the Bank of Greece conference on "The crisis in the euro area", Athens, 23 May 2013 (ECB website).*

der banks and the area-wide financial sector, thus less subject to domestic considerations.

With a microprudential task and an extensive set of powers, the SSM should be able to monitor risks faced and stemming from individual banks in the system and address them in a timely fashion. This is supported by the macroprudential task conferred to the ECB entailing the monitoring and addressing of risks from a system-wide perspective. The fact that the ECB has been given power over the direct application of macroprudential instruments as well as a coordinating role among all Member States, is an important innovation of the new Regulation that will improve financial stability in the euro area. Furthermore, the SSM will have a European focus and support the development and effective application of the single rulebook, the harmonisation of supervisory practices and procedures, creating a level playing field and reducing compliance costs. The SSM, coupled with the other elements of the banking union should be conducive to ensuring the most efficient allocation and transfer of intra-group capital and liquidity. Therefore, it should contribute to the creation of truly pan-European banks and enhance cross-border banking integration which will reduce transaction and compliance costs and bring efficiency gains.

On the other hand, the new framework may lead down the road to a period of consolidation in a not much concentrated European banking sector. In fact, there is scope for further consolidation without reinforcing the so-called "too-big-to-fail" problem and for reaping the benefits of efficiency-driven consolidation. The present weak profitability in the banking sector and the existence of over-capacity in certain areas of the European market suggest that some efficiency gains could be achieved.

Besides these fundamental goals, banking union also involves two practical aspects of more immediate concern that I will now address: (i) the repairing of banks' balance sheets to unclog the impaired credit channel and consolidate the on-going mild economic recovery; (ii) the reduction of the bank-sovereign loop in order to further mitigate the remaining financial fragmentation.[6] I will complete my remarks by addressing the role of the SRM as the necessary complement to the SSM in the banking union and finally, by dwelling upon the broader implications of banking union for European Integration. I will only briefly touch upon the SSM as my colleague Danièle Nouy will elaborate on SSM issues during her speech later today.

Bank Recapitalisation and the Economic Recovery

In the past few years, one could hear many voices urging European policy makers to repair the balance sheets of banks so that these could again lend to the real economy and jump start GDP growth. There will be no growth without finance, the narrative goes. In this vein, the fact that the U.S.A. has returned to robust economic growth faster than Europe has been, to a large degree, attributed to policy-makers acting quickly to repair the balance sheets of U.S. banks.

This narrative, while intuitively compelling, is missing two crucial points. The first is that euro area bank

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[6] *Constâncio V. 2014. Banking Union: meaning and implications for the future of banking, speech held at the Banking Union Conference organised by Master in Banking and Financial Regulation, Navarra University, Madrid, 25 April 2014.*

balance-sheet repair has started for some time already. As I recalled recently,[7] since the onset of the global financial crisis, the top 20 European banks have increased capital, net of share buy-backs, by higher amounts than the corresponding top 20 American banks: USD 289 billion by EU banks against USD 179 billion by U.S. banks. And according to the FDIC, the leverage ratios of the biggest European banks, calculated according to the same accounting standards, are very close to their American peers.[8] Furthermore, since mid-last year in particular, European banks have implemented write-offs and increased provisions and capital, partly anticipating the Comprehensive balance-sheet Assessment that the ECB is conducting this year. Our estimates based on public information indicate that SSM banks (comprising 128 institutions) have, from July 2013 to April 2014, strengthened their balance-sheet by EUR 104 billion. Measures taken include: EUR 34 billion through issuance of quoted shares (implemented and publicly announced), EUR 15 billion through the issuance of contingent capital hybrids or EUR 19 billion relating to additional provisioning. As a result, confidence in the euro area banking sector has improved and since the first quarter of last year, banks' stock prices have risen at almost double the rate of the market average growth.

But even if we were to agree that completing the strengthening of European banks is a necessary condition to consolidate the recovery, it is far from being a sufficient condition for jump starting growth in Europe. I caution that even a complete rehabilitation of the euro area's banking system (which is well on its way thanks to the various policy steps related to the banking union) will not guarantee a quick return to high growth and low unemployment. In fact, there are a number of challenges, both immediate and particularly medium-term ones, that the euro area economy is facing and which are potentially more difficult to overcome than repairing the banking sector. Let me name a few: in spite of the confirmed on-going economic recovery, investment is still 20% below its 2007 level; there is a general weakness of demand and medium-term challenges to introduce structural reforms necessary for a quantum leap in total factor productivity are compounded by negative demographic developments. In fact, in the near future, the European workforce will start declining by 0.6% a year until 2030.

Of course, this is not to say that financial sector weaknesses are not important, or sufficiently recognised. The broad Comprehensive Assessment that we have started reflects precisely the importance of balance-sheet repair. My point is rather that while the on-going deleveraging in the banking sector certainly plays an important role in the inadequate current levels of credit supply to the real economy, factors related to the demand side may play an even more important role. The weak demand outlook combined with the slack in industrial capacity is the most important explanation for the drop in private investment since the crisis, and the most relevant limiting factor for future investment. In addition, the protracted period of low inflation and consequent

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[7] *Vitor Constâncio, "Growing out of the crisis: is fixing finance enough?", speech at the Levy Institute Hyman Minsky Conference on The state of the US and the World economy, Washington DC, 10 April 2014 (see ECB site).*

[8] *"Basel III Capital: A Well-Intended Illusion", remarks by FDIC Vice-Chairman Thomas M. Hoenig to the International Association of Deposit Insurers, 2013 Research Conference in Basel, Switzerland.*

low nominal growth will increase the burden of the debt overhang of households and governments, further complicating the recovery process.

The Separation of Banks from Sovereigns

As I mentioned before, the goal of separating the fortune of banks from that of the sovereigns and vice-versa through direct European recapitalisation of weak banks via the European Stability Mechanism (ESM) was present in the embryo of what later became the banking union project. Somewhat ironically, however, this widening of the focus caused the initial objective to become obscured. The question of European direct recapitalisation – for which a framework has still not been published – ceased to be the main focus of attention. In the view of many commentators, the SRM became the expected instrument to achieve the separation between banks and sovereigns. But I think this is a somewhat misleading view as I will explain later.

The SSM and the SRM, both components of the banking union thus contribute to reducing the negative feedback loop between banks and sovereigns. One important objective of the SSM Regulation is to improve the quality of supervision and to ensure strong homogenous supervisory standards across the euro area. The essential contribution that European supervision can give to the separation of banks and sovereigns is the build-up of trust in the robustness of banks as stand-alone entities, so that enhanced confidence by their peers can help normalise interbank markets and overcome financial fragmentation.

The establishment of the SRM also addresses the problem of breaking the bank-sovereign nexus because the orderly resolution of banks, even large ones, helps to avoid costly rescues by sovereigns that may endanger their own finances.

In practice, however, the SSM and SRM may not be sufficient to completely sever the ties between sovereigns and their domestic banks. The effect of SSM and harmonised supervision on trust among banks may be more limited than expected, while the SRM, important for organising orderly resolutions, is limited in the amount of resources it can contribute to recapitalisations.

The Bank Recovering and Resolution Directive (BRRD) is in my view the most crucial regulatory change in Europe in relation to breaking the bank-sovereign nexus. It represents a true paradigm change, ending the culture of bail-out and ushering in a culture of bail-in. As of 2016, in all resolution cases, the BRRD will require a bail-in of shareholders and creditors equal to at least 8% of total liabilities of a given bank, including own funds. Only after the 8% threshold of bail-in is attained can money from the resolution fund be used and for a maximum amount of 5% of total liabilities (including own funds) of the concerned bank. Public money for recapitalisation, either national or European, can thus only be considered at the very end

of the process after the other two sources of remedial action have been used. Furthermore, the "government financial stabilisation tools" that the Directive introduces is an instrument of last resort after having assessed and exploited the other resolution tools to the maximum extent possible.

The amount of 8% is very substantial compared to the losses banks faced in the recent crisis. To give you an idea, between 2008 and 2010 only one bank had losses exceeding the 8% threshold, and the average for all other banks was slightly less than 3%. Thus, under the BRRD, the injection of public money into banks, either from national governments or from direct European recapitalisation, will happen only in quite rare occasions. Bail-in of shareholders and creditors plus the use of the Resolution Fund should in most conceivable cases be enough to cover the losses incurred by a failing bank. Consequently, part of the debate about direct European recapitalisation and about the role of the SRM in delinking banks and sovereigns, was post-factum somewhat misplaced.

The implications of this Directive are therefore far-reaching. Participant countries in the banking union are shedding considerable sovereign power. In fact, large countries with strong public finances are effectively renouncing their ability to provide domestic banks with the implicit subsidy of public support that would reinforce their advantages in increasing their market share. The strength of these banks when competing in the European market will be reduced as the new situation will be progressively reflected in their ratings and funding costs. Similarly, countries with vulnerable public finances and smaller banks will no longer be able to support and possibly not be able to keep their national champions. In accepting the transfer of supervision and resolution of banks to the European level, euro area countries are committing to a remarkable sharing of sovereignty which could be a positive sign of their willingness to deepen European integration in general.

It is worth mentioning that the BRRD rules about bail-in enter into force only in January 2016. They will therefore not apply to the recapitalisations in the context of the Comprehensive Assessment that the ECB is conducting and to be implemented this year and the next. The bail-in rules that will be then in place stem only from the European Commission's communication on "State Aid rules to support measures in favour of banks in the context of the financial crisis" of July 2013, which establishes that any public support to banks considered as State Aid should be preceded by bail-in of bank shares, capital hybrids and subordinated debt. The text contemplates that exceptions "can be made where implementing such measures would endanger financial stability or lead to disproportionate results". For specific cases at the end of the Comprehensive Assessment, it may be adequate to invoke such principles.

On a more general note, it is clear that to avoid moral hazard, any public interventions should penalise shareholders and managers appropriately, as was done in the exemplary case of the Nordic banking crisis. Here financial and economic collapse was avoided with, in the end, virtually no costs for taxpayers when the restored banks were sold. Thus, after the misbehaviour of several institutions that triggered the recent crisis – which by the way is still being uncovered – I fully support the change of culture from easy public bailouts to a new culture of private bailing-in. The burden of proof should be put on those who want to invoke exemptions to the new approach.

Yet, we need to bear in mind that it is not only direct public support for banks that has a cost for taxpayers, but also financial instability – indeed, the costs of the latter may be higher. Compare the worldwide costs for taxpayers stemming from the absence of public intervention to rescue Lehman Brothers, with the zero cost for taxpayers following the U.S. TARP 700 billion dollars injection into U.S. banks in 2008 which have by now been totally repaid by the banks. In other words, financial instability can have a meaningful cost to taxpayers even if it is not visible in the very short term – a notion that all policy makers should keep in mind.

The new European legislation does allow, as a last resort, for interventions that can safeguard financial stability in a Member State or in the area as a whole. I trust that this legislation will be applied by the competent authorities with rigour, wisdom and a sense of proportion in the aftermath of our Comprehensive Assessment.

SRM as a Necessary Complement to the SSM

My remarks about the SRM – as a mechanism less relevant than the BRRD rules for the severing of the bank-sovereign nexus – do not aim to belittle the crucial importance of the SRM for banking union. To begin with, the implementation of the BRRD bail-in rules will be done by the SRM at the European level. The credibility of the SSM as supervisor is also dependent on the existence of a credible mechanism to proceed swiftly, orderly and efficiently in the resolution of banks that have attained the point of non-viability.

The crisis showed that the cooperation and coordination between national resolution authorities is often incapable of taking swift and efficient decision on cross-border bank failures. In past cases, national interests tended to prevail, even if resolution costs became larger. In the SRM, the Single Resolution Board will take the resolution decisions for all cross-border banks and all banks under direct ECB supervision. Resolution decisions can be taken under a common interest, in swift and unbiased fashion, notably in the case of cross-border cases, while taking into account spill-overs and contagion risks.

A robust SRM, as a complement to the SSM, will address all these shortcomings. The ECB has always been of the view that a robust SRM should contain key essential features for effective resolution, namely: (a) a single system, (b) a single authority with efficient decision-making procedures (c) a single fund and (d) a backstop facility for bridge financing. We have stated this in our opinion on the SRM proposal as well as in many speeches. I am therefore very pleased that the agreed SRM regulation broadly fulfils these criteria.

A Single System

To begin with, the SRM follows an integrated approach, in which all banks of EU Member States that participate in the SSM fall under the SRM. Any Member State outside the euro area which opts to join the SSM will thus automatically also fall under the SRM.

The powers of the SRM will embrace all resolution tasks, e.g. from assessing the resolvability of banks and drawing up resolution plans, to deciding on resolution schemes for failing banks and whether to make use of the Fund in such cases. These tasks are shared between the Board at the European level, which is directly responsible for all banks under direct ECB supervision and all cross-border banks, and the national resolution authorities, which are responsible for the other banks.

However, the Board may at any time decide to directly exercise all the relevant powers under the Regulation with regard to any of the indirectly supervised banks. In addition, the Board also becomes directly involved whenever a resolution of an indirectly supervised bank will make use of the Fund. Finally, there is also an option for Member States to choose that the Board will be responsible for all banks in their jurisdiction. These features make the SRM a single system.

The Single Resolution Board

At the centre of the SRM there needs to be a single authority with operational independence and sufficient decision-making authority to take resolution action in the interest of the euro area and of the Union as a whole. This is achieved with the setting up of the Single Resolution Board.

The Board will meet in two different compositions: the plenary and the executive sessions. The executive session will consist of a Chair, four independent full-time members and two observers from the European Commission and the ECB, respectively. The plenary session will encompass all members of the SRB, which – on top of the ones just mentioned – will include one member appointed by each participating Member State, representing the national resolution authorities.[9]

The fact that the ECB will be an observer in the Board, with no voting rights, is supported by the ECB. This accurately reflects the need to have the supervisor involved in resolution matters, while maintaining the necessary separation of institutional responsibilities between the supervisory and resolution function in the banking union.

The decision-making within the Board is designed to enable taking resolution action in the interest of stability within the euro area and of the Union as a whole. In particular, decisions in the executive session should be made by consensus. If the executive session is not able to reach a joint agreement by consensus, the Chair and the permanent members will take a decision by a simple majority. By reaching a decision either by consensus or by a major-

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[9] *The plenary session will take decisions by simple majority when it discusses issues of a general nature, such as the annual work programme, the budget, or the rules of procedure. Each member will have one vote, and in case of a tie the Chair will have the casting vote. The executive session will prepare all decisions concerning resolution procedure and adopt those decisions. When deliberating on the resolution of a bank or group, the executive session will also involve the members of the directly concerned Member States in the decision-making process. Each member, including the Chair, will have one vote. In neither session will the observers have a vote.*

ity, efficient European decision-making should be ensured.[10]

Decision-Making in Resolution

It is important that the decision-making process in the SRM allows for timely and efficient decision-making, if necessary, within a very short time such as a weekend. It is therefore welcomed that the decision-making process in the SRM is capable of this, in spite of the fact that it may involve both the European Commission and the European Council. Let me describe this process as simply as I can.

If all the conditions for resolution are met, the Board will adopt a resolution scheme for the institution or group in question, which is thereafter transmitted to the European Commission. This may be fairly straight-forward if the scheme is based on agreed and adequate ex-ante resolution planning for the institution or group in question, and if preparations for resolution had been taken prior to the triggering point.

The European Commission can approve the resolution scheme from the Board in two ways: approving it upfront or raising no objections within 24 hours. After this, the resolution scheme is adopted and can be implemented by the national resolution authorities as instructed by the Board. It is an important feature of the final text that the European Council only becomes involved in the decision-making at the explicit request of the European Commission.[11]

The Single Resolution Fund

Turning to the Fund, the Board's control of a common resolution fund is an essential element of the SRM. The Fund will be key to ensure adequate resolution financing without drawing on public funds and for taking swift actions, since it eliminates the need for protracted burden-sharing discussions for cross-border banks.

Although the SRM Regulation set up the Fund, the order by which bank contributions are raised at national level

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[10] *There are exceptions to this division of responsibilities between the plenary and executive sessions. First, whenever a resolution scheme would require the use of the Fund above certain thresholds, which depend on what the Fund's means will be used for, a member of the plenary can within a strict deadline request the plenary session to decide. In such a case, the decision will be taken by a simple majority of the plenary members, but the majority must also represent certain levels of contributions to the Fund. Second, any decision which would involve the raising of ex post contributions from the banks or voluntary borrowing between financing arrangements, among other things, will also be taken by the plenary session. During the transitional period, such decisions require a majority of 2/3 of the plenary members, representing at least 50% of contributions to the Fund. In the steady state, after eight years, the same majority share of the plenary only needs to represent at least 30% of contributions to the Fund to take such decisions.*

[11] *This would be the case when the Commission does not agree with the scheme adopted by the Board. In such case, within 12 hours from receiving the resolution scheme from the Board, the Commission may propose to the Council to either: (i) object to the resolution scheme on grounds that there is no public interest of resolution, or (ii) approve or object to a material modification of how much the Fund is used in the resolution scheme. In such a case, the Council should, still within these first 24 hours, either approve or object to the Commission's proposal by a simple majority decision. In other words, they cannot amend it, only approve or reject it. If the Council approves the proposal of the Commission, the Board must modify the resolution scheme accordingly within 8 hours.*

and pooled at EU level are detailed in accordance with an Intergovernmental Agreement on the transfer and progressive mutualisation of those contributions into a single fund. According to the political agreement reached, the target level for the Fund will be 1 % of the amount of covered deposits of all banks authorised in the participating Member States. This target should be reached in eight years, with the gradual mutualisation being frontloaded with 40% of the total in the first year.

During the transitional period of eight years, the contributions collected at national level will be allocated to separate national compartments corresponding to each participating Member State. These national compartments will be subject to progressive mutualised usage and will cease to exist at the end of the transition period. If there is a need to draw on the Fund in the transition period, the Intergovernmental Agreement lays out a funding pecking order, which should be used by the Board.[12]

Surely, one cannot rule out that situations may arise where the means available in the Fund are insufficient, e.g. because they are currently being tied up in an on-going resolution case, and where ex post contributions cannot be accessible in a timely manner. For the credibility of the Fund, and thereby the SRM and the banking union as a whole, it will be of paramount importance that effective and sufficient financing of the Fund is ensured.

The ECB pleaded for the creation of a credit line to be made available as it is the case the American FDIC or that, in alternative, that the Fund could go to the financial markets to raise resources with the guarantee of Member States. In the end, the final text only mentions that there is an obligation of the Board, in cooperation with the participating Member States, to take the necessary steps to develop the "appropriate methods and arrangements" that will boost of the borrowing capacity of the Fund by the date the SRM will be applicable.

Nevertheless, it is somewhat encouraging that in addition the Intergovernmental Agreement specifies that a common backstop will be developed during the transition period of the Fund. Such a backstop will undoubtedly facilitate borrowings by the Fund.

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[12] *In the first instance, national compartments of the directly affected Member States will be used, up to a predefined limit set for each year in the transition period. This limit will decrease during the transition period. Starting at 100% in the first year, it will decrease to 60% and 40% for the second and third year, respectively. Thereafter, the limit will decrease linearly for the subsequent years. As a second step, only if the first step was insufficient, available means in all compartments – including the ones just used – will contribute up to another predefined limit, also set for each year in the transition period. As I mentioned earlier, the pace of mutualisation is substantially frontloaded, starting at 40% in the first year. It will increase to 60% in the second year and thereafter increase linearly for the subsequent years until it reaches 100%. As a third step, to be used if the previous steps were insufficient, any remaining resources in the national compartments of the directly affected Member States will be used. If these three steps are still insufficient, ex post contributions from the institutions authorised in the affected Member States will be used. However, if such contributions are not immediately accessible, including for reasons relating to financial stability, the Board may exercise its power to contract borrowings or other forms of support for the Fund, or to make temporary transfers between national compartments.*

Let me be clear, however, that in an event that the credit line to the backstop would temporarily be drawn upon, it will be subject to the principle of fiscal neutrality, i.e. the banking sector will ultimately be liable for repayment by means of contributions in all participating Member States, including ex post contributions.

Banking Union and European Integration

I mentioned before that the banking union complementing Monetary Union will have far-reaching implications for European integration in general as it implies a vast sharing of sovereignty. European construction is still under the grips of the Jean Monnet functional method of integration: at each new reform step, other become logical and pressing. Regarding banking union itself, the other element that should complement centralised supervision and bank resolution in a banking union concerns a centralized deposit insurance scheme.

Such a scheme would have several benefits. It would be commensurate to the centralized supervisory regime, and ensure that decisions that are taken on a centralized level affect depositors in all countries in the same way, thus ensuring a level playing-field. Depositors would be treated in a uniform way across countries, independently of their location and the location of the bank to whom they have entrusted their savings.[13]

What was achieved in December 2013, when the co-legislators agreed on the Deposit Guarantee Scheme Directive (DGSD) was only a little part of what in the end will be necessary. Undoubtedly, the DGS Directive will further strengthen and harmonise depositors' protection, thereby enhancing financial stability in the EU. It will ensure that deposits will continue to be guaranteed up to EUR 100.000, per depositor and bank, in all Member States. Furthermore, it will strengthen the financing of the DGS in all Member States, notably by requiring a significant level of ex-ante funding (0.8% of covered deposits) to be met in ten years. However, a full-fledged scheme to foster financial integration would imply the setting up of a euro area wide deposit protection scheme. In particular in times of widespread financial instability, deposit insurance payoffs depend not only on the legal framework they are based on, but also on the ability of the deposit insurance fund to cope with large-scale banking failures. Doubts on this ability, due to concerns on the fiscal health of the sovereign, could for instance easily reinforce the possib of local bank runs.

From a central bank perspective, the establishment of a common deposit insurance scheme is of less urgency than the other components of a banking union. Still, it is an important element that should be pursued later, as it will be important to fend off bank runs on cross-border banks, thereby enhancing trust in the European banking sector.

The completion of banking union is however not the end of the journey. For instance, I mentioned before that the banking union will tend with time to consolidate the banking sector and open the possibility for an increased role of capital markets in diversifying the financing of the European economy. However, to fully reap the benefits of capital markets' integration, we

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[13] *Schoenmaker, D. and D. Gros. 2012. A European Deposit Insurance and Resolution Fund: An Update. DSF Policy Paper Series. September.*

need legislative changes that complete the programme of financial services integration, particularly in relation to the capital markets. That would include changes to company law, bankruptcy rules and procedures, and higher harmonisation in the taxation of financial products. I would urge the European Commission to promote these issues.

Other necessary institutional developments have also been well identified in the President Van Rompuy's Report "Towards a genuine Economic and Monetary Union".[14] They include the reference to progress towards fiscal union, economic union and political union.

First, a more complete Fiscal Union along the lines described in that Report seems necessary for the euro area, which goes beyond mere disciplinary rules. Specifically, it calls for the euro area *"….the establishment of a fiscal capacity to facilitate adjustment to economic shocks. This could take the form of an insurance-type mechanism between euro area countries to buffer large country-specific economic shocks."*

Second, under the umbrella of Economic Union, we need further progress towards the completion of the single market in services, and a more coordinated approach to macroeconomic policy at the euro area level.

Finally, the sovereignty-sharing that monetary union represents implies moving forward towards political union. We need now to complete the integration of European nations. The political union pillar, is needed to ensure that the other pillars have sufficient democratic legitimacy. I will not dwell long on this issue, as it is fundamentally a matter for the Member States and European citizens. It should suffice to say that the crisis has shown the limits of applying a national mindset in a deeply integrated monetary union. In this sense, political union is not about moving forward, but about catching up with the depth of economic and financial integration that already exists.

What is at stake refers basically to democratic accountability and legitimacy. An important element of legitimacy has been provided in the past, in the European Union and other democracies, by what Fritz Scharpf called output legitimacy (or government for the people)[15], that is, by the effectiveness of the system in ensuring the continuous improvement of the citizens' quality of life. All advanced democratic countries and consequently the European Union will face challenges in this front stemming from the prolonged period of slow economic growth that has now just started. This is the consequence of two types of processes. First, the adjustment, in the form of balance-sheet recession, that the crisis represented. Second, by the structural problems created by ageing populations, globalisation, energy and environmental risks and decreasing returns of technological progress recently underlined by Robert Gordon.[16]

In this context, the attention that will have to be given to the other form of political legitimacy referred by Scharpf gains accrued importance. This

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[14] *"Towards a genuine Economic and Monetary Union", a Report by the President of the European Council in close collaboration with the Presidents of the European Commission, the Eurogroup and the ECB (www.european-council.europa.eu/the-president/eurozone-governance).*

[15] *Scharpf, F. W. www.mpifg.de/people/fs/publikation-art_en.html.*

[16] *Gordon, R. 2012. Is US growth over? Faltering innovation confronts the six headwinds. CEPR Policy Insight 63. Gordon, R. 2014. The demise of US economic growth: restatement, rebuttal and reflections, NBER Working Paper 19895 February.*

calls for greater participation by citizens in European decisions. In some ways, it may stand-out as contradictory with the search for effectiveness linked with the first form of legitimacy requiring stronger central deciding bodies. To understand the great difficulty in addressing this issue, we could establish an analogy with the political trilemma of the world economy, as recently stated by Dani Rodrik[17]: "we cannot simultaneously pursue democracy, national determination and economic globalization", but I will not enter into such complications. I will recall, however, that in this context, we should never forget that Europe is unique: it is neither a nation nor a state. Political life and legitimacy continues to take place mostly at the level of nation-states. This implies that to foster legitimacy we have to act on the two levels – the European and the national – by giving for instance, the European Parliament a stronger euro area dimension and encouraging greater engagement of national parliaments in euro area discussions.

Conclusion

Let me conclude.

We must recognize and confront the fact that the logical steps towards deeper integration that I just mentioned seem to run against what seems to be the mood of many Europeans, on the eve of European Parliament elections. It is true that crises always open the door to discontent and this crisis is not over yet. Some policy-makers seem too complacent in showing a sense of relief because the situation in Europe has stabilised and turned a corner, since economic growth is resuming, even if at incipient level. This sentiment is not shared by public opinion in many countries. It should rather be recognised that adjustment costs across nations and segments of the population could have been more balanced. In this context, it is useful to retain that the legitimacy of Europe has been always much more based on outcomes of growth and prosperity than on values or input legitimacy.

In any case, economists have good arguments to demonstrate, for instance, that subject to the turmoil of an international financial crisis, nations outside the euro, like the UK, Denmark or Norway did worse than the average euro area and many of its members in terms of GDP growth per aging population, since the beginning of the crisis.[18] Other studies, which build a counterfactual world by comparing the euro area countries with synchronised non-euro area countries in past periods, indicate that in terms of GDP and productivity growth, all countries (except Greece), did better as part of the

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[17] *Rodrik, D. 2011. The globalization paradox: why global markets, States and Democracy can't coexist. Oxford University Press.*

[18] *Fatás, A. Blog. 2014. The UK makes the Euro Area look good. May 8.*

euro area than they would have done outside the currency union.[19] We know nevertheless that times of crisis are not favourable to rational arguments and Goya famously illustrated how the sleep of reason engenders monsters. The same reasoning underlines the renowned Vienna Lecture of May 1935 by the German philosopher Edmund Husserl[20] as he characterised the European crisis of that time as "a collapse of rationalism". In those more ominous times his conclusion was: "The existential crisis of Europe has only two outcomes: either Europe will disappear in becoming ever more distant from its own rational signification, that is its vital sense, and will sink in the hatred of the spirit and in barbarity; or Europe will be reborn from the philosophical spirit as a result of a heroism of reason that will overcome naturalism. … Europe's greatest danger is weariness. Let us as "good Europeans" do battle with this danger of dangers with the sort of courage that does not shirk even the endless battle". He was right then. And today, Europe seems a tired and aged continent. Declining demography, under the heading of "no children, no immigrants" is historically a sign of a declining civilisation. In these grim years of crisis, our nations, ever more interdependent, have been bound mostly in a community of fear. We now need that European leaders return it into a community of hope.

Thank you for your attention

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[19] *Campos, N., F. Coricelli and L. Moretti. 2014. How much do countries benefit from membership in the European Union? VoxEu. 9 April.*

[20] *Husserl, E. 1965. Philosophy and the crisis of European Man. In: Harper Torchbooks. Phenomenology and the crisis of Philosophy. Also available at www.users.cloud9.net/~bradmcc/husserl_philcris.html.*

Session 1

Toward a European Banking Union: Transitional Issues

Andreas Ittner

Vice Governor
Oesterreichische Nationalbank

Opening Remarks

Ladies and Gentleman,
I warmly welcome you to the first Session of today's conference *Toward a European Banking Union: Transitional Issues*. I am privileged to present you two speakers for this session, which are well known as two of the most prominent protagonists in the process of implementing the European banking union. It is indeed a pleasure for me to welcome *Danièle Nouy* and *Elke König*. I would like to thank both of you very much for finding the time to participate in this conference and to share your views on the banking union with us. Though I am convinced that you are well known to the audience, let me briefly introduce Danièle Nouy and Elke König.

Danièle Nouy has been appointed early this year as the first Chairperson of the high level decision making body of the Single Supervisory Mechanism (SSM), the Supervisory Board. Previously, she worked for many years in the area of supervision in various leading positions at the national (French) as well as the international level, like for example as secretary general of the Basel Committee on Banking Supervision. Hence, she is certainly recognized as one of the most experienced and acknowledged supervisors in Europe.

Elke König has been President of BaFin, the German Federal Financial Supervisory Authority, since 2012. Before her present position she gained extensive financial industry experience through various high-level management positions including positions in the management board as well as the supervisory board of insurance companies and banking groups and as a member of the International Accounting Standards Board (IASB).

Before I leave the floor to Elke König and Danièle Nouy, let me briefly highlight *4 important general aspects of the European banking union:*

1 The Banking Union Constitutes the Most Considerable Step of European Integration since the Introduction of the Euro

The creation of the banking union constitutes a *fundamental reform of Europe's financial architecture*. It certainly represents the *most considerable step of European integration since the introduction of the euro*. When political consensus was reached regarding the establishment of a European banking union in autumn 2012, a major *objective was to break the vicious circle between sovereign and bank debt*. In order to do so, it was necessary to establish a regulatory framework that allows weak banks to exit the market without major disruptions in the financial system so that the extensive use of tax-payers money for rescuing these banks can be avoided.

With the adoption by the European Parliament of the Single Supervisory Mechanism (SSM) in November 2013 and the adoption of the Single Resolution Mechanism (SRM) together with the Banking Recovery and Resolution Directive (BRRD) and the Deposit Guarantee Scheme Directive (DGSD) in April 2014 the *legislative process for establishing* the three well known pillars of the *banking union has been completed on the European level*. However, besides the legislative implementation on the national level, we face still *enormous challenges in order to make the banking union operational.*

2 Creating the Legal Basis Has Been Crucial – Making the Banking Union Work However Is a Long-Term Project – It Will Face Numerous Challenges and Requires Stamina and Tenacity

Most progress has already been made regarding the first pillar of the banking union – the *Single Supervisory Mechanism (SSM).* The ECB as well as national supervisors are intensively preparing for handing over direct banking supervision of around 120 to 130 significant European banking groups to the ECB in November 2014. Though I am confident that this deadline can be held, we have to be aware that we still *face a series of operational challenges.*

Just one example is the *Comprehensive Assessment* that has to be conducted by the ECB prior to the take-over of full responsibility for supervision under the SSM in November 2014. The assessment is being carried out in cooperation with national supervisors and third parties. The aim of this exercise is to obtain greater transparency regarding banks' balance sheets and to restore investors' and clients' confidence in the European banking sector. The *outstanding nature* of this exercise becomes clear, if one recalls a *few figures in this regard:* balance sheets of the *128 largest banking groups* in the euro area are reviewed. About *6,000 supervisors and auditors* are involved in the review of *760 portfolios and 135,000 individual loan files.* With a total of risk weighted assets of approximately EUR 3.7 trillion this corresponds to a review of almost 60% of credit risk taken by participating firms.

3 The SRM is Key to Complete the Banking Union – Without a Properly Functioning SRM, There Will Be No Delinking of Sovereign and Bank Debt

The second pillar – *the Single Resolution Mechanism (SRM)* – is certainly the most important element for breaking the vicious circle between sovereigns and banks. Hence, it was *crucial for the completion of the banking union* that a respective agreement has been reached before the elections to the European Parliament in May 2014. *Without a common resolution mechanism the banking union would certainly not work.* A well-functioning common supervision has to go hand-in-hand with common rules for bank resolution, if *market-exit of weak or failing banks* shall be established as a *credible option.* However, the establishment of the SRM will even be more challenging than the creation of the SSM. While in the case of the latter involved institutions – the ECB and national supervisory authorities – were already established this is not the case for the SRM: In many countries national resolution authorities are not yet installed and the central body, the *Single Resolution Board* to be located in Brussels, *has to be built from the scratch.*

As regards the third pillar – *the Deposit Guarantee Scheme* – the main challenge will be to *maintain depositors' confidence in the safety of their savings, despite of the potential market exit of weak or failing* banks in the future.

4 Completeness of the Banking Union Is Not Just about Its Three Pillars, It's also about Geographical Scope

As stated before, the regulatory framework for the banking union has been completed recently and making it operational is the main challenge we currently face. However, *completeness not only refers to the framework* itself, but also to the *number of countries* that participate. So far, the banking union has been established for the euro area. I believe that it is also of *utmost importance* for its success that *as many of EU Member States outside the euro area as possible choose to opt-in*. I am convinced that joining the banking union is not only in the interest of a country like Austria with banks heavily engaged in non-euro countries in Central, Eastern and Southeastern Europe, but also beneficial for these countries themselves. As the legal framework of the banking union has been completed now, the time has come for them to *think about the pros and cons of opting-in* and it is my conviction that in most cases *the advantages of joining the banking union will clearly outweigh the disadvantages* in most cases.

Elke König

President of the Federal Financial Supervisory Authority (BaFin)

Comprehensive Assessment: How to Prepare for the Results and What to Do Next

Ladies and gentlemen,
First of all, many thanks to Andreas and Danièle. Ms. Nouy, you have painted an impressive picture for us of what you expect from the Single Supervisory Mechanism (SSM) and have outlined some of the challenges awaiting us. I would like to follow up on this and say a few words on the Comprehensive Assessment, which is supposed to – and certainly will – get European supervision off to a smooth start but which is itself not yet without points of friction.

128 banks that have been categorised as "important" and are expected to come under the direct supervision of the European Central Bank are taking part is this assessment. As you will no doubt know, they must among other things undergo an Asset Quality Review (AQR) and a stress test. I am not exaggerating when I say that the Comprehensive Assessment is an examination of historic proportions for *all* those involved. They now *have* to pass it – with no dress rehearsal.

What is especially important for us is that the results of the Comprehensive Assessment must be reliable, credible and of a high quality. This objective currently has priority. But at the same time we must prepare ourselves for the time that comes after and ask ourselves how we will handle the results, which are awaited with much excitement. I'll come back to that later.

Phase 1 of the current Asset Quality Review, the portfolio selection, has already been completed. We are now in the middle of Phase 2, the impairment tests, which are being carried out in Germany, as in other countries, by certified public accountants in cooperation with Deutsche Bundesbank und the Federal Financial Supervisory Authority (BaFin).

In order to shoulder the weight of the huge Asset Quality Review project, BaFin and the Deutsche Bundesbank have created an extensive infrastructure, as the ECB has also called for. Among other things, there are now the National Steering Committee (NSC), the Project Management Office (PMO) and the Quality Assurance & Technical Assistance Team (QA&TAT). We have also established a helpdesk function to manage the tide of queries from the banks and accountants. Weekly internal reporting is intended to ensure that any risks to the project are identified early and addressed effectively. The Quality Assurance Concept aids – as its name states – quality assurance of the AQR. In addition, ECB country teams are to support national supervisors. In practice, however, the work of these teams is limited to overseeing work at the national level, thus controlling the NCAs. Germany is bringing 24 banks

to the party and – unlike any other SSM-country – has its own country team. For that reason our impression may not be representative.

No matter how elaborate the infrastructure, in the case of the Asset Quality Review many obstacles still have to be overcome. The whole thing is like a hurdles race for which a highly ambitious time target has been set. We are all feeling the heat of the fixed deadline of 4 November. For that reason, many jobs are running in parallel that would in other circumstances tend to follow one another. Hold-ups in this complex structure, be they only data being delivered late for technical reasons or a question directed to the ECB helpdesk not being answered without delay, may throw the whole process out of kilter. But that is not an option – it promptly has to end. Therefore, pragmatism and good supervisory judgement are key.

The immense time pressure is a fundamental problem of the Comprehensive Assessment. What we have here is a case of credibility versus feasibility and definitively a high operating risk. On the one hand, the data must be of a high quality, in order to guarantee the credibility of the Review. On the other hand, because of the sheer volume of data required, in the short time available the data quality requirements are often too much to manage for both the banks and the supervisors and accountants involved. Some banks are complaining that their day-to-day business is suffering considerably and that the workload is completely overwhelming them. What is often at issue is how the templates in which the banks have to insert non-standardised data, or data that they do not hold for their own management or do not hold in this form, are designed. And this remains an issue despite the testing of these templates with banks and NCAs.

I therefore have some sympathy for the European Banking Federation (EBF), which is urging the ECB to reduce the data queries. In some cases BaFin and the Deutsche Bundesbank have also questioned the sense of data requests and have managed to persuade the ECB to simplify templates. This subject is bound to keep us busy during the months ahead as well. But I am sure that the ECB management will approach the matter in a careful and considered manner.

Something else that is susceptible to disruption is cooperation between home country and host country supervisory authorities. The need to consult and agree is great. Responsibilities must therefore be clearly defined and demarcated in order to prevent friction and time losses.

One particular problem is that some states outside the SSM expressed general reservations about the Asset Quality Reviews. For instance, in some countries outside the euro area there are legal restrictions that prevent the unencrypted transfer of borrower data to third parties. A solution had to be found, especially since in Germany certified public accountants are collaborating in the reviews as third parties. It took us a lot of hard negotiating and a lot of persuasion before a work-around was finally agreed with these countries. Naturally, such negotiations also tie up resources and may give rise to delays in the process. But national supervisors and the colleges have no legal leverage in the ECB to force, say, the Brazilian supervisory authority to transfer data.

There is *another* point which in our view has not been finally settled yet: the relationship of prevailing accounting standards and certain Asset Quality Review findings. This in the end will be a question of enforceability of any capital requirements resulting from the Comprehensive Assessment.

If the Asset Quality Review reveals deviations from the relevant accounting standards, then the banks must adjust their 2014 accounts accordingly. This has nothing to do, though, with the so called "adjusted CET 1 ratio", a mathematical variable which according to the ECB's ideas is meant to create a standardised and conservative basis for the stress test and to make the results comparable. For the time being, this adjusted CET 1 ratio is not to be taken into consideration in the banks' annual financial statements. In the calculation of the adjusted CET 1 ratio, there will be temporary restrictions on valuation options that exist under the current IFRS or national GAAP. The ECB describes this procedure as "lines in the sand", which hopefully does not mean "built on sand". The restrictions therefore apply solely to the Comprehensive Assessment and have no lasting influence on official accounting.

The ECB will, for example, use a so-called "challenger model" to calculate general loan loss provisions. If the value calculated by the ECB is more than 10% higher than that arrived at by the banks using their internal models, the causes will be sought. So far, so good. If there is no plausible explanation for the difference, the challenger model will be used in the Asset Quality Review in order to adjust the estimated loan losses. That also sounds quite reasonable and appropriate. However, a sense of proportion is called for here, since the challenger model uses only two dates (end-2012 and end-2013) for the calibration of the calculation parameters and is therefore inevitably less precise than internal bank models. In addition, adjustments to estimated loan losses based on the challenger model are also scheduled to be taken into account in the stress test. So they have a substantial knock-on effect.

There is therefore a danger of the Asset Quality Review departing from the accounting rules, even though it continues to use them as a basis. Although creating better comparability is the right way, if a capital shortfall were to arise in the stress test, the ECB's demand for additional capital to make good the shortfall would be based on these conservative and partly modelled values. So not only would the scope for discretion be de facto restricted at the accounting level, but also bank-specific valuation approaches would be replaced by model assumptions. The adjusted CET 1 ratio would have an impact on the banks' balance sheets by the back door. The banks might think of attacking the idea of setting aside more capital in this way. It remains to be seen whether the ECB draws its "lines in the sand" or whether a new "de facto standard" for regulatory accounting is created that is someday carved in stone. What I would like is clear consistent and conservative rules with a sense of proportion. The existing accounting framework including national implementation has to be respected and the entire endeavour has to be put on a firm legal footing.

Just a few more words on the stress test, ladies and gentlemen. As you know, on 29 April the European Banking Authority (EBA) published the methodology and macroeconomic scenarios for the 2014 bank stress test. With a common methodology, standardised scenarios and coordinated disclosure the EBA wants to ensure consistent and comparable results. As before: So far, so good. But I still see some points open to criticism with regard to the stress test as well. And: A few aspects of the methodology raise questions.

Such as the area of funding. In its Methodology Note the EBA does not aim to replace central bank refinancing universally by market funding. Rather, it calls for the ECB's longer-term refinancing operations (LTROs) to be replaced as they expire by the ECB's main refinancing operations (MROs). As you are aware, longer-term refinancing operations were intended to provide the banks with the liquidity they needed at the height of the crisis for security of planning purposes. These were, it was said, exceptional and temporary measures. I am not in favour of longer-term refinancing operations being replaced by other forms of central bank refinancing, since that would delay the return of the interbank market to pre-crisis mode. I would therefore be in favour of replacing any form of central bank refinancing by market funding in the baseline scenario. The ECB Council, on the other hand, envisages unlimited main refinancing operations up to 2015. On the basis of the stress test methodology, this also means some imbalance between those banks that are market-funded today and those that are still availing themselves of LTROs. The ECB will – that would be at least my expectation – have to address this in its evaluation of the results.

Another question that I am not the only one to be preoccupied by is: How can the results of the Asset Quality Review be used in the stress test? The bank balance sheets that are being examined in the Asset Quality Review are, as we know, going to be used as the basis for the stress test. However, for time reasons, both exercises are in part running alongside each other. How we might link the two is still the subject of intense discussion. At the centre lie two different approaches:

The *top-down join-up approach,* in which the banks first perform the stress test calculations on the basis of their annual financial statements as of 31 December 2013. The results of the Asset Quality Review are ignored. The ECB then adjusts the stress test results on the basis of standardised assumptions about the results of the Asset Quality Review. With this approach, the banks themselves are not directly involved nor can they re-run the results.

With the *bottom-up join-up approach* the banks are provided with the results of the Asset Quality Review for stress test purposes. The banks then re-work their calculations for certain parts of the stress test. Further top-down adjustments are not necessary.

At first, the ECB favoured a top-down join-up approach. As a compromise and a practical solution, a hybrid approach is now being pursued. This means the banks would be given the opportunity to take into account material partial results of the Asset Quality Review in the stress test. This procedural method is similar to the bottom-up approach. But the hybrid approach still contains elements that the ECB would be taking into account in the stress test on a top-down basis. We do not think much of this idea either, since with top-down adjustments there is always a risk that the banks will then question the results.

There is also another side to this issue: If the banks are told the results of the Asset Quality Review before the Comprehensive Assessment is completed – for example, for stress test purposes – the question of ad hoc disclosure requirements also needs to be addressed. It would be conceivable, for example, that a bank, when discussing its circumstances with the auditor, will draw conclusions about the results of the Review. But other reasons for this could be the findings in the Policies & Accounting Review Process or the results for the Data Integrity Validation. These are to be discussed with the banks shortly, in order to give them an early opportunity to express their views and so conduct quality assurance but also to prevent subsequent vulnerabilities. According to the ECB's proposals, national supervisors would organise data transfer in such a way that the banks are not exposed to the ad hoc disclosure requirement. It is unclear how that is supposed to be done. Merely stressing the "temporary nature of the results being communicated", as planned and desired by the ECB, may well not be enough. We are on the horns of something of a dilemma. EU legislation is in any event unambiguous and, as mentioned, gives the banks the final decision-making power and responsibility regarding its responsibility to go "ad hoc". Any piece of information that can be classified as "insider information" triggers an ad hoc disclosure requirement. It is up to the banks to assess whether an item of news has the potential to influence their shares prices. A bank could therefore see itself legally compelled to publish partial results of the Comprehensive Assessment before the scheduled publication in October. Neither the ECB nor national supervisors can prevent that. And since the ad hoc disclosure requirements of the Market Abuse Directive (2003/6/EC – MAD) apply in all Member States, this problem affects all banks quoted on the stock market that are undergoing the Comprehensive Assessment. However, not too much importance should be attached to this problem either. This supposed risk exists with any supervisory examination and with the auditing of the annual financial statements, too – it's just that the magnitude and possible domino effects are different in this case. In any case the risk of ad hoc publication cannot be used as an excuse not to discuss and confirm AQR findings appropriately with the banks. This would be short sighted and expose the Comprehensive Assessment to substantial risk.

Now I'd like to venture a brief look into the future. What are BaFin's expectations of the results of the Asset Quality Review for the German banks like? Cautiously optimistic. I do not believe that the review of the 24 German candidates involved will come up with any great surprise. Otherwise, we would have to seriously question present accounting practice and the work of certified public accountants to date – and naturally our own work as well. With all due self-criticism, we know of nothing to suggest that. And please keep in mind: The banks have done

their home work, too. They have raised capital and de-risked the balance sheets significantly over the last 3 to 4 years.

Our expectations of the results of the stress test are somewhat different. The baseline scenario should not throw up any major surprises here either. But it is at least conceivable that some banks will have problems withstanding the adverse stress scenario.

According to the ECB capital shortfalls identified in the Asset Quality Review and/or stress test baseline scenario are to be covered within six months. Capital shortfalls coming to light in the adverse scenario must be made good by the bank within nine months. For this purpose, as a matter of principle it must use capital instruments of the highest quality. Capital shortfalls identified in the Asset Quality Review or baseline scenarios may as a matter of principle be covered only by CET 1 capital instruments. Only in the adverse scenario AT 1 is eligible, too – subject to tight restrictions.

As far as making capital shortfalls good is concerned, although there is nothing automatic about it. The mere publication of the results will exert enormous pressure of expectations, which will, of course, also trigger a demand for the capital plans of the banks concerned to be implemented. Formally, of course, the banks are not obliged to increase their capital until notice to that effect has been received from the supervisory authority. In my opinion, it has to be the ECB, precisely the SSM that issues the appropriate administrative acts.

In late April 2014, the ECB announced how the banks concerned would have to meet the additional capital requirements. Basically, there are two options: the banks can generate more capital or they can reduce their risk-weighted assets. The ECB – so I expect – will lay down clear requirements. In general, a reduction on the basis of an internal mathematical model or a switch of further portfolios into internal modelling would, according to the ECB's current thinking, be permitted only if these changes were already planned and known to the respective national supervisory authority before the Comprehensive Assessment. That also makes sense, since otherwise the Comprehensive Assessment would not have the desired effect of making the banks "fit for the SSM". Please consider the criticism that "model optimisation" triggered after the 2011 stress test.

But it would also not be helpful if the banks were to run down debts overmuch, for that might trigger a credit squeeze. And that is precisely what the ECB wants to avoid with its monetary policy and what politicians want to avoid, too.

Indeed, considering the current market environment, I assume it is in the best interest of banks to anticipate any capital needs and to make every effort to raise the required capital up front. It is important that holes in banks' capital should be plugged first of all by private funds. Here, too, the ECB's thinking appears to be going in the same direction. If it is not possible to plug the holes with private funds, it is up to Member States to seek to ensure the recapitalisation of the banks before the ECB assumes the responsibility. And that, only if these banks still have a viable future. I therefore welcome the fact that the talks and negotiations in Brussels in the past few weeks have brought clarity: public funds are a last resort only and they come into play only after bail-in of equity and junior debt.

To round things off, the question that still remains open then, of course, is how to deal with banks which fail the Comprehensive Assessment and of which the owners, the capital markets and supervisors think no longer have a viable business model. Should the Comprehensive Assessment be used to bring about a market shakeout before the start of the SSM? When exactly is a business model no longer viable, especially in the case of bigger universal banks that have several main pillars? Questions that are difficult to answer, but questions on which potentially answers need to be found.

Last but not least, I'd like to point out that we need to have national resolution schemes and powers in all SSM countries as soon as possible in order to be prepared for any scenario.

Ladies and gentlemen, for all of us – the NCAs, the ECB, the banks and the broader public – the Comprehensive Assessment is a great opportunity and at the same time a great challenge. I have highlighted a few critical issues here, which we must all work together to resolve. What I would like to see is a deep and fruitful discussion with our colleagues at the ECB and the national supervisory authorities and in fact this is taking place already within the Supervisory Board of the SSM. Together, we will succeed in smoothing the way into the SSM and reaping the fruits of our current efforts.

Danièle Nouy

Chair of the Supervisory Board of the Single Supervisory Mechanism

Toward the European Banking Union: Achievements and Challenges

Europe has made significant achievements over the past five years. Since the start of the crisis in 2008, we have come a long way and the political will of the actors has been strong enough to defend the integrity of the euro area, which, in terms of economic fundamentals and institutional set-up, is today on a sounder footing than before. Also, the regulatory landscape has been revised substantially. We have taken major steps forward, the banking union being one of them.

Nonetheless, some challenges still lie ahead. The first and most immediate one is to rebuild confidence in euro area banks. To this end, the comprehensive assessment conducted by the ECB and the national competent authorities (NCAs) will play a key role. The goal of the comprehensive assessment is to foster transparency of banks' balance sheets, to repair them where needed and, consequently, to foster confidence in the banks, thereby unlocking a needed revival of credit to the euro area economy.

The comprehensive assessment is based on two important pillars: an asset quality review (AQR) and a stress test. The AQR covers EUR 3.72 trillion of risk-weighted assets (RWA), representing 58% of total credit RWA in the scope of the exercise and involving some 135,000 credit files. The stress test will provide a forward-looking view of banks' shock absorption under stress. The results of these closely interlinked elements will be published in October 2014. The SSM is now proceeding with the actual execution of the AQR (Phase 2), which will be completed by the end of July 2014. Regarding the stress test, the ECB is closely cooperating with the European Banking Authority (EBA). The capital thresholds for the baseline and adverse scenarios are 8% and 5.5% Common Equity Tier 1 respectively. The end result will be more demanding than in previous exercises. Banks will be given six to nine months to address possible capital shortfalls.

The second immediate challenge is to complete the SSM preparatory work before assuming supervisory responsibilities on 4 November. Much work has been done and several milestones have been reached, most recently the Framework Regulation that lays down the rules ensuring the smooth functioning of the SSM. At the same time, good progress is being made in finalising our supervisory model and recruiting supervisors in time. We have received over 8,000 applications and we are hiring the best of the best.

Long- term challenges are also being dealt with. The goals are to perform supervision with a truly European view, to ensure the effectiveness of the Supervisory Board, to foster convergence of supervisory practices and to integrate local supervisory best practices to the benefit of all SSM members.

The banking union is testimony to what Europe can achieve when it sets its mind to it, and by working together the ECB and the NCAs can meet their remaining challenges.

Ladies and gentlemen,
Thank you for inviting me here to this conference.

The topic of this session – *Toward a European Banking Union: Transitional Issues* – is well chosen at this point in time. We stand today in a transitional (and very busy) period, before the historical moment when the European Union will for the first time have a single European supervisor – the Single Supervisory Mechanism (SSM) – for the banks in the euro area and in any other Member State that wishes to join. As Chair of the Supervisory Board of the SSM, it is my pleasure to explain what we are trying to achieve.

Today, Vîtor Constâncio has already elaborated on banking union, with a focus on the Single Resolution Mechanism and on financial integration.

I would like to concentrate on two other aspects.

First, I will briefly remind you of Europe's significant achievements over the past five years. I believe this will put into perspective how far we have come in such a relatively short time.

As Chair of the SSM Supervisory Board, my goal is for the SSM to be a robust and effective supervisor, contributing to the safety and soundness of banks in the SSM area. Such an SSM will support financial integration, financial stability and economic growth. In order to achieve this goal, the SSM will need to overcome some challenges.

Second, I will take a forward-looking view and discuss the challenges that remain for the SSM.

Our Achievements

Since the start of the crisis in 2008, we have come a long way forward in a relatively short time. Indeed, the political will of all actors involved since the start of the crisis has been strong enough to defend the integrity of the euro area. Many had underestimated this will.

Remember that barely two years ago, at the peak of the crisis, there were fears about a break-up of the euro area and markets were pricing in this risk.

Today, however, the euro area is – in terms of economic fundamentals and institutional set-up – on a sounder footing than before.

In the public sector, gradual and continuous deleveraging has taken hold. The euro area has the lowest budget deficits and debt levels of the large advanced economies in the world. Moreover, the divergence within the euro area has been reduced.

As regards institutional set-up, we have taken major steps forward. We now have a stronger Stability and Growth Pact and the so-called fiscal compact. The Macroeconomic Imbalances Procedure (MIP) was introduced to enable macroeconomic imbalances to be identified and corrected at an earlier stage. We improved the effectiveness of European crisis management with the agreement on the European Financial Stability Facility and the European Stability Mechanism. We have established the European Supervisory Authorities (EBA, ESMA, EIOPA) as well as the European Systemic Risk Board (ESRB). Last but not least, we are of course working hard on the implementation of banking union. I will come back to this topic shortly when I look ahead.

In addition to the complete overhaul of the institutional set-up, the regulatory landscape has also been revised substantially.

Basel III and the Capital Requirements Regulation and Directive (CRR/CRD IV), which implement Basel III in Europe, introduced new requirements on the level and quality of capital, new rules on liquidity and leverage and instruments for macroprudential supervision. In December last year, political agreement was reached on the Bank Recovery and Resolution Directive (BRRD) and the recast Deposit Guarantee Systems Directive (DGSD). Both these directives will ensure a harmonised framework across the EU for resolution and deposit guarantees and are a prerequisite for the Single Resolution Mechanism.

Although we have come a long way forward in a short period of time, we are not there yet.

Let me therefore turn to the challenges that lie ahead. I will first discuss the challenges facing the SSM in the short term, before looking at the longer term.

The Challenges Ahead – Short Term

Our first and more immediate challenge is to help rebuild confidence in the balance sheet of SSM area banks. To this end, we are performing a comprehensive assessment. And by “we” I mean all of us together: staff from the ECB and from national competent authorities (NCAs) such as the OeNB and the Austrian Financial Market Authority.

As the comprehensive assessment is an essential element of the preparations for the SSM, please allow me to go into it in detail and explain the latest state of play.

The goal of the comprehensive assessment is threefold. First, to foster transparency of banks' balance sheets. Second, to repair balance sheets, where needed, by identifying and implementing necessary corrective measures. Third, to consequently foster confidence in the banks, thereby unlocking a needed revival of credit to the euro area economy.

The comprehensive assessment is built on two important pillars:

The first is an asset quality review (AQR), during which we review the quality of a banks' assets as per 31 December 2013. The assessment will be based on a capital benchmark of 8% Common Equity Tier 1.

To illustrate the scope and the comprehensiveness of the AQR, let me recall some figures. A total of around 760 banking book portfolios have been selected from the 128 banks in scope for a detailed examination. The AQR covers EUR 3.72 trillion of risk-weighted assets (RWA), representing 58% of the total credit RWA of all banks in the scope of the exercise. The examination will involve the review of approximately 135,000 credit files. In total, more than 6.000 supervisors, external auditing staff, consultants and independent specialist appraisers are working on the AQR. Quite impressive figures in my opinion!

The second pillar is a stress test, aimed at examining the resilience of banks' balance sheets to stress scenarios. The stress test will provide a forward-looking view of banks' shock-absorption capacity under stress. This exercise will follow the approach agreed with the EBA.

These elements are closely interlinked and will ensure a rigorous, independent and centralised comprehensive assessment. The results will be published in October 2014, shortly before the SSM is due to assume its operational responsibility.

Let me now turn to the state of play regarding the asset quality review.

Phase 1, the selection of asset portfolios to be reviewed for the asset quality review, has been completed.

We are currently in Phase 2, which is the actual execution of the AQR. It includes data integrity validation, sampling, on-site review of files, collateral valuation and recalculation of provisions and risk-weighted assets.

The AQR is all about transparency. In this spirit, the ECB published the AQR Phase 2 manual on 11 March 2014. The full details of the different building blocks of the AQR are now available online for everyone to see. As the manual runs to around 280 pages, we held conferences with NCAs and auditors to fully explain the methodology and templates. By providing full disclosure of the AQR methodology, the ECB has further increased the credibility of the exercise and shown its rigour.

Phase 2 of the AQR is now well under way and will be completed by the end of July 2014, when the results of the AQR will feed into the stress test.

All in all, we are on track for the AQR. Disclosure of the results (together with the stress test results) is planned for October 2014.

As regards the stress test, the ECB is cooperating closely with the European Banking Authority (EBA).

The EBA published the stress test methodology and the scenarios on 29 April 2014. While the extensive process of banks' balance sheet repair is already under way, the stress test, designed to assess banks' resilience to hypothetical external shocks, will identify remaining vulnerabilities in the EU banking sector and will provide a high level of transparency on EU banks' exposures. The capital thresholds for the baseline and adverse scenarios will be 8% and 5.5% Common Equity Tier 1, respectively.

The common methodology and underlying assumptions cover a wide range of risks including credit and market risks, exposures towards securitisation, sovereign and funding risks. To ensure consistency, the methodology is restrictive and rests on a number of key constraints. These include a static balance sheet assumption during the stress test horizon of three years, which precludes any defensive actions by banks. The methodology defines prescribed approaches to market risk and securitisation, and a series of caps and floors on net interest income, risk-weighted assets and net trading income. Other key components of the methodology are a sovereign shock that impacts banks' entire balance sheets, including exposures held in the available-for-sale portfolio via the internationally agreed gradual phase-out of prudential filters, and a shock to banks' funding costs that pass through to the asset and liability side in a conservative asymmetric fashion.

The adverse scenario, designed by the ESRB, reflects the systemic risks that are currently assessed as the most pertinent threats to the stability of the EU banking sector. Allow me to highlight four particular risks that demonstrate the severity of the stress test.

First, an increase in global bond yields amplified by an abrupt reversal in risk assessment, especially towards emerging market economies; second, a further deterioration of credit quality in countries with feeble demand; third, a stalling of policy reforms jeopardising confidence in the sustainability of public finances; and fourth, the lack of necessary bank balance sheet repair to maintain affordable market funding.

The stress test for the banks subject to the comprehensive assessment will incorporate the results from the AQR. Banks with a capital shortfall arising from either the baseline or adverse scenario relative to agreed benchmarks or identified in the AQR will be required to strengthen their capital buffers. The end result will hence be more demanding than in previous exercises.

Banks will be expected to raise capital to cover a capital shortfall arising from the AQR or baseline scenario within six months. For capital shortfalls arising from the adverse scenario, banks will have nine months to raise capital, on the basis of an agreed capital plan, so long as regulatory minima are respected. The periods of six or nine months will start from the release of the comprehensive assessment results in October 2014.

The bank's capital plans should show that they will first draw on private sources of funding to strengthen their capital positions so as to meet the required targets, including retained earnings, reduced bonus payments, new issuances of common equity, suitably strong contingent capital, and sales of selected assets at market prices or reductions of RWAs associated with restructuring plans agreed with the European Commission.

Recapitalisation measures to cover any shortfalls detected should rely on capital instruments of the highest quality, unless the shortfalls are reduced through other means. Shortfalls revealed by the AQR and the baseline stress test scenario may only be covered by Common Equity Tier 1 (CET1) capital instruments. The use of Additional Tier 1 (AT1) capital instruments to cover shortfalls arising from the adverse stress test scenario is limited, and depends on the trigger point of conversion or write-down.

Helping rebuild confidence in the SSM banks' balance sheets is not the only short-term challenge. *The second challenge is to complete the SSM preparatory work before assuming supervisory responsibilities on 4 November 2014.* Much work has already been done to ensure we will be ready.

The latest milestone we reached in this respect is the finalisation and publication of the SSM Framework Regulation on 25 April. The purpose of the Framework Regulation is to lay down the main rules which will ensure the smooth functioning of the SSM. In this context, it sets out the procedures governing the cooperation between the ECB and NCAs and the methodology for the assessment of the significance of institutions.

Much remains to be done, however. Let me mention two major milestones ahead.

First, we need to finalise our supervisory model. Our supervisory model is reflected in the draft Supervisory Manual of the SSM. The manual covers issues such as the methodology for the Supervisory Review and Evaluation Process (SREP), off-site and on-site reviews, risk assessments and model validations. Through the supervisory manual we will ensure that the same supervisory standards will be applied across banking union – and indeed, through harmonisation with the European Banking Authority, across the EU as a whole. The Supervisory Manual is an internal SSM staff document, but we intend to derive a public version from it, entitled *"Guide to supervisory practices and methodologies in the SSM"*.

Second and not least, we need to recruit supervisors. Many of them, in fact – approximately 800. We are also progressing well on this front. Most of the recruiting campaigns should be concluded before the summer break and the remaining ones soon after. We need the best of the best and our call for applications has been very successful so far. We have received over 8,000 SSM-specific applications, so there is no scarcity of talent from which to choose.

Successful applicants will have the opportunity to help build the SSM and to work in a challenging new environment. Austrian applicants will bring their own expertise and best practices to the SSM. This will be of benefit to all of us – the SSM, the OeNB and Austrian Financial Market Authority, and the Austrian and European financial sector.

Challenges Ahead – Long-Term

Our first long-term challenge is to perform supervision from a truly European perspective

Supervisors at the ECB will come from diverse backgrounds. But we are all "European" when we supervise a bank. The supervisory culture within the SSM should be European rather than national. With this objective in mind, the SSM Regulation contains provisions regarding independence. Supervisory Board members should act in the interest of the EU as a whole and not in their national interests. Similarly, the ECB has introduced Joint Supervisory Teams (JSTs), which will be responsible for the operational supervision of significant banks and will consist of supervisors from different countries. This will allow us to incorporate the existing local expertise at a central level, while at the same time ensuring a European view when supervising individual banks.

Second, we need to ensure that the Supervisory Board is effective

You will know that the Supervisory Board consists mainly of a large group of supervisors from the SSM area who act in the interest of the EU as a whole. And in the future, non-euro area Member States may also join the SSM. The governance structure of the SSM is therefore carefully designed, with a Supervisory Board which interacts with the ECB Governing Council.

National competent authorities (NCAs) will present this governance structure with multiple issues for decision and action, especially in times of stress. Decisions relating to supervision may considerably outnumber those relating to monetary policy.

I am very ambitious to meet this long-term challenge. I want to make the SSM function as a European institution, taking European decisions. I believe our accountability towards the European Parliament – the champion of European decision-making – will be helpful in this regard.

The third long-term challenge is to bring about a convergence of supervisory practices and approaches

Ideally, we would have fully harmonised EU regulations – there are still too many national options in CRD IV, meaning that the EU capital requirements regime may differ across Member States on a number of points. That is why I fully support the development of the single rulebook for the EU.

The SSM's Supervisory Manual I referred to earlier will be embedded in this single rulebook. It is my aspiration to make the SSM a benchmark for supervisors worldwide. This manual is therefore being developed on the basis of the best supervisory practices and processes of supervisors from the SSM Member States.

But ultimately, the Supervisory Manual must be more than words on a page. It needs to be implemented in all SSM countries to foster the necessary convergence of supervisory practices and we will make sure that happens. The manual will be subject to a continuous review process against internal evaluations, internationally accepted benchmarks and international regulatory developments.

Finally, I wish to mention *the long-term challenge relating to local supervisory best practices*. The SSM needs to integrate local supervision best practices to the benefit of all SSM members. As the SSM aspires to be a single best practice framework, we need to ensure that it fully incorporates the expertise of national supervisors in order to enhance the quality of supervision for the SSM area as a whole. We can all learn from each other, and local supervisory best practices should not be discarded *accidentally or unintentionally*.

I think we can learn from the strong role played by Austrian supervisors in assessing and mitigating risks stemming from Austrian banks granting foreign exchange loans to households. I understand that the end result was a restriction on issuing foreign exchange loans to retail customers. The SSM could draw on this experience when it comes to addressing unsustainable business models.

Conclusion

To conclude, let me take you back to 2009. To Wednesday 25 February 2009 to be exact, the day of publication of the "de Larosière Report", advocating the creation of a European System of Financial Supervision (ESFS) and a common framework for bank resolution. If de Larosière had then suggested having a *single* European supervisor and *single* European resolution authority – rather than the decentralised network of the ESFS he proposed in his report – the almost universal reaction would probably have been, "That is not realistic."

Five years after de Larosière and less than two years after Europe committed to building a genuine banking union, this is where we stand!

Europe has delivered on its banking union promise. For those that criticise Europe for being slow in taking decisions, I think this is testimony to what Europe can achieve when it sets its mind to it.

I am therefore confident that – together – we can meet our remaining challenges and leave the transitional issues of banking union behind us. And I look forward to working with you – the OeNB and the Austrian Financial Market Authority in particular – when supervising the SSM area.

Thank you!

Klaus Liebscher Award

10th Klaus Liebscher Award for Scientific Work on European Monetary Union and Integration Issues by Young Economists from EU and EU Candidate Countries

On the occasion of the 65th birthday of Governor Klaus Liebscher and in recognition of his commitment to Austria's participation in European Monetary Union and to the cause of European integration, the Oesterreichische Nationalbank (OeNB) established in 2005 the *Klaus Liebscher Award*. This award is the highest scientific distinction, the OeNB offers every year for up to two excellent papers on European monetary union and European integration issues written by young economists (up to 35 years) from EU member or EU candidate countries. The award is worth EUR 10,000 per paper. The papers are refereed by a panel of highly qualified reviewers. The Klaus Liebscher Award is granted for the 10th time this year.

The winners of 2014 are *Saleem Abubakr Bahaj*, University of Cambridge for his paper *Systemic Sovereign Risk: Macroeconomic Implications in the Euro Area* and *Claudia Steinwender*, London School of Economics for her paper *Information Frictions and the Law of One Price: When the States and the Kingdom Became United*.

In his paper *Systemic Sovereign Risk: Macroeconomic Implications in the Euro Area*, Saleem Abubakr Bahaj analyzes a question, which was intensively debated during the European Sovereign Debt crises: Are rising risk premia for sovereign borrowing the market's correct refelction of underlying macroeconomic weaknesses of countries and a forward looking signal for anticipated hikes in public debt? Or is there a causality going the other way: A rise in sovereign risk premia for reasons unrelated to a country's macroeconomic situation induces an economic downturn and as a result leads to a deterorating state of public finances of a country, feeding a doom loop of a mutually reinforcing rise in risk premia and a hike in public debt. Constructing a new dataset which uses newswire data for Irland, Italy, Portugal, Spain, Cyprus and Greece and combining them with financial market data the author is able to disentangle these different views empirically. The results show a nuanced picture with both effects at work. However the variation in risk premia explained by factors unrelated to local macroeconomic conditions is high. Up to 60% of the trough to peak movement in a countries borrowing costs seems to be due to systemic reasons not directly related to the local macroeconomic conditions.

In her paper *Information Frictions and the Law of One Price: When the States and the Kingdom Became United*, Claudia Steinwender looks into an old debate in international trade. For long trade theorists have hyothesized that international competitive trade of goods should lead to an allocation where the prices of identical goods in different locations will differ by no more than the transport costs of shipping them between places. Empirically this hypothesis often does not hold and there is an open debate what are the reasons for this fact. Empirically direct trade barriers have found not to be very important. Since then the literature has shifted its attention to information problems as a possible explanation. But this is a concept that has so far turned out to be elusive and difficult to measure. Claudia Steinwender has found an original and innovative way to pin down the information frictions debate by building and exploiting a historical data set from a unique historic episode: The building of the first transatlantic telegraph connection between the United Kindom and the United States during the 19th century. This cable reduced information transmisssion time across the Atlantic from 15 to 1 day. Using the price of cotton as her object of study, Claudia Steinwender finds conclusive evidence that the abolishment of information barriers indeed lead to cotton prices that show on average the properties competitive trade theory would predict. The benefits for consumers and producers are estimated to be significant and on an order of magnitude of 8% of the annual export value of American cotton. The methods developed in the paper that allow to calculate these welfare gains could in principle be used to assess the social benefits of new information technologies that allow a swift global distribution and accessability of information.

Session 2

The European Banking Union in a Global Context

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The European Banking Union in a Global Context

European banking union has been hailed as the most important step of EU integration since the formation of European Economic and Monetary Union. It forms part of the post-crisis trend towards (i) international re-regulation of the financial system, (ii) closer international supervisory cooperation, in order to better cope with systemically relevant, globally active financial firms, (iii) an institutional overhaul of financial supervision worldwide, and (iv) the European Union's crisis-triggered strengthening of economic and financial governance.

As other types of integration, its economic effects cannot be expected to be limited to the countries forming part of the integration area; substantial "side effects" may be expected for the rest of the world.

At a first level, the question arises whether effects akin to trade creation versus trade diversion might happen. In other words, to what extent will the stabilisation and strengthening of the euro area economy resulting from the banking union create positive effects for financial firms outside the banking union; and to what extent might the expected continuation of a deepening of financial integration among participating countries „deflect" business to financial firms from within the banking union.

Which circle of countries should form a banking union? For the European banking union, this question was decided pragmatically in the sense that euro area countries will take part, non-euro area EU Member States may opt in, while other countries are excluded. This solution seems to make sense in many respects. The euro area indeed implies and requires deep financial integration and the formation of the banking union was a strong signal of political will towards deeper integration. But the decision was not primarily based on economic grounds, let alone on an economic theory.

Does the European banking union constitute an „optimal banking union" or "optimal regulatory and supervisory area"? While for currency unions there is a widely known theory and large literature on "optimal currency areas", hardly any research exists on banking or regulatory unions. Dell'Ariccia explains in this volume a theoretical framework to evaluate this question, based on regulators' incentives, including regulatory capture, and on externalities from regulation. He concludes that the benefit from regulation is the internalisation of externalities which characterize regimes with nationally separate regulators. By contrast, the costs of centralized, "one size fits all" regulation become bigger for countries whose banking, financial markets and real economy structures differ substantially. Thus, countries with higher financial integration and similar regulatory needs are likely to benefit more from a banking union. This result would advise to base a decision on banking union membership on financial integration and structure. This

analysis neglects, however, aspects of crisis management, the breaking of sovereign-bank vicious circles, problems of suboptimal ring-fencing and lack of cross-border coordination in banking resolution – all these problems can be tackled by a banking union.

What are the economic consequences for ”outsiders“ of the European banking union? As Benediktsdóttir in this volume points out, there are different degrees of „outside-ness“: non-euro area EU Member States (who may opt into the banking union), European Economic Area (EEA) countries (bound by the single rulebook but having no option to become part of the banking union), and the non-EU/EEA rest of the world. Particularly, internationally active banks covered by the European banking union may expect to reap a number of benefits: reduced compliance costs due to a single supervisor, a “seal of approval“ by a strict, credible central supervisor, and resulting better ratings and lower refinancing costs. This may also create pressure for regulators outside the banking union to regard rules and procedures in the banking union as a “benchmark“ for their own rules and practices.

Furthermore, the banking union dramatically increases the size of the “backing“ supervisor, central bank and fiscal authority, creating a much more generous reference point to judge when a bank becomes „too big to fail“. All these aspects may potentially put banks operating from outside the banking union at a competitive disadvantage. Furthermore, during times of crisis, the stability generated by the banking union may result in the euro area becoming a safe haven, with several more or less welcome implications (interest rates, exchange rate, credit etc.).

The banking union may also increase the international perception of the euro area as one single entity, potentially strengthening its clout in international negotiations on regulatory, supervisory and monetary matters.

But there are also arguments that argue against non-euro area EU Member States opting into the banking union. The positive externality, in terms of higher stability for the global financial system generated by the banking union, may reduce the incentive for further countries to join, because this benefit is reaped also without their participation. At the same time, the costs of less „elasticity“ to accommodate national institutional and structural specificities and of less „regulatory and supervisory lenience“ to support the profitability and global competitive position of domestic banks or an entire financial centre can be avoided by staying outside the European banking union. Finally, for countries (such as the U.K.) whose banks have their main links with other parts of the world outside the banking union, it may indeed be economically more optimal not to join.

All these issues are elaborated in more detail in the following two contributions in this volume by Dell'Ariccia and Benediktsdóttir. Similarly to EMU, also European banking union is a bold historical experiment. Experience with its practical implementation will likely evolve over time, and so will its implications for, and the resulting reactions by financial firms, regulators and supervisors, in the rest of the world.

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European Banking Union: Will Outsiders Be Affected?

European Banking Union

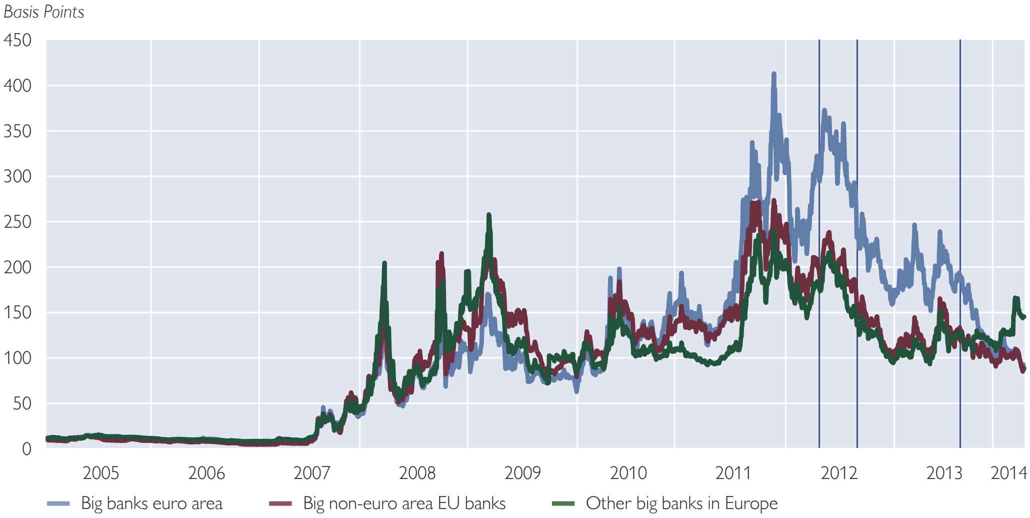
In the run-up to the financial crisis in 2007 European banks increased their cross-boarder linkages both through the creation of banking groups that spanned a number of countries and through increased reliance on financing in international financial markets. Stefan Ingves (2006) elaborated on the potential challenges associated with these developments and concluded that "the present situation with a growth of cross-border banks […] combined with national responsibility for supervision and financial stability is not satisfactory. If we are hit by a critical crisis in one or more of the major financial institutions today, the regulatory and supervisory framework is not sufficient." Stefan Ingves went further and proposed as one of potential pan-European solutions that the mandate and responsibility for supervision of cross-boarder banks would be transferred from the national level to the EU level. "This would imply the creation of a European Financial Services Authority (FSA), as well as granting the European Central Bank (ECB) a role as a lender of last resort for cross-border banks." (Ingves, 2006).

In the midst of the European sovereign debt crisis, the idea of a pan-European banking union gained momentum. In the spring of 2012, the European Commission called for the banking union, followed by a euro area summit statement. In the fall of 2012 the European Commission presented legislative proposals, with the stated objectives of breaking the linkages between Member States and their banks, increasing the credibility of the financial sector and to preserve taxpayers' money (European Commission, press release 10 September, 2012). At the time increasing the credibility of the financial sector of the peripheral euro area countries was pivotal as the capital flow out of those economies was heavy. As can be seen in chart 1 the Credit Default Swaps (CDS) spreads for all European banks declined in the summer and fall of 2012, while the spread between the CDS on euro area banks and non-euro area EU banks or other big banks in Europe did not start to decline notably until after the European Commission's press release in September. The spread between the CDS on euro area banks and non-euro area EU banks then disappears following the announcement that the European Parliament had adopted the European Commission proposal in September 2013. This co-integration in the CDS spreads on euro area banks and other European banks indicates that the commitment to establishing a banking union has in fact increased the credibility of banks in the euro area.

The banking union is defined as based on four pillars: a single regulatory framework for financial institutions, a Single Supervisory Mechanism (SSM), a harmonized system of deposit guarantee schemes, and a Single Resolution Mechanism (SRM). In March

Chart 1

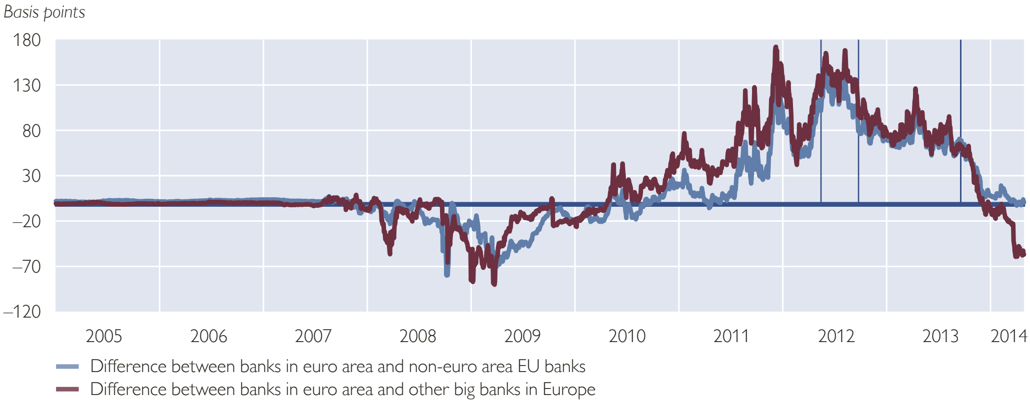
CDS Spreads – European Banks



Source: Bloomberg.

Chart 2

Difference betweeen CDS Groups – European Banks



Source: Bloomberg.

2013[2] an agreement was reached on the SSM and in March 2014[3] an agreement was made on the SRM, while there remain differences of views on the modalities of the harmonized system of deposit guarantee schemes.

Theoretically the banking union has been proposed as a solution to the financial trilemma which had been highlighted during the financial turmoil (Hakkarainen, 2013). The trilemma refers to the mutual unattainability of financial stability, financial integration and national financial policy independence. Schoenmaker (2011) showed in a simple model of cross-border bank failures that financial stability and national financial policies were compati-

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[2] *http://europa.eu/rapid/press-release_MEMO-13-251_en.htm?locale=en, retrieved on 21 July, 2014.*

[3] *http://ec.europa.eu/internal_market/finances/banking-union/single-resolution-mechanism/index_en.htm, retrieved on July 21, 2014.*

Table 1

Cross-Border Foreign Bank Claims

% of reporting country's GDP

Q4 10		Counterparty										
		DE	FR	IT	ES	UK	CH	PT	IE	GR	US	JP
Reporting country	DE		11.0	5.6	8.4	17.9	2.4	1.8	3.2	0.3	12.6	1.9
	FR	14.2	×	6.2	5.7	21.4	2.6	0.9	1.2	0.3	16.4	5.1
	IT	10.1	4.3	×	1.5	3.4	0.7	0.3	0.4	0.0	1.4	0.1
	ES	0.9	2.1	0.7	×	13.8	0.8	1.6	0.3	0.0	4.6	0.3
	UK	11.1	21.2	1.4	3.3	×	2.5	0.3	2.9	0.4	24.3	8.5

Q4 13		Counterparty										
		DE	FR	IT	ES	UK	CH	PT	IE	GR	US	JP
Reporting country	DE		8.3	2.7	4.6	13.6	1.4	0.3	1.0	0.6	6.8	0.5
	FR	5.7	×	5.3	4.5	17.6	1.2	0.6	1.8	0.0	5.4	4.8
	IT	7.1	3.2	×	1.3	3.4	0.3	0.0	0.2	0.2	1.6	0.1
	ES	0.9	4.5	0.9	×	6.8	0.3	1.2	0.3	0.0	4.2	0.3
	UK	5.5	12.1	0.5	4.1	×	1.8	0.3	1.1	1.4	11.6	5.8

>15
10–15
5–10
2.5–5
<2.5

Source: BIS, Macrobond and staff calculations.

ble only if financial integration was limited. Given the high level of financial integration in Europe he concluded that the EU had two options to solve the trilemma. The first option is to reverse the current level of financial integration, i.e. reinforcing local control by ring-fencing the cross-border operations of financial institutions, and requiring systemically important banks headquartered in other countries to operate through locally incorporated subsidiaries rather than branches. This has occurred to a certain extent during the European sovereign debt crisis as can be seen in table 1. Cross-border foreign bank claims declined substantially between 2010 and 2013 in part due to attempts by local authorities and banks to preserve financial stability at the national level instead of the pan-European level. The second option is moving financial regulation, supervision and responsibility for financial stability to the European level. Hakkarainen (2013) suggests along similar lines that there are three options: renationalizing the financial markets (losing the single markets, single currency and single monetary policy), accepting the risk of financial instability, or creating a banking union with single supervision and resolution.

The idea of the financial trilemma is akin to the much discussed monetary policy trilemma which states that with free capital mobility it is impossible to conduct independent monetary policy, unless the currency floats. Aizenman, Chinn and Ito (2010) revalued the importance of the monetary trilemma in light of the recent financial crisis. They concluded that the choice of which two of the three goals were adopted was directly related to the macroeconomic goals that had been selected. More recently Rey (2013) showed that the global financial cycle, which depends on the monetary policy in the center country, did constrain national monetary policies regardless of whether exchange rates floated or were fixed. She concluded that the global financial cycle had in fact converted the trilemma into a dilemma, where independent monetary policies have to rely on managing the capital account. In light of developments following the financial crisis it appears to be likely that the impacts of the global financial cycle are no less important for financial stability regulations than for the conduct of monetary policy.

The question to ask then is whether it is clear that a banking union is the right solution to the financial trilemma for Europe. Could the benefits of securing financial stability under national financial policies outweigh the benefits of striving for an ever more integrated cross-border financial market? Theory has not been developed sufficiently to answer the question concerning the trade-off between these choices. More importantly for the topic addressed here, the question about who should participate in a banking union has not been answered. Should a banking union be limited to countries in a currency union with unified monetary policy, or should countries rather participate based on financial integration, irrespective of a currency union? Further, how much financial integration would make a banking union beneficial or potentially necessary?

The economic literature indicates that efficient currency unions are limited to countries that have high factor mobility and adhere to similar economic fluctuations (Mundell, 1961 and 1973). For free trade agreements the literature indicates that such agreements are most beneficial to "natural trading partners" (Krugman, 1991). Hence a trading union may be highly beneficial between countries which are far apart geographically with dissimilar economies with the exception of their connections through trade. Economic research concerning these two kinds of economic integration agreements is vast and spans decades, while research on optimal banking unions is in its early stages and somewhat lacking.

The European Commission has decided that the European banking union should include euro area countries plus non-euro area EU Member States that opt into the cooperation. Other countries will then remain outside. Elliott (2012) agrees with this decision, arguing that other options may be politically impossible. That argument is however not backed by economic research.

Outside or Inside

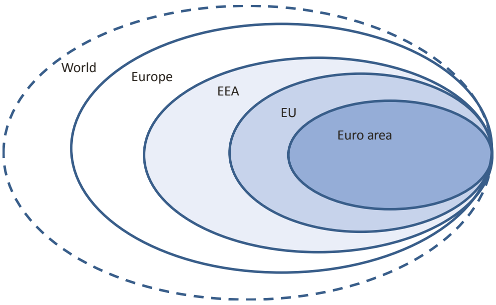
For the banking union there are levels of "outsidedness", both in respect of the euro area vs. the EU vs. EEA. vs. rest of Europe vs. others. Non-euro area EU Member States have the option of joining the banking union while EEA countries are obligated to adopt the common rulebook while they do not have the option of joining the banking union. Other countries stand completely outside.

Non-Euro Area EU Member States

There are ten non-euro area EU Member States and they make up about 26.6% of the gross domestic product of the EU. The so-called "outs" have the

Chart 3

Multinational Banks Operate Subsidiaries and Branches Not Only Cross-Borders within the EU



Source: Central Bank of Iceland.

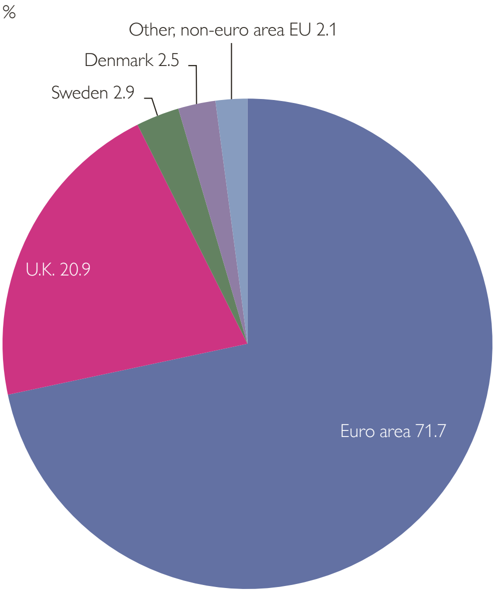
option to participate in the banking union through a close cooperation agreement. They are however required to implement the common rulebook, and in an effort, called for especially by the UK, to protect their interest the voting rules for decision making in EBA will be strengthened to require a double majority. That is a simple majority amongst banking union member states and a simple majority among those EU Member States that opt to stand outside the banking union.[4]

The banking union offers risk sharing, especially once the common safety nets with backstops are in place, and the aim is to ensure least-cost bank resolution. It will most likely reduce compliance costs for cross-border banks and eliminating home-host coordination issues. The quality of supervision may also improve. But there may also be costs and complications associated with opting to join the banking union. Those potentially include loss of sovereignty and less flexibility in dealing with domestic problems with micro- or macroprudential policies (Goyal et al., 2013). Additionally it is not even certain that a banking union which includes explicit and implicit safety nets and deposit insurance is even advisable in the absence of a currency union. The literature is unfortunately scarce concerning that as Giovanni Dell'Ariccia pointed out in his presentation at the 42nd Economics Conference in Vienna in 2014.

Among the non-euro area EU Member States the UK is the largest and it is home to the largest banking sector in the EU. The UK has decided not to participate in the banking union, leaving out over one fifth of all monetary and financial institutions in the EU. Given the size of the UK's financial sector, the establishment of the banking union is likely to have more extensive ramifications for the UK than for many other non-euro area EU Member States. At the same time the five largest banks in the UK have more assets outside the EU than within the EU excluding the UK. That

Chart 4

Balance Sheet of MFIs in the EU in 2013



Source: Bankscope.

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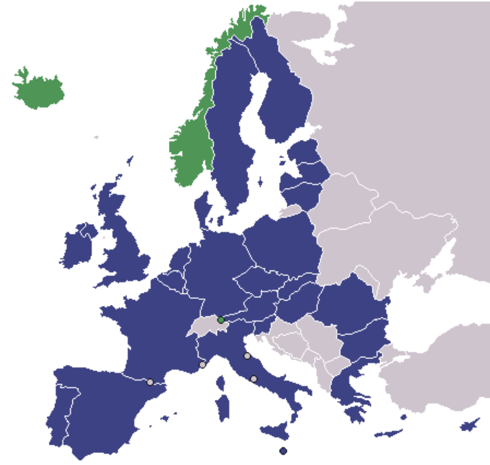
[4] European Commission 19 March 2013, press release http://europa.eu/rapid/press-release_MEMO-13-251_en.htm, retrieved on 21 July, 2014.

would indicate that financial integration with the rest of the world is higher than with the other EU Member States, potentially supporting the argument for the UK not joining the banking union (Schoenmaker and Siegmann, 2013).

It remains to be seen what other non-euro area EU Member States decide concerning banking union membership. It is likely that the non-euro area EU Member States en route to becoming euro countries will opt to participate in the banking union while other countries may decide by weighing the above-mentioned potential costs and benefits. Some may opt to stay outside, especially to begin with, as the UK has done.[5]

Chart 5

Member Countries of the EEA Agreement



Source: EFTA.

EEA Countries

The European Economic Area (EEA) consists of the EU Member States and three EFTA states (Iceland, Liechtenstein and Norway) and joins its members into an Internal Market governed by the same basic rules. These rules enable goods, services, capital and persons to move freely within the EEA. The EEA agreement hence covers rules pertaining to the financial market or more precisely the single rulebook. The EEA EFTA states are hence obliged to implement all EU Acquis pertaining to financial markets. This has proven to be challenging as increasingly the four European Supervisory Authorities (ESAs[6]) have been given wide-reaching powers to issue decisions that are binding for national authorities and individual market actors. This arrangement raises a number of questions relating to the EEA Agreement and poses constitutional challenges for the EEA EFTA states.[7] With regard to Iceland for example these constitutional issues are first that the implementation of the ESAs' regulations would clearly involve the transfer of sovereign powers to the EU institutions, which is incompatible with Iceland's constitution, and second that from a constitutional point of view, it would be unacceptable to leave final rulings on rights and obligations of subjects within Icelandic jurisdiction entirely, and without any judicial review by Icelandic or EFTA courts, to the ESAs. It has been tentatively suggested that an agreement on a horizontal approach within the existing EEA two-pillar structure could be reached and the EEA EFTA states are currently in talks with the EU on this.[8]

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[5] *The UK's parliamentary publications (2012): http://www.publications.parliament.uk/pa/ld201213/ldselect/ldeucom/88/8804.htm#note23, retrieved on 21 July, 2014.*

[6] *ESRB, EBA, ESMA, EIOPA.*

[7] *European Economic Area Joint Parliamentary Committee (2013).*

[8] *European Economic Area Joint Parliamentary Committee „The future of the EEA and the EU's relations with the small-sized countries and Switzerland" CO-rapporteurs: Paul Rübig (EPP, Austria) Svein Roald Hansen (Labour Party, Norway). 30 May, 2013.*

A more relevant issue in this context is the exclusion of the EEA EFTA countries from the banking union at the same time as the EEA agreement supports legally a high degree of financial integration that gives the EEA countries few choices when it comes to solving the financial trilemma problem. The authorities seem to face the dilemma of having nationally financial policy independence and the EEA agreement may make it difficult to limit financial integration, which according to theory may come at the cost of financial stability.

It is accepted in Iceland that the international expansion of the domestic banking system and unrestricted capital movements in the years prior to the financial collapse in conjunction with a lack of cross-border supervision and more importantly a lack of credible backstops was one of the main causes of the failure of the big banks. The so-called passport that the EEA agreement gave the domestic banks turned out to be costly for the economy. The risks have been largely unchanged since prior to the crisis and an establishment of a European banking union does little to mitigate them. It is hence left up to the EEA EFTA countries to deal with the risks within the framework of current international agreements. Currently risks are managed in Iceland with capital controls but it has been stated by the Central Bank of Iceland that one of the prerequisite to lifting the capital controls is the implementation of a number of prudential rules aimed at mitigating risks arising from unrestricted capital movements (Central Bank of Iceland, 2012). This is an attempt to solve the financial trilemma within the given framework and to maintain financial stability, which is one of the objectives of the Central Bank of Iceland.

Others

There seems to be little concern about the potential effect of the banking union in non-EU and non-EEA countries. Little discussion is taking place about the banking union and there is little if any literature on the potential effect of the banking union on non-EU or EEA member states.

Issues to Consider for Outsiders

It may be worth looking at some potential issues that countries outside the banking union may have to think about. There is little research on this so the points mentioned below may be seen as motivation for further research and the discussion remains at this time incomplete.

- *Competitiveness and financing costs of euro area banks vs. outsiders*

Will banks within the banking union have a competitive advantage? The potential competitive advantage may come about due to the market perceiving supervision as being enhanced within the banking union and also due to the increased credibility of the explicit and implicit safety net and backstop for the banks.[9] The credibility of the supervision, safety nets and backstop will be based upon the credibility of the ECB and the fiscal situation in the euro area countries combined. Financing costs may hence decline for some banks as the creditworthiness of individual banks may be lifted above the *sovereign cap*, thus exceeding the creditworthiness of their home member state. It may hence become possible, given that the safety nets become credibly independent of the status of the sovereign of individual countries, that a bank will be able to finance itself at a lower cost than the bank's home country.

Initially market reaction does indicate that financing costs will indeed decline for members of the banking union as charts 1 and 2 show. Further research is needed to substantiate whether banks in the participating countries will in fact enjoy a discount on their financing. However, increased competitiveness of banks within the banking union is not guaranteed with lower financing costs only. It may still be the case that due to – for example – an increase in supervisory burdens competitiveness would not increase. One potential way to estimate the industries' view on the benefits of the banking union is to monitor the behavior of outside banks within the banking union. If outside banks will strive to become a major subsidiary, which means they will become a part of the banking union supervision and safety nets, it can be deduced that they believe that the benefit of becoming an insider outweighs the costs.

- *International cooperation*

There are potential pros and cons here for outsiders. For home-host supervisory and resolution cooperation for cross-border banks outsiders will now only have to deal with one consolidated supervisor and resolution authority. This will increase effectiveness in dealing with cross-border matters. However, there may be a risk of competence creep, as the ECB may be in the position to exert more authority than authorities from individual Member States are able to exert.[10]

- *Small fish in a big pond*

As the three large Icelandic banks grew bigger much of the growth occurred via expansion into foreign markets, most notably other European markets. The banks were small in all of these countries, staying well below the radar of the national supervisory authorities until it was too late. At the same time the banks became too large for Iceland. There is a risk that this problem has been elevated by enlarging the supervisory area to the whole euro area. Branches and subsidiaries set up by banks from small countries outside the euro area may become very large relative to their home country while they will not reach the status of a major subsidiary and hence will not fall under the common supervision, resolution and

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[9] *Pentti Hakkarainen (2013).*

[10] *UK Parliamentary Publications (2012).*

deposit insurance. This is something outsiders will have to be mindful of, especially those who have banks that have the European passport such as non-euro area EU Member States and the EEA EFTA countries.

- *Financial flows and financial stability*

Government supervision and implicit and explicit safety nets provide crucial support for private banking firms. During periods of financial calmness a small price is placed on credible supervision, resolution and deposit insurance. During periods of financial turmoil this changes. These fluctuations in market sentiment toward the importance of financial supervision and credibility of explicit and implicit backstops may have a great effect on capital flows. If the banking union will result in a credible supervisor, resolution and deposit insurance for the euro area banking sector, then there is the risk that outsiders who cannot match that credibility will experience increased fluctuations in financial flows. During times of calmness or complacency toward financial risks financial flows will be based on prices, with little concern for supervision and safety nets. A few basis point differences in the pricing of financial assets will entice investors. However, once market scrutiny turns to potential risks, funds will flow to countries with more credible supervision and backstops. This may increase financial fluctuations in countries that stand outside the banking union.

It is important for outsiders to strive to maintain supervision as credible as it is within the banking union. Additionally, what is potentially more important, is to maintain the same credibility in the safety nets and backstop behind the financial system. It is hence pivotal that the financial system will not outgrow the explicit or implicit safety nets and backstops in place. This may prove to be a challenging task for national micro- and macroprudential supervisors as they will have to restrain the economy from making the most of potential capital inflows in times of complacency. Immoderate capital inflows, which are often accompanied with a rapid growth of the domestic financial system, raises domestic asset prices, exchange rates, imports and over all domestic demand. It magnifies economic growth. The supervisors will have to remove the punchbowl once the party gets going, or else risk an abrupt capital reversal where capital will flow to countries where supervision and explicit and implicit safety nets are credible.

- *Will big euro area banks get bigger?*

The banking union widens the borders of the home market for banks within the union. A bank which has a large balance sheet compared to the GDP of e.g. the Netherlands, Spain or Ireland, does not appear nearly as big when compared to the GDP of the euro area, or the EU. Helmut Ettl pointed this out in his presentation at the 42nd Economics Conference in Vienna in 2014. For example, the balance sheet of the largest bank in Ireland is now over 200% of Ireland's GDP, while it will be well below 5% of the GDP of the euro area. The largest banks in the euro area have total assets only amounting to little over 20% of the total GDP of the euro area. This may cause complacency while the banks which may have already been large when compared to their home countries, grow until their balance sheets become large when compared to the euro area GDP. One of the lessons of the recent financial crisis is that in fact banks which are labelled as "too big to fail" or even "too big to rescue" are simply "too big," period. A change in point of reference to the GDP of the euro area potentially escalates the problems that eventually may appear if banks can grow significantly under the single supervisory mechanisms. One hindrance to the growth of banks has in fact been the differences in supervisory regulations between countries and the capability of individual countries' implicit and explicit safety nets. The full banking union will remove these hindrances to growth. The likelihood is then that large banks will grow larger. The potential risks associated with banks within the banking union becoming "too big" before they run into serious trouble are grave both for countries within the banking union and outside it.

Conclusions

The creation of the banking union is a step in the direction of increased financial and economic integration in the euro area. Potential effects of the banking union on those standing outside have not been adequately researched. Theoretical and empirical research may not be available for a number of years. The issues mentioned here concern competitiveness, international cooperation, big banks and financial stability for outsiders. Most of them rely on the premise that the banking union will improve supervisory quality and increase the credibility of safety nets and backstops within the euro area. Outsiders will then have to strive to match that quality and credibility of financial supervision, which will hopefully bring us a financial system that supports growth with financial intermediation and is at the same time more resilient during times of financial turmoil.

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Benefits and Challenges of International Regulatory and Supervisory Cooperation[1]

Introduction

The crisis has brought international financial linkages to the center stage of the economic policy debate. It demonstrated the limitations of a financial architecture in which markets are increasingly integrated and financial institutions operate across borders, but supervision and regulation remain largely nation bound. This regulatory fragmentation has caused problems both before and during the crisis. Before the crisis, it limited the monitoring and understanding of cross-border linkages and hindered efforts to contain growing imbalances. After the crisis started, it led to often locally-driven and globally-inefficient policy actions; especially in the context of bank resolution.

In the euro area, a fragmented supervisory architecture and bank safety net strengthened the link between a country's banking and real sectors and the health of its public finances. During the boom, in several countries, banks grew to a scale that challenged national supervisory capacities. After the bust, the implicit and explicit liabilities associated with the size of these banking systems overwhelmed national fiscal resources.

This has led some observers to the conclusion that (akin to the traditional trilemma of international economics between monetary policy independence, fixed exchange rates, and free capital flows) a "financial trilemma" exists between financial stability, free capital flows, and fragmented regulators and safety nets (Schoenmaker, 2011; Obstfeld, 2014). And it contributed to the reopening of the debate on the role of capital controls (see, for instance, Ostry et al., 2012).

In the euro area, the answer to these challenges has been the nascent banking union based on a Single Supervisory Mechanism (SSM), a Single Resolution Mechanism (SRM), and a agreement for the mutualization of at least a portion of the safety net. At the global level, the response has led to renewed efforts to improve cross-border cooperation and information flows through initiatives such as the Financial Stability Board; but also greater acceptance of capital flow measures as a tool to preserve macrofinancial stability.

That said, regulatory unions present costs and challenges. For instance, it may become harder to tailor policies to an individual country's needs; and it may be difficult to design effective internal governance for a supranational regulator. This begs the question of how far should a banking union extend. Can we achieve enough stability through international cooperation? If not, what are the main factors one should look at to decide whether countries should join into supervisory/regu-

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[1] *The views expressed herein are those of the author and should not be attributed to the IMF, its Executive Board, or its management.*

latory unions? And conditionally on a partial union being formed, how do incentives to join in change for the countries left out?

We are very far from a formal theory of what constitutes an optimal regulatory area. What follows in this note are explorations.

Regulatory Externalities

In recent years, technological progress and regulatory changes have led to the progressive integration of international financial markets. As a result, banks' cross-border activities have become increasingly important, raising new challenges for regulators that have remained country bound. In this environment, prudential regulation and supervision generates cross-border externalities that neither regulators nor the financial institutions they are supposed to oversee might take into account. This section explores the implications of these externalities for the benefits and costs of switching to a centralized supervisory agency. And, in a multi-country setting, it discusses how the formation of a banking union by a subset of countries affects other countries' incentives to join in.

A Simple Theoretical Framework

Here we follow the stylized model proposed in Dell'Ariccia and Marquez (2006). Consider a setup in which banks compete internationally, but are regulated and supervised by domestic agencies. These domestic regulators/supervisors' mandate includes domestic financial stability and bank profitability. The latter may be the reflection of regulatory capture or more generally of the fact that supervisors care about all domestic stakeholders in the banks. Critically, this entails a tradeoff. Tighter regulation/supervision will make the domestic banking system safer. But it will represent somewhat of a burden for the banks and reduce their profitability. Further, since banks compete internationally, these policy actions will entail externalities. Safer banks at home will improve stability abroad (for instance, by reducing counterparty risk). But more intrusive regulation and supervision may decrease bank competitiveness vis-à-vis foreign institutions, increasing its impact on bank profits.

Under these assumptions, domestic agencies acting independently (uncooperatively) are likely to reach an inefficient outcome. In this model, both externalities tilt regulators' behavior in the direction of laxer standards. Indeed, each domestic agency will not take into account the benefit that tighter standards bring to the other country (through its banks' interaction with a safer banking system). But they will be concerned with the increased negative effect that tighter standards have on domestic banks' profits because of the loss of international competitiveness. The outcome (in a Nash equilibrium) is one with excessively lax standards: a race to the bottom; or, more precisely, standards that are laxer than those that would prevail if the two domestic agencies were to fully take into account the cross-border effects of their policies.

Now compare this setup (in which national agencies concerned solely with their respective domestic banking system set policies non-cooperatively) to one in which an international regulator sets uniform standards for all banks. The benefit of centralizing regulation is that it internalizes any externalities that may exist due to the integration of financial systems. From that standpoint, it is immediate from the discussion above that a centralized agency will impose tighter standards than independent regulators. The shortcoming is that centralization reduces flexibility in designing policy; at least to the extent that political economy considerations limit the regulator's ability to tailor standards to individual countries under its jurisdiction. Then, there is a cost, if regulatory needs (and thus the optimal policy design) differ across markets because of institutional and structural reasons.

Under these assumptions, a banking union is more likely to emerge (to offer a Pareto improving solution) between countries that exhibit a greater degree of financial integration and relatively similar regulatory needs. The degree of inefficiency under the "independent" solution is likely to increase with financial integration. And the cost of switching to a centralized agency is likely to be smaller when country needs are not too far apart. In practice, this means that a banking union is more likely to be beneficial (and politically acceptable) among countries with a greater foreign bank presence, cross-border flows, etc.; and countries with relatively similar financial structures in terms of bank design (for instance universal banks versus narrow banks) and market structure.

Incentives to Join Partial Unions

The model also speaks to the incentives to form of a banking union among a subset of countries when multiple financial linkages exist, and to how the formation of such a union changes the incentives to join for those left out. Relative to the simpler two-country case discussed above, the analysis of a multi-country setting offers two additional insights.

First, the formation of a union among any country pairs is affected by the existence of financial links with other countries. As discussed above, the main benefit of joining a union is that the centralized agency will take into account regulatory externalities and, hence, standards will be tighter than under independent domestic supervisors. However, in the presence of financial linkages with "third-party" countries, this benefit will be tempered by a decrease in bank competitiveness vis-à-vis financial institutions from countries that did not join the union. This means that the existence of financial linkages with multiple countries makes the formation of unions among a subset of partners more challenging.

Second, the formation of a union among a subset of countries reduces the incentives for those left out to join it. The intuition is immediate from the forces in this model. The union will reduce the race to the bottom among participating countries and tighten their standards. This reduces the potential benefits from joining in for those outside.

In practice this means that countries that have strong financial linkages with third-party countries will find joining a partial union less attractive. Further, from the limited point of view of a model based on regulatory externalities, a partial union does not necessarily represent a pole of attraction that will naturally evolve in a more comprehensive one.

Limitations of the Analysis

The analysis in this section focuses solely on issues of regulatory externalities and coordination. It does not take into account other benefits of banking unions such as crisis management (avoiding sovereign-bank doom spirals, limiting inefficient ring fencing, and improving cross border resolution) and regulatory capture discussed in the next sections.

Second, as for any other framework, the results critically rely on one buying the building assumptions in the model. In particular, the objective function of the regulators, the idea that a centralized agency would find it challenging to tailor policy asymmetrically across its jurisdiction, and the sign of the main externalities. While we find the assumptions reasonable and the results relatively robust, there are obviously possible exceptions. For instance, regulators could be interested in the total amount of credit provided to the economy. If so, tighter standards abroad would lower rather than increase the domestic regulator's utility. Yet, as long as this effect is not too strong (as long the supply of credit has a small enough weight in the regulators' utility function) the results discussed above hold.

Similarly, the assumption that a centralized supervisor/regulator would have to impose the same regime across all countries participating in the union seems a very strong one, but results are relatively robust to its relaxation. All that is needed for the model's predictions to hold is that a centralized agency would have less leeway than independent regulators in imposing asymmetric requirements across countries. Political economy considerations suggest that this would likely be the case. One could challenge the idea that independent supervisors with asymmetric objective functions cannot coordinate their actions to achieve a better equilibrium (put differently, one can question whether Nash equilibria are the right analytical framework in this context). This is a relevant issue and, in practice, domestic agencies do cooperate across borders. However, it is also true that this cooperation is often fragile and put to the test during crises (when it matters the most). Further, while certain aspects of the relationship between independent agencies can be agreed and contracted upon, others – think about the exchange of high quality informal information (Holthausen and Rønde, 2004 and Calzolari and Loranth, 2011) – are much harder to enforce. For these, uncooperative solutions are likely to remain the appropriate theoretical benchmark.

Finally, the simplified framework discussed here is consistent with an economy in which national regulators have an impact on a bank's stability and its international competitiveness, but no direct control over foreign banks. This is obviously the case in a system where foreign affiliates are subject to "home country regulation," and for direct cross-border lending. But it does extend to "host country regulation," (meaning that domestic regulators have authority over all banks operating in their jurisdiction) to the extent that there is not a one-to-one matching between a domestic bank's foreign loans and foreign-raised deposits and capital. That is as long as regulatory conditions at home affect the competitiveness of a bank's foreign subsidiaries (Dell'Ariccia and Marquez, 2006, for further discussion).

Crisis Management

The experience during the crisis highlighted a host of additional issues associated with fragmented bank jurisdictions. Some of these aspects (such as the lack of a common safety net) were particularly evident within the common currency area. But others (such as limited cooperation in cross-border supervision and resolution) had broader reach. Here we focus primarily on the effects of fragmentation on the development of sovereign-bank spirals (for a discussion, see Bolton and Jeanne, 2011; Acharya et al., 2013; Farhi and Tirole, 2014) and on the challenges fragmentation represents for cross-border bank resolution.

Sovereign/Bank/Real-Sector Spirals

Before the crisis, the common currency and single market promoted financial integration in the euro area and EU. Banks and other financial institutions progressively established affiliates and operated with relative ease across borders; credit flows allowed savings to be reallocated across countries; and financial portfolios became increasingly more diversified. The interbank market functioned smoothly, with relatively uniform interest rates across the euro area. And the monetary policy transmission mechanism worked efficiently, with policy rate movements quickly translating into changes in bank lending rates.

This growth in financial integration had also a darker side, as large capital flows across euro area countries allowed for the buildup of sovereign and private sector imbalances. In several countries, these imbalances manifested in credit booms (mostly funded through capital inflows) which fueled and were supported by booming house prices and buoyant real estate activity (these would later contribute greatly to the cost of the crisis). But, at the time, the "incomplete" financial architecture based on a single currency and common market, but national-based financial safety nets, bank supervision and regulation seemed to serve the euro area well.

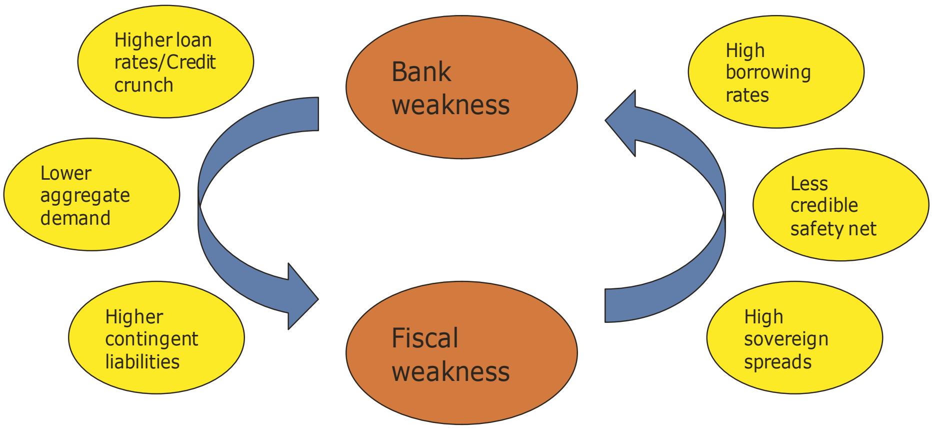
The crisis laid bare the tensions inherent in this institutional design. Sovereign/bank/real-sector vicious spirals emerged that imparted procyclicality to local lending conditions and impaired the monetary policy transmission mechanism. Even within a single monetary and fiscal jurisdiction, local conditions will have a tendency to exhibit procyclicality during distressed times, to the extent that bank portfolios are regionally specialized. A negative regional shock to the real sector will reduce borrowers' creditworthiness and increase the risk of local lending. Banks with portfolios concentrated in the region will becomes riskier and their cost of funds will increase. The subsequent increase in local rates will further hinder real activity and so on. However, in a single country setting, two elements intervene to stop or at least contain this spiral. First, a nationwide safety net will assuage the concern for regional bank stability (think about what would have happened during the crisis if the states of California or New York had had to be responsible for bank stability). Second, should the crisis be broader than regional, and

potentially bring the public sector into the spiral, monetary policy can intervene (at least to some extent) to control interest rate conditions.

In contrast, the pre-crisis euro area's financial architecture strengthened the link between a country's banking and real sectors and the health of its public finances; in particular for countries with weak fiscal positions and/or very large banking systems (relative to GDP). In fiscally weak countries, the soundness of national-based bank backstops came into question. Banks became increasingly perceived as vulnerable which led to rising bank funding costs and lending rates. This, in turn, hindered real activity, further damaging public finances. In countries with large banking systems, bank distress overwhelmed national fiscal resources (again the effect of national-based fiscal backstops) directly, through explicit and implicit public guarantees, and indirectly, through its effect on real activity.

Chart 1

Sovereign/Bank/Real-Sector Spirals

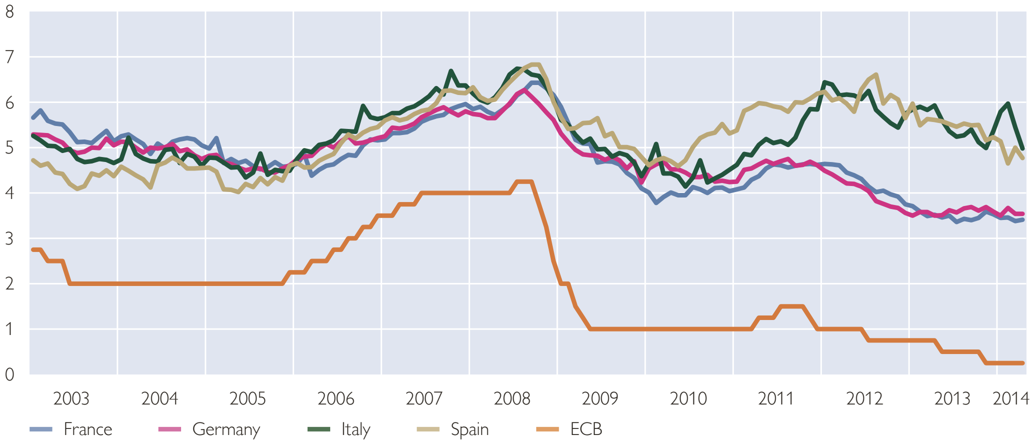


Source: Author's illustration.

Chart 2

Lending Rates and ECB Policy Rate

%, 1–5 years maturity, up to EUR 1



Source: ECB.

An Impaired Monetary Policy Transmission Mechanism

The inability to control local interest rate conditions, because of centralized monetary policy exacerbated the problem. The interaction of bank and sovereign weakness described above led to increasingly fragmented financial markets. In certain countries, banks and at times the sovereign found themselves rationed out of lending markets. The result was an inversion of the pre-crisis trend of increasing financial integration. Financial intermediaries retrenched in their home markets (in some cases partly responding to regulatory pressures-ring fencing) and bank spreads started to differ markedly across borders.

Bank lending rates (which until mid-2010 had co-moved closely across euro area countries started to differ. And notwithstanding the ECB's aggressive policy easing, monetary conditions in distressed economies such as Italy and Spain remained relatively tight (and actually moved in the opposite direction for a while). Indeed, there is evidence that the pass-through of the policy rate onto bank lending rates (especially for small business lending) dropped dramatically in the countries hardest hit by the crisis, while remained roughly stable in others (Al Eyd and Berkmen, 2013).

Challenges in Cross Border Resolution

The crisis also demonstrated the challenges associated with intervening and resolving large multinational institutions in a system of independent supervisors and regulators. National authorities mandated to protect domestic stakeholders may fail to coordinate with the necessary speed on globally optimal solutions. The likely outcome is a financial system which is at the same time less stable and potentially more expensive from a fiscal standpoint (IMF, 2010; see also Basel Committee on Banking Supervision, 2010).

Relative to a centralized system with a unified resolution framework, uncoordinated actions by national authorities may inadvertently hasten the failure of a multinational financial institution in a way that fails to preserve value. Local jurisdictions can engage in activities such as ring fencing that, while optimal from an individual country's standpoint, are detrimental to the stability and franchise value of the overall financial institution (think, for instance, to a local host supervisor requiring a transfer of assets to cover the liabilities of a branch without taking into account its implication for the stability of the parent institution). Similarly, uncoordinated local liquidation proceedings may prevent the efficient transfer of assets and liabilities across sections of a distressed institution that operates under different jurisdictions. Put differently, cross-border resolution is not necessarily a zero-sum game, and the focus of national authorities on domestic stakeholders can prevent cheaper and more effective coordinated solutions.

Finally, even in cases when policy actions are eventually the right ones, ex-ante uncertainty as to how and whether national authorities will coordinate their moves may lead to, otherwise avoidable, panics and contagion. And the need for multiple supervisory agencies to agree on a course of action makes it difficult to move quickly, which in turns jeopardizes any strategy that seeks to both preserve value and limit contagion.

The challenge of coordinating a resolution strategy across borders is likely to lead national authorities to opt for more lenient and fiscally expensive options. For instance, the concern for contagion, absent a prompt and transparent strategy to bail-in shareholders and unsecured creditors, is likely to make the bail-out option more attractive. Further, an uncoordinated approach may not maximize the value of a cross-border financial institution, thus increasing the total fiscal cost of its failure. For example, it may be more effective (more attractive to eventual investors) to break up a financial group operating in numerous jurisdictions across business rather than national lines. But uncertainty about valuations and the difficulty in establishing compensatory side payments may mean that independent national authorities will opt for the former.

The crises of Lehman and Fortis provide stark examples of these challenges. They illustrate how national interests can become paramount during crises and hinder cross-border cooperation, even between jurisdictions whose financial regulators have a long tradition of co-operation and whose legal frameworks are considerably harmonized. Fortis was resolved along national lines in a protracted process that failed to preserve franchise value. In the case of Lehman, insolvency officials in different jurisdictions wound down various international components of the group with little or no coordination (IMF, 2010).

Other Inefficiencies

A fragmented supervisory structure entails additional inefficiencies. First, local agencies may lack the resources and sophistication to properly monitor the activities of large multinational banks operating in or from their jurisdiction (especially, in the case of smaller countries); although, the potential loss of local expertise in switching to a centralized system may represent a countervailing element.

Second, local agencies may be more subject to issues associated with "too big to fail" institutions and "national champions". Banks that are considered large and systemic at an individual country level may not be so in the context of a larger cross-border market. This is likely to reduce moral hazard behavior associated with the perception of laxer supervisory standards and the expectation of bail-outs. Evidence from the United States suggests that this may be the case. Comparing federal and state regulator supervisory ratings within the same bank, federal regulators appear to be systematically tougher, downgrading supervisory ratings almost twice as frequently as state supervisors (Agarwal et al., 2014).

How Can a Banking Union Help?

A well-designed banking union can help address the tensions discussed in the previous sections. To be effective on all these fronts, the new institutional framework has to comprise three elements: a single regulatory and supervisory framework, a single resolution mechanism, and a common safety net. In this context, Europe is moving in the right direction and (given the institutional constraints) at a commendable speed. There are of course implementation challenges related to putting into practice effective common supervision and resolution. It is essential also to avoid stalling on reforms. In this regard, agreeing on a framework and timetable for common safety nets and backstops is critical.

Indeed, all three elements are necessary (at least for countries belonging to the euro area). A single supervisory agency without a common safety net framework may help with externalities (see section above) and reduce the risk of regulatory capture, but will do little to break the vicious circle between banks and sovereigns and reestablish a properly functioning monetary transmission mechanism. And supervision requires a credible resolution framework to be effective (not only to allow for timely decision-making during crises, but also to provide supervision with "teeth" during tranquil times). In turn, bank recapitalization as well as resolution and deposit insurance mechanisms would lack credibility without the assurance of fiscal backstops and burden sharing arrangements. Finally, common safety nets and backstops without effective supervision and resolution would break sovereign-bank links, but risk distorting incentives, reinforcing tendencies for regulatory forbearance, and shifting losses to the euro area level. In short, power and resources have to go hand in hand.

For countries that retain an independent monetary policy sovereign-bank spirals are a less pressing concern (although, they come back to center stage for systems with a high degree of liability dollarization). And, while other shortcomings of uncoordinated regulation and supervision policies remain, for these countries the choice between independent and centralized regulators is less clear cut. Indeed, a centralized supervision, resolution, and safety net framework also entails costs and challenges. An important one we discussed before: A common agency will find it more difficult to tailor policies to individual countries under its jurisdiction. In this regard the current European design attempts to strike a balance between common supervision and local flexibility by leaving smaller banks under the responsibility of national authorities and allowing some leeway in the use of certain regulatory tools (see, for instance, the treatment of macroprudential measures).

Another important implementation challenge relates to the internal governance of a centralized agency; especially one organized around a hub-and-spokes model. Internal mechanisms will have to be devised to guarantee that the spokes, which (at least in a transition period) may have different objective functions from the hub, act accordingly to the centralized mandate, including with regard to information collection and exchange (Holthausen and Rønde, 2004). Finally, there can be unwanted side effects. Financial institutions and their relationship with the real sector will evolve with the new regulatory structure. This may lead to even greater imbalances. For instance, countries may be able to run even larger current account deficits once banks are protected by a common fiscal backstop; or banks may grow even larger in the attempt to become "too big to fail" at the supra-national level. Vigilance and new policy tools (such as those classified as macroprudential) may be required to limit these risks.

Conclusions

We are still very far from a comprehensive model that could guide the choice between a system of independent regulators and a supervisory and regulatory union. However, the trade-offs discussed in this note provide some insights on what country characteristics are likely to shift the balance between the costs and benefits of joining a union.

Countries that are more financially integrated with each other; in particular through cross-border bank lending and a significant presence of foreign banks in their domestic banking system are more likely to benefit from coordination. At the same time, however, close links with third party countries that would not be part of the union will tend to limit those benefits.

Countries belonging to a currency union would benefit from an overlapping jurisdiction on the regulatory front. A benefit that may extend to banking systems characterized by widespread balance-sheet "dollarization" (meaning asset and liabilities denominated in the currency prevalent in the banking union) and countries with hard pegs.

Regulatory unions will likely be less challenging when member countries share similar financial structures and, hence, have roughly similar supervisory and regulatory needs. The costs associated with decreased policy flexibility will be greater when financial institutions and markets differ substantially across members.

Finally, the implications of political economy considerations are less clear cut. Smaller countries (especially those with large banking systems) may reap relatively greater benefits from joining a union in terms of reduced "capture" and "too big to fail" problems and greater risk sharing on the fiscal backstop front. However, these are also countries that may have less influence on the decisions of the union as a whole. So the appeal of membership might depend critically on the union internal governance rules.

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Session 3
Regulatory Capture

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Introductory Remarks

Ladies and Gentlemen,

The European banking union is seen by many commentators as a major shift in ideas about banking regulation in Europe and about the organisation of the relationship between the public sector and the banking sector. The extent to which this view is justified is a major topic of the discussions and presentations at this conference.

In this session we want to focus on the issue of regulatory capture. The capture of regulatory policy by interest groups and lobbies is an old topic in policy discussions on regulation. The global financial crisis has created a new awareness of the issues and a renewed interest in this topic. For example, the extent to which banking regulation during the 1990s adopted industry standards in risk assessment that have turned out highly problematic afterwards is astonishing and now seems like a textbook example of how regulation can become an instrument of industry interests and thereby can be made even ineffective or dysfunctional.

With this and other examples in mind it is legitimate to devote the next hour of this conference about a major regulatory reform project in banking regulation to the reflection of the issue of regulatory capture. Have the initial goals been achieved, or have they been watered down significantly? Did the public sector prevail in redefining the rules of the game in the interaction between government and the banking sector or was the process skilfully seizured by industry interests?

One could argue that the European banking union has some promising aspects that might give rise to hopes of pushing backs the forces of regulatory capture by shifting supervision to a transnational level. But has the current framework actually been successful in implementing this shift?

I am very happy that we have today two leading experts in the field with us, who will in the next 60 minutes go through some of the aspects of regulatory capture and the banking union.

Professor *Engelbert Dockner* is Professor of Finance in the Department of Finance, Accounting and Statistics at the Vienna University of Economics and Business. He holds a Ph. D. in applied mathematics from the University of Technology Vienna. Prior to his appointment at the university he was full professor of finance and head of the Department of Finance at the University of Vienna. He has intensive international experience either as a faculty member or as visiting scholar at the Sauder School of Business, University of British Columbia, Canada; Haas School of Business, University of California at Berkeley, U.S.A.; University of Magdeburg, Germany; Australian National University, Australia; University of Bielefeld, Germany; Queen's University in Kingston, Ontario, Canada, and University of Saskatchewan, Canada. From 1996 to 2006, he was head of the Center for Banking and Finance at Donau Universität Krems, Austria. He acted as General Secretary and President of the Austrian Economic Association and currently is a member of the Board of the Austrian Science Fund.

His research interests include asset pricing and industry structure, product and financial market interactions, industrial economics and differential games theory. He published over 50 papers in leading economics and finance journals, including American Economic Review, Journal of Economic Theory, Journal of Economic Dynamics and Control, Management Science.

Thierry Philipponnat is Secretary General of Finance Watch, an independent non-profit association dedicated to analysis and advice for improving European Financial regulation. After graduating from the Institut d'Etudes Politiques de Paris and training as an economist (Diplôme d'Etudes Approfondies en économie), Thierry Philipponnat started a career in finance in 1985, holding successively the following positions: corporate banker at BFCE (Banque Française du Commerce Extérieur), options and convertible bonds trader for O'Connor & Associates, head of structured products at Exane, executive director in charge of equity derivatives for French-speaking Europe at UBS, deputy-head of equity financing structuring at BNP Paribas, and global head of equity derivatives of Euronext.Liffe. As part of this last activity, he was member of the executive committees of both Euronext (Paris) and LIFFE (London).

In 2006, Mr. Philipponnat crossed into the NGO world, campaigning and lobbying on behalf of Amnesty International, with a particular emphasis on the impact of the financial sector on human rights. He was later elected as an Executive Board member of Amnesty International France.

In 2010, he was selected by a cross-party group of Members of the European Parliament to develop Finance Watch (www.finance-watch.org) as an organisation advocating for public interest in financial regulation. He was appointed as the first Secretary General of Finance Watch the following year and has led the organisation since then. Since December 2013, Thierry Philipponnat has also served as a member of the College of the AMF, the French financial markets regulator.


TOWARD A EUROPEAN
TAKING STOCK
ONNAT
SUMMER

Engelbert J. Dockner

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WU Vienna University of Economics and Business

Regulatory Capture: Why? How Much? What to Do About It?[1]

Regulatory capture is a much debated issue in regulatory economics that applies to many industries including the financial services industry. This paper discusses what the economic incentives leading to regulatory capture are, presents a case study on banks' capital requirements that helps to shed light on the possible magnitude of regulatory capture and finishes with policy recommendations what to do about capture. The main message of the paper is that although regulatory capture is deeply rooted in the incentive system of regulators and regulated industries it appears in different degrees ranging from strong to weak capture. Depending on its degree alternative measures can be applied to mitigate regulatory capture.

1 Introduction

When markets fall short to deliver outcomes that are in the interest of the general public, it is necessary to make use of regulatory actions to correct these failures. Once regulatory actions and agencies are in place, their objectives must be set in such a way as to serve the common good. Specifying theoretically what the common good is only requires the application of the appropriate theory framework. It is, however, far from trivial to implement it in practice. Regulatory agencies are delegated institutions embedded in industry structures that are subject to agency problems and economic incentives that do not necessarily serve the common good. In a framework consisting of the general public (represented by the legislature), the regulator, and the regulated industry, it might be possible that incentives for regulators are in conflict with public interests and serve the regulated industry, instead, resulting in an economic force known as regulatory capture.

The purpose of this paper is to analyze regulatory capture in the financial services industry. It is widely accepted that regulatory capture of public agencies and policy has been a main causal factor of the financial crisis 2007-09. As Daniel Kauffman, a senior fellow at the Brookings Institution wrote in a column in Forbes: "There are multiple causes of the financial crisis. But we cannot ignore the element of 'capture' in the systemic failures of oversight, regulation and disclosure in the financial sector."[2] In light of these conclusions, it seems necessary to have a closer look at capture within the financial industry. Therefore, the paper engages in a discussion of how to define regulatory capture and advances a broad and a narrow interpretation. Next, economic motives are studied that explain why there is capture. Following Zingales (2013) it is argued that

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[1] *I am grateful to Otto Randl for critical and helpful discussion.*

[2] *A similar conclusion has been reached by Simon Johnson, a former chief economist of the IMF, in an article entitled "The Quiet Coup", published in The Atlantic (2009).*

capture is pervasive because it is the outcome of the interplay of economic incentives. We summarize three economic mechanisms that explain the existence of regulatory capture. Using a case study on trust preferred securities first analyzed in Boyson et al. (2014) we discuss the potential magnitude of capture and the mechanisms that promote it in the banking sector. According to Baker (2010) there are at least four mechanisms that enhance capture in the banking industry with revolving doors being the most prominent one. Finally, we report on a recent study about regulatory capture and social identification. Using an extensive questionnaire among regulators and regulated managers Veltrop and de Haan (2014) find that (i) social identification is negatively correlated with task performance of regulators and (ii) prior tenure in the financial services industry is positively correlated with social identification to an industry. As a consequence, prior tenure in the financial services industry causes capture through social identification. We conclude the analysis by analyzing how to mitigate regulatory capture in the banking and financial services industry.

2 Defining Regulatory Capture

In a seminal paper Stigler (1971) articulated the view that even when a regulatory authority was set up to prevent monopolistic abuse of consumers, regulation ends up being "captured" by the firm it is supposed to discipline.[3] This view triggered a large body of literature on the economics of regulation, summarized, for example, in Kahn (1988). Stigler (1971) applied his theory of regulation to the U.S. trucking industry and found that in the 1920 trucks emerged as competitors for existing railroads on inter-city freight. Railroads responded by capturing public authorities to impose severe limits on trucks to deliver freight from one city to the other. Stigler (1971) concluded from his industry analysis that regulators could be swayed by special interests of the industry being regulated and hence, governments and/or regulators should be rolled back. As a consequence of Stigler's insights a branch of regulatory economics emerged in the spirit of the Chicago School of Economics that stipulates to get rid of regulation altogether because of capture's severe distortions of public interests.

According to a recent survey by Dal Bo (2006) regulatory capture can be defined in terms of a narrow and a broad interpretation. In the broad sense it is the process through which *special interests affect state intervention in any of its forms while in the narrow* interpretation *regulatory capture is the process through which regulated (financial services) firms end up manipulating the authorities that are supposed to control them* (Dal Bo, 2006). It must be stressed, that regula-

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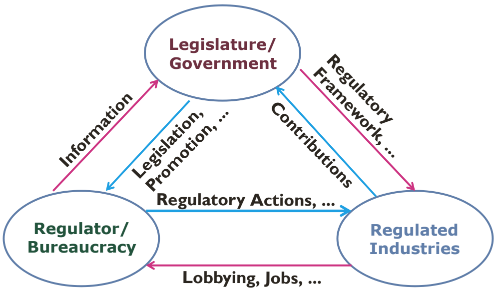
[3] *See Dal Bo (2006) for a review of the theory and applications of regulatory capture.*

tory capture in the broad and narrow interpretation is neither corruption nor associated illegal action such as bribes and threats. Corruption and illegal actions are cases for the court that are beyond the scope of this analysis.

Alternatively Carpenter and Moss (2013) define regulatory capture as *the process by which regulation is consistently or repeatedly directed away from the public interest and toward the interest of the regulated industry by the intent and the action of the industry itself.* This definition rests on three important notions: public interest, regulated industry, and intent. The interplay among those can best be elaborated using the traditional model of the iron triangle (Mitnick, 1980). Chart 1 presents the players involved in the iron triangle, the legislature, the regulator put in place by the government, and the regulated industries. Although these players are intertwined in a complex way, aiming for a first best solution of the system as a whole requires all three institutions to serve the public interest. It is not a trivial issue to pin down what public interest is but we identify it with economic welfare of all agents represented in the system.

Chart 1

Iron Triangle



Source: Author's illustration.

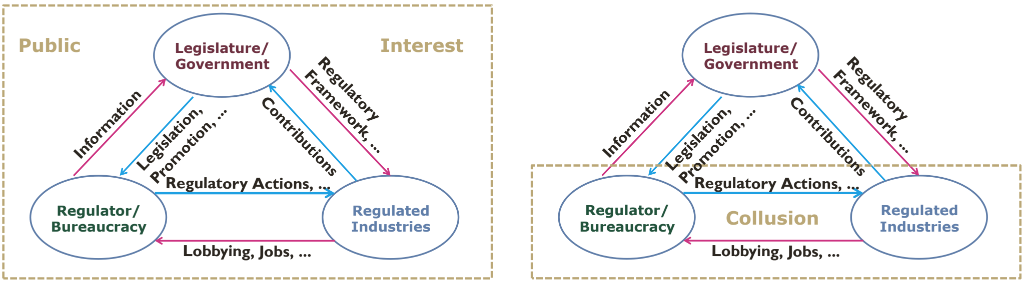
In a first best world legislature sets all the rules in such a way that individual actions taken by agents serve the common good and hence maximize economic welfare. This, however, requires the absence of externalities, market power and market failures that are integral parts of modern market economies. As a consequence, regulatory bodies come into existence with the duty to control industries and the objective to serve the public interest. If regulators fail to serve the public interest and collude with the regulated industries, instead, the system is characterized by regulatory capture. Chart 2 contrasts the two opposing cases. On the left side we see the system set up to serve the public interest and on the right side we see the case of regulatory capture.

According to the right part of chart 2, regulatory capture comes into existence because the regulator and the regulated industry collude and maxi-

Chart 2

Regulation Serving the Common Good

Captured Regulation



mize the sum of their own interest at the expense of the public interest. Collusion as represented in chart 2 is neither the outcome of corruption nor of illegal action but the response to economic incentives driving the actions of agents representing the regulator and the industry. In this setting capture corresponds to optimal (equilibrium) behavior and hence can only be mitigated if incentives are changed.

3 Forces Leading to Regulatory Capture

Starting with the seminal works by Olson (1965) and Stigler (1971) economists have analyzed economic forces that cause regulators to change their behavior and become captured. In a recent paper Zingales (2013) summarizes these theories by identifying different channels that correspond to incentive mechanisms which might cause regulators to act in the interest of the regulated. The two most important channels are

- Career concerns of the regulator
- Industry specific information needed by the regulator to take regulatory actions that has to be provided by the industry

In a world in which salaries of the regulator substantially differ from the salaries of the industry being regulated, regulators face attractive outside offers that might substantially change their careers.[4] In case an industry player wants to hire a former regulator to take advantage of her skills, industry will prefer regulators with a record that indicates appreciation of the industry. If regulators later in their careers want to benefit from attractive outside offers, they have a strong incentive to signal appreciation of the industry already during their tenure as a regulator. Alternatively, if institutional knowledge is important for running an industry, regulators might have the incentive to increase the number and the complexity of institutional rules industry has to follow. By doing so, regulators might also increase their job opportunities in the outside industry. This would, however, be an opposite effect to regulatory capture.

Even if regulators do not care about outside job offers their careers might strongly be affected by outside interests. If an outside interest group spreads false rumors about the regulator, the regulator's career might be affected by the actions taken by this outside group. Hilton (1972) proposes a related model in which the regulator tries to avoid "squawking". In this setup policy makers might interpret negative feedback about the regulator as efficient regulation and reward her for that.

In taking actions the regulator needs a lot of industry specific information. In the absence of disclosure requirements the two parties, regulator and regulated, might trade information for favorable treatment. In terms of chart 2 from above the regulator and the regulated industry establish a cooperative environment and collude. Collusion is supported by the implicit threat that any of the parties can withdraw from the cooperation making them worse off.

In addition to these two forces there is also an external force at work. Regulators need a lot of industry specific human capital to do a good job. As a consequence, they have the vested interest to take actions that make this capital more valuable. This can lead to social identification with the concerns and

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[4] *A regulator quitting her job and moving to the industry she used to regulate is referred to as "revolving doors" (see Makkai and Braithwaite (1992), Salant (1995) and Shive and Forster (2014)).*

challenges of the industry, resulting in capture. Veltrop and de Haan (2014) empirically demonstrate that social identification with the financial sector is an important mechanism for capture.

The forces that are identified to promote regulatory capture do not work well if all interest groups are symmetric and have the same level of influence. In such a case competition among conflicting interest groups results in an efficient outcome and hence mitigates regulatory capture. Regulatory capture relies on asymmetries either in terms of information or in terms of influence. Laffont and Tirole (1991) are the first to present a theory of regulatory capture in an agency setting with asymmetric information. In this setting capture is identified as equilibrium behavior between the regulator and the regulated industry.

Regulatory capture might also be promoted by the regulator hedging against mistakes she makes. If the regulator makes a mistake that is against the interest of the regulated, industry members might strongly complain about the regulator. On the contrary, if the regulator makes a mistake against the interest of the public, this will most likely stay unnoticed. As a consequence, it is safer for the regulator to lean more towards the industry. This strategy hedges the regulator against mistakes affecting the regulated (Zingales, 2013).

The arguments discussed here identify capture as a pervasive force that can hardly be mitigated. What makes capture manageable, however, is the degree at which it prevails in an industry. Regulatory capture is not something that exists or does not exist – it prevails by degree. Carpenter and Moss (2013) distinguish between weak and strong capture. Strong capture violates the public interest to such an extent that the public would be better served with either no regulation or by replacing existing regulation and authority altogether. While this cannot be ruled out it is not the standard in the regulation of financial services. What we observe frequently, instead, is weak capture. According to Carpenter and Moss (2013) weak capture occurs when special interest compromises the capacity of regulation to enhance the public interest, but the public is still being served by the regulation. In such a case capture can be mitigated by exploring the incentives of the special interest group in detail and responding to it. A lot of financial regulation is exposed to weak capture and hence can be cured by altering incentive structures.

Recent research emphasizes the role of social identification as a force that promotes capture (Kwak, 2013; Nicholson, Kiel and Kiel-Chisholm, 2011 and Veltrop and de Haan, 2014). Veltrop and de Haan (2014) use data from two Dutch regulators, De Nederlandsche Bank (DNB) and Autoriteit Financielen Markten (AFM) collected through questionnaires and find that (i) social interactions are negatively correlated to regulator's task performance and (ii) prior tenure in the financial sector is positively correlated to social identification with the industry. As a consequence, regulatory capture related to revolving doors runs through the channel of social identification with the financial sector.

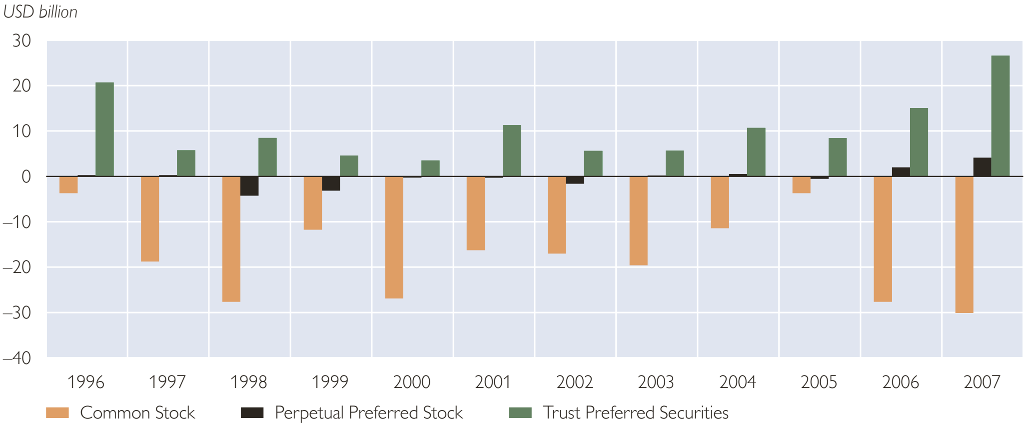
4 Case Study: Trust Preferred Securities

In the preceding section we have analyzed the economic mechanisms and forces that are responsible for the existence of capture. In this section we address the issue of how much capture can be observed in the financial industry. This is a delicate issue because demonstrating existence and degree of capture is very hard, as it requires a measure of public welfare as a benchmark. We avoid these issues by presenting a case study on regulatory arbitrage of U.S. banks that was recently introduced by Boyson, Fahlenbrach and Stulz (2014).

In October 1996 the Federal Reserve Board authorized bank holding companies to use trust preferred securities (TPS) as Tier 1 regulatory capital up to a threshold level. TPS are hybrid capital, i.e. a mix of equity and debt. They are cumulative non-perpetual preferred securities issued by subsidiaries of bank holding companies whose sole asset is junior subordinated debt issued by the bank holding company. Interest on TPS is tax deductible to the holding company and hence generates value through the tax shield. Hence, bank holding companies have an incentive to issue TPS and as this helps to meet capital requirements makes the bank holding company better off. Using TPS instead of equity as Tier 1 capital, however, makes the bank riskier as the capital cushion in the event of an adverse shock has weakened. Chart 3 taken from Boyson, Fahlenbrach and Stulz (2014) demonstrates how U.S.

Chart 3

Net Issuance of Common Stock, Perpetual Preferred Stock and TPS between 1996 and 2007



Source: Boyson, Fahlenbrach and Stulz (2014).

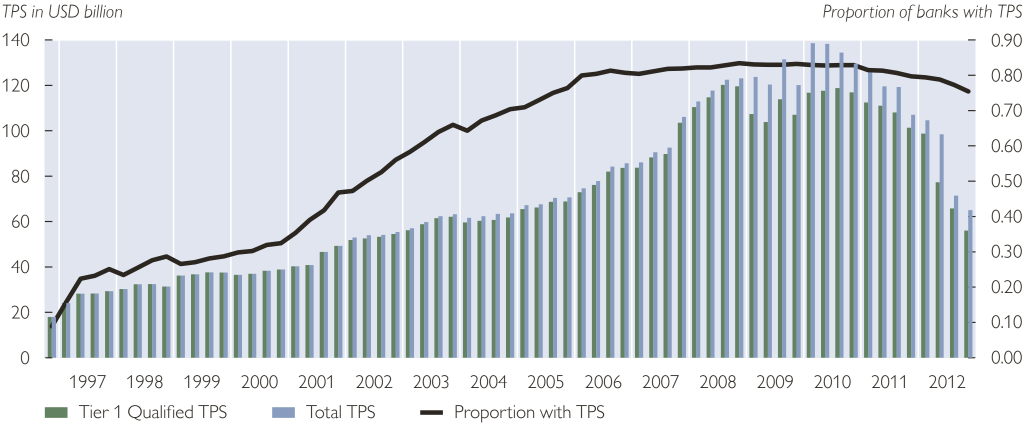
bank holding companies raised regulatory capital through TPS and retired common stock during the period 1996 to 2007.

It is obvious that TPS was substituted for common equity throughout the period 1996 to 2007. Analyzing the policy change of the regulator from the point of view of regulatory capture it is important to point to the two following facts: (i) the use of TPS as regulatory capital benefited the bank holding companies as they were able to substitute TPS for common equity and therefore take advantage of the tax shield; (ii) the use of the TPS as regulatory capital was at the expense of the general public as this substitution made the bank holding companies riskier and hence the banking system in general more instable. Hence, it is fair to say that regulatory agents served the interests of the banking industry at the expense of the general public.[5] To measure the magnitude of this capture it would be necessary to estimate the welfare loss triggered by the policy change of the Federal Reserve Board. As we lack a sensible aggregate welfare measure it is impossible to quantify the costs of regulatory capture. Instead, we present the total amount of TPS issued and total Tier 1 qualified TPS outstanding together with the proportion of bank holding companies that issued TPS in chart 4. A detailed analysis of how the bank holding companies benefited from the qualification of TPS as Tier 1 capital can be found in the original paper Boyson, Fahlenbrach and Stulz (2014).

The case study presented demonstrates how capture might exist in the financial services industry and how it might affect public interest. This triggers the general question what are the mechanisms that most likely promote capture in the financial services industry and to what extent has there been a change between prior and post financial crisis? Baker (2010) identifies four mechanisms that promote capture and analyzes how they operated prior and

Chart 4

Total Amount of TPS Outstanding and Qualified for Tier 1 Capital Together with Fraction of Bank Holding Companies Using TPS



Source: Boyson, Fahlenbrach and Stulz (2014).

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[5] *This is true if we know that the required level of capital before the change was the correct one. Yet, if capital requirements could have been excessive (or appeared so with the knowledge available then) the action taken by the Federal Reserve Board must be seen as a step to correct a mistake.*

post crisis in the U.S.A. These mechanisms are (i) lobbying, (ii) degree of political salience, (iii) revolving institutional doors and (iv) intellectual capture. Concentration of wealth in the financial industry gave banks huge political weight prior to the crisis and led to a financial oligarchy that is a big player in political campaign financing. Therefore, the financial services industry has a large influence on the political process including regulation. In terms of political salience Baker (2010) argues that during boom periods the general public does not have an interest in financial regulation making capture, i.e. collusion between the regulator and the regulated, easier. The issue of revolving doors promoting capture was addressed at some length already in section 2. Finally, Baker (2010) writes that in addition to industry capture there is large intellectual capture at work in the financial services industry as regulators and industry experts share the same education in identical Business Schools.

5 What to Do About It?

The preceding analysis has documented that regulatory capture is triggered by forces that are built into the incentive system of the policy process and that its impact depends on the degree of capture, varying substantially across industries. While weak capture can be mitigated by appropriate policy responses, strong capture by definition cannot. Baxter (2011) identifies a set of channels towards the common good that can be applied in case of weak capture. It needs to be stressed, however, that an effective solution to regulatory capture would have to be complex, multidimensional, and would require a serious attitude toward regulation (Baxter, 2011). The most important channels to mitigate regulatory capture are

- Applying the model of *"tripartism"*: regulatory policy that fosters the participation of public interest groups in the regulatory process.
- Limiting the size and hence the influence of industry players.
- Setting up properly structured and resourced agencies (e.g. tenure of management).
- Introducing better institutional roles for regulators.
- Being aware of the incentives going along with *revolving doors.*

Any process that aims at reducing regulatory capture needs to be built on the obvious, i.e. that taxpayers, regulators, and industry players are all agents that have influence on the outcome of a regulatory process. What needs to be ensured, however, is that any influence must not be disproportionate. Ayres and Braithwaite (1992) have advocated the model of tripartism. Tripartism refers to a regulatory policy that fosters the participation of public interest groups in the regulatory process. These groups have full access to all the information available to the regulator and if possible a seat at the negotiating table. By providing a continued role on the part of state attorneys in the enforcement of consumer protection laws against financial institutions, the Dodd-Frank act has made a step towards tripartism (Baxter, 2011).

A very simple policy response to restrict the influence of the financial industry is to limit their size and power. This is a serious issue as the concentration of wealth in the financial sector has been huge prior to the crisis and has gained momentum since then. The introduction of the European banking union is an important step to deal with this issue but it requires a firm commitment on behalf of all countries in the union and detailed concepts about different stages of the regulatory process including the living will.

Mitigating regulatory capture requires the public to have an interest in the regulatory process, support regulatory actions and give regulators appropriate institutional roles. This must include attractive salary schemes. As pointed out in section 2 a big salary differential between the industry and the regulator might be the first step towards capture. The public needs regulators who understand the business of the financial industry and have the moral authority to persuade those regulated.

As regulators need to understand the business they regulate, doors between the industry and the regulator cannot be closed. Hence, revolving doors are not only unavoidable but in some cases even desirable if there is need for industry specific human capital as is the case with the financial services industry. What might be a solution, however, is to implement a cooling off period or at least put more emphasis on how to motivate, fund and train regulators. Doing this might uncover some of the incentives that promote capture and hence can actively be avoided.

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Thierry Philipponnat

Secretary General
Finance Watch

Regulatory Capture in the Context of EU Lawmaking

Regulating an industry, regardless of the nature of that industry, is always a delicate exercise. Beyond the technicalities inherent to any particular field of the economic or the business world, the difficulty of regulating an industry comes essentially from a very natural phenomenon of proximity between the business elites which are to be regulated, the relevant political elites and, by extension, regulatory authorities.

This phenomenon, I believe, exists pretty much everywhere in the world and regardless of the industry that needs to be regulated. Elites usually come from similar social and educational backgrounds, they have a natural tendency to get together, to be close to each other, to exchange services, to belong to the same circles and to party together. This should not surprise anyone.

But, saying that this phenomenon of proximity should not be a surprise is not to say that it is neutral, that we should satisfy ourselves with it nor that it does not have consequences. The first consequence, obviously, is that proximity creates complacency and forbearance. The second consequence is that the proximity between the elites in charge of public interest (political and regulatory elites) and the business and economic elites whose job is to develop and promote private interests creates an environment where public interest and private interests tend to be confused.

It has to be said that the problem here is not that private interests should defend themselves and promote the arguments and the regulations that will benefit them: this is normal, this is legitimate, this is to be expected. The problem here is the possible confusion between public interest and private interests: democracy and the rule of law require that elected officials and civil servants have the conviction that public interest is not equal to the sum of private interests and that they have the understanding, the vision and the courage to take the measures necessary for the public interest even if and when they will hurt some private interests. Do not get me wrong, I am not saying that public authorities should not make all possible efforts not to hurt private interests, they should. I am simply saying here that there exists situations where promoting and defending public interest will require going against some private interests and that public authorities should not be afraid of doing so when necessary.

When it comes to regulating financial services, the universal phenomenon of proximity that I just described is "supported", if I may use that expression, by Adam Smith's notion of the "invisible hand" which has been highjacked by large parts of the financial industry as meaning that if an activity, any activity, makes a profit for someone it is necessarily good for the entire society. We all know that this is not what Adam Smith meant and that in reality he was a strong advocate of a sensible regulation to counter balance the natural hegemonic momentum of private

interests but this is what the public debate kept of his work. We also know that this degenerated version of Adam Smith's *invisible hand* is what led to 20 years of deregulation in financial services with the consequences that we know.

Interestingly, from my years advocating on the ground with Finance Watch, I can assure you that even seven years after the burst of the last financial crisis, the *invisible hand argument* is still widely used: I remember for instance with a fond memory the honourable Member of the European Parliament who during the public hearing on MiFID, in response to my statement on why high frequency trading was not what European financial markets needed to bring capital to productive use, asked me during the Q&A session: "Please reassure us Mr. Philipponnat, you are not against computers, are you?". By asking that question, that gentle lawmaker was showing his conviction that since high frequency trading is about clever people making good money in financial markets, it is necessarily good for society precisely by the simple virtue of the fact that it generates revenues for high frequency traders.

But understanding regulatory capture in financial services in the context of the European Union also requires to take into account another factor: The European Union, as we know, is working on building a single market with a single rule book but it is not a homogenous political zone. In fact, it is composed of 28 Member States who, of course, say they want to cooperate to build the single market but also compete with one another to develop their own domestic markets and defend their national interests. When it comes to financial services, more or less all EU Member States equate defending their national interest with defending the interest of their national champions and their national financial industry against the rest of the world, including against their European competitors. This is where the phenomenon of proximity between business and political elites comes back: at national level, the capture through proximity of political elites and, to a non-negligible extent, of regulatory authorities by private interests exists. And the consequence of this phenomenon is striking: the typical EU lawmaking process in financial regulation over the past 5 years has seen the European Commission propose texts that often did make a difference despite the army of Brussels based lobbyists trying to convince them day after day not to do so, the European Parliament takes up the texts, works on them, debates them and in many cases improves them and the Council almost systematically waters the texts down away from the European public interest in order to make them as close as possible to each time different national interests of different Member States. I could easily illustrate this point on legislations as diverse as European Market Infrastructure Regulation (EMIR), Capital Requirements Directive (CRD 4), Markets in Financial Instruments Directive (MiFID), Money Market Funds, Packaged Retail Investment Products (PRIPS), Bank Recovery and Resolution Directive (BRRD), banking union or the recent proposal by the Commission to reform the structure of the EU banking sector, to name but a few. I think, I can affirm that no European Union Member State is exempt from the practice of transforming the private interest of its national financial sector champions into national interest and subsequently influencing the EU lawmaking process through the Council.

Obviously, this is made possible by the fact that the EU is not a politically integrated zone and that its lawmaking process is based on a co-legislation mechanism between the European Parliament and the Council in a context where the Parliament, for all its imperfections, has an EU mandate when the Council acts as the representative of national interests. The dichotomy between the positions of those two institutions is often difficult to reconcile for the better of the European public interest.

Among the many anecdotes that could be told to illustrate this point, the situation that prevailed in January of this year is worth to mention. On 19 December of last year, the Commissioner for internal markets and services Michel Barnier banned his department's staff from holding meetings with bankers in the wake of the then coming proposal to reform the structure of EU banks that was being finalised at the time. The objective was to allow its staff to come up with a proposal that would not be watered down too much by the pressure of banking lobbies. What happened then was quite extraordinary as banking lobbies who had seen the door shut on them came back through the window with the help of a number of national governments that spent an enormous amount of energy pushing the rhetoric of their national champions that had been barred from doing it themselves directly. Regardless of what one thinks of the text in question, this illustrates perfectly how the phenomenon of regulatory capture functions in the EU: through proximity with national authorities, local financial interests make their way in a very effective manner into the EU lawmaking machine and manage in many cases to have the last word thanks to a less than perfect EU governance that has not decided who should have the last word between the institutions representing European interest (European Commission and Parliament) and the institution representing national interests (European Council) and that, in reality, has given a clear advantage to national interests over European interests as political careers are still made at national level.

What Conditions Should Be Put in Place in Order to Limit, If Not End, Regulatory Capture in the European Union?

First of all, it has to be said that a significant number of high level European politicians, regulators and civil servants, in particular – but not exclusively – in European institutions and agencies, are very conscious of the necessity for society to fight regulatory capture. Regulatory capture is very much a systemic question more than a question of persons and addressing the issue will therefore require, in my view, a thorough real world approach that should concentrate on improving the system.

We saw that regulatory capture derives from the combination of national proximity between regulators and regulated entities with the complexity of the European lawmaking process. The complexity of the EU lawmaking process being what it is, and given the fact that we have little perspective of making it evolve in the short term, we should concentrate on improving the national proximity situation.

This, very simply, can be done by increasing the distance between regulators/supervisors on the one hand and regulated/supervised entities on the other hand. And the best way to achieve this is to broaden the mandate of regulators.

The good news is that, as we know, this is what is actually being done in the EU. And I believe that with all its imperfections linked both to the time any ambitious project takes to implement in the real world and to the imperfections of the EU itself (obviously a much broader topic), the EU is on the right track to at least diminish in a significant manner regulatory capture in the field of financial services.

Let me illustrate my point with a brief reference to the main two pieces of financial supervision architecture that the EU has been working to put in place over the past five years.

The first one is the European System of Financial Supervision (ESFS) that led to the creation of the three European Supervisory Authorities (EBA, ESMA and EIOPA) and of the European Systemic Risk Board (ESRB) in 2011. Even if the ESFS still depends to a large extent on the relationship with national supervisory and regulatory authorities for reasons linked to the very nature of the European Union, it is without doubt a step in the direction of creating a more integrated European financial system that will have increased chances of functioning in a coherent manner with less chances of being captured by specific interests.

The second one, obviously, is the banking union with its two institutional pillars respectively in charge of the single supervision of European banks and of resolving them if and when need be. Regardless of all the challenges that they will have to overcome, the mere fact that they will operate at European level will make the Single Supervisory Mechanism (SSM) and the Single Resolution Board (SRB) less prone to (if not immune from) regulatory capture than would be the case (or was previously the case) with national supervisory or resolution authorities.

It seems clear to me that the European Union is putting in place today a regulatory and supervisory architecture that – everything else being equal – will be better equipped to fight regulatory capture than it was the case in the past. This is without doubt a step in the right direction.

Conclusion

One last dimension of regulatory capture that must also be borne in mind is the situation created by the combination of size and complexity of the financial system: When a system becomes so large and so complex, policy-makers reach a point where they can decide, consciously or unconsciously, not to reform what needs to be reformed from fear of the unintended consequences that their regulatory actions could trigger. In other words, fear of the unknown triggers immobility. A sort of negative interpretation of the "principle of precaution" and, without doubt, a recipe to change nothing and give up on regulating what needs to be regulated.

The issue of size is particularly sensitive in the EU context as the European financial services industry seems to be on a path of never ending size expansion which makes it, by construction, always more powerful. Between 2001 and 2011, the cumulated balance sheet of the EU banking sector grew by 80% to reach EUR 45 000 trillion (350% of EU GDP). The cause of this expansion is, as we know, the notorious "too big to fail" syndrome and the funding subsidy derived by "too big to fail" institutions which feeds a phenomenon where size feeds size. The power of the biggest financial institutions has never been as important as today.

Admittedly, there is a point in the argument saying that legislators and politicians are not equipped to deal in detail with all the complexities of a financial sector which has become, indeed, so large and so sophisticated.

This is why I believe that the trend that we are seeing today where more and more so-called level 1 legislations delegate very important rules to regulators to be elaborated at level 2, makes sense.

We can see this, for instance, in the importance of the level 2 work to be realized on MiFID 2 but also in the proposal of the European Commission to reform the structure of the EU banking sector. Typically the impact of those two texts, the first one having now been adopted at level 1 and the second one still to be discussed by European legislators, will depend on the work done by regulators at level 2.

In my view, banking union is also a case in point in that respect. Banking Union has the right objectives and has put in place a system which is a very significant progress towards diminishing moral hazard in the banking sector and eventually reducing the doom loop between European sovereigns and European banks.

Journalists often ask me whether banking union will achieve its objective of protecting tax payers against potential bank defaults. And my answer to this question is “it will depend”, which usually creates a frustration with the person who asked the question and who was expecting a clear “yes” or a clear “no” as an answer. And the complete answer is: “It will depend on the way regulators and supervisors apply the rules and perform their duties without being captured.” Banking union, in particular in its Single Supervision and Single Resolution dimensions, has all the potential to improve in a considerable manner the situation of the EU banking sector but whether this potential converts into reality will depend crucially on the way regulators, supervisors and resolution authorities use the tools that have been put in their hands by legislators. The Single Supervisory Mechanism (SSM) is now well on its way to being established and what we are seeing gives us, despite the difficulties inherent to this exercise, many reasons to be optimistic on its ability to deliver on its crucial mission. On the SRM side, it is obviously too early to have a view on the yet to be established Single Resolution Board (SRB) but its role will be as important as that of the SSM and the ability of the SSM and of the SRB to cooperate will be essential to achieving the objective of the banking union.

All this leaves a historical responsibility on the shoulders of European regulators, supervisors and resolution authorities which will need to make sure that they do not get captured in the course of exercising their extended responsibilities. The financial stability and therefore the social cohesion of our societies depend on it. Thank you for your attention.

Michael Spindelegger

Austrian Federal Minister of Finance

Challenging Tasks Ahead

Governor,
Ladies and gentleman,
I am here today to talk about the topics that cause you some headache. I am convinced that due to the flood of new regulations your job is getting harder every day. But I reassure you: The last months as finance minister have not been a walk in the park either.

Due to a bank that you all know from the news the budgetary procedures have been extraordinary challenging this year. Due to the creation of a Bad Bank for Hypo Alpe Adria our deficit ratio rises by 1.2% to 2.7%, the debt to GDP-ratio rises by 5.5% to 79.2%.

I am well aware of the fact that Austrian Banks contribute to this budget by a tax that is not very popular with them. But I am also well aware of the fact that until the end of 2013 the Austrian state granted state aid in the volume of EUR 14.4 billion to stabilise the banking system.

We are not very optimistic about the full repayment of this money at the moment. So it is reasonable to insist on further contributions by the financial industry to reduce the costs for the tax payer.

On the other hand, I understand that the financial situation of many banks in Europe is tight because of the aftermath of the financial crises and new regulations like Basel III. Plans on the European level that could bring new costs are seen with scepticism.

The banking union will become a challenging task for the financial industry. Beside the national bank levy the contributions to the Single Resolution Fund as well as the contributions to the European deposit guarantee scheme could be extra burdens for the Austrian banks.

I hear warnings of the CEOs of the banks that new burdens will curb credit growth. But I also hear my coalition partner expecting the banking levy not expiring until incurred costs for the tax payer are covered. It will be a major task to cast these different opinions into one workable agreement.

Apart from the question of financial contributions the banking union itself is an important step for us in overcoming the financial crisis. During the last months we have had heavy discussions in the Ecofin Council over the Details of the Single Resolution Funds.

This Fund is an important step to cut the connection between struggling banks and the tax payer. It is not acceptable that governments all over Europe have to save every single bank and the tax payer is always paying the bill.

The Fund should be the answer to this dilemma. The decision to save or close a struggling bank will be made on a European level. Within 24 hours the future of the bank shall be clear. The financial industry as a whole will contribute to the EUR 55 billion fund. After capital and bond holder bail-in the fund will pay the costs for winding down the troubled institute.

This regime will start in 2015. Over 10 years the banks will have to fill up this fund. After 8 years the fund will be fully established. There have been many voices urging that the banks fill up the fund much faster. Our position was always that we must not overburden our financial institutions because credit growth is essential for the growth of our economy.

For banks that can be saved there should also be a Fund on a European Basis as a back-stop mechanism. The Ecofin Council discussed that in the future the European Stability Mechanism-Fund could not only provide sovereign states but also struggling banks with financial support. This ESM-Restructuring-Fund is the next step on our way to the stabilization of the European banking system.

A key element of the funds is the establishment of a rule for bail-in. Our position always was: In the future, the banks themselves are liable for their risks, not the taxpayers! Creditors of banks must participate in the risks. Savings less than EUR 100.000 will be excluded from the bail-in.

Another important pillar of the banking union is the Single Supervisory Mechanism (SSM). This mechanism should bring an end to the fragmented supervision of banks in Europe, that can be blamed for the big dimension of the financial crises, too. As we have European banks, we also need a European supervisory system to detect the risks on a broader basis.

I know that the European Stress Test and the Asset Quality Review means commitment of resources, bureaucracy and loads of paperwork for banks' employees. But I am convinced that at the end of this process we will have a financial system in Europe that is way more solid than it was before the financial crises.

Let me now come to another topic that kept us busy within the last months – the Financial Transaction Tax (FTT). We have discussed the FTT for a while now and reached an informal agreement at the last Ecofin Council in May. The Ministers of 10 European Member States including Austria agreed on implementing a Financial Transaction Tax by the 1 January 2016.

These Member States are taking part: Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia and Spain.

We also agreed on implementing the FTT in a step by step approach. In the first step the tax will include shares and some derivatives. More technical work is required to specify the details. This will be done in the Council and in the Council working groups. Details should be finalised by the end of 2014.

As expected many Member States criticised this agreement as they oppose the FTT as such. We are willing to hear their objections but are also willing to keep on track.

Further negotiations are necessary. But we also made clear that if individual Member States would like to impose taxation for other products that are not included from the beginning of a progressive implementation, in order to maintain existing taxes, they would be allowed to do so.

We are confident that this will provide a sound foundation for the technical work at the Council that lies ahead of the implementation of this new tax. It shows us that the instrument of enforced cooperation works and is a useful toolkit in a topic where we have different opinions within the Member States.

Finally I want to inform you about a topic that was also relevant on a European level – the topic of Tax Evasion. For years Austria has been criticised by its European Partners because of the position on the Savings Directive.

Since my appointment in December 2013, I have made big efforts to ensure the compliance of Austrian rules with international standards in fighting tax evasion.

In March 2014, we have brought to an end the long-lasting gridlock between the European Commission and Austria about the savings directive. We presented a solution at the Ecofin in March. In April, Austria has signed the FATCA-Treaty with the U.S.A. that ensures an information exchange upon request by the U.S. authorities about U.S. citizens.

We have not been hesitant, we have just insisted on a level playing field, especially with neighbouring countries as Switzerland and Liechtenstein.

Now that a common global standard for the automatic exchange of information will be established by the OECD, Austria is prepared to switch to the automatic exchange of information.

One important point for Austria in the Ecofin council was to avoid the establishment of two different standards that would cause enormous administrative costs for the banks that cannot be justified. Therefore, Austria pushed for the adoption of the broader OECD-standard also on EU-level.

The second main point for Austria was the push for more corporate transparency. An automatic exchange of information must fail as long as anonymous investments are possible by using the corporate veil. It is easy to conceal real beneficial ownership through labyrinthine combinations of anonymous companies and arrangements such as trusts and foundations. Therefore, Austria is pushing for a central trust register to be included in the Anti-Money Laundering Directive to foster the fight against tax evasion.

We have positive signals that also our neighbouring countries like Switzerland and Liechtenstein are willing to negotiate on the basis of the new global standard. Of course, there are some counterclaims, like improving access of their financial institutions to the internal market. But given the emerging new global standard, it seems clear for us that even our neighbours are changing their positions.

Let me draw a balance at the end: Being 6 months in office now, I have realised that the basic conditions for the financial industry are changing fast.

Politicians are dealing everyday with more and more complex circumstances that are essential for the stakeholders, but far away from earning you applause by boulevard media and voters.

More and more tasks are shifted on a European level to keep up with Banks growing bigger and more international and more interconnected.

But I'm convinced that in the end all these parts of the puzzle make sense when being seen as one big picture. Your efforts are as essential as mine to make sure we cut the link between struggling banks and tax payers. Your efforts are as essential as mine to make sure that the banking system is getting more and more stable. And our both efforts are essential for enabling further growth, new loans for companies, new investments and new jobs.

Let's work together on this common goal to make our countries prosperous and worth living.

Thank you.

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Session 4

Panel: Implementing the SSM: Implications for Banks and Regulators

Peter Mooslechner

Executive Director
Oesterreichische Nationalbank

How to Change the World (of European Banking) by Implementing the SSM? Implications for and Demands on Banks and Regulators

> *"Integrity is doing the right thing,*
> *even when no one is watching."*
> *(C. S. Lewis, 1898–1963)*

As early as in the fall of 2008, it became obvious that the existing regulatory and supervisory framework was not able to prevent one of the biggest global financial crises since the 1930s. Equally important, the crisis revealed also quite a significant amount of "misbehaviour" in financial markets in addition to institutional shortcomings, calling for a fundamental change in the governance of financial behaviour. The G20 – in particular at their London Summit in 2009 – as well as the European Commission called for and designed an encompassing set of initiatives to cover all these areas, ranging from capital requirements to financial incentives.[1]

As one consequence of the many avenues followed in this context by 4 November 2014 the ECB will assume responsibility for banking supervision in the euro area, making a major institutional reform in Europe to become operational. This reflects that from its very beginning in 2012 the Single Supervisory Mechanism (SSM) has been driven by the lessons learned from the recent financial crisis: The focus of the Single Supervisory Mechanism has thus been explicitly geared towards achieving a new framework that would be able to induce shift in behaviour, both on the side of supervisors as well as on the side of market participants to improve the situation towards a fundamentally improved governance structure for European banking.

Shortcomings in Supervision and in Banking Revealed by the Crisis

Before addressing some of the shortcomings in supervision revealed by the crisis, a brief account of structural change in the European financial system during the past two decades might be helpful as a starting point. The international expansion of the financial sector starting from about the mid-1990s was one of the biggest processes of financial globalization in modern financial history.[2] This process – amplified by the creation of European Monetary Union – has also substantially changed the financial landscape of Europe, reflecting the efforts and needs

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[1] *See G20 "London Summit – Leaders' Statement", 2 April 2009 and European Commission Communication "A reformed financial sector for Europe", COM (2014)279 final and SWD (2014)158 final, Brussels, 15 May 2014.*

[2] *See Allen F., T. Beck, E. Carletti, P. Lane, D. Schoenmaker and W. Wagner. 2011. Cross-Border Banking in Europe: Implications for Financial Stability and Macroeconomic Policies. CEPR.*

for intensified European financial integration at the same time. Cross-border mergers in banking became a characteristic feature of this development during this time as well as a marked increase in foreign ownership, most pronounced in the CESEE region. The result of these merger waves was a relatively small number of countries holding high market shares in cross-border banking in Europe. At the same time, the financial institutions dominating cross-border banking activities not only expanded rapidly in balance sheet size but set up extremely complex organisational structures including huge numbers of (foreign) subsidiaries.

The creation of big cross-border institutions through mergers and acquisitions was a very visible but by far not the only significant structural change that contributed to the creation of crisis prone European financial structures. At least as important, and in contrast to traditional and more localized (commercial) banking models, which relied strongly on deposit funding, these new institutions to a much larger degree used short term debt (wholesale funding) and international capital markets to fund their activities. Thereby, a significant substitution in the liability structure of banks from non-bank customer deposits towards more short-term and volatile funding took place. This made banks very vulnerable to funding problems. Liquidity crises transmitted through international financial markets and it increased the interconnectedness and the systemic nature of European banking at the same time. Moreover, it led to complex and opaque intermediation chains that in turn created hidden maturity transformation, liquidity risks, credit risks and distorted incentives. These complex chains of intermediation with their origin in a model of financial intermediation depending on short term funding from international capital markets have been pointed out and discussed in detail by Shin (2010).[3]

The increasing cross-border nature of banking in Europe together with its considerable dependence on international markets for short-term debt was not matched by an appropriate regulatory and supervisory development at the supranational level. This was one of the important structural shortcomings revealed by the financial crisis of 2007 and 2008. Despite a certain harmonization process of regulatory frameworks, supervision remaining organised along the traditional boundaries of nation states had a very difficult task to uncover the risks hidden in complex cross-border chains of financial intermediation, starting with the access to appropriate information.

As pointed out for example by Hellwig (2014), the crisis has revealed another critical aspect of supervisory shortcomings resulting directly from the organisation of supervision along national borders. In the course of any banking crisis, issues of insolvency had to be dealt with by regulators and poli-

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[3] *Shin, H. S. 2010. Risk and Liquidity. Chapter 6. Oxford University Press.*

ticians, which are particular complicated in the case of big banks. First of all, insolvency problems must be identified as early and as correctly as possible. The standard criterion to identify an insolvent banks is when the value of its assets falls short of the threshold of its regulatory capital. When such a situation occurs, it is inferred that at some point the bank will not be able to cover its liabilities. In practice, especially when markets freeze and market prices are often unreliable during a crisis, the valuation of assets and liabilities becomes very difficult and contains a considerable amount of judgement. At this stage, if supervision is organised at the level of nation states, attempts that would force banks to reveal their losses, to recapitalize or cut back their activities might be postponed. This situation is likely to be reinforced by fiscal concerns, especially since the fiscal authorities that might start operating are also confined to national borders and coordination might be difficult and the willingness for burden sharing limited. If the recapitalization or closure of insolvent banks implies a large fiscal burden for particular countries, supervisors are likely to be challenged between their individual supervisory mandate and general macrostability concerns in a situation like this. In a cross-border institutional design like the SSM, supervisors, by definition, are in a much stronger position to address the relevant issues.[4]

An additional important point in this respect is the widespread lack of appropriate resolution instruments (in Europe). Authorities and supervisors might feel that anything other than forbearance and playing for time might be worse; this is to say risking a disorganised wind down of financial institutions with complicated cross-border coordination and burden sharing issues down the road. As a consequence this will have an impact on bank behaviour and supervision ex ante, resulting in excessive risk taking by banks and probably a soft and light touch approach in supervision and regulation.

How Will the SSM Change the Behaviour of Supervisors?

The SSM will change the supervisory framework in Europe significantly. For the first time in the history of the European Union there will be a banking supervisor with a European mandate that is based on a common set of rules developed by the European Banking Authority. The new framework enables supervisors to look at cross-border banks beyond a viewpoint shaped mainly by national borders already in non-crisis periods. If supervisors actively use this opportunity, this will become a strong force against market fragmentation and financial disintegration. This fragmentation was fostered during the crisis by the spiral of weak banking systems impairing the sovereign states that had to provide fiscal backstops, which in turn affected the banking systems themselves. This negative feedback loop contributed strongly to a further fragmentation and disintegration of financial markets, complicating the effectiveness of monetary policy as well as putting a burden on cyclical development at the same time.

Within the SSM the ECB will be responsible for the direct supervision of about 130 banking groups, which together represent about 85% of all banking assets in the euro area. Overall, this comprises about 1,200 credit institutions. The centralized supervision and the key role of the ECB in the

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[4] *For a clear and detailed discussion of these issues see Hellwig (2014).*

process shall have a strong impact in ameliorating two of the weak spots identified in the previously existing framework: Information flows will be centralized and no longer fragmented according to national institutional arrangements. This setting shall make it much easier to detect risks as early as possible that were hidden in the complex interconnectedness of cross-border financial institutions. The centralization of supervisory responsibility at the level of the ECB should also shield supervisors from a certain home bias and from unequal treatment of financial market participants that may have played some role in a purely decentralized setting.

How Will the SSM Change the Behaviour of Market Participants?

At the level of financial institutions and financial market participants the implementation of the SSM removes many opportunities to exploit the regulatory and supervisory fragmentation of markets that was previously existing. Dealing with a central supervisor will in the short run create a number of practical challenges for individual institutions. Banks will have to deal with a new supervisor who is remote from domestic peculiarities and politics. They will have to ensure compliance with the new uniform guidelines and standards. They will have to cope with new issues in data collection and the provision of information. Banks will have to decide whether they need to expand (cross-border) or if they can deal with the new situation by restricting themselves to “domestic markets”. These are all major challenges that are likely to consume lots of organisational capacity in the short run.

In the medium term the new framework will force banks to think much more in terms of a common European market and a single set of rules. Whether this will lead to a material change in behaviour is of course crucially dependent on how the new supervisory framework is backed up by a credible set of resolution rules. Only if these rules are clear and credible the balance of power can be readjusted in the right direction.

As it has been demonstrated by the evolution of the recent crisis, strategic behaviour of market participants, implying self-interestedness, does not mix well with shared or common interests, such as European integration in general and financial and economic integration in particular. Despite rules and norms in place before the crisis, encouraged by innovation in financial products and enormous profits and gains, financial market behaviour got out of control and restrictions on risk taking or approaches of (self-) regulation functioned less and less effectively (Groenleer et al., 2014).

Will the SSM Change the Role of the ECB?

The integration of supervisory functions with central banking has always been controversial and triggered extensive discussions over decades. Over time, many countries have gained experiences with various models and with a switch between different models. Some countries had integrated supervisory functions into the central bank for a long time, based on the central bank’s role in stabilizing the financial system, its role as a lender of last resort[5] as well as because of its role as a producer of the relevant data. Other countries had

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[5] *Goodhart, C. 1988. The evolution of central banks. MIT Press.*

kept the two functions separate from the beginning, in many cases in the institutional form of an independent financial markets authority. With the SSM it has now been decided that the ECB, as the monetary policy authority for the euro area, will also be in charge of the SSM.

In terms of information sharing this can be seen as a significant improvement compared to the previous arrangements, where monetary policy, in particular liquidity provision, was supranational and banking supervision was national. The challenge for the ECB in the new setting is how to keep the decision making processes separate but efficient within the new arrangement. Beside this difficult challenge of developing appropriate institutional arrangements and procedures in this respect, there are also several immediate practical challenges for the ECB.[6] The most immediate one will be the successful completion of the balance sheet assessment for the European banking system (asset quality review + stress testing exercise). The successful completion of this exercise will be crucial for the reputation of the SSM and define the starting point for the SSM to operational normality.

Beyond that several other urgent issues need to be addressed, including the cooperation between the various involved European and national institutions and the application of a coherent supervisory model across all the different members of the banking union. Another area concerns the collection and analysis of banking data across the banking union. This is a challenge, both in technology as well as in analytical capacity. It is a technological challenge because of the heterogeneity and diversity of systems in which these data are currently stored as well as to bring in line the collected data with the cross-border perspective to be implemented.

Finally, on the side of the regulator there will be the challenge of attracting staff with the right expertise. There will be competition between the ECB and national authorities for qualified staff and there will be a need to train a substantial number of new employees to cope with all the qualifications needed for the new complex supervisory regime.

Will the SSM Achieve the Desired Results in Practice?

One important lesson drawn from the Lehmann experience during the financial crisis in September 2008 is that in a crisis even the best supervisor will be helpless if there exist no practical procedures and arrangements that allow the authorities to deal with problem banks effectively. Much of the success of the SSM will thus depend on the functionality and effectiveness of the European resolution regime to be established in parallel to the creation of the SSM (Veron, 2012).

Most relevant in this respect, the Bank Recovery and Resolution Direc-

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[6] *See Constancio (2013), Hellwig (2014) and Nouy (2014).*

tive (BRRD) and the Single Resolution Mechanism (SRM) are intended and designed to provide an adequate framework for dealing with troubled banks in an operationally predefined way. Thinking about the quite far reaching consequences of this it comes as no surprise that among commentators as well as within the financial industry this part of the new framework has stirred most of the controversy. Not at least because the outcome of the recent asset quality review and stress testing exercise is directly linked to this issue.

The sceptical arguments that have been put forward are that a multi-entry resolution with different national procedures will not be viable. In particular, because first, the SRM has no facilities to provide funding during a systemic crisis when market funding disappears and second, the fiscal backstops in place are still in the domain of the member states and seem too weak to be able to provide assurance to investors during a crisis. Moreover, as has been pointed out by many critical commentators on the banking union and the SSM in general, the existing European fragmentation of fiscal policy makes the central bank as a backstop less effective than it would be in a situation with some stronger form of fiscal responsibility for banks at the European level as currently envisaged (Dullien, 2014).

While it is too early to draw any final conclusion, it is clear that for the effectiveness of the SSM to trigger material changes in behaviour of supervisors and banks the resolution regime seems to play a decisive role. The BRRD and the SRM are important steps in the right direction but ought to be enhanced in order to conclude the project sustainably in the long-term.

On the Road Back to Integrity in Financial Markets

The SSM constitutes a significant institutional reform in the European Union which was triggered by the lessons learned from the crisis and should change (and stabilize) the European landscape of banking for the future. Information fragmentation as well as coordination issues of a fragmented banking supervision system in Europe had created an environment where supervision and regulation were not as effective as it could and should have been to mitigate at least the propagation of the crisis. Misconduct of financial institutions that were not disciplined to a sufficient extent was one of the crucial determinants of the amplification of crisis effects.

Many of the (old) problems had their roots in fragmentation of supervision in a world of cross-border banking, which will be overcome in the new framework. Nevertheless, the centralization of supervision is only a first step to have a material impact and to produce a considerable improvement. Complementary, an operationally effective resolution structure together with a European deposit insurance mechanism are key. While the European authorities have clearly recognized this and therefore initiated the BRRD and the SRM, this crucial add-on elements to the new framework will remain extremely controversial in the public discussion for some time.

Overall, regulatory stability is needed as a necessary precondition first, while at the same time much more focus than in the past has to be put on reinforcing the importance of "high quality financial market governance" as well as "financial market culture" and "good behaviour" to counteract a general attidtude of de-responsabilisation that led to the current crisis. It has to be recognised that the lasting success of the fundamentally new institutional structure of European banking depends heavily on substantial changes in financial behaviour on the side of the banking industry and financial market participants as well as changes in the conduct of banking supervision and resolution. Only if these changes in the direction of a "more prudent behaviour" of financial market participants will really take place on both sides, a better and more resilient European banking system will emerge.

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New Frameworks Require New Perspectives: Realizing Common European Banking Supervision

The establishment of the Single Supervisory Mechanism (SSM) signifies a fundamental and radical change in the framework for supervising banks by all banking supervisors in the euro area. It necessitates a change in the legal framework, a change in institutional settings, and a change in the distribution of responsibilities. These changes, however, will not instantly lead to a total change in our thinking and behavior. Realistically, we will see a lag between changes in structures and the changes in hearts and minds that will have to follow. Hence, for the SSM to be successful from the beginning, it will be essential to start thinking as a Single Mechanism from today and start acting as a Single Mechanism from the first day.

To establish a successful new and common approach to banking supervision right from the beginning – as is intended – the following three conditions will have to be met: First, a new supervisory perspective, with the euro area's aggregate economic strength as the point of reference, needs to be adopted. Second, this new perspective will need to translate into taking common decisions in the interest of the European Union as a whole. Thus, a European approach to banking supervision will have to be formed, an approach that will be shaped significantly by the SSM Supervisory Board as the central body for decision making. Third, when decisions are taken, temporary shortcomings and unintended effects such as a possible increase in bank concentration will have to be considered. The following sections will explore the three conditions in more detail.

1 Adopting a New Supervisory Perspective

In the era before the SSM, supervisory measures and actions were significantly limited by each member state's capacity to absorb the negative effects of a bank failure or to rescue a bank deemed "too big to fail". The economic strength of the respective member state was the point of reference for supervisory agencies.

The importance of this point becomes most apparent when relating the balance sheets of the largest banks in an economy to its GDP. According to data from 2012, the total assets of the largest banks were outweighing national GDP in 6 out of 18 economies (chart 1). Ireland and Cyprus represent extreme cases, where in each case the ratio of one bank's total assets to GDP exceeded 200%.[1] As a consequence, Irish and Cypriot banks are "too big to fail", and perhaps also "too big to res-

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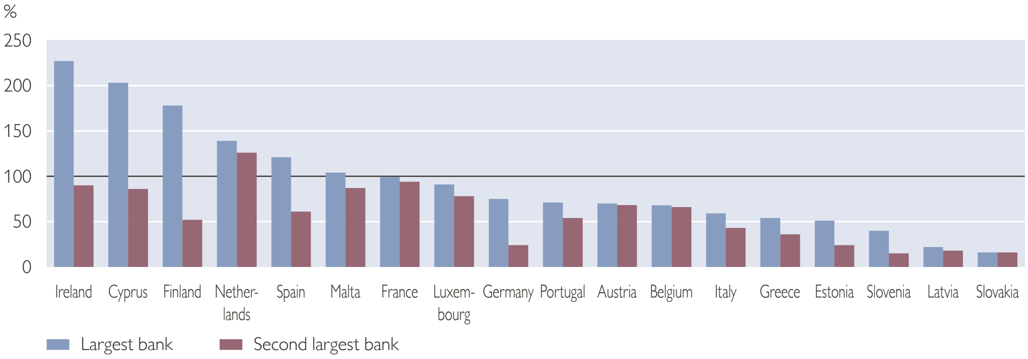
[1] *In Austria, for instance, the largest bank's balance sheet amounts to 70% of Austria's GDP.*

Chart 1

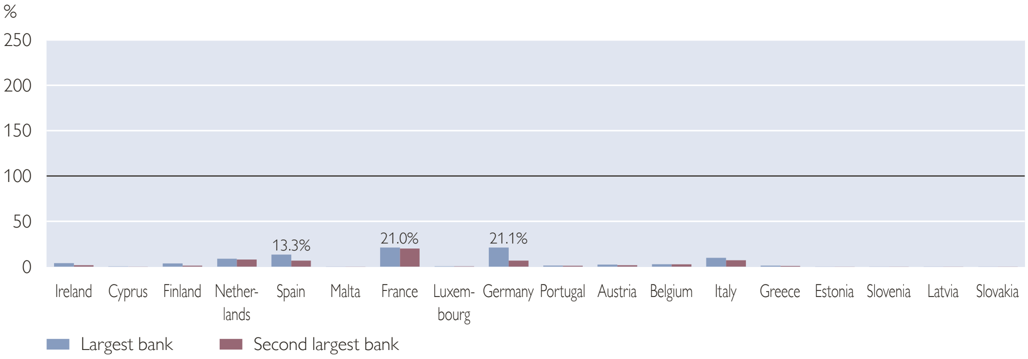
Total Assets of the Two Largest Banks as a Share of the Home/Host Country's GDP by Member State by End-2012



Source: FMA database (2014).

Chart 2

Total Assets of the Two Largest Banks as Share of Euro Area GDP by Member State by End-2012



Source: FMA database (2014).

cue", in relation to the domestic economies. Moreover, as demonstrated in the recent crisis, even the rescue of a bank that is much smaller relative to GDP can create a massive burden on the budget and the tax payer.

The establishment of the SSM does not necessarily affect the size of banks. Rather, it matches the level of governance integration to the degree of market integration. With that, the euro area as a whole will be the new point of reference for banking supervisors. By comparing bank total assets to the euro area GDP (chart 2), we get a very different picture: The majority of significant banks have balance sheets of less than 10% of euro area GDP. Banks with total assets exceeding 10% of GDP can be found in only three countries (Germany, France and Spain), and no bank in the euro area has total-assets-to-GDP ratios exceeding 21% of euro area GDP.[2] The relation between the supervisory jurisdiction and the largest banks is reduced remarkably.

With the euro area as the new point of reference, the figures of the largest

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[2] *The largest banks of the euro area such as Deutsche Bank, BNP Paribas and Groupe Crédit Agricole each has assets equivalent to about 20% of GDP.*

European banks are now – in terms of economic weight – comparable to those of the U.S.A.. For example, the largest U.S. bank (JP Morgan) has assets 15% of U.S. GDP (or 23% on an IFRS-equivalent basis).[3]

Thus, from the SSM perspective the weight and importance of each individual euro area institution is reduced to a fraction of its national weight.[4] Therefore, a new economic relationship between the supervised entities, its supervisors, and the European economy will emerge, and have important effects. As a large majority of banks will be far from being "too big to fail", their bargaining power will be reduced, and more pressure can be exerted on them by regulators to act prudentially. A healthier and more balanced relationship will be the consequence. It will be the foundation for a new sustainable supervisory culture.

2 Institutionalizing Decision-Making in the Interest of the European Union As a Whole

Until now, the change of regime exists largely on paper. It needs to be translated into common decision-making processes, formally and informally. Formally, such a translation has been effected through the establishment of the Single Supervisory Board which had its initial meeting in February and has operated since then. Even more importantly, however, a change of regime necessitates a change in mindset. Without adjusting our ways of thinking to the European mandate, we will not be able to establish a level playing field with all its benefits. Thus, the question is how the newly established organizational structures can be transformed into common decision-making processes with the interest of the European Union as their focal point.

Every individual National Competent Authority (NCA) needs to actively contribute to the creation of a European supervisory institution that aims for the common good and that ultimately acts in the interest of the European citizen. While the Joint Supervisory Teams (JSTs) will be the central fora in which supervisors from different countries join to find a common understanding and way of supervision, the Supervisory Board of the SSM will be the place to substantially shape the common supervisory approach.[5]

The Supervisory Board's central position in the supervisory framework is based on its particular features. Formally, the Board's members are the executive directors of the NCAs[6] plus a Chair and a Vice-Chair, and four repre-

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[3] *ESRB. 2014. Is Europe Overbanked? Reports of the Advisory Scientific Committee, 4.*

[4] *To give an example: Erste Bank Group, presently the largest bank in Austria, has total assets amounting to only 2% of euro area GDP.*

[5] *Joint Supervisory Teams are composed of staff from National Competent Authorities and are led by an ECB JST Coordinator. Every significant banking institution will be supervised by a full JST.*

[6] *If the National Competent Authority is not the national central bank, a representative of the national central bank may attend the meeting. The voting right is to be exercised by the representative of the National Competent Authority.*

sentatives of the ECB. Its main responsibility is to adopt decisions on the microprudential level concerning any of the – currently around 130 – banks that are deemed to be "significant" and thus fall under direct ECB oversight.[7] These supervisory decisions will be made by the collegial board by simple majority. Most importantly, the Supervisory Board is obliged to act in the interest of the European Union as a whole, as stipulated in the SSM Regulation. This means that the common good of the European Union, not national interests is to guide the actions and decisions in the SSM.

These are all very important prerequisites for a common European way of supervision. However, bridging the gap between national supervisory habits and a common way of European supervision in the interest of the European Union is not straightforward. It will be crucial to ensure that decisions are not made on the basis of hard bargaining as particular national interests are played out against each other. Such an outcome would be far from desirable from the viewpoint of the European citizen. To some degree the risk of national interest-based bargaining can be avoided by protecting the votes of individual Supervisory Board Member by not making them publicly available. Studies in the field of public choice (e.g. Stasavage, 2004[8]) have shown that overly-extensive transparency in political negotiations may have detrimental effects on consensus finding and the provision of public goods because national representatives are then incentivized to take positions that are close to national interest and potentially less beneficial for the entire community. As in arrangements applied to the ECB's Council, the internal rules of the Supervisory Board restrict the public disclosure of the views of individual members and protect their individual deliberations, proposes, and vote record at Board Meetings.

Essentially, the Board will live by the individual experience and knowledge of its members at the table. Ideally, the Supervisory Board shall be a forum of discussion based on each member's individual (and largely national) experience, which acts upon this collective knowledge in the interest of the European citizen. We need to "raise our hands, not our flags". This will be the key factor in the process of successfully creating a common European supervisory mechanism.

3 Anticipating Shortcomings and Avoiding Unintended Effects of the SSM

We need to consider also possible shortcomings and unintended effects of the SSM that can, especially during the first phase of the SSM, counteract su-

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[7] *This means that we will co-decide on banks located either in Austria or in other euro area member states such as Spain and Germany.*

[8] *See Stasavage, D. 2004. Open-door or closed-door? Transparency in domestic and international bargaining. In: International organization 58. 667–704.*

pervisory goals and complicate regulatory tasks.

In this regard, it is worth remembering that the SSM can be fully effective only from 2016, when all components of the banking union are operational. For instance, the complete range of bail-in instruments will not be active before 2016, and the Single Resolution Fund will be fully funded after a transition period of another eight years. During this transition period, we need to anticipate possible situations in which decisions are taken at the European level and risk is still be borne at the national level, because neither the formal mechanisms nor the framework for a common resolution scheme will be fully operational, and so individual member states and tax payers will have to pay in full the eventual bill for a failing bank. This asymmetry during the transition period requires the Supervisory Board to consider more carefully and consistently national particularities when deciding, for example, on capital and liquidity adequacy requirements for supervised banks, or on corrective measures. Therefore, a more complete shift from a national to a European perspective will be feasible and desirable only in the medium term.

We should be aware also of other possible unintended effects of the SSM. Common regulatory standards and a common supervisory mechanism could favor another wave of consolidation in the European banking industry, following the consolidation wave set off by the establishment of the EU's Single Financial Market. While, given the paradigmatic shift in banking supervision, a certain degree of consolidation may be natural and may strengthen the competitiveness and profitability of banks, consolidation should be avoided where it increases systemic risks and oligopolistic tendencies. Also, consolidation can lead to attenuated competition and reduced availability of financial services in some regions, and hyper-competition and low margins in other regions.

4 Conclusion

We have already come a long way to reach the present state of the Single Supervisory Mechanism. Much has been done so far to draft the legal framework, determine the basic institutional settings, and design the new way of European banking supervision. Yet, while the formal implementation of the SSM has made good progress, transforming the formal provisions into a real change of regime requires our minds and habits to change as well. For this reason, it is worthwhile taking a step back and considering the metamorphoses we have to undergo to create a real European Single Supervisory Mechanism. First and foremost, we need to adopt a new supervisory perspective with the euro area as the new point of reference. Second, this new perspective has to be translated into decision-making for the benefit of the European citizen, while making use of diverse national experience. Overcoming national habits and constraints will be a key factor in establishing a real level playing field with the industry. Third, we need to be aware of temporary shortcomings of the SSM during the transition phase before all components of the banking union are operational. Thus, unintended effects, such as a further increase in bank concentration, need to be considered even more carefully when taking supervisory decisions in the first phase of the SSM. We need to implement the Single Supervisory Mechanism in national legislation and formal national procedures, but most importantly, and ultimately, we need to adopt a European perspective for a truly common and single supervisory mechanism.

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SSM and ECB: Supra-Nationalization of Banking Politics

1 Background

In November 2014, Europe's Single Supervisory Mechanism (SSM) will be launched. In fact, for Europe's banking industry – that is, supervisees but also supervisors – the SSM has been in place ever since the comprehensive balance sheet review was contemplated and then implemented since the end of 2013. The SSM is part of an indeed ambitious project: the three-pillared banking union, whose second part is a set of tools to handle banks in trouble, be it by restructuring, downsizing or unwinding them (i.e. market exit) and whose third part is a harmonized deposit guarantee scheme.

The two-and-a-half legged stool which emerged after barely two years of construction is not exactly according to the blueprint as it might have been conceived by a benevolent (platonic) stool-maker's king. That is, there is substantially less commonality – common backstops – than federalists might want to see. But the new setup, still very much a construction site, is a far cry from what was deemed achievable – or, better, appropriate – in the euro area before the crisis broke in the summer of 2007. In fact, it needed two additional ground-shaking developments (the near implosion of financial markets in the fall of 2008 as well as the Greek sovereign debt crisis plus its fallout, beginning in the fall of 2009) before Europe – the Commission, the Parliament and the Council – could convince itself to move. This reluctance to adapt becomes evident when interpreting the de Larosière Report from today's angle. This very influential work, which was implemented in a surprisingly faithful way, led to the European System of Financial Supervision, encompassing a network of three micro-prudential European supervisory authorities, complemented with the macro-prudential European Systemic Risk Board (Grande, 2011). At the time, de Larosière was seen as pushing the (federalist) envelope, going to the limits of what many European nation states were prepared to accept. This is palpable, for example, in the setup of the European Systemic Risk Board (ESRB), which attempted to delicately accommodate national prerogatives and preferences. It became even more evident after the Deauville signal on private sector involvement (October 2010) ultimately forced Europe's hand in changing the temporary European Financial Stability Facility (EFSF) into a permanent European Stability Mechanism (ESM). Some – maybe even many – see this as being incompatible with a proper reading of the European Treaties, more specifically with the no bail-out clause (Art. 125 TFEU). From this angle, requesting (national) sovereignty in decision-making simultaneously implies bearing the consequences, i.e. taking responsibility for your acts. Otherwise, with

perimeters between competence and responsibilities diverging, incentives will be distorted.[1]

There are basically two ways of harmonizing radiuses: devolving (nationalizing and coordinating) or centralizing (supra-nationalizing). The SSM (as well as the banking union more generally) opts for the latter: centralizing. This represents a distinct rupture with initial ideas about monetary union, a change of paradigm in a literal sense: A defining part of the national policy (and political) domain is now supra-nationalized, namely the politics of banking. These brief remarks focus on how the re-orientation came about – very protractedly at first, but then abruptly. This has been less a cognitive issue – how to appropriately face externalities in structurally integrated financial markets. Institutional change always betrays the tensions of the situation. Nothing really new here: Therefore, most such innovations are children of crises. Paradigms are changed when they become untenable. This requires as a rule: crises.

In the following, we will – summarily – touch on two topics: the denationalization of banking policy, meanwhile seen (after the supra-nationalization/Europeanization of monetary policy) as a logical corollary of the common currency, i.e. "one market, one money – one supervisor", its inexorable complement. Inextricably linked to this issue is the question of how to institutionalize the interaction between monetary and banking policy. But first, we will start with a conceptual point.

2 Monetary and Banking Politics in a Monetary Union

Courses on money in German-speaking (and other) universities used to be offered under the title: *Geld und Kredit*, at least until the mid-1990s. This also highlighted the unavoidable link between outside (high powered, central bank) money and inside bank money, as created by lending (and deposit-taking) institutions. Those courses also had strong relationships with principles of banking classes. Nowadays, with the slicing-up of banks' value chains, in heeding this tradition, more of an emphasis is put on financial markets, which increasingly serve as functional substitutes (consider asset-backed securities, etc.). One could read this as reflecting the strong link between monetary policy and banking politics.

Adding to this perspective is an important argument of Charles Goodhart, impeccably developed in his "two concepts of money". One view, which he calls the "Mengerian" view, stresses money's intrinsic value in use. Having

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[1] *The German Constitutional Court has twice deliberated on this. Here is not the place to contemplate this debate, which is very controversial amongst euro area members. However, both cases were concerned with institutional innovations which were deemed crucial to prevent the euro area from falling apart. In both cases, the ECB was forced to take unconventional measures, as its confreres had done earlier (and still do). The opportunity costs of not acting had been judged as prohibitive (my view also). But this setup of the game clearly makes the ECB, given that it is the strongest player at the European level, highly vulnerable to both financial as well as fiscal dominance. There is a continuous incentive to re-optimize.*

the lowest information costs, it is the most effective device to economize on search and transaction costs. The competing understanding insists that fiat money's value largely emanates from the power of the backing institution, i.e. the state. For Goodhart, these are the Cartalists, which one could rightfully also call the "Knapperians".[2]

While analytically neater (since arithmetically tractable), Mengerians have politically less pertinence than Knapperians, the latter insisting on the determining influence of institutions. From this perspective, one could have wondered ever since the launch of EMU whether there were too many national concepts of banking as well as too much diversity in supervisory philosophies before the crisis. However, these thoughts showed mainly implicitly. Reference was made to the heterogeneous structure of financial intermediation and its consequences for the (uneven) transmission of monetary policy measures. But debates remained largely muted, the more so since the great convergence of interest rates (over the whole spectrum) could reasonably be interpreted as an ever deeper integration of markets (see the ECB's various integration reports). Also, major attempts at creating a common, integrated financial market environment were made, most importantly all the efforts around the *Financial Services Action Plan*, implemented since the early 2000s with its more than 40 directives and regulations (including directives on capital requirements or investment/markets in financial instruments, etc.).

Nonetheless, as an immediate upshot of the financial crisis, the euro area saw its markets disintegrate. This held particularly true for interbank (wholesale) money markets, those markets which had been most swiftly as well as deeply integrated. The ECB was forced to become an intermediary, standing in for banks not prepared to go cross border. Nationality of financial instruments became pertinent again. Spreads widened. With ever more reluctant international investors, in the so-called periphery, a detrimental loop between fragile banks loading up on domestic public debt and endangered sovereigns arose.

The ECB's coinage of an "impaired monetary transmission mechanism" – highlighting the asymmetric impact of monetary instruments – correctly captures this inevitable link between banking politics and monetary policy.

3 EMU: Monetary Policy Without Banks

The canonical reference for Europe's common currency was, of course, the optimal currency area (OCA) literature (de Grauwe, 1994). Here, the core question was about functional substitutes to the nominal exchange rate. However, in practically determining the geography of Europe's money, OCA was barely acknowledged (Gretschmann and Kotz, 1998). Moreover, it was also seen from the very beginning that monetary integration would have a strong impact on financial market integration, and vice versa. Just think of the very influential EU Commission report on *One market, one money* alluded to before. Therefore, a harmonization of regulation and its implementation was seen as a logical corollary (Kotz, 2001). But the more encompassing idea of a banking union was seen as quite unrealistic, almost impossible to accomplish for political reasons. In fact, what was

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[2] *After Georg Friedrich Knapp's Staatliche Theorie des Geldes (1905), stressing that (fiat) money is first and foremost a legal construct or product.*

dubbed banking union by Nicolas Véron in 2009 had been discussed in the mid-1990s by Charles Goodhart or Gary Schinasi, the latter mainly referring to the U.S. financial setup, its historical evolution, more precisely: the crises which forced a union in banking (sort of) on the United States. (In the U.S., still today, even after passage of the Dodd-Frank Act, there is much of state involvement in banking and, especially, insurance regulation.)

The banking union idea was pondered again in the 2007 to 2009, against the background of emerging "financial market turbulences", as the contemporaneous lingo downplayed it, which then morphed into the Great Financial Crisis in the fall of 2008. But these were purely academic debates that met with insurmountable resistance in the real world of politics and the web of industry interests. Indeed, for some reason, the academic blueprints supposed a level of federalism (mutualization) which did not exist. More realistically, the reach of regional solidarity probably shrank. Only when facing the potential break-up of the euro, with its potentially gigantic opportunity costs, did more radical institutional innovations become fathomable. With two unconventional policy instruments – very long-term refinancing operations (with full allotment, given collateral availability) and the outright monetary transaction commitment – the ECB served as a trail-blazer and ultimate underwriter of this new approach.

As already mentioned, on the drawing board banking union was as a three-legged stool – including in addition to the supervisory function also recovery and unwinding tools as well as Europeanized deposit insurance. The two latter legs, however, would imply a mutual solidarity between euro area taxpayers which would have to come with a commensurate sharing in decision-making, currently beyond political feasibility.[3] Nonetheless, as concerns the common supervisory approach, here most of the way as outlined in academia has in fact been covered.

The SSM is the centerpiece: it is about reading from the same script book (Single Rule Book) and, at least as important, implementing principles in a consistent way across member states. Rather explicitly, this new approach also acknowledges that the previous, decentralized setup had been found wanting in rising to the challenges of the crisis. This was in particular the case in managing its cross-border externalities, inevitably involved with and amplified by deeper integration of financial markets. It needed in fact two crises to go substantially beyond de Larosière, who, to reiterate, was at his time seen as over-ambitious. Academics, most obviously, not being politically responsible, enjoy the luxury of always being more straightforward, more consistent and less messy. Alas, it is easy to be courageous when you are not in charge, which means not dealing with conflicting claims and trade-offs. Therefore, it is important to understand where impediments to implementation come from.

Since time immemorial, banking policy has been an important lever of national politics more generally. The highly instructive *Varieties of Capitalism*

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[3] *Nonetheless, the recovery and resolution directive, as agreed upon by the EU Council in March and adopted by the EU Parliament in April 2014, takes significant steps in that direction. In principle, banks should be resolved without taxpayer support. In worst cases, however (and they do happen!), a Single Resolution Fund, starting with national compartments, to be mutualized after eight years, will be available as a backstop. Legally, this is based on intergovernmental agreements.*

approach (Hall and Soskice, 2001) prominently insists on banking (financial market) philosophies as defining, complementary elements of different models of capitalism. They refer, for example, to the Hausbank principle and the close, long-term horizon relationship which used to prevail in systems dominated by Universalbanks (Elsas and Krahnen, 1998) (Ewald Nowotny, in his introductory remarks to this Volkswirtschaftliche Tagung, stressed this point also.) Clearly, those institutions are part and parcel of a distinct institutional setup with a substantial degree of complementarity (between the spheres) and consistency. Consider, for example, what one calls after Michel Albert *capitalisme rhénan* with its connotation of long-term orientation, patient investors, apprenticeship systems and Mitbestimmung. Or think of the institutional complementarities (co-investment, co-specialization), collaborative networks which arise in such environments. While this might be fading, there are certainly important remnants: the municipally owned Sparkassen with their local focus ("regional principle" – somehow not completely dissimilar to the U.S. Community Reinvestment Act of the mid-1970s). Or, to pick a different development, think of the French financial revolution of 1983 which (with its emphasis on money market funds, capital market funding more generally) made France much more Anglo-Saxon.

To be brief: We have different levels of public (not always state!) involvement, different background characteristics and philosophies – but one monetary policy. This complicates things. This leads to a crucial issue: How much financial sector variety can a monetary union accommodate? If we take the U.S. as a real-world counterfactual (we think in particular of the McFadden Act), there variety faded, though only very protractedly, in a long-drawn process.

4 SSM: De-Nationalization, Supra-Nationalization

In focusing on supervision – the factual implementation of rules through the examination and inspection process – there have been, quite obviously, national idiosyncrasies. From a bird's eye perspective, one can distinguish between two supervisory philosophies. One would try to provide for an environment of "workable" competition, implying low-margins, hence less attractive for banks, but potentially beneficial for clients. A second, more industry-oriented approach shows a stronger concern for adequate, sufficient margins (the franchise value) to allow for a healthy, stable banking industry.

With the SSM (and the Recovery and Resolution Directive), a substantial change of model is lurking. Banks cannot bank on "their" state anymore, that is, not in concept. But this implicit guarantee was clearly substantial (Schweikart and Tsesmelidakis, 2011). In the same vein: national champions will be a thing of past, European ones barely imaginable. Therefore, European banks will be largely de-nationalized, lose their national trappings.

Given the embeddedness argument referred to before, this could have significant consequences for corporate sector funding as well as corporate sector governance.

What will be decisive is to develop and implement a consistent supervisory philosophy. Examiners will become more intrusive. Having more discretion makes supervision more difficult and subject to critique, in particular when it is about learning to say no (Viñals and Fiechter, 2010).

How did we arrive here? The necessity of a banking union has meanwhile become conventional wisdom, though first acknowledged only in the report of the four presidents (*Towards a Genuine Economic and Monetary Union*) in June 2012. However, it took a deep fragmentation of financial markets to convince the median view. Resegmentation of intra-euro area finance implied:

- A substantial impediment to the singleness of the ECB's monetary policy. This meant, in particular, a distortion of the credit channel along national lines. Thus, access to and costs of funds were significantly dependent on the nationality of borrower. This implied a plurality of monetary conditions;
- A tighter link between banks and their sovereign. Of course, in times of crisis, it was always an ambitious objective to break this nexus. Banks are somehow necessarily characterized by their local background characteristics. Local betas are larger than European betas.

Banking union, in particular the SSM, is now seen as an instrument to get the banking system going again, also implying a smoother transmission of monetary policies. Supposing it is consistently conducted, the comprehensive assessment of banks' perspectives – by means of an asset quality check and a stress-testing exercise – deals with the otherwise highly implausible uncooperative outcome in a cross-jurisdictional dimension (of which Giovanni Dell'Ariccia also spoke at this *Volkswirtschaftliche Tagung*.)

But quite obviously, SSM is barely one-third of the story – the proof of the pudding is how stressed banks will be handled. Promises not to bail out will, given circumstances, be honored in breaking. They are not credible under all skies; the temptation to re-optimize can become irresistible. Therefore, without cross-jurisdictional burden-sharing, when push comes to shove, the banking union stool is a wobbly affair.

5 Conclusion, Policy Issues

Still, Europe always advanced on the back of incomplete institutions: la méthode Monnet. Fragility, vulnerability – what was achievable under prevailing political constraints – was often a means to advance Europe's integration.

There are a number of such fragilities or open issues: Given that monetary and banking policies are joined at the hip, one might wonder: What is the optimal institutional division of labor between these two policy areas? The new European setup opts for a strict separation. In fact, some would prefer an ultimate separation, a clear allocation of responsibilities. This would indeed be a preferable option, given that conditions for separability exist. The U.K., starting from a separation baseline (established in 1997), reversed its approach, however, opting for complete integration. The Bank of England has coined a convincing headline for its new remit: *One mission, one bank,* integrating macro-, micro-prudential and monetary policy, i.e. acknowledging the inevitable interaction and spillovers. In times of crises, when central banks use their balance sheets for (financial) stabilization purposes, this is evident. But it also holds true under more normal conditions when it is useful for monetary policymakers to know about the state of their banks and supervisors to have a robust information base concerning monetary policy (Peek et al., 1999).

In my view, there are decisive arguments in favor of the Bank of England approach. But they could only be implemented in the euro area if the necessary political background conditions were in place. Banking policy is ultimately politics. And the ECB is a stateless bank, which is appropriate when it is about the objective of conducting a neutral, nation- or jusrisdiction-blind monetary policy. However, given Europe's financial market background conditions, the borderline between monetary and banking (fiscal) policy is inexorably blurred. Therefore, it is highly questionable whether a stateless (that is, a politics-free) SSM can work properly also in periods of systemic malfunctioning. At the same time, robust banking systems – and the plural will remain the appropriate tense for a while in Europe – are of the essence for monetary policy.

The ECB could not convince national policymakers (i.e. the Council) that a credible balance sheet assessment requires a fiscal backstop. Such a backstop, and not some technical stress testing mechanics, was the reason for the positive outcome in the U.S. Such a backstop is in particular important for those who would like to shield the ECB from financial dominance.

On its way to completing Europe's monetary and economic union, SSM is an important, logical step. We now see that monetary union without banking union was not nirvana, but rather, given our background conditions, a flawed setup. SSM can contribute to stronger, more robust integration of markets. It is an ambitious project indeed – starting with a due diligence on a grand scale. Of course, it is also subject to imperfections, not a panacea to all what ails Europe: for example, differences in cost and access to external funds. They do reflect different background characteristics, as they should – commensurate with distinct differences in credit risk (default probabilities). They are, however, dysfunctional when they betray break-up risk.

Sharing of sovereignty (and power) is a crucial step to completion of the Euro project, with ultimate completion always a bit elusive. This is not unlike the introduction of the common monetary policy.

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SSM: Strengthening the Euro Area through Joint Banking Supervision

The Single Supervisory Mechanism (SSM) should make the market more transparent and help us to better deal with systematic risks. We would need to have a look back in the history to understand the effectiveness of the SSM if a systemic risk arises again. Those of you who have been in business for more than ten years will recall that Austria at one point in time and for a pretty long period of time had over 40% of the yen loan volume of the European Union, although our total loan volume represents about 2% of the loan volume of the European Union. Such a situation occurred because there was a time when every grandmother in Burgenland bought her new refrigerator on a yen-loan basis. This went on for a long time. It was not a very intelligent form of lending , and we all knew this. But on the other hand it was hugely successful, and I'm sure that there are still quite a few people in this room, who were benefactors of that form of lending. Immediately after we stopped yen lending in Austria, we switched to Swiss franc lending. And only recently we did stop lending in Swiss francs. For many, many years, for more than decades, the regulators and the central bankers were actually accepting the systematic risk of retail FX lending. Maybe some of the central bankers even had their own Swiss franc loan to refurbish their apartment. And then suddenly we realized: We should not sell this product. What we really learnt was that you can do some forms of lending only if the liquidity situation of an economy and the liquidity situation of the banking system in a country are in order. If the liquidity situation of a country is in disorder, this is mirrored in the banking system. So, what worked in Austria for a pretty long time, did not work in Hungary, and did not work in other countries of Central, Eastern and Southeastern Europe (CESEE) because the financial situation of the banking system and the countries themselves could not support it. They needed funding from outside in order to fuel the economy. So, this was a systemic risk for Europe. But it's over now.

Was there any other real systemic risk in bank lending in Europe during the last 15 years that caused the current crisis? I think we'll agree that there was no corporate lending crisis in Europe; we did not have a corporate systemic risk in Europe. We did not have any SME-systemic risk in Europe. We have never actually had a true consumer lending-systemic risk crisis in Europe. What we had in many countries, whether it's Ireland or Spain, is a serious systemic mortgage lending crisis. What did this mortgage lending crisis stem from? Did it stem from irresponsible banks making irresponsible loans, or did it stem from irresponsible real-estate investors requesting irresponsible products from irresponsible banks? At the end, who cares? The crisis was there; who initiated it is not really important. But there is one huge difference between that crisis that we had in Europe and the crisis that we had in the U.S.A. The banking system had to cope with it because all mortgage loans were on our books. And that's a completely different situation compared to the U.S.A., where most of the mortgage products that created the crisis were not in the books of the banks. Instead they were in the hands of investors that were tricked into buying products that they did not understand. So, banks are absorbing the systemic risks in Europe on our balance sheets. That is one point that, in my view, currently the regulators do not have a lot of respect for. That huge differentiation of "is there a banking system that absorbs its own risk without passing it on to unknowledgeable, naïve investors" or, put it in very simple words "do we deal with the dirt that we produce ourselves or do we produce dirt and pass it on to other people?" We don't do that. The way we absorb the systemic risk in Europe is not taken into account. We do not differentiate between the banking systems that absorb their own risk and the banking systems that pass on their risk to the public. This is not reflected in the assessment of the risk situation of the banking system. That's what I criticize the most.

Other than that there is hardly anything to be criticized about the SSM. It is, of course, from our point of view, hugely bureaucratic, but we have to cope with it. It's our task and it is definitely a dramatic improvement of the risk situation in Europe as it leads to transparency and simplification – if we stop having national rules – and it ends up in having one common European regulatory view. Of course, we still have to be aware, particularly in our region, that there is a huge difference between the euro area countries and non-euro area countries, unless the non-euro area countries are opting in, which some of the most important countries of our region presently don't seem to be willing to do, although even the Czech Republic is now turning more for it. We would be very, very happy if all the countries in our region would actually opt for SSM.

However, the SSM is only one step. The next steps are the Single Resolution Mechanism (SRM) and the European depository insurance. That, of course, should lead to a fiscal union and not only a banking union. And that is the real test on whether we get into that direction or not.

If we look back at the time when we installed the euro, I was a big fan of it. I still am, although I am now completely convinced that it is the euro that causes many of the problems that we have, and it is the euro that has caused the actual renationalization of the financial markets in Europe. Are we going to be able to fight the renationalization of the financial markets in Europe with the SSM, or are we again making a step too soon, because we do not know if the politicians are going to follow? You don't really believe that. You don't really believe that we will take the necessary political steps in the near future that actually will support what the regulators do. And isn't that exactly the problem that we had with the euro? We installed it because we thought it was good, but we didn't take the necessary political action to make it work. Are we convinced that what we are doing now is going to push politicians to go for a deep financial and fiscal union in Europe? Because this is what this all is for, and this is in the end the only thing that will save the euro in the long term.

So, getting back to the SSM, there is nothing wrong with it if we could merge the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) and have one accounting standard across the globe. I'd be the happiest man in the world because it would make banks substantially more transparent and easier to understand. A common regulator is a wonderful thing because it will help create more transparency. But the real question is "how about the bail-in at that point in time?".

Now, if the Asset Quality Review (AQR) and the stress test are going to be a really serious exercise and they do to the banking system what they are supposed to do, are the EUR 55 billion enough? Where will we get the capital from in case if some of the banks need substantial capital, because there are no EUR 55 billion around? What if potentially this will require more, who will be the investor? The state, European pension funds or Chinese banks? So, that's going to be an interesting game very soon.

Session 5

Future Challenges: The Big Picture

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Future Challenges: The Big Picture

So far, the conference has tackled various aspects of the European banking union. Among these aspects were issues of strategy and transition, the potential impact on the role of the European financial system in the global economy, issues of regulatory capture as well as the immediate challenges that the Single Supervisory Mechanism (SSM) brings for banks and regulators. In addition, ongoing balance sheet repair, peers in the U.S., bail-outs and bail-ins dominated the discussion.

This last chapter will bring us to the bigger picture.

During the height of the European debt crisis in 2012, it became clear that the supervisory and financial architecture in place at that time was very vulnerable. Banks and sovereigns were caught in a downward spiral in which banks undermined the financial strength of sovereigns, who in turn undermined the financial strength of national banking systems in a destructive, negative feedback loop. The outcome of an intensive debate, the banking union was meant to be an institutional reform that would be able to break this vicious cycle in a possible future crisis. It was to change the institutional architecture of the monetary union as a whole toward enhanced financial stability. It was to improve the relationship between banks and sovereigns, and it was to reduce the fragmentation of financial markets. Overall, the banking union could play a vital role for the European integration process as a whole. By the way, these expectations have already been partly fulfilled, as the fears about the break-up of the euro, which dominated the public debate during the peak of the crisis, are no longer relevant.

It was clear from the beginning that an endeavor as immense as the banking union would go beyond pure supervision issues and would comprise resolution as well as deposit insurance. In the process, all these factors were discussed and found entry in the new legislation. Will the final outcome of the initial idea be functional and will it be able to deliver?

Critics of the recent agreement on the banking union framework have pointed out that the idea of building a resolution fund at the order of magnitude of only a tiny fraction of the value of banking assets with no further backstops beyond the national level will not be able to defuse the negative spiral between sovereigns and banks in a future crisis. Some have gone so far as to claim that a banking union with the current kind of backstop regime is worse than no banking union at all. Others, among them the European Parliament, supported the agreed framework and wanted it to be implemented as soon as possible.

There are of course other big picture questions, like whether the banking union will change the structure of banking in Europe in the medium term or whether it will change the overall functioning of the monetary union. Is the banking union a structural change that is able to enhance the sustainability of the monetary union?

Doubts and open questions remain. Does the banking union encourage shadow banking and therefore create new systemic risks? What about the non-euro area countries? So far, they have been quite hesitant to join the SSM. At first glance, their membership would increase the impact of the SSM and therefore the attainable stability. But it would also make the institutions and the decision-making processes more complex, which could be counterproductive when things are going wrong and urgent action is needed.

If we wish to see the "big picture," we should ask the "big names" what they have to say. They are not only familiar with the issues in detail, but also know what implications decisions may have, how to avoid negative outcomes and how to promote positive ones. These "big names" have frequently weighed into the public debate with their voices and their expertise.

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Yes, Virginia, There Is a European Banking Union! But It May Not Make Your Wishes Come True

1 Introduction

The title of this paper alludes to an episode in 1897 when an eight-year-old girl had written a letter to the *New York Sun* asking: "Is there a Santa Claus?" and that newspaper published a full-page article under the headline "Yes, Virginia, there is a Santa Claus!" In listening to speeches or reading documents about the European banking union, I sometimes get the feeling that banking union is regarded as a kind of Santa Claus, which will make our wishes come true and solve all the problems of the euro area financial system.[1]

As an academic, I am always impressed by the ability of people in office to make succinct statements about problems and policies without explaining how the latter relate to the former. The Euro Area Summit Statement of June 29, 2012 affirms "that it is imperative to break the vicious circle between banks and sovereigns" and asks the European Commission "to present proposals … for a single supervisory mechanism" for banks, without explaining how the latter relates to the former. Nor does it explain what precisely is meant by "the vicious circle between banks and sovereigns".

I am also impressed by the ability of people in office to congratulate themselves on having come to an agreement or passed a law without worrying whether the agreement or the law will actually work and whether the new arrangements will solve the problems they are supposed to solve. The mere fact that a new arrangement has been put into place is treated an achievement. In terms of the political process, this assessment may be appropriate, but, if the underlying problems are not addressed, the "achievement" may just be a way of wasting time and exposing us to further risks. If the policy makers have got the analysis wrong, we may all end up being the worse for it.

Right now, we are all congratulating ourselves on the steps that have been taken towards a European banking union, the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), together with the Banking Recovery and Resolution Directive (BRRD), and previously the Capital Requirements Directive IV (CRD IV) and Capital Requirements Regulation (CRR), as well as the Regulations establishing the European Supervisory Authorities. These are big steps forward. However, I have serious doubts whether they will substantially improve the future financial stability in

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[1] *Full revelation: I was a co-author of ASC (2012), which can be read in this vein. However, ASC (2012) and, subsequently, Sapir et al. (2012) are very clear about the need for a viable resolution regime; the discussion of the shortcomings of banking union in this paper follows directly from the analysis in those reports.*

Europe. I even have doubts whether they will suffice to take us out of the straights we are currently in. The reasons for these doubts will be laid out in this paper.

2 What Are the Problems? Where Do They Come From? Why Are They Not Solved?

Fundamental Weaknesses

European economies today suffer from three interrelated weaknesses:

- Economic growth is disappointingly low, not only in the periphery countries that pursue austerity policies but also in the core countries of the euro area.
- The levels of indebtedness of governments, nonfinancial companies and private households are very high and in most areas still rising.
- Financial institutions are weak, not only in the periphery countries but all over Europe.

These observations are reminiscent of the experience of Japan over the past two decades. In Europe as in Japan, some of the weaknesses may be due to fundamentals such as population aging and may therefore be unavoidable. However, some of them are also the result of flawed policies and should be mitigated by political reform. In the euro area, the problems are exacerbated by the fact that the arm's length relation between the central bank and the member states puts limits on the authorities' ability to deal with the banking problems effectively.

The poor growth performance is to a large extent due to the effects of overhanging debt and to the weakness of financial institutions. Because of excessive indebtedness, governments that were used to spending substantially more than they took in have been forced to retrench their activities, to raise taxes, or to obtain new funding through financial repression. All this harms economic growth. Weak financial institutions have reduced their lending, in particular to new firms that might provide impulses for innovation and growth. Some of this retrenchment has been a reaction to overexpansion before 2007, some of it has been imposed by financial repression, and some of it reflects the banks' own forbearance towards problem borrowers, motivated by a desire to avoid laying open the problems and taking the resulting losses on the books.[2]

Banks and Sovereigns: A Vicious Circle?

In this context, the formulation "vicious circle between banks and sovereigns" in the Euro Area Summit Statement of June 29, 2012 is not helpful. We have seen – and continue to see – contagion effects from sovereigns to banks in some countries and from banks to sovereigns in others, but the picture of a doom loop between the

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[2] *For extensive accounts of these issues, see ASC (2012), as well as Caprio and Klingebiel (1996, 1997) and Hoshi and Kashyap (2004, 2010). On financial repression and biases in bank lending in Europe, see Acharya and Steffen (2013) as well as the chapters by Bruni, Caminal et al. and Borges in Dermine (1990).*

two is more confusing than clarifying. The so-called “euro crisis” is in fact composed of different kinds of crises reflecting different failures of governance in the relation between financial institutions and governments.[3]

Some countries had old-fashioned sovereign debt crises that were caused by the inability of their politicians to set priorities and make hard choices so as to make ends meet. Examples are given by Greece, Portugal and, to a lesser extent, Italy. As documented by Reinhart and Rogoff (2009), this kind of crisis has a long tradition. Sovereign debt crises spill over into the financial system if the sovereigns in question have used their power to induce “their” banks into funding them and the sovereign’s default imposes large losses on these banks. An example is given by Argentina in the 1990s and early 2000s. In the case of Greece, the 2012 haircut on sovereign debt necessitated substantial ESM contributions to recapitalizing Greek banks in order to save them from being insolvent.

Other countries had equally old-fashioned banking crises that were induced by boom-and-bust developments in real-estate markets. Examples are given by Ireland and Spain. This kind of crisis also has a long tradition. A little over twenty years ago, boom-and-bust developments in real-estate markets (and in lending to nonfinancial companies) were major causes of the banking crises in Japan, the United States, the Scandinavian countries, and Switzerland.[4] When such developments occur, governments that find it necessary to support their financial institutions may see their debt levels rise dramatically so that the financial crisis in turn may induce a sovereign debt crisis. This was the experience of Ireland in 2010. Fear of such an experience was the reason why in 2012, Spain asked for the ESM to recapitalize its banks.

Except for the case of Spain, where the impact of the financial crisis on government deficits and debts in turn forced the government to increase its reliance on Spanish banks, there is little that is “loopy” about these developments. The two kinds of crises that I have described originate in quite different failures of governance. Conventional sovereign debt crises originate in failures of the political system; if these crises spill over into the financial sector, there is not much of a spillover back to the sovereign, which probably is unable to provide a bailout anyway. Conventional real-estate boom-and-bust and banking crises originate in failures of risk control in banks and in failures of prudential supervision over banks; if such a financial crisis spills over to the sovereign, a spillover back to the financial sector can occur if the initial financial crisis was localized, and the sovereign’s difficulties affect the rest of the financial system, a constellation that seems to have been relevant for Spain, where the financial crisis was concentrated in the *cajas* and their successor institutions, but not in Ireland, where the entire banking system seems to have been affected from the beginning.

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[3] *For a more extensive discussion of the interplay between the different crises, see Hellwig (2011).*

[4] *See Hellwig (1994, 2009). In the United Kingdom, at the time, the costs of the downturn in real-estate markets and of the mortgage defaults were to some extent shifted to institutions in the insurance sector that had provided credit insurance to the building societies.*

The Weakness of Financial Institutions is More Widespread

The notion of a "vicious circle between banks and sovereigns" diverts attention away from the fact that the weakness of European financial institutions is not limited to countries where the sovereign has problems. This weakness also plagues countries such as France and Germany, where, so far at least, the sovereign has been able to bear the costs of the crisis. Quite generally, banks suffer from the weakness of their equity positions, from excessive reliance on short-term funding through wholesale markets, and from an inability to earn profits in an environment that is characterized by excess capacity and intense competition.[5]

The events of 2011 are paradigmatic. With the results of the stress test of July 2011, the European Banking Authority also divulged information about the different banks' exposures to sovereign risks. Investors realized that a haircut of 50% or more on Greek sovereign debt, which they considered likely,[6] might push some major European banks into insolvency because the equity of these banks was too small to absorb the impending losses. Consequently, investors withdrew their funding. When in September 2011, the need for a larger haircut was officially acknowledged, the pressures intensified. They were reinforced by the banks' own defensive measures, such as asset sales, which contributed to the downturn in asset prices and caused further losses in the banks' trading books. The October Summit's decision to raise capital requirements accelerated the downturn because the requirement was initially formulated in terms of ratios of equity to risk-weighted assets, and banks responded by further deleveraging. The process was only stopped when the ECB's Long-Term Refinancing Operation provided financial institutions – and markets – with an assurance that reliable funding would be available in large amounts.

The impact of the Greek debt haircut on banks outside of Greece should be seen as evidence of these banks' weakness, rather than a doom loop between sovereigns and banks. As of late 2010, the Belgian-French bank Dexia had equity equal to less than 2% of its assets. The bank did not have much Greek debt in its portfolio, but with so little equity, the haircut on Greek debt was enough to make the bank go under.

And fear of such an event will cause the wholesale short-term lenders to run. Dexia, which did not have a strong deposit base, was particularly dependent on wholesale lenders. Intense competition had forced this bank to engage in significant maturity transformation, using short-term funding of long-term investments (the excess coverage needed as collateral on covered bonds) in order to improve its ability to compete on margins.

Dexia was perhaps an extreme case.[7] Throughout these years, however, most large European banks have exhibited

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[5] *For extensive discussions of these issues, see ASC (2012, 2014).*

[6] *Investors greeted the announcement of the European Summit of July 21, which referred to voluntary private-sector involvement amounting to only EUR 37 billion, with scorn. In a letter of August 3, written to the European Union's heads of state and government, the President of the European Commission indicated that he shared this skepticism. Publication of this letter accelerated the market implosion.*

[7] *The German bank Hypo Real Estate (HRE), which also did not have much of a deposit base, had pretty much the same experience, except that, in 2010, HRE had put more than EUR 170 billion of problem assets into FMS Wertmanagement, a "bad bank" owned by the German government, so that the costs of the Greek haircut did not affect HRE. Because of their reliance on wholesale short-term funding, both Dexia and HRE had previously been particularly hard hit by the breakdown of money markets in September 2008.*

very low equity ratios and most large European banks have significantly relied on wholesale short-term funding.[8] Many of them relied on funding from U.S. money market funds to expand their activities in the United States, or more generally, U.S. dollar markets. This reliance – and the withdrawal of U.S. money market funds – played a major role in the events of 2011 as well as the post-Lehman turmoil in 2008.

Consciousness of the vulnerability of financial institutions has shaped political reactions throughout. The sentence "This might be the next Lehman event" has been prominent in many discussions. I suspect that the breach of the no-bailout clause of the Maastricht Treaty in 2010 was at least partly motivated by a fear that the exposures of weak banks in France and Germany towards Greek debt might endanger these banks if there was a haircut.[9] The ECB's Securities Markets Programs in 2010 and 2011, its Long-Term Refinancing Operation in 2011/2012, and last not least, its ECB's announcement of Outright Monetary Transactions in September 2012 all seem to have been motivated by a sense that financial institutions were weak, financial markets were jittery, and financial instability was undermining the stability of the financial system and the macroeconomy.

Current Stability Hides Underlying Problems

Since September 2012, the European financial system seems to have become somewhat more stable. But this only means that we are no longer in an acute state of crisis. The underlying problems have not been resolved. Indeed, there are substantial reasons to be concerned about financial stability even now:

- Overall debt levels of nonfinancial actors have continued to go up, in particular, public debt levels. For debtors whose risks are considered to be small, the burden of this debt may be light because nominal interest rates are small. However, for debtors whose risks are considered significant, private borrowers and sovereigns in the European periphery countries, the burden is significant. Moreover, there always is a risk that investors might become yet more pessimistic again and ask for even higher risk premia. Such increases in risk premia would further increase the burden on borrowers, which might end up confirming the pessimism of investors.
- Endeavors to improve the competitiveness of periphery countries may

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[8] *As discussed by Brealey et al. (2010) and by Demirgüc-Kunt and Detragiache (2010), unweighted equity ratios have been significantly better indicators of bank robustness than risk-weighted equity ratios. From the late 1990s until 2007, unweighted equity ratios of large European banks went down significantly while risk-weighted equity ratios remained roughly the same. Even after correcting for differences in accounting rules, unweighted equity ratios in Europe tend to be significantly lower than for commercial banks in the United States. For an account of European developments, see ASC (2014).*

[9] *Subsequent sales of these positions seem to have contributed to the exposure of Cypriot banks so that, when the haircut came in March 2012, it caused problems for these banks, which culminated in the Cypriot crisis a year later.*

further increase the burden of their debt. Many commentators have suggested that periphery countries would easily regain competitiveness if only they were allowed to devalue. Such comments overlook the difficulty that devaluations raise the burden of debt denominated in foreign currencies.[10] The same difficulty arises if the real exchange rate is lowered by domestic deflation, rather than a devaluation of the currency.

- Many banks are still weak, in particular in the periphery countries. Specifically, many banks still have little equity and rely on the ECB for substantial funding. Such banks tend to concentrate their investments in their own governments' debt and in tradable securities. Lending, in particular, lending to new firms, tends to come from banks that are better capitalized.[11] As mentioned above, the diversion of funds away from lending to nonfinancial companies is a drag on the macroeconomy, in particular on economic growth.
- In contrast to their counterparts in the U.S.A., European banks' profits do not seem to have recovered yet. This is problematic because retaining earnings is the easiest way to rebuild equity. The ability to earn profits would also be the best means of restoring market confidence, enabling banks to reduce their reliance on ECB funding. There seem to be several reasons for this low profitability: First, banks may find it hard to earn significant profits because, following the crisis, banking capacity has not been much reduced and competition is still intense. The post-Lehman policy of bailing-out most banks has prevented the adjustment of market structures that would otherwise have occurred. Second, the low-interest environment, while allowing for cheap funding, also reduces the rates banks can charge and may thus contribute to margins being low. If so, we face the dilemma that higher interest rates might seem to provide for better margins on new lending, but higher interest also raises the risks from high levels of outstanding debt.
- The low profitability of banks also raises questions about the skeletons that they may still have in their closets. For a few years now, we have seen European banks earning moderate profits in the first three quarters of the year and then showing sizeable losses in the last quarter. These losses seem to be driven by write-offs that are calibrated so that the overall result for the year is a black zero. While it is reassuring to see operating profits that enable them to pursue this strategy at all, one may wonder about the write-offs that have not yet been taken. This concern is particu-

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[10] *This problem is well known from the experience of Latin-American countries. Devaluation of the currency reduces the debt burden only if debt is denominated in the currency itself. On the inability to issue debt in the country's own currency, see Eichengreen and Hausmann (1999).*

[11] *This is shown in Acharya and Steffen (2013).*

larly relevant for positions in the bank book. I am not convinced that the asset prices that underlie the collateral valuations for German shipping loans or Irish or Spanish real-estate loans have been properly adjusted to the realities of the asset markets in question, to the extent that these markets are operating at all. I appreciate that asset markets are sometimes excessively volatile but I also know that some of the asset price declines that we have seen reflect a substantial asset overhang rather than any short-term market jitters. The shipping crisis, for example, will not disappear before the excess of prevailing capacity over demand at marginal-cost prices has been removed and shippers are again able to earn margins over average variable costs. This simple outcome of elementary microeconomic analysis has been neglected in all predictions from shippers and their bankers that I have seen.[12]

- Such concerns are also among the reasons why some banks still do not have much access to market funding and why for others such funding may become jittery again. As long as there are reasons to believe that a bank has not yet laid open all its losses, investors will also be concerned that the bank might be insolvent and will not be willing to fund it unless they expect to be bailed-out, by taxpayers or by the central bank.

Political Procrastination

Some of these problems lie beyond the purview of banking regulation and banking supervision. However, the persistent weakness of European financial institutions also reflects shortcomings in the policies that have been followed since the crisis. In particular, as mentioned, the post-Lehman policy of bailing-out most banks has prevented the adjustment of market structure that is necessary if the intensity of competition is to be reduced to a level where banks do not have to take unconscionable risks in order to survive because there is too much capacity in the market.

An important role was also played by regulatory forbearance towards the problematic assets that banks might have in their books. Closing one's eyes to the fact that performance of loan customers and collateral values may be questionable may seem a convenient way to avoid disagreeable and potentially costly interventions. However, more often than not, the problems do not disappear on their own and the delay is likely to make the intervention that much costlier when it becomes unavoidable.[13]

There are several reasons for these shortcomings. First, intervention is always costly. If a bank is in serious trouble, a recapitalization costs money, and resolution may bring turmoil to the economy. Governments and supervisors must also fear public scandal as people ask why the problems have been allowed to arise and why they have not been dealt with before. Kicking the can

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[12] *I made this prediction in 2009 when, as chair of the Lenkungsrat Unternehmensfinanzierung, I was involved with the applications of two major shipping companies for support from the German government's Wirtschaftsfonds Deutschland. According to the documents we got at the time, the shipping crisis would run in parallel to the business cycle and was therefore predicted to be over by 2012. In 2013, when the governments of Hamburg and Schleswig-Holstein proposed to raise their second-loss guarantees for the asset portfolio of HSH Nordbank, the prediction was that the crisis would be over by the end of 2014, even as excess capacity in shipping was still building up; see Hellwig (2013).*

[13] *On this point, see ASC (2012), as well as Caprio and Klingebiel (1996, 1997).*

down the road and hoping for the best may therefore seem more attractive. If the banks in question are extremely large or if there are very many of them, the problem may also be too big to handle because the public funds needed to avert the negative fall-out from the crisis may exceed the government's fiscal capacity. Thus, when the Swedish government intervened very promptly to clean up the banking system in 1992, it lacked the fiscal capacity to also smooth the recession (which however was short, thanks to the clean-up of the banking sector and to the trade effects of currency devaluation).

Second, banks are political. This is true in particular of public banks like the German Landesbanken, whose lending policies are often tailored to the interests of the regional governments that own them. More generally, political authorities tend to think of banks as institutions that should serve to fund their policies, promoting the government's industrial policies or simply funding the government itself.[14] In some cases, the government's industrial policies have been focused on the banks themselves, using financial institutions that attract funds from the rest of the world and invest funds in the rest of the world as a tool for creating a fair number of high-paying jobs very quickly.[15] With such a policy stance, they are not likely to engage in active interventions that would force the banks to lay open their losses and either recapitalize or retrench their activities.

Cross-Border Externalities in the European Union and the Euro Area

European integration also plays a role. In the European Union, and in particular in the euro area, national policies towards banks are fraught with cross-border externalities. If a bank's activities in all countries of the European Union, indeed, in the European Economic Area, are regulated and supervised under the home country principle, any bank's customers and counterparties depend on the home country's authorities' doing a good job to ensure the safety and soundness of their banks. If the home country's authorities are interested in using the banking sector as a source of economic growth however, they may be willing to compromise on supervisory standards.

Such laxness played a role in Icelandic banks growing by acquiring deposits from customers in the United Kingdom and the Netherlands. In the crisis, the costs of bailing-out these depositors were borne by the United Kingdom and the Netherlands rather than the home country of the failing banks.[16] In Ireland, a promise of "light-touch" regulation and supervision was a means of attracting financial business to Ireland, and funds from abroad fuelled the Irish real-estate bubble. In the crisis, the Irish government ended up bailing-out the senior unsecured creditors, many of them banks from other European countries, but from what I have been told, this decision was anything but a foregone conclusion and involved much pressure from European institutions and from other member states.

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[14] *For a more detailed discussion, see chapter 12 in Admati and Hellwig (2013).*

[15] *This has been the experience of Iceland, Ireland, and Cyprus. More traditional financial centers, such as the United Kingdom or Switzerland have also seen economic growth fuelled by promoting the financial sector as an export industry but their dependence on this sector has been somewhat less pronounced.*

[16] *Remarkably, the EFTA Court accepted the argument of the Icelandic government by which it was legitimate to transfer Icelandic deposits but not foreign deposits from the failing banks to the successor institutions so that the government's bail-out measures benefited only domestic depositors.*

In the case of Ireland, the decision to bail-out the senior unsecured creditors required the country to seek help from the EFSF. The problem of cross-border externalities was thus shifted from the level of cross-border externalities for investors to the level of cross-border externalities for other Member States and European institutions. The Spanish request in 2012 for ESM funding of bank recapitalization exhibits the same kind of externality. In the mid-2000s, national authorities in Spain failed to interfere with banks fuelling a real-estate bubble. Ultimately, this failure was at the origin of the need for ESM support in 2012.

In the summer of 2012, the other member states of the euro area had a substantial interest in the matter. Markets were dominated by a sense of panic that threatened the funding of financial institutions all over Europe, as well as the funding of the Spanish sovereign. There were substantial fears that the Spanish authorities had been less than incisive in dealing with the problems of the *cajas* and their successors and that the hidden losses might exceed the sovereign's capacity to bail-out the banks' creditors.

As in 2011, these developments put the ECB on the spot. Financial stability is not explicitly mentioned in the Treaty as an objective of ECB policy, but banks are an important part of the monetary system, and a banking crisis poses a serious threat to monetary stability. In Spain in 2012, markets were again jittery and the monetary system was under pressure. Even depositors, usually the most patient of investors, were moving their funds out of the country.[17]

Putting the ECB on the Spot

Throughout these years, with unorthodox measures in 2008, the Securities Markets Program in 2010 and 2011, the Long-Term Refinancing Operation in 2011/2012, the announcement of Outright Monetary Transactions in 2012, the ECB has repeatedly stepped in to preserve financial and monetary stability by counteracting the effects of financial sector weaknesses. It could do so because it was in a unique position to act without regard to funding constraints.

There are, however, substantial reasons to believe that the Long-Term Refinancing Operation benefited not only healthy banks but also banks whose

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[17] *In this context, it is helpful to go back to the simple quantity theory approach of Friedman and Schwartz (1963). For the years 1929–1933 in the United States, they observed that, while the monetary base grew by 15%, the quantity of money (M1) contracted by 33% because the banking crises induced behavioral changes among depositors as well as banks, raising both the currency-deposit ratio and the reserve-deposit ratio. In their assessment, monetary policy in these years was "contractionary" because the expansion of the monetary base failed to compensate for the implosion of deposits. Bernanke (1983) focuses on the credit channel for monetary transmission, arguing that bank closures caused the loss of information capital that had been accumulated in banks' lending to firms and disappeared when the banks went under. Despite the differences in their accounts of the transmission mechanism, the different authors agree that commercial banks are an essential part of the monetary transmission mechanism and that a breakdown of banking calls for additional measures of the central bank.*

health was doubtful perhaps even banks that would have been insolvent if they had been forced to uncover their hidden losses. In fact, reliance on ECB support was most important for those banks that had the weakest capital positions and the greatest difficulties in obtaining market funding.[18]

A decade ago, the various Memoranda of Understanding (MoU) for how to deal with banks in difficulties provided for a clear division of tasks: Solvency problems were to be covered by the national treasuries, liquidity problems of individual institutions by the national central banks, and liquidity problems of the entire system by the ECB.[19] If supervisory forbearance at the national level enables *de facto* insolvent banks to benefit from ECB funding, these principles are violated, and there is little that the ECB can do about it.

The very strength of the ECB is a source of weakness. If the ECB is serious about monetary stability, it is forced to follow a policy that effectively supports the financial system, including those institutions that should be resolved but are not. Given the knowledge that the ECB will support the system anyway, the pressure on national governments and national supervisors to clean up their banking systems is that much weaker. Some politicians may in fact have come to understand that the very weakness of their banks gives them an indirect access to the printing press. After all, in the case of the Long-Term Refinancing Operation, a large part of the money that banks got from the ECB was lent to the banks' own governments.[20]

The division of tasks that was enshrined in those MoU was naïve. Acting as a lender of last resort has always been an important role of central banks, and this role has always involved the provision of implicit subsidies to the banks that received the support.[21] One of the more successful central banking operations of recent decades was the 1990 turnaround of U.S. monetary policy. When the large money center banks in the U.S. were in a state of crisis, the Federal Reserve lowered short-term interest rates quite drastically and allowed the troubled banks to rebuild their equity by playing the yield curve for years. However, apart from the implicit transfer of *seigniorage* from the central bank to the commercial banks, this policy had the drawback that, as seen in 1994, commercial banks became very vulnerable to interest rate shocks and, more importantly, that they came to believe in the "Greenspan put" as protection against any risks that they might run.

In the European context, the availability of ECB support has contributed to the maintenance of market structures and the failure to close unprofit-

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[18] *Acharya and Steffen (2013).*

[19] *For a critical discussion of this arrangement, see Hellwig (2007).*

[20] *Acharya and Steffen (2013).*

[21] *For a systematic discussion, see Hellwig (2014), with references to Goodhart (1988).*

able banks. Here again, national government policies involve significant cross-border externalities. Countries that expand their financial sectors as a means of industrial policy put pressure on bank margins Europe-wide. So do countries that provide explicit or implicit guarantees to some or all of their banks. The fact that banks like Dexia and HRE had to engage in wholesale short-term funding for the excess of their portfolios over their covered-bond issues must in part be ascribed to the German legal "reform" of 2005, which reduced barriers to entry into covered-bond markets, a measure that allowed the Landesbanken to much expand their activities in this segment. While the crisis has induced some retrenchment, many of the basic structures are still in place, ready to expand again when the occasion arises.

Maintenance of market structures with excess capacities through explicit or implicit guarantees and other subsidies should in principle be prevented by the European Commission's state aid control. However, as shown by the decade-long fight over the public guarantees for the Landesbanken, in the area of banking, where significant political stakes are involved, state aid control is weak and slow.[22] With the crisis, state aid control has become even weaker because any government that wants to maintain a bank will simply claim that, if the bank is resolved, financial stability will suffer.[23] Such a claim may be dubious but the rules for state aid to financial institutions that have been put in place since 2008 allow for financial stability considerations, and it is not easy for the European Commission to question whether the bank really poses a threat to financial stability.

3 Will Banking Union Solve the Problems?

The Decision of June 2012

The many cross-border externalities in financial-sector regulation suggest that, in a monetary union, a system with purely national control over financial institutions may not be viable.[24] Given the importance of judgment in supervisory decisions, the mere harmonization of the legal framework through regulations and directives may not be enough to eliminate moral hazard and negative cross-border externalities. Recognition of these problems led many to argue for the creation of a European banking union.[25]

However, the different participants in the June 2012 decision had different interests and were pursuing different objectives. The European institutions saw banking union as a further deepening of European integration and hoped that this would overcome the problems. In particular, the European Commission was pushing for a European deposit insurance system in order to stop the outflow of deposits from countries that were perceived to be at risk. The European Central Bank was pushing for a Single Supervisory Mechanism in order to get out of the straightjacket of

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[22] *The Steinbrück-Stoiber-Monti agreement of 2001 enabled the European Commission to establish the principle that public guarantees were a form of illicit state aid without having to go to court over the matter. However, the European Commission had to accept a four-year transition period. Public banks used this period to raise significant additional funding under public guarantees. Wasteful investment of the funds was a major reason for their difficulties in the crisis, from German banks Sachsen Landesbank and West Landesbank to Austrian Hypo Alpe Adria.*

[23] *See for example the case made in 2013 by the German government to justify renewed support for HSH Nordbank.*

[24] *Some of the problems with the previous arrangement were pointed out in Hellwig (2007). ASC (2012) suggests that, even for the European Union as a whole, with the internal market in banking, a purely national control over financial institutions, subject to European regulations and directives, is problematic.*

[25] *Brussels-based Bruegel provided some of the key arguments and ideas.*

having to tailor its monetary policy to the needs of financial stability that were insufficiently taken into account by national authorities. Spain was pushing for ESM support for recapitalizing its banks. Germany, it seems, was pushing for European control as a prerequisite to making ESM funds available to Spanish banks, perhaps without appreciating that this might also involve European control over German banks.

Developments since then have been much influenced by these differences in interests and objectives. They have also been influenced by differences in legislative procedures for the different components of the banking union. In the euro area, supervision will be handled by the Single Supervisory Mechanism (SSM), which is created by a Regulation of the Council under the auspices of Art. 127 (6) TFEU. Resolution in the euro area will be handled by the Single Resolution Mechanism (SRM), which is created by an EU Regulation under the auspices of Art. 114 TFEU, and will be funded by a Resolution Fund, which is created by an intergovernmental agreement with the approval of the European Commission and the Parliament. In the European Union as a whole, procedures for dealing with banks in difficulties will be governed by the Bank Recovery and Resolution Directive (BRRD), which still needs to be transposed into national laws. New rules for deposit insurance will also be governed by a directive. I am wondering to what extent the differences in legal foundations may end up affecting the viability of the overall system.

Supervision: Heterogeneity of National Laws and Judicial Review

An important innovation of Council Regulation (EU) No 1024/2013, which creates the Single Supervisory Mechanism, concerns the status of supervisory authorities. According to Art. 19 of the Regulation, the ECB and the competent national authorities shall be independent in their supervisory activities. This is a welcome change from the *status quo ante*, which had at least some supervisory authorities subordinated to their respective governments.[26] This change provides some hope that supervisory decisions will become less influenced by the national governments' political interests.

As a practical matter, the shift to the SSM is unlikely to pose major problems. But even here, there are pitfalls. One involves the heterogeneity of laws and jurisdictions that are involved. One might think that, in principle, there is just one set of rules for the entire European Union. However, only regulations are directly applicable. Much of the relevant EU law takes the form of directives, which are not directly applicable but require transposition into national law. Art. 4 (3) of the Regulation stipulates that "the ECB shall apply all relevant Union law, and where this Union law is composed of Directives, the national legislation transposing those Directives."[27]

This means that the ECB will have to apply 17 or more different laws. This heterogeneity raises issues of consistency across member states. It also raises questions about judicial review. Decisions taken by administrative

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[26] *A decade earlier, this had been a matter of dispute in the discussion about the European Constitution. The ECB would have liked the Constitution to stipulate independence of central banks in all their activities, not only in matters of monetary policy. The Constitutional Convention did not accept the ECB's proposal.*

[27] *The question of how to deal with legal norms that are codified at the European level in the form of Directives was raised by Sapir et al. (2012) in a comment on the European Commission's first draft of the Regulation, which did not address the problem at all.*

authorities are usually subject to judicial review. In some member states, access to judicial review of administrative decisions is treated as a constitutional right.

The Regulation is silent on this issue. It mentions the judiciary only in Art. 13, in connection with the authorization by a judicial authority of an on-site inspection if such authorization is required under national law, stipulating that in such cases the national judiciary shall control that the measures taken in this context are not taken wilfully, but shall not decide on the lawfulness of the measures; lawfulness is to be assessed by the European Court of Justice (ECJ).

Art. 22 of the Regulation asserts the need for due process in the preparation of supervisory decisions of the ECB without however referring to judicial review. Perhaps the assumption is that this goes automatically to the ECJ. But then I wonder how qualified the ECJ will be to assess the lawfulness of decisions taken in the application of national law (even if this law implements a European Directive).

On the other hand, if the national courts are in charge, the heterogeneity of administrative-law traditions may play a destructive role. This heterogeneity concerns, for example, the exercise of judgment by the administrative authority. In some countries, for example in Germany, administrative courts draw the lines for such exercise of judgment very narrowly and require a substantive justification of the decision by the authority, *quasi* a derivation from the legal norm. In other countries, requirements are less strict, allowing the administrative authority to choose freely provided it can show that its decision is not arbitrary. This difference is relevant because much supervisory activity does involve an exercise of judgment, judgment about the quality of assets that a bank holds, about the riskiness of a bank's strategy and even the professional quality of its management. Moreover, this exercise of judgment is where the governance of supervision matters most and where the shift to a Single Supervisory Mechanism may be presumed to have the biggest impact.

One may hope that these issues will never arise because nobody goes to court. However, even if nobody goes to court, the mere threat that affected parties might do so can have an effect. Consider the public discussions that we have had after the crisis about supervisory laxness in the preceding years, for example, the German supervisor's acceptance of practices whereby banks created special purpose vehicles to hold mortgage-backed (and other) securities without backing them by equity, funding them through asset-backed commercial paper and providing the creditors with liquidity guarantees for these vehicles. These vehicles and the commitments that banks made to them played a major role in the build-up of risks before the crisis, and they caused substantial losses. The German supervisor has maintained that they were aware of the risks but, under the letter of the prevailing law and given the

strictness of German administrative courts, they did not see any room for prohibiting these practices. Other supervisors were more restrictive and disallowed such practices. Would this have played out any differently if the ECB had already been in charge?

Such problems would of course be removed once for all if all the relevant legal norms were brought into the Regulation. I expect that, at some point, we will get there, and I hope that, in the intervening time, the uncertainties and impracticalities associated with the heterogeneity of national laws will not be too costly.

Dealing with Banks in Difficulties: Recovery and Resolution Procedures

The most careful and most professional supervisor is helpless if there is no practical way of dealing with problem banks.[28] The Lehman experience has made us all very sensitive about this issue. We learnt that "too big to fail" is not a myth: Letting a bank fail can indeed have catastrophic consequences, and can be much costlier than a bailout.

Since the Lehman crisis, authorities worldwide have been torn back and forth between two concerns, on the one hand, the desire to avoid a repetition of the post-Lehman panic, on the other hand, the desire to develop procedures for dealing with problem banks that would avoid the kind of tsunami that we saw in September 2008. The BRRD and SRM are part of this program.

However, I sometimes wonder whether improvements in resolution procedures are really meant to make resolution viable, or whether they are meant as placebos to avert political protest against a regime in which the financial industry has blackmailed taxpayers into providing support, for fear that otherwise things might get much worse. Many of the reforms that have been instituted are likely to prove impractical if we get into another crisis.

In the rhetoric accompanying such legislation, the proponents never show how the new legislation would have worked in the Lehman crisis if it had been available then. If we want to avoid a repetition, however, it is imperative that we recall precisely those problems and see what can be done about them. Actually, the post-Lehman experience was different in different countries:

- From the perspective of the United States, the post-Lehman experience is dominated by the implosion of money market funds.[29] The Lehman Brothers bankruptcy caused Reserve Primary to break the buck. News of this event triggered a run on Reserve Primary and on other money market funds. As a result, all money market funds withdrew funding from banks,

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[28] *This point is very much emphasized in ASC (2012), Sapir et al. (2012).*

[29] *The AIG episode occurred at the same time but, as far as I can tell, this episode was not directly related to the Lehman Brothers bankruptcy. For a more detailed account, see Admati and Hellwig (2013), chapter 5, and the references given there, in particular FCIC (2011).*

in particular U.S. investment banks, which the Lehman Brothers bankruptcy had made to appear more risky anyway. As banks the world over were scrambling for cash, they tried to sell assets, which sent asset prices into a tailspin.

- In the United Kingdom, the post-Lehman experience is dominated by the disappearance of a key market maker in derivatives markets. Maintenance of systemic functions was deemed to be impossible because there was no legal basis for doing so and because there was no funding. Lehman Brothers, London, was a legally independent subsidiary, but the different subsidiaries in different counties had integrated cash management. When authorities in the U.K. took over the bank, they found that there was no cash because all cash had been sent to New York at the previous close of business.

Three important difficulties emerge:

- As different legal entities belonging to the same group go into different bankruptcy/orderly liquidation/recovery and resolution procedures, each one in the country where it is located, the integrity of corporate operations is destroyed, and this can destroy the viability of systemically important functions. In the case of Lehman Brothers, this was most noticeable for their integrated cash management. Potentially even more important are integrated IT systems, where the entry of multiple resolution authorities in multiple places raises the question of what is the legal or contractual basis, and what are the rules and the pricing, for continued joint use of these systems which is essential for the maintenance of systemically important operations.
- Any maintenance of systemically important operations requires funding. Without funding, such operations cannot be maintained. Market funding, however, is likely to vanish unless creditors are given guarantees that they will not be harmed.
- Systemic effects are not limited to domino effects from the breakdown of existing contracts. The disappearance of contractual partners on whose availability one had counted or the implosion of asset prices from fire sales may be much more important.

In thinking about the maintenance of systemic functions, it is worth recalling that Lehman Brothers had hundreds if not thousands of subsidiaries.[30] If such subsidiaries act in an integrated fashion, managing the system is a daunting task even for those who know it. For the authorities replacing incumbent managing, the task is that much more difficult.

Dealing with Banks in Difficulties Banks with Systemically Important Subsidiaries in Different Countries

On the key issue of how to maintain systemic functions of a bank with systemically important operations in different countries, progress since 2008 has been miniscule. Multiple-point entry, i.e., the entry of different authorities of different countries into the legally independent units located there, is still the prevailing legal rule. The United States and the United Kingdom have been negotiating about single-entry procedures, but they seem to be thinking more of recovery than resolution, and the issue of loss sharing in resolution has not been settled. The living

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[30] *Herring and Carasi (2010) mention 433 majority owned subsidiaries, Miller and Horowitz (2012) speak about 8,000 subsidiaries in over 40 countries.*

will that Deutsche Bank has submitted to the Fed and FDIC proposes that U.S. authorities should let the German authorities deal with any crisis situation. However, the U.S. authorities do not seem to be convinced by this proposal. Their recent ruling that foreign banks must organize their U.S. subsidiaries so that U.S. equity and liquidity requirements can be imposed indicates that they are thinking of ring-fencing the U.S. operations of foreign banks. Given the experience of ring-fencing by European supervisors, e.g., the restrictions that Bafin imposed on Unicredit Germany in 2012, one can hardly blame them.

Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms (Bank Recovery and Resolution Directive – BRRD) provides for some coordination within the college of resolution authorities. However, this coordination can hardly substitute for the organizational integration of operations in the bank as a going concern. This basic problem remains unsolved. Therefore, I predict that, if a bank like Barclays, BNP Paribas or Deutsche Bank, with systemically important functions in different countries were to get into trouble, authorities would be unwilling to enter into a recovery and resolution procedure, i.e. we would continue the post-Lehman practice of bailing banks out.

The SRM provides for a centralized procedure with single-entry resolution for large banks. However, the procedure is complex and provides much scope for participants to veto decisions they do not like. For institutions of the importance and complexity of BNP Paribas or Deutsche Bank, the mechanism will therefore be no more practical and trustworthy than the provisions of the BRRD. Indeed, since the USA and the U.K. do not participate in the SRM, a major part of the multiple-entry problem is not even addressed.

Dealing with Banks in Difficulties: The Need for Interim Funding

Another shortcoming of the BRRD is its naiveté about the time needed for resolution and the need for funding during this time. Recitals 103 – 105 note that such funding may be needed and assert that it should be provided by resolution funds under the control of resolution authorities. Given the numbers involved and given past experience, this is unrealistic.

The Single Resolution Fund for the SRM is targeted for a level of EUR 55 billion, the German Bank Restructuring Fund for a level of EUR 70 billion, to be reached after many years. These numbers are much too small to ensure interim funding of institutions like Deutsche Bank or BNP Paribas, with liabilities on the order of EUR 2 trillion, a large part of which is wholesale and short-term, i.e. easy to discontinue if counterparties get nervous. Promises of support from a fund with EUR 55 or EUR 70 billion are not going to stop a run if creditors with claims amounting to EUR 1 trillion or more are worried about a bank. In fact, this is not just a problem for banks with trillion-euro balance sheets. The problem also arises with banks like Commerzbank or the Landesbanken, whose liabilities amount to several hundreds of billions of euros.

Discussions about the funding of recovery and resolution procedures usually pay too little attention to the distinction between the need to fund operations as long as they are ongoing and the need to allocate or to absorb ultimate losses. Resolution or restructuring fund target levels in the double-digit-billion range may be sufficient to absorb ultimate losses, but they stand in no realistic relation to the interim funding that is needed to keep systemically important operations going, at least for a while. The SRM will be able to borrow from the ESM but the numbers that have been given there, like those for restructuring or resolution funds, stand in no realistic relation to what is needed to maintain interim funding.

In ordinary insolvency law, the problem of interim funding for ongoing operations is usually handled by giving new creditors, i.e., creditors who come in after the firm has entered into insolvency proceedings, priority over previous creditors. For nonfinancial companies, this arrangement is viable, at least for a while, because the funds needed to maintain ongoing operations tend to be small relative to the firm's assets.

For a bank, this arrangement is problematic, which is precisely why we need a procedure that is different from ordinary insolvency procedures. Banks have a lot of short-term funding, through wholesale loans as well as deposits. If these claims on the bank are frozen, there may be substantial systemic damage. For example, a money market fund whose claims are frozen may be run upon, as Reserve Primary was after the Lehman Brothers bankruptcy. As we saw in September 2008, such runs on money market funds may endanger the entire system of short-term wholesale bank funding. If the short-term claims on the bank are not frozen, maintenance of bank funding requires that these claims be renewed or replaced. For a bank in a resolution procedure, such renewal or replacement of funds will not be forthcoming unless the lenders are given public guarantees. Priority over previously incurred liabilities of the bank is not sufficient because the amount of such funding is large in relation to the bank's assets so that, without public guarantees, there is a risk for the lenders.

Nor is it sufficient to exempt secured claims and very short-term inter-institution claims from bail-in, as the BRRD does. For lenders with secured claims, there is always a question whether the collateral is sufficient. With Bear Stearns and Lehman Brothers, doubt about the collateral caused the "repo runs" on these institutions. Such doubts can be caused by concerns of the collateral value itself. They can also be caused by concerns about re-hypothecation, i.e., the fact that the same securities are used as collateral for several loans. If such doubts cause lenders to increase collateral haircuts, encumbrance of the bank's assets by collateralization is exacerbated – and the ability to maintain funding further endangered.

Exemptions of very short-term inter-institution claims are more clear-cut but even so these claims are vulnerable to the risk that the lenders themselves might be run upon, as happened to U.S. money market funds after the Lehman Brothers bankruptcy.

The problem of interim funding can be solved by providing resolution authorities with public guarantees or by allowing these authorities to borrow from the public purse. Under the Dodd-Frank Act in the United States, the FDIC can simply borrow from the Treasury.[31] Under the BRRD, however, the problem is not addressed. An important question will be whether national legislation will go beyond the BRRD and provide resolution authorities with sufficient access to interim funding or with sufficient backstops so that they can give the guarantees that are needed to maintain the systemically important functions of a bank at least for a while.

Dealing with Banks in Difficulties: Asset Valuation and Bail-Ins

To some extent, the neglect of interim funding problems seems to be due to the fact that the BRRD has a very optimistic vision of how resolution is carried out: Some Friday, the supervisory authority determines that a bank is likely to fail. It calls for the resolution authority to take over. The resolution authority obtains an independent valuation of the bank's assets and liabilities. On the basis of that valuation, it writes down the bank's equity, and it writes down the bank's liabilities or converts them into equity, following the hierarchy of claims under insolvency law. If all this is done over the weekend, then by Monday the bank is again well capitalized, and the resolution authority is in a good position to move forward. Perhaps it has already used the weekend to sell the business or to set up a bridge bank.

This vision is too optimistic. First, asset valuation is problematic. At the time of entry of the resolution authority into the bank, the bank's prospects and the value of its assets are highly uncertain. The uncertainty about the value of the assets may itself be a key factor in the difficulties of the bank.

What was the value of the United States S&L's assets in 1990? What was the value of assets and derivatives in the books of Long-Term Capital Management in September 1998? What was the value of mortgages and mortgage-backed securities in the books of Lehman Brothers or AIG in September 2008? What was the value of real-estate loans in the books of Spanish cajas in 2012? The answers to these questions are highly sensitive to the chosen principles for valuation. They are also a matter of judgment as to how long the current crisis is going to last. Finally, they depend on how quickly the assets in question have to be liquidated. In the case of the U.S. S&L, estimates of the costs to deposit insurance institutions were on the order of USD 600 to 800 billion around 1990; in the end, these costs came to USD 153 billion.[32] In the case of LTCM, the Federal Reserve feared that a bankruptcy followed by a quick liquidation of assets and derivatives might trigger an asset price implosion and therefore put pressure on other

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[31] *The German Bank Restructuring Act of 2010 also allows for borrowing from the public purse, but the scale of the restructuring fund is by an order of magnitude smaller than interim needs for funding and/or guarantees.*

[32] *Curry and Shibut (2000).*

banks to provide the interim funding for a slow liquidation. The strategy was successful so that the banks involved did not actually lose on the interim funding.

The directive does allow for a preliminary valuation as a basis for bail-ins, but it also asks for an *ex post* valuation to be performed "as soon as possible". In the case of the S&L, "as soon as possible" would have been ten years later, which probably is not what is meant by the BRRD. A reliable final loss allocation however does require a lot of time – unless the authorities are willing to speed the procedure up, if necessary by selling assets prematurely.

Second, resolution involves more than a valuation of assets and a recapitalization on the basis of writedowns and debt-to-equity conversions. Key questions concern the correction of past management mistakes, the search for new owners, the decision as to which assets should be part of the bank as a going concern and which ones should be separated and wound down. Answering these questions takes time. During this time, uncertainty about the future of the bank and about the value of its assets encumbers the bail-in mechanism and endangers funding – even from creditors whose claims are not subject to bail-in.

Dealing with Banks in Difficulties: Fiscal Backstops

Most legal reforms of recovery and resolution procedures that have been introduced since 2008 have come with a promise that never again will taxpayers have to foot the bill for bank bail-outs. The Dodd-Frank Act in the United States is one example, the German Bank Restructuring Act of 2010 another. The BRRD follows the same principle, albeit somewhat less stringently.

These promises are either naïve or cynical. If systemically important banks are in trouble and the choice is whether to let them go under or to support them, the answer will be "We do not want to have another Lehman experience!" This is the lesson learnt in 2008, and in many respects it is the right lesson. The costs of the Lehman Brothers bankruptcy and the financial turmoil it induced far outweighed whatever the fiscal costs of a bail-out might have been.

In such a crisis situation, some public funds are needed, at least to maintain interim funding of systemically important operations. Putting in public funds, even temporarily, puts taxpayers at risk. If the bank is insolvent, somebody has to pay for the difference between liabilities and assets.

Ostensibly, this is what restructuring or resolution funds and industry levies are there for. However, in a crisis that affects the entire industry, these funds are likely to be too small to cover the losses. Even if industry levies are increased *ex post*, there is no guarantee that it will be sufficient to cover losses. In a crisis situation, the capacity of surviving industry members to contribute to such a levy will be severely limited.[33] Even if the charges are spread over time, there is still a substantial burden, which affects the banks just as an excess of debt overhang would.

For example, in the S&L crisis of the 1980s in the United States, the industry was in such difficulties that it could not bear the costs of the crisis; the Federal Savings and Loans Insurance Corporation (FSLIC) became insolvent and was merged with the FDIC.

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[33] *In any event, it should be clear that the levy itself is a kind of tax, supporting institutions in difficulties at the expense of institutions that have not seen risks materialize.*

Out of USD 153 billion of losses, in the end, the industry paid USD 29 billion and taxpayers USD 124 billion. If a comparable systemic crisis was to happen today, in the U.S. under the Dodd-Frank Act or in Germany under Bank Restructuring Act, the experience would be repeated. This would be a breach of the promises with which these laws were introduced but at least it would work.

The S&L example may be seen as atypical in that most S&L funding in the United States had come in the form of deposits, which were federally insured. Thus there was little room for clawbacks or bail-ins of creditors. One may therefore hope that ultimate losses in bank resolution will be smaller if more creditors are bailed-in, i.e., if more creditors are forced to participate in losses as they would have to do if the bank entered a bankruptcy or insolvency procedure.

On this point, the BRRD is not reassuring. The BRRD contains important statutory exceptions from bail-ins: Covered deposits, secured liabilities and derivatives, and inter-institution liabilities with maturities of less than seven days. The authorities can also grant additional exceptions on the spot if they deem such exceptions to be necessary to forestall contagion or other forms of systemic risk. To ensure that, in spite of these exceptions, there is at least some debt that can be bailed-in, the directive requires that exempt liabilities amount to no more than 92% of a bank's funding. Loss absorption from equity and bail-in-able debt can be as little as 8% of total assets.

The Lehman crisis and the post-Lehman bailouts have created a strong lobby against any creditor liability. Forcing creditors to bear losses, we are told, entails a danger of systemic risks from domino effects, as those creditors themselves may be too weak to absorb those losses, or as the realization that creditor liability must be taken seriously hurts funding conditions of other banks. This thinking has dominated public discussion and public policy for quite a while, including initial discussions about the Cypriot crisis. The Cypriot crisis and the treatment of SNS Reaal provided for some change, but as yet I am not convinced that these events determine the new paradigm.

Indeed, given the uncertainties about how systemically important functions are to be maintained and funded, I expect that, in a clutch, most governments will decide that it is better to avoid a resolution procedure altogether. Back to "too big to fail"!

The BRRD leaves room for such avoidance by allowing recapitalizations of banks even before they enter into the recovery and resolution procedure. Such a recapitalization presumes that the requisite funding is available, as is the case in countries with strong fiscal positions. If the requisite funding is not available, the recovery and resolution procedure may still be avoided if the authorities exert forbearance and procrastination as they have done in the past. Without a fiscal backstop at the European level, I am not convinced that, on this account, the SSM will change so much.

Dealing With Banks in Difficulties: Legacy Risks and Fiscal Responsibility

Ironically, the legislation for banking union took so long that the concrete problem that was of concern to the June 2012 Summit, namely the recapitalization of Spanish banks, has been dealt with even before the legislation had been passed, let alone entered into force. In 2012/2013 ESM provided some EUR 41 billion for the recapitalization of Spanish banks, with conditionality for restructuring of the industry; by now, the Spanish government has declared that no new assistance will be needed; the funds that were provided will be repaid over a period of more than a decade. However, in this process, the Spanish government remained (and remains) liable as the ESM funds did not go directly to the banks but the Spanish government's recapitalization fund.

The question of national liability has been at the core of the political controversy. Whereas the original Spanish proposal for direct recapitalization of Spanish banks through the ESM would have provided for a Europeanization of legacy risks, channeling these funds through the Spanish government's recapitalization fund implied that the Spanish government itself would be liable for the debt service.

The BRRD and the SRM leave the principle of national fiscal responsibility for banks untouched. For the BRRD, which applies to the entire EU, this is a matter of course – as a directive, the BRRD merely provides the legal background to the Internal Market in banking and does not in itself promote the banking union. In the SRM, the issue is dealt with by denying that it is an issue at all. Claiming that recovery and resolution will be paid for by the industry without any imposition on taxpayers is a way to avoid taking a clear stand on fiscal responsibility. In a crisis, if the institutions that are at risk are sufficiently important, if national governments are unable to provide the requisite backstops, and ESM loans are insufficient, one may find out that the problem must be dealt with anyway. As in other contexts, the crisis be used as an occasion for further integration, albeit by hurried stopgap measures.

In the political debate about the issue, legacy assets and legacy risks have played an important role. Even people who would in principle acknowledge that a mutualization of fiscal responsibilities for banks might serve a useful insurance function have argued that you shouldn't provide insurance for a house that is already on fire, i.e. any mutualization of fiscal responsibilities for risks in the financial system should not cover losses on existing assets. Given the externalities from keeping those losses hidden and having the weakness of financial institutions endanger financial stability and growth all over Europe, I do not find this argument altogether convincing. However, it has played an important role in the debate.

One might also argue the issue with a view to moral hazard. National policies affect the safety and soundness of banks in a given country, so fiscal responsibility for any bail-outs would ensure that these risks are properly taken into account. But there is another side to the coin: Supranational institutions for supervision and resolution take decisions that affect risks to taxpayers. National fiscal responsibility may therefore generate moral hazard on the side of those institutions. Indeed, until now, this argument has played a major role in justifying national competence for supervision and even the subordination of supervision to the national finance minister.[34] As constituted at present, therefore, the new regime is bound to raise questions about the legitimacy of decisions taken at the supranational level that impose fiscal burdens on national treasuries.

In the short run, there is a danger that the maintenance of national fiscal responsibility will deepen the split between "periphery" and "core" countries. There is also a danger that the clean-up of the financial system will be further delayed. Countries with sufficient fiscal capacity will be able to use the recapitalization option under BRRD to preempt any recovery and resolution procedure. At the level of the individual institution, this may be satisfactory, if costly for national taxpayers, but the needed adjustment of market structure will not take place. Countries that do not have the requisite fiscal capacity will try to continue sweeping problems under the rug; if this is not possible, they may again be forced to have recourse to ESM support. However, there will be enormous pressure on supervisors to exercise forbearance and act as if the problems with some of the banks' assets were merely temporary and hopes for an eventual recovery would justify asset valuations at which the banks can be deemed to be well capitalized.

From this perspective, it will be interesting to watch the Asset Quality Review that is to take place later this year. On the one hand, the ECB has a strong interest in ensuring that the Asset Quality Review is serious and that problems are laid open and remedied. Otherwise there is a risk of problems emerging soon after the SSM begins to work, which would be disastrous for the ECB's credibility. On the other hand, national authorities, and to some extent the ECB itself, have a strong interest in ensuring that not too many problems are laid open. Otherwise national authorities will be blamed for past laxness; moreover, the needed remedies and adjustments may not be feasible for some of the participants. At this point, the outcome of this conflict is up in the air.

In the medium run, I believe that banking union will require a Europeanization of fiscal responsibility. First, this would contribute to defusing the issue of loss sharing in dealing with banks that have significant cross-border operations, making single-entry resolution more palatable. Given that the U.S.A. and the U.K. are not included, this would only be a small step, but one that is nevertheless worthwhile. Second, a Europeanization of fiscal responsibility is necessary for the protection of monetary policy. To the extent that national fiscal responsibility prevents a clean-up of the financial system, the

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[34] *See Wissenschaftlicher Beirat (2008), Hellwig (2011).*

ECB remains hostage to the weakness of the financial sector. In particular, there is little hope for overcoming the fragmentation of financial and monetary systems that we currently have. This fragmentation makes the ECB's task of ensuring monetary stability in the euro area all but impossible to fulfil.[35]

The question is whether a Europeanization of fiscal responsibility can be achieved without the creation of a European fiscal sovereign. The fiscal backstop that is needed for the SRM to be viable requires some tax base. So far, such a tax base does not exist. Will banking union become a reason for moving forward in this direction?

4 Concluding Remarks

As indicated by the preceding discussion, I am skeptical whether banking union as it has been designed so far will really allow us to deal with the problems that currently plague our financial sector. Whereas the Europeanization of supervision and the independence of supervision from political authorities may eliminate some of the distortions in supervision that we have seen in the past, the resolution regime remains nonviable in my view. "Too big to fail" is still with us. Moreover, the maintenance of national fiscal responsibility for banks preserves incentives to sweep problems under the rug, and preserves some of the factors that have been responsible for the fragmentation of financial and monetary systems that is plaguing the monetary union.

Politically, the development of banking union seems to involve a bet between the European institutions, in particular, the ECB, and the member states. From the perspective of the ECB, banking union holds the promise that, if it works, the ECB may get out of the straightjacket where it has to provide funding to banks, even if they are suspected to be insolvent, which then provide funding to their governments. From the perspective of those governments, banking union holds the promise that the ECB is drawn even more deeply into being responsible for financial stability and therefore the indirect access to the printing press becomes even easier. Which side will win is unclear but it is by no means a foregone conclusion that it will be the ECB.

To be sure, European arrangements have always evolved dynamically, dealing with problems as they came along. One day's problems have often become the next day's reforms. In that sense, my skeptical remarks can be read as an agenda for further reform. I hope that this reform will come before the problems become unmanageable.

At a deeper level though, I am wondering. Banks are political and have always been. The example of Jakob Fugger financing Charles V's election to be Holy Roman Emperor is paradigmatic. So is the example of the Medici taking over the government of Florence in order to protect their bank from bankruptcy. The symbiosis of banks and treasuries has for centuries been a key element of sovereignty. Are member states really prepared to transfer this part of their sovereignty to the European institutions? I consider this transfer to be necessary if monetary union is to survive, but I wonder whether the political will is there.

However, if the European Monetary Union were to fall apart, the de-

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[35] *In this context, it is worth nothing that the German Constitutional Court's indictment of Outright Monetary Transactions placed particular weight on the selectiveness of the program, a selectiveness that seemed mandated by the fragmentation of the monetary systems but whose distributive implications the judges considered unpalatable.*

tails could be ugly. In those countries where people expect claims on euros to be devalued, we must expect to see bank runs, breakdowns of banks and of payment systems, and severe economic and social crises. Economic and social damage could be enormous. So could be the effects on people's feelings about European integration and all that it stands for.

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Revolution or Evolution

The Structural Effects of Banking Union on National Economic Policy Making

Banking union will change the structure and functioning of financial markets in Europe. And it will change economic policy making in ways not yet fully discussed. In order to capture a number of possible effects, I will start by describing some aspects of policies under the present regime, and then try to draw out some of the changes from 2015 onwards. Some of these changes are more certain to materialise than others. It is the latter that may matter more.

1 Where Did Banking Union Come from?

Financial integration and regulatory practices have developed in cycles for more than a century with changing degrees of restrictive regulation and supervision. The choice between market efficiency on the one hand and tighter regulation in order to avoid boom-bust episodes on the other is seldom free of self-interest. Liberalisation of capital movements and the conduct of monetary policy have followed similar cycles, and are closely related to the issues of financial regulation and supervision. In their design, beliefs often play a larger role than knowledge.

Within the European Union the Internal Market brought about a significant degree of financial liberalisation and market integration from the early 1990s onwards. However, even with the advent of Economic and Monetary Union (EMU) it did not become "One Money, One Market" as the title of a then Commission publication suggested. This is not surprising considering the problems of (lack of) rules on burden sharing and supervisory cooperation in a large and integrated financial Internal Market. Attempts by the European Commission to elaborate and codify such rules were met with very effective resistance. An agreement on supervisory cooperation in crisis situations, signed in 2008, had more than 100 signatories. It was never put into practice even at the height of the crisis. The legal framework was mostly created by way of Directives (i.e. not fully harmonised Regulations); cross border banking by way of branches remained the exception, not the rule.

The Maastricht Treaty already contained a provision that allowed for banking supervision tasks being established in the context of the ECB. This was the last remnant of earlier drafts of the Maastricht Treaty that had recognised that a Monetary Union needed to be complemented by – inter alia – a common banking supervisor in order to avoid supervisory arbitrage or competition. For 20 years these provisions remained unused, and indeed it seemed nearly unthinkable that they ever would be used. Supervision remained firmly anchored at the national level, which has had at least two consequences of interest in the present context: In the case of cross-border banks the divide between host country and home coun-

try supervisors has intensified over 20 years with both sides mistrusting each other. The even more significant result has been an industrial policy type approach to financial supervision that has contributed strongly to the current financial sector problems.

The economic risks of supervisory nationalism were partially understood by the main actors, and the political obstacles to tackling them were considered unsurmountable. Discussions between Ministers of Finance of macroprudential risks remained few and far between in the Eurogroup. The degree of contingent liabilities that had accumulated in balance sheets was little understood, and the international interlinkages underestimated. There were only very few examples of risk mitigation even at the national level, such as in Spain. But with the global economic and financial crisis playing out in Europe the consequences became quite obvious.

This became very clearly visible from 2008 onwards as the EU tried to coordinate its approach to banking rescue and restructuring. Close relations of politics, supervisors and banks have been a defining feature of economic policies in many countries. In most of the EU Member States with macroeconomic adjustment programmes – and also others – such "special relationships" led to bank activities that were considered to be in the interest of certain groups or regions. Ultimately they usually were to the detriment of the financial health of the bank and of the tax payers as asset/GDP ratios reached multiples of GDP. In Cyprus for example that ratio reached around 800% of GDP.

A related issue is that bank balance sheets have historically been heavily biased towards government bonds of the home country. In times of a sovereign debt crisis this accelerated the deterioration of the balance sheet of the banks holding government bonds of vulnerable countries, as we have witnessed over the past few years.

The tension between financial stability concerns on the one hand and the avoidance of moral hazard on the other usually only emerges at times of acute crisis. Priorising one over the other is in practice a difficult choice as second and third round effects are especially hard to foresee, and even more difficult to reverse. The choice in Europe and Japan has historically been to try to avoid contagion and ensure systemic stability at nearly all costs. The U.S.A., and to a certain extent the Nordic countries have had a higher emphasis on holding market participants accountable for their actions. A corollary to bail-out being the rule was that decisions on resolution of banks that were failing, or in danger of failing, were taken far too late, thus aggravating the problems and costs of failure or resolution for tax payers.

Instead of rapidly cleaning up banks' balance sheets which would eventually have led to shutting down some of the troubled banks, governments in Europe have usually intervened with capital injections, loans and guarantees. Since such support qualified as state aid it had to be approved at the EU level. During the crisis state aid was allowed to be disbursed rapidly, before the final approval of the restructuring plans and time tables had been given by the European Commission. This led to significant delays in restructuring plans and decisions by national authorities, in a few instances dragging on for years. Bailing-out the banks with tax payers' money continued to be the norm. The overall costs of bank bail-outs in the EU in the recent crisis period is estimated at EUR 413 billion (equity only), added to which 179 billion in impaired asset measures, EUR 258 billion for liability measures other than guarantees (i.e. loans and direct liquidity), and guarantees that reached a peak in 2009 at EUR 836 billion.

The stress tests of the banking (and insurance) industry in 2010 and 2011 coordinated by the European Banking Authority (EBA) were conducted and influenced by national authorities with some top-down coordination and plausibility checks. As it turned out they were too mild to trigger sufficient restructuring. Even certain banks that were later resolved under euro area financial assistance programmes passed the test.

As the financial crisis in Europe reached new dimensions in 2012 the negative linkages between banks' and sovereigns' balance sheets influenced the financial stability of the euro area as a whole. In May of that year it was considered that one of the means for breaking this feedback loop, and thus for stabilising sovereign debt markets, was to directly capitalise banks in need through the European Stability Mechanism (ESM). In these cases programme lending to the sovereigns concerned would have been superfluous. Macroeconomic stigma effects would have been avoided.

As these discussions progressed it became evident that this would be conceivable only if the banks concerned were supervised by a common (and thus impartial) supervisor. At the European Council meeting on 29 June 2012 it was thus concluded that such a supervisor should be set up. Two years on it is all set to start operating. It has long ago left the reasoning of merely underpinning direct recapitalisation far behind and became a part of something larger, the banking union.

2 A Changed Environment for Policy Makers

Following the crisis a new and more robust regulatory framework has been set up for the EU as a whole. Banking union as per 2014 is made up of different complementary components. The *Single Supervisory Mechanism (SSM)* in Frankfurt will directly supervise the major banks within the banking union, and indirectly the minor ones. New rules on the *recovery and resolution* of banks will ensure that tax payers no longer bear the financial burden of bank bail-outs, but that owners and investors of banks will contribute to these costs by bailing-in their assets. A *Single Resolution Mechanism (SRM)* for the banking union will trigger the resolution of failing banks and will adopt resolution plans for these institutions. After a mandatory bail-in of shareholders and investors, remaining costs of resolution will be born by the *Single Resolution Fund (SRF)* which will be financed by industry contributions. This Fund will be progressively mutualised from 2016 onwards. This means that the costs of bank resolution will partially be born by levies of banks throughout the banking union, and not just by those located in the country concerned, as is the case for countries outside banking union. A single *Deposit*

Guarantee Scheme is not foreseen for the nearer future as this is regarded as a step too far in the direction of Fiscal Union.

A Gradual Disappearance of "National" Banking Systems?

With a Single Supervisor strategic industrial policy approaches to banking will largely cease to function. Supervisory practice will become more of a level playing field with the issuance of a single rulebook as the SSM supervisory manual. Discretionary actions will no longer be "granted" by national policy makers. This also changes the political economy of relationships between banking and politics at the national level – also for the only indirectly supervised "smaller" banks.

Ring-fencing of liquidity within bank groups will no longer be possible – national regulators will not be able to limit transfer of assets from banks on their national territory to subsidiaries or to the parent located elsewhere. This should facilitate the functioning of the monetary transmission mechanism, which has over the past years been severely hampered. Supervisors with a national microstability mandate have - individually acting rationally – often acted against the macrostability interest of the euro area as a whole.

The more independent, transparent and objective the single supervisor, the less possible it will be for national authorities to refuse to acknowledge identified risks to viability of individual banks. This will result in quicker triggering of the resolution process. When the Single Resolution Mechanism is operational (in 2016), an independent Single Resolution Board will make it more difficult to justify financial stability concerns in order to be allowed the use of public money to rescue failing banks.

Over time, as conditions of competition become more and more aligned across banking union differences in cost structures will play an ever increasing role in the competitive position of banks. This will influence the strategies of banks in gaining market shares even more so than today. It may also lead to a different type of industrial policies as tax regimes will have a very direct effect on competitive positions, and ultimately on the location of headquarters.

Does Bail-in Change the Macropicture?

With the updated state aid rules as of summer 2013 bailing-out banks as in the recent crisis is no longer possible, and the applicable rules for bail-in will get more stringent over the coming years. Therefore, the traditional reliance on bailing-out banks in trouble will no longer occur as it did in the past. This shifts the costs of bank resolution which is budget positive for the sovereigns. In a truly integrated financial market the effects of the new rules also should be beneficial for the economy across the whole banking union. What is not a priori clear is whether the new rules:

- change the overall costs of bank resolution,
- or merely change the incidence.

On the issue of overall costs the experience of recent years suggests that costs of resolution have been larger than necessary for a number of reasons: national authorities have certified banks as "sound" where an independent authority would not have done so; resolution decisions and plans have thus been taken much too late, usually thereby increasing the costs. And in the case of cross-border resolution coordination failures between supervisors have led to higher costs, and sometimes an asymmetric attribution of costs to the national authorities concerned.

The question of incidence is less straight forward. In the case of bail-out the costs are born by future tax payers, whereas in the case of bail-in the costs are born immediately by investors and possibly unsecured depositors. To what extent the wealth effect of the costs of resolution have significant domestic macroeffects depends not only on the size of the problem or the magnitude of resolution costs, but on the distribution of ownership between different classes of investors. Only in certain cases, such as with a large non-domestic investor base can one unequivocally say that the sign of the macroeconomic effects of bail-in will be clearly different than in the case of bail-out. Obviously, the inter-temporal distribution effects will be very different from each other, but the impact on banks, business and households will be more direct than has been the case so far.

When the Single Resolution Fund (SRF) contributes towards the costs of resolution this will have a noticeable burden sharing effect across banking union as of 2018, when significant parts of the SRF will have been mutualised. This implies that the costs of resolution covered by the SRF will be born by bank levies across banking union as a whole, and no longer by national banking systems. This should have macroeconomic stabilising effects compared to the status quo, especially for small countries with large banking systems.

The main dynamic economic effects of bail-in can obviously not be quantified as they relate to the positive incentive effects of bail-in and thus to risk management within banks. They should dampen the cyclicality of banking crisis as they lead to lower risk. On the other hand they should contribute to slightly higher cost of capital.

Risk and Pricing

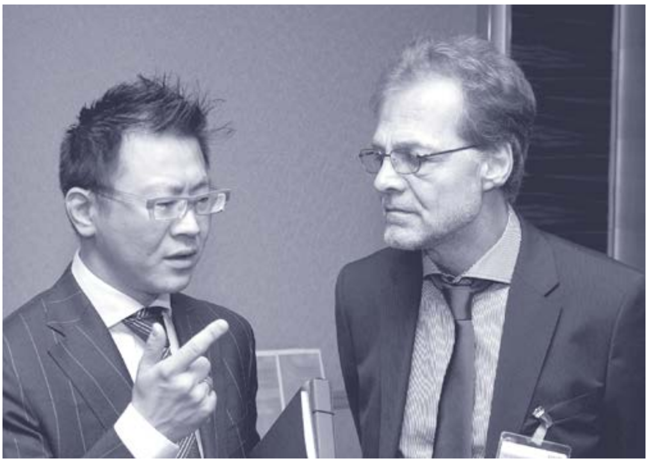
Given the new rules on resolution attitudes towards risk will change. Bank finance will be considered relatively riskier, thus the cost of funding will go up and the structure of financing bank balance sheets will become more conservative. Interestingly, banks' risk managers will do well to not only focus on risks in their own balance sheets. Given the fact that bank levies of all banks in the banking union will contribute to the financing of resolution costs there will be an inherent interest in the de-risking of competitors' balance sheets. First signs of this awareness come as some central banks start hiring supervisors in order to start analysing banks abroad.

Consequently, banks will have to re-evaluate their lending policies. As the loan to deposit ratio comes down, the costs of financing the economy will be pushed upwards, with slightly mitigating effects from positive selection bias for less risky projects and loans. The corporate sector may thus be encouraged to diversify its funding strategy and look for other sources of funding.

For large corporates this is, even in Europe, not a new situation as they routinely finance themselves via capital markets. For midcaps and especially SMEs the situation may change more perceptibly. Given the lower degree of capital market development in large parts of Europe this will pose challenges. Leading (larger) SMEs towards capital markets will also require a new kind of investment banks with a different cost and fee structure. Initiatives to develop markets, e.g. through securitisation are underway, but will take a long time to have a significant impact.

3 And Effects on Policy Makers?

As these changes work through our economies the role of economic policy makers will shift. The present crisis has already shifted requirements significantly. Gone are the days when Finance Ministers and officials could focus largely on spending and taxation as the main drivers of growth and stability. Gone are the days when banking supervision was a mainly domestic occupation.



With an independent banking sector, integrated across the EU, national policy makers will have to better understand the implications of its functioning on their respective economies.

The role of banking and finance in Europe is changing. The contribution of finance to GDP, i.e. the value added of the sector to the national economy will not be as much of a growth driver as it has been in the more recent past. Financing of investment will face different challenges. As deleveraging of the sector (and other sectors of the economy) continue there will be additional transition issues. Policies will need to address these challenges preemptively. A non-exhaustive list of issues includes the following:

- Developing the necessary framework conditions for the development of capital markets and for SME financing;
- Influences on savings and investment decisions will undergo changes as costs and risks of instruments change; especially on the saving side this needs to be handled with care;
- As sources of growth shift, a better understanding of what is hampering and what is driving growth needs to evolve at the national and the European level. The interaction between public spending, taxation and financing decisions on growth and employment needs to be understood precisely.

Economic Policy is "Risk" Management

Policy makers, among others, tend to ignore the difference between risk and uncertainty, and treat everything as a risk. This may actually at times increase risk. Such an approach may lead, for example, to ever more detailed regulation of activities in the attempt to address known risks, but does not take into account that uncertainty is the problem.

Sources of instability will not go away in the banking union, but dealing with them will require careful analysis at the national level and subsequent policy action at the national level, or the banking union level – sometimes joint. We will therefore need to develop (or improve) our analytical apparatus for detecting emerging imbalances, and stand ready to take action. Instability may come from the real sectors of the economy, such as housing and real estate. Or it could emerge from different parts of the financial system. As intermediation chains get longer the role of shadow banking gets more important. At the same time the use of collateral does not reduce risk, but shifts it around in the financial system. While understanding banks and their balance sheets is important, understanding the other parts of the financial system is more complex, but at least just as important. Only then can one design policies that mitigate risk and decrease uncertainty. This need not be only at the global or EU level, but also national risk management will play a decisive role.

The role of publicly owned financial institutions will face new challenges as risky behaviour with the backing of implicit, and sometimes explicit state guarantees may lead to the resolution of such institutions, instead of bail-outs. Thus, owners of such institutions will need to exercise a different quality of control than sometimes seen in the past. This also implies that "public interest" mandates may have to be rethought and reformulated as a consequence.

A last remark on some debt management issues: The risks associated with banks loading up their balance sheets with government bonds of "their" sovereign has at times exacerbated the financial crisis. This may bring about changes to the risk weighting of such instruments in the future. Direct supervision by an impartial SSM may possibly contribute to judging this "privileged access" as risky. National funding strategies for (potentially) vulnerable Member States may need to change. This also puts further pressure on lowering government debt levels as exposure to market risk gets greater when the bond-absorption capacity of the domestic banking system shrinks. Understanding market reactions and funding strategies becomes part of the tool kit of policy makers not yet exposed to international market pressures due to "captured" domestic markets.

Cooperation and Coordination Ever More Important

The design and implementation of policies that have a direct and indirect impact on banks balance sheets and profit and loss will to a large extent be decided at the EU level, whereas the implementation will remain in the hands of national institutions. They should therefore play an active role already in the EU decision-making process in order to understand the implications of the proposed EU-wide legislation to be able to shape it to the benefit of the national banking sector and economy.

National authorities will have to consider how to best adapt to the new environment – not only regarding their structure, but also the ways in which they interact with each other. A separation of the function of banking supervision from central banks at the national level may be desirable to match the EU structure, where the SSM is independent from the ECB.

National authorities will have to cooperate closely with the SSM and SRM and with relevant national authorities in other banking union member states. This will especially be important when dealing with groups directly supervised by the SSM, where national authorities will remain involved for subsidiaries located on their respective territories. Supervision of smaller banks will still remain in the hands of national institutions, but always in cooperation with the SSM. If such a bank is resolved, the SRM will take over from the national resolution authority if the funds from the Single Resolution Fund are used in the process.

With an increasing impact of policy decisions and events taking place beyond their borders on macrofinancial stability in individual countries, the question of how to organise the flow of information and discussions between the relevant institutions (ministry of finance, central bank, supervisor, resolution authority) will gain importance.

Their interaction at the national level will be complex enough, but at the EU level we will be facing several dimensions: monetary union for the euro area (currently 18 Member States), banking union for the "euro area plus", and the single market for the EU as a whole (all 28 Member States). A reduction of this complexity is desirable, but difficult to bring about.

4 Concluding Remarks

Banking union is going to change the structure and organisation of banking and financial markets in Europe. It will also bring about noticeable changes in the interaction of these sectors with other parts of our economies, and thus their functioning. This will also require a different approach to national economic policies, and a more holistic understanding of how the different parts of the puzzle that our economies are fit together.

Max Watson
Fellow of Wolfson College
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From Regulatory Capture to Regulatory Space?[1]

Influences on Regulation in the Run-Up to the Financial Crisis and the Relevance of EU Banking Union

The global financial crisis tends to confirm four findings from the literature on regulatory capture. First, the notion of binary capture – industries capturing agencies – is too simple: It is more accurate to think of a regulatory space in which these industries, agencies, politicians, consumer interests and other actors interact. Second, in changing the opportunities and constraints for capture, a key role is played by ideas – including, in the years before the crisis, an ideology of scepticism about regulation and the role of the state. Third, the economic habitat is a key factor; and notably, in the run-up to the crisis, debt-financed imbalances were important in shaping the context for both market participants and official agencies. Fourth, adaptive markets pose growing challenges of regulatory arbitrage, with complexity tending to change the distance and the balance of power between regulators and the regulated. Looking ahead, the creation of a banking union in Europe, and the role of the ECB as a single supervisor, can potentially be seen as a game-changer in some of these regards, potentially shifting incentives for players in the regulatory space. Nonetheless, important challenges will need to be overcome by the ECB in the macroprudential field – including in coordinating with other agencies to address issues of regulatory arbitrage.

> *"Economic regulation under advanced capitalism... invariably involves interdependence and bargaining between powerful and sophisticated actors against a background of extensive state involvement."*
>
> (Hancher and Moran, 1989)

1 Introduction

The concept of regulatory capture has had a roller-coaster history. The capture of policy by industry interests was viewed at one time as the dominant paradigm for failures of regulation, following the work of Stigler (1971), Jordan (1972), Posner (1974) and others. Subsequently, the analysis of experience in different industries in the United States dethroned this concept. Industry capture of this *binary kind* was put in perspective as one among several risks and influences to which regulation is exposed. It was noted that the shift in the 1970s to more aggressive regulatory approaches was hard to explain in terms of industry capture (Wilson, 1980). Thereafter, richer models evolved of capture and of warping of the public interest – ranging from group public interest theories, and insights from the literature on public choice, to the concept of a *regulatory space* in which powerful and interdependent actors bargain for favourable outcomes (Hancher and Moran, 1989; Vibert, 2014).[2]

Recently, the global and euro area financial crises have re-awoken interest in regulatory capture. Indeed, it is striking how regulators adopted much

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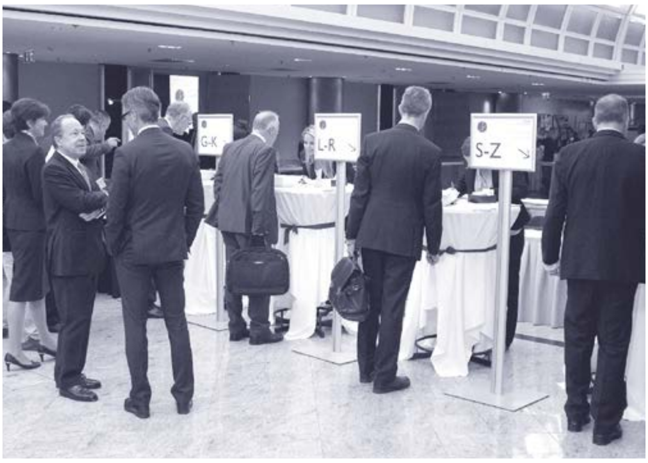
[1] *The author would like to thank particularly, without implication, Professors Robert Baldwin and Denis Galligan, Clive Briault, Chris Decker, Stewart Fleming, Valerie Herzberg, Russell Kincaid and Frank Vibert. All judgements in the paper, as well as remaining errors, are the responsibility of the author alon*

[2] *A discussion of this literature will be found in Breyer (1982), and Baldwin and Cave (1999). The scope to strengthen defence mechanisms against capture in light of the global crisis is discussed in ICFR (2012)*

of the toolbox of bankers in assessing risks, and outsourced important aspects of risk assessment to rating agencies that were paid by debt issuers and worked closely with investment banks. The literature on capture certainly offers an interesting point of departure for analysing such influences.

The present paper therefore takes as a starting point the notion of capture, and some of the conceptual apparatus from that literature. Subsequently, however, it moves beyond this frame of reference as it explores the ways in which a range of influences interacted to shift the philosophy and practice of regulation. The binary notion of industry capture is confirmed to be too narrow. Ideology, politics, economics, and technology all entered into the equation, at times in mutually-reinforcing ways. The paper discusses that the concept of capture as such does not provide an adequate framework to think about such complex interactions: A more promising approach is to envisage different influences interacting in a *regulatory space*. The main sections of the paper end with a review of the extent to which EU banking union, and the role of the ECB as a single supervisor, may serve as a game-changer in altering incentives within the regulatory space.



Some of the issues explored in the paper concern longstanding tensions concerning the consumer interest; political influence; and obstacles to preemptive policies. There are new issues too. Complexity has increased to a degree that changed relationships between the main actors; and relations between agencies and markets evolved beyond regulatory arbitrage to become an interactive learning experience, or even a game. These issues are found in other industries also. They are particularly important when the advanced economies, under severe fiscal stress, may tend to substitute regulation for public spending to achieve policy goals.

The paper is organised as follows. Section 2 outlines the analytical framework suggested by the literature on capture – including ideological capture, and public choice considerations. Section 3 discusses the interplay of factors that influenced regulation in the pre-crisis period. Section 4 discusses the limitations of the capture framework, and highlights key issues in regulation that emerge from this experience. Section 5 discusses the potential impact of EU banking union. Section 6 concludes.

2 The Concepts of the “Public Interest” and of “Regulatory Capture”

The hypothesis of *capture* presupposes a counterfactual. Conventionally, this is the notion that regulation exists to protect *the public interest*. One must acknowledge, however, great ambiguity in this concept. Mitnick (1980) warns that “the concept of the *public interest* is of course the most notorious and the most cautioned against”. There is, as Mitnick notes, some rhetorical value in the broad idea of the public interest. But this diffuse concept needs to be made more concrete in terms of intermediate objectives in any industry context.

In the case of financial markets, the literature clearly indicates that regulation is specifically warranted by a number of economic concerns. These issues arise from specific hazards that are endemic in financial markets. These hazards go beyond those prevalent in many other industries, such as the abuse of dominant market power. They concern inherent imperfections and potentially costly externalities in the functioning of financial markets. The most commonly cited are severe asymmetries of information, dilemmas surrounding principal-agent relations, problems of adverse selection (gambling on risky projects with high returns), herd behaviour, institutions that are *too big to fail*, other instances of implicit public guarantees, and moral hazard in general. A concise summary of these hazards will be found in Demirguc-Kunt and Detragiache (1998).

These factors have been cited in connection with many financial crises in the past, which on any definition were seriously prejudicial to the public interest, and which were consequently followed by moves to tighten financial regulation (Reinhard and Rogoff, 2011). In the early 1930s, the Glass-Steagall Act, separating commercial and investment banking activity in the United States, and the Federal Reserve Board's Regulation Q, which limited interest payments on bank accounts, were high-profile examples of this process.

When we speak of the public interest in this paper, this concerns first and foremost the need to address such economic issues in financial markets in order to preserve economic and financial stability. To that extent, the phrase is typically shorthand for *effective economic regulation to ensure stability and efficiency in the financial sector*. However, this is not the only dimension of the public interest discussed in the paper. The question *of the consumer interest* is also addressed – and found to be quite complex, as it is in many industries.

Turning to the concept of *regulatory capture*, this is well established in the literature. Here, we use the term *capture* to describe all industry efforts aimed at diverting regulation towards the industry's narrow economic goals. This is sometimes termed *binary capture*, since it concerns only the industry and the regulatory agency. The concept of binary capture has long been recognised to be too simple a description of influences that may divert regulation from the public interest. Hence the emergence of terms such as *ideological capture*.

However, when we then extend the use of the term capture beyond the industry to other influences and interest groups, there is a concern that it begins to lose clarity and traction. It is useful to identify this dilemma at the outset, and in particular to clarify the terminology used in the paper. At the end, we will return to this issue and ask whether experience in the financial sector sheds further light on satisfactory frames of reference – advancing the view that concepts along the lines of the *regulatory space* may prove more enlightening.

2.1 Industry Capture

The underlying process in *industry capture* is driven by economic motivation. As argued by proponents of the Chicago theory of capture, failures of competition generate rents. Firms seek to benefit from these rents; and when regulation is introduced, they seek to influence that regulation in order to derive *regulatory rents* (Jordan, Posner and

Stigler, op. cit.)[3] This simple vision of an industry capturing its regulatory agency is referred to as binary capture.

Regulatory regimes can in fact be dominated and shaped by industry interests from their inception (Breyer 1982; Kolko 1977). Regulation may be created to serve the economic interests of the regulated, not the public, by reducing competition – in particular by raising entry costs to an activity. Airline regulation in the United States is often cited in this regard. More commonly, the original goal of regulation is to protect the public interest, but it is – so to speak – hi-jacked over time by industry interests.

2.2 The Interests of Agencies

Corporations can only achieve capture if legislators or regulatory agencies are prepared to cater to their special interests. It takes two to tango. Any theory based solely on corporate endeavours is evidently incomplete. In this paper, however, we will not speak of *legislative capture or agency capture*, for example, when referring to self-interested action by legislators and agency officials. It is confusing to think of an agency capturing itself. We will instead follow convention in referring to a diversion, distortion or *warping* of legislator or agency goals (Mitnick, op. cit.).

The *venality* view holds that regulators are personally corrupted by opportunities for economic profit. Thus, the regulation they administer is warped to serve their personal interests – including future employment possibilities (Mitnick, op. cit.). They serve industry interests for economic gain. An interesting exploration is to be found in Grabosky and Braithwaite (1986), who suggest that capture by the industry may be more likely where there is a low *relational distance* between agency officials and the regulated population in terms of experience, outlook, class and frequency of contact.

In the case of regulatory agencies, incentives that are unrelated to industry capture are highlighted in the *public choice* literature. These include the motivation of seeking for the agency larger budgets or greater political influence. Both legislators and regulatory agencies may thus pursue entirely their own agendas, differing from the prescribed goals of the agency and from industry's self-interested agenda.

Some *institutionalists* are sceptical of arguments that see economic motives as the sole factor diverting political or official actors from the public interest. They see institutional structure and arrangements and social processes (including norms that derive from cultural and historic contexts) as shaping regulation in ways that go beyond the play of individual preferences and economic interests (Baldwin and Cave, 1999; Wilson, 1980). One branch of this literature highlights *bureaucratic drift*, in which agency behaviour deviates autonomously from the intent of legislators (McCubbins, Noll and Weingast, 1987). Another insight (Wilson, 1980) is that there may be different coalitions within agencies, reflecting the existence of differently motivated officials (careerists, professionals, and politicians).

2.3 The Interests of Legislators[4]

The actions of politicians may be driven by the garnering of votes in local areas

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[3] *As Adam Smith (1776) put it: "People of the same trade seldom meet together even for social merriment and diversion but the conversation ends in a conspiracy against the public or in some contrivance to raise prices...*

[4] *In a European context, the term "legislators" should be understood as relating not only to parliamentarians but to political figures who are initiating legislation (who in some countries may not be members of parliaments or national assemblies). We will therefore refer not to "legislators" but more broadly to "politicians".*

affected by regulatory decisions. They may also reflect expectations of current or future favours, including a *revolving door* to employment in the industry concerned. Alternatively, they may be related to broader gains of a less personal sort: for example, the benefits for the ruling party of high employment or strong tax revenues from a flourishing industry. Such self-interested concerns are very different from the aim of balancing various special interests when securing the passage of legislation that is basically intended to serve the public interest.

An important area in which industry and policy-makers co-operate is regulatory competition. Just as countries protect favoured industries by subsidies and tariffs, the same can be achieved through industry-specific regulatory frameworks. In the United Kingdom, the issue of the City of London as a flagship industry gives this topic special prominence. It is part of a wider phenomenon in which politicians or officials act in a spirit of regulatory competition to avoid losing market shares of global business (Sun and Pelkman, 1995; Trachtman, 1993; and Siebert and Koop, 1993).

In practice, the public interest impact of industry-regulator transactions falls along a spectrum of outcomes. The results of such a dialogue, in other words, may not be malignant. A potentially benign variant of industry influence is to be found in Group *Public Interest Approaches* (Mitnick 1980, Bernstein 1955), where legislators negotiate a package that takes account of special interest groups, but is viewed as being in the public interest. Taken to an extreme, the nature and impact of regulation has been seen as arising from an *intermingling* of public sector motivation and private interests, which takes place in the shared *regulatory space* of Hancher and Moran (1989). Indeed, the picture that emerges from recent experience in the financial sector may be most accurately described as an interplay of different influences within the regulatory space.

2.4 Other Interest Groups

As society becomes more complex, with political, structural and technological changes, additional groups – not just industry, regulatory agencies or consumers – may also seek to influence policy (Wilson, 1980). Their interests may include ideological elements, or they may reflect a confluence of diffuse interests that are economically affected by a regulation.

Frameworks such as the *Group Public Interest Approaches* assume a context of competing interest groups, with potentially benign effects, rather than a single lobby that seeks to benefit from legislation. This said, a more sceptical rendering of such an interplay of interests is that *the idea of public interest becomes a fiction used to describe an amalgam which is shaped and reshaped in the furnace of conflicts* (Bentley 1908, quoted in Mitnick 1980, p. 109). An *amalgam* wrapped in a *fiction* has an almost Churchillian ring! But this dark view of the political process – potentially exploiting the concept of *public*

interest as a stalking horse for more venal influences – has to be kept in mind.

2.5 Ideological Capture – or the Influence of Ideas

It is conventional to use the term "ideological capture" in discussing periods when the influence of ideas became particularly important in shaping changes in regulatory philosophy or approach. Interest in the power of ideas was awoken from the mid-1970s onwards, when the regulation of several industries, particularly in the United States, took a confrontational turn that does not fit with economically-based "industry capture" accounts, or indeed with a warping of regulation by agency officials (Wilson, 1980). With the advent of Nader's consumer activism there was evidence of a powerful impact of ideas on regulatory regimes. Thus "ideological capture" became a topic of academic interest (Hood 1994, Harris and Milkis 1996; Wallace and Wallace, 1996). In the words of Wilson: "We must be struck at every turn by the importance of ideas. Regulation itself is such an idea; deregulation is another" (Wilson, 1980).

To take, first, a benign view, it was perceived that the persuasive power of ideas, and the public benefits they may target, can potentially empower politicians to overcome vested interests in both industries and regulatory agencies. One might describe this as a *recapture* of regulation by the public interest! However, it is not predestined that ideological influences will serve the wider public interest. Ideology may potentially divert regulation from protecting the public interest, for example by overemphasizing the view that regulation causes costs by stifling initiative, while unfettered markets can assure competition. It thus becomes very important to explore the nature and impact of ideological currents and lobbies.

There are some problems with the term ideological capture, however. It can be questioned when it is that *ideas* amount to *ideology*. And the term capture may be read as having a pejorative connotation, by analogy with *industry capture*. This would be misleading. Most commentators judge, for example, that the influence of consumerist ideas (*Naderism*) was benign in strengthening public interest aspects of regulation. Indeed, in the run-up to the financial crisis, the intent of thinkers who emphasized the *magic of the marketplace* was to serve the public interest by cutting back harmful and distortive government regulation. This is one of several factors that lead the discussion in the paper towards a wider framework of analysis than *capture*. And it leads us to prefer the expression *influence of ideas*.

3 Influences on Regulation in the Run-Up to the Crisis

The literature on regulation identifies four main sets of influences that likely trigger major changes in the regulatory status quo: changes in ideas; changes in habitat, including economic changes and technological advances; a shift in interest group (including industry) pressures; and internal agency problems of incentives or practice that undermine the status quo (Hood, 1994; Baldwin and Cave, 1999). These factors reflect the role of ideas and of different interest groups which were highlighted above, with one addition: The effect that exogenous economic and technological change may have on some or all of these players.

Economic change and technological progress are crucial aspects of the changes in habitat cited by Hood (1994). As already cited, the financial crisis that preceded the Great Depression in the United States gave rise to a range of financial sector regulation. Continuing changes in communications, transport and energy technology over the past century have led to a great expansion of regulation. Changes in habitat may affect regulation directly, and they may also do so by changing the effectiveness of interest groups (see below). A further stimulus for regulatory changes at the national level may lie in responses to changes in the global regulatory habitat, to the extent that politicians or officials respond in a spirit of *regulatory competition* to avoid losing market shares of international business.

Changes in ideas can be of great importance in setting new directions for regulation. In the literature, the advent of consumer safety regulation in the United States is the locus classicus of a change in ideas, driven by an effective pressure group. Another instance is the emergence in the 1970s of the strong voices attacking industry capture, in the literature discussed above, which highlighted the dangers of such capture and became influential in shaping regulatory policy and institutions. In some cases it seems that "the economist's pen is mightier than the lobbyist's expense account" (Keynes, 1936, quoted by Hood, op. cit., p. 5).

This brings us to *changes in the effectiveness of interest groups*. The changes in habitat we have discussed, together with broader political and social factors can influence the effectiveness of dispersed groups (Wilson, 1980). An example would be changes in industrial structure. The impact of globalisation, technology, firm size, and the role of state ownership have undermined the power base of some trade unions. Advances in communications and information technology have also resulted in the cost of access to the political process being lowered (Wilson, 1980). Thus, both economics and technology can change the potential for diffuse interests to form effective coalitions.

The *incentives or context for action by agencies and legislators* may change. For example, changes in habitat and shifts in the effectiveness of interest groups may alter concerns and incentives. The literature also identifies a class of changes that occur when regulatory regimes or agencies have proved dysfunctional for internal reasons, and need to be reorganised. Among other factors, the passage of time has been seen as a key variable. On this view, regulatory regimes and agencies in their *youth* are in a state of vitality (though inexperience) as they seek to protect the public interest, but they decline into capture in their maturity and old age, due to internal and external forces (Bernstein, 1955).

The drivers for change discussed above may combine to catalyse change in a process of *confluence and coincidence*. The possibility that powerful interests might press certain ideas against a background of new technological advances was already highlighted by Baldwin and Cave (1999). So the dynamics of change can be complex – with coalitions of external influences acting on legislators and agencies, and coalitions of the latter responding.

In a globalised economy, then, it could seem appealing to picture broad and increasingly widespread swings in opinion that are ideologically driven, interacting with economic and technological changes affecting the international economy. The need for a sceptical critique of this vision is underscored by Hood (1994), who warns that similar outcomes across countries may have differing and complex causes. An important trigger for privatization in Japan, he notes was opportunistic U.S. economic policy activism, rather than domestic ideology; and new ideology is at times fashionable re-labelling: The era of deregulation has seen growth in many areas of regulation.

In other words, the factors causing change, as well as the substance of the change, may vary across countries and industries: One needs to probe the empirics of each case. This cautionary message about generalizing explanations recalls the salutary puncturing of industry capture as a dominant model by Wilson (1980) in his broad survey of industry experience.

We can now ask how far this analytical framework sheds light on possible regulatory capture in the run-up to the global and euro area crises. A useful starting point is the set of *drivers of change* outlined above. To what extent did shifts in ideas, in the economic and technological habitat, in the effectiveness of interest groups, or in incentives for politicians and officials pre-dispose the system towards regulatory changes which were not in the public interest?

3.1 Changes in Ideas

There was a sea-change in economic ideology in the decades preceding the global financial crisis, and this exercised a strong influence on academic and policy elites in both advanced and emerging market economies. The new ideology stressed the economic and political virtues of private markets, and stimulated a concern that these were being dampened and distorted by government intervention and ownership. This intellectual movement – in its more extreme forms, termed *neo-liberal* – had its roots in Hayek (1944) and von Mises (1920), and it flourished particularly strongly in the U.S. academic community.

This was a political as well as an economic view of the world. In part it was a reaction against a dominant view in the early post-war period, which had featured a benign and crucial role of the state not just as an economic rule-setter (nationally and globally), a fiscal and monetary manager, and a regulator, but also as a planner, owner and employer directly influencing major reaches of the economy. To borrow the vocabulary of Priestland (2012), that post-war vision had seen the state as a sage, countering merchant interests which, left to play freely, would be destabilizing.

By the end of the 1960s a neo-liberal *counter-reformation* was beginning to get under way, seeking to roll back the much expanded role of the state, after a period of tight regulation that began in the Depression. The combination of economic stagnation and inflation in the 1970s undermined the view that Keynesianism and/or state planning (of some variety) could assure full employment – and in economic management this *stagflation* underscored the risks and limits of *fine-tuning*. Subsequently, the collapse of the Soviet Union at the end of the 1980s further reinforced a neo-liberal view of the state in so far as it discredited the opposite extreme – a vision of the state as a comprehensive, indispensable and benign planner.

This shift in ideology had a pervasive effect on policy frameworks in advanced economies. It is no coincidence that it was accompanied by a change in approaches to macroeconomic management. The new faith in private markets encouraged policy architects to believe that monetary and fiscal policy could be assigned simple and transparent targets (such as inflation targeting, and debt sustainability), since imbalances in private markets could be regarded, over time, as reflecting fundamentals efficiently, and as being essentially self-stabilising. Discretionary adjustments to policy were seen as largely misguided and destabilising.

These medium-term macroeconomic policy frameworks seemed to fulfil Tinbergen's desideratum of *one instrument, one goal* (Tinbergen, 1956), and also to insulate official agencies from capture by deficit- and inflation-biased politicians. But too simple a set of macroeconomic policy rules – and major failures in the field of macrofinancial risk assessment and policy coordination – eventually contributed to a policy disaster in terms of financial stability and levels of public debt.

It was in financial regulation and supervision that, in some countries, theories of efficient markets and rational expectations had their most devastating effect. They seemed to lend depth and intellectual credibility to a view that financial markets will deliver growth and stability, provided only that they are not intrusively regulated; and that instability largely reflects misconceived intervention by governments. This confidence flew in the face of experience with markets and their supervision over many decades, and it was misplaced.

As a general proposition, the swing towards deregulation or liberalisation (the two words are used interchangeably here) was not confined to right-wing or neo-conservative political groupings. It reflected broader intellectual currents. Indeed, financial deregulation began to take root somewhat before the advent of the Reagan and Thatcher administrations – although economic and technological factors also help explain this, as discussed below. In the United Kingdom, a shift away from state intervention and towards greater competition in the financial sector dates from the *Competition and Credit Control* reforms of 1971. In the United States, it was the Carter administration at the end of the 1970s that initiated industrial and financial deregulation, and which saw the initiation of the *monetarist* revolution of Paul Volcker at the Federal Reserve.

To be fair, these moves towards deregulation were often accompanied or followed by various forms of re-regulation, so the number of regulators employed in many cases rose even during periods of deregulation. The question is whether this re-regulation was well-adapted to changing markets, and whether it was sufficiently intrusive and assertive.

It was the period after 2000, however, that saw the most striking ideological claims made by some policymakers concerning private markets. The philosophy of former Federal Reserve Chairman Greenspan showed great faith in markets, despite some concerns about *irrational exuberance*; featured a resistance to pre-emptive action in the face of possible bubbles; but stood ready to *pick up the pieces* after market crises. Yet in many ways this was also the praxis of central banks in other advanced economies also, as they failed to take policy action or sound macroprudential alarm bells during credit and asset price booms, but stood ready with an official underwriting of risks – which set perverse incentives. More diffusely, the philosophy and practices in the Basel supervisory community showed much increased dependency on the internal risk assessment processes of market firms and on rating agencies, and placed more reliance on this approach than was sensible.

This climate strongly influenced national practices in the regulation and supervision of banks in some countries. Among the leading *crisis cases*, Ireland, the United Kingdom and the United States are clear examples in which regulation and supervision was not sufficiently intrusive, critical, or insistent – as indicated in the U.K.'s various reviews of supervision, and in the reports on Ireland's crisis (Honohan, 2010; Regling and Watson, 2010). And, more generally, central banks and regulatory agencies in advanced economies bought into the idea of a much greater reliance on markets in performing risk assessment.

3.2 Changes in Economic and Technological Habitat

The changes in regulation that were set in train in the United States and the United Kingdom in the 1970s can partly be attributed to the evolving intellectual climate of the time; but they also had roots in changes that were underway in the material habitat of financial markets. The shift towards financial deregulation in the 1970s reflected to an important extent exogenous changes in the economic and technological environment in which markets functioned.

The economic roots lay mainly in fiscal imbalances and excessive monetary expansion. Stresses of this kind were evident in the United Kingdom from the late 1950s, and similar pressures emerged in the United States during the Vietnam War period, and especially from 1968 onwards. Such tensions spread more widely among advanced economies after the oil price shocks of the 1970s. The core feature was that governments sought to sustain economic activity in the private sector at levels that were unrealistically high, given prevailing conditions. This environment, coupled in some cases with rather rigid labour markets, bred accelerating inflation in a setting of weak growth.

This volatile macroeconomic setting implied a need for higher and more variable interest rates to maintain monetary stability. But financial sector regulations in many countries made that difficult technically – as well as unpalatable politically – to implement. In some cases, such as the United States, there were ceilings on deposit interest rates. In other cases (such as France), credit was rationed not by price but by quantitative limits, and a move to market-clearing interest rates would have involved a major shock. Thus economic tensions and strains worsened, whether suppressed or explicit.

Faced with volatile capital flows, and pressure on public bond markets, governments in some cases responded by introducing or intensifying capital controls and/or wage and price restraints. This included the United States, with the Interest Equalisation Tax, the Voluntary Restraint Programme on capital outflows, and a brief period of wage and price controls. But macroeconomic imbalances eventually undermined such regulations and controls.[5] Thus economic pressures, and not just ideology, made it well-nigh impossible to persist with a financial system that was subject to comprehensive price and quantity regulation.

Technology and market innovation also played important roles in triggering deregulation. Two examples illustrate this well. In the United States, technological changes made it possible to sweep funds overnight into savings accounts from current accounts, which were not allowed to pay interest, thus vitiating the impact of the regulation. In the United Kingdom, the regime of credit ceilings on established banks that existed until 1971 proved increasingly porous as new financial institutions sprang up to provide credit outside this framework. Hence the term *regulatory arbitrage* entered the financial lexicon.

Indeed, as financial innovation expanded, the public sector often led the charge. Governments with large borrowing requirements experimented with innovative borrowing techniques. During the 1980s, for example, the Swedish National Debt Office led bond market innovations as it sought to contain public borrowing costs. The first mortgage securitisation in the United States was effected by a U.S. housing agency.

The wave of innovation that started to gather pace in the 1980s ended in the alphabet soup of securitised products whose mispricing was a key flaw in pre-crisis markets. Information technology played an essential role in the development of such products. The complexity of the transactions and financial linkages that grew up tended to obscure where ultimate risks had been passed to. It was possible to assert that the unbundling and re-packaging of risks, by spreading risks more widely, was diminishing systemic risk; but in key fields the reverse turned out to be the case.

In these respects, macroeconomics and technical innovation interacted in a mutually-reinforcing manner during the 1970s and 1980s to peel back financial regulation, for reasons that were certainly complementary to, but not inherently driven by, industry pressures or ideology. As technology advanced over the following decades, indeed, it became growingly important for policy-makers to anticipate future regulatory arbitrage; and markets in turn increasingly shaped their activities to regulation in an adaptive manner. In a sense, regulators became too dependent on the risk assessment of markets; but also, markets were losing sight of fundamentals as they moulded the structure of their activities to the forms of regulation.

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[5] *Germany was an exception to these trends: It avoided macroeconomic imbalances and largely abstained from controls, except occasionally on inflows. However, it maintained a strict segmentation of short-term markets, avoiding the emergence of traded instruments in this sector, in order to facilitate monetary management.*

3.3 Changes in the Effectiveness of Interest Groups

Advances in technology – including information technology – and a deepening of globalisation also contributed to reshaping the influence of different interest groups in society. It is not just that trades unions lost ground in the workplace. Households, firms and other associations of individuals became connected – at falling prices – to the internet, the worldwide web, and a range of electronic media. The cost of access to the political process, identified by Wilson (1980) as an important factor in the effectiveness of interest groups, was steeply reduced. The challenge is to disentangle the relevant ways in which these trends affected regulation. This deserves systematic research in the future, but one can perhaps identify already several important strands.

First, where individuals or firms were dissatisfied with outputs of the financial sector, their ability to make their opinions effective increased. However, public concern before the crisis was not typically in the direction of reducing risk-taking. An illuminating example was discontent in Ireland with a lack of competition in banking, which included the levying of high charges, and a failure to provide reasonably easy access to mortgages. This campaign gained strong political momentum. One reflection of this was that the director for competition of the reformed financial services agency was made an ex officio board member of the agency, whereas the director for prudential supervision was not. That public concern was warranted. But the policy response overshot, and the climate it helped foster was one factor contributing to Ireland's financial crisis. This example shows how complex it is to foresee the impact of changes in interest group effectiveness. Moreover, calls to mitigate capture by *measures to strengthen the position of consumer groups and other groups with a diffuse membership in the policy-making process* (International Centre for Financial Regulation, 2012) need to bear in mind that the goals of such groups may not be well aligned with those of prudential regulation and supervision.

Second, changes also took place in the power of interest groups in the labour market, and in the culture surrounding pay: remuneration and incentives for risk-taking in the financial sector, if extreme, were still an instance of a wider trend. It is clear that globalization and technology drove a secular decline in the relative pay of low-skilled labour in advanced economies. These factors, together with a shifting industrial structure, also contributed to a decline in unionisation: the United Kingdom saw union membership fall from 39% of the labour force in 1989 to 26% in 2011. There may have been some influence, too, from the collapse of the competing economic model in centrally-planned economies, which had appeared to offer a more egalitarian model.

While the share of labour income did not fall everywhere (in the United Kingdom it was fairly stable from the 1970s onwards), returns to high skills and to a managerial elite commanded a growing share. Gini coefficients in countries as egalitarian as Sweden signalled widening inequality, and only part of such shifts reflected tax changes. In the United States, the pay of the median worker virtually stagnated after 1976, despite ongoing productivity gains. In the literature on the financial crisis, it is acknowledged that pay trends not only affected risk-taking incentives in the financial sector but were also a factor behind rising household debt levels. In the United States, official concern about distributional issues affected housing finance policy, and Rajan (2011) sees this as a significant contributing factor in lowering income and collateral standards for residential mortgages (Rajan, 2011).

As a third example of the role of interest groups, one may perhaps view rating agencies, for the purpose of this analysis, as such a group – distinct from the remainder of the financial sector in their risk assessment role. As such, they provide an example of the changing influence of interest groups as a result of technology and innovation. As financial products became more far more complex, regulators became dependent on rating agencies in evaluating the riskiness of portfolios. The rating agencies were also increasingly conflicted: They had always been paid by issuers, but now the securities they assessed were at times designed by banks with the active participation of the rating agencies themselves. This nexus was a factor in the mispricing of financial products that was a key source of the crisis.

Finally, and related to this point on rating agencies, there is a more general issue about the impact of technical complexity on the supervisory process and the effectiveness of industry influence. The sheer difficulty for supervisors of understanding the techniques being used in the market place means that "a constant and close interaction with market participants under their surveillance is required in order to stay abreast of constantly changing financial markets, to monitor the build up of risks and to understand the impact of their regulatory policies" (ICFR, 2012). Such constant interaction may present heightened opportunities for market participants to influence regulators, and if the latter are poorly remunerated may even result in a form of skill dependency on the side of the agency.

3.4 Changes in Incentives Affecting Legislators and Agencies

Looking beyond the changes in ideology discussed above, there is a question whether more tangible factors (including economic gain) changed the incentives for parties in power and regulatory agencies. There are indeed several areas involving economic benefits, in which legislators and agency officials may potentially have been particularly open to *capture* during this period.

First, political parties in power in many countries benefited strongly from a surge in tax revenues during extended financial booms. In some cases, such as Ireland and Spain, they were alerted by international agencies to the fact that these revenues were transient, and also that their structure was increasingly vulnerable to an economic downturn (Martinez-Mongay et al., 2007). These warnings may have seemed inconvenient: they were certainly ignored. This is an important additional element in the *political cycle* outlined by Green (ICFR, 2012), in which public support for tough regulation fluctuates over the business cycle, being weakest at the cyclical low point (when small firms complain about access to credit) and highest just after a crisis breaks.

An important question is whether this and other more venal consider-

ations led Ministers to guide agency officials to take an unduly benign view of financial sector risks. This question was explored in a report on Ireland's banking crisis by incoming central bank governor Honohan, whose analysis illustrates how difficult it can be to nail down such a trend: "While it is easy to imagine that senior management or CBFSAI Board or Authority Members might have instinctively and almost unconsciously shied away from aggressive action to restrain politically connected bankers and developers during a runaway property boom, no evidence has been presented suggesting that this was the case. Furthermore, although the climate of regulatory deference might have been unconsciously reinforced by social interaction – modest though it might have been – organised by regulated institutions, there is no evidence or hint of corrupt regulatory forbearance" (Honohan, 2010). It is easy to imagine that a nuanced assessment along these lines might apply also in other countries at issue.

Second, in countries such as Ireland, the United Kingdom and the United States, one can see a relevance of the suggestions by Grabosky and Braithwaite (1986), referred to above, as regards the influence of a low *relational distance* between agency officials and the regulated population in terms of experience, outlook, class and frequency of contact.

Third, and more specifically, in the United States, and to a lesser degree in some other countries, there has been over time what is uncharitably termed a *revolving door* between the financial services industry and senior government appointments. Whether earlier or prospective employment in the financial sector influenced government officials unduly during their tenure is an issue on which there seems to be no hard evidence.

Fourth, there is clear and recent evidence from the United States that voting patterns in Congress on financial sector issues reflected the garnering of local votes (Mian et al., 2010).

A further set of political incentives is evident in the fact that countries with large financial industries – important sources of employment and of tax revenue – found ways to allow them an expanding global role outside the scope of national controls. The United States allowed a large market in *eurodollars*, with active participation of its own banks. The United Kingdom welcomed the growth of offshore activities in London in US-dollars, and later in other currencies that were regulated at home, such as Japanese yen and indeed pound sterling itself – in a sense an example of the *regulatory competition* referred to earlier. These offshore markets facilitated capital flows; and they offered arbitrage opportunities that, over time, contributed to eroding domestic controls.[6]

An interesting question in the case of the United Kingdom (and also in Ire-

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[6] *One of the roots of U.S. support for action in Basel on capital ratios was to 'normalise' the competitive position of the highly-leveraged Japanese banking sector.*

land) is how far the *light-touch* approach that was in fact adopted in financial regulation, under the disarming caption of *principles-based regulation*, reflected considerations of regulatory competition with other centres. Certainly, for the U.K., the creation of the euro and growing integration of euro area financial markets could have intensified such concerns; and the statutes of the FSA obliged it to pay regard to the competitiveness of the U.K.'s financial services industry (ICFR, 2012). There is some anecdotal evidence – in the form of comments by officials under the *Chatham House Rule* – to support the view that this was an important driver of regulatory ease. Briault (in ICFR, 2012) cites the concession given in 2004 to U.S. investment banks to operate in the U.K. even though they were not supervised as banks in their home country. The financial crisis in Cyprus in 2013 is adding a chapter to this branch of the literature.

Turning to the internal workings of regulatory agencies – a major theme in the literature – there is indeed some evidence that these proved dysfunctional, though in *new* ways. Partly for ideological and partly for technological reasons, there was a trend in the advanced economies to separate bank regulation from central banking. This seemed desirable not only to insulate the *pure* pursuit of monetary stability (often in the form of inflation targeting), but also because of the scope for arbitrage among instruments designed by different types of financial institutions, including insurance companies – some of which had typically never been among the entities regulated by central banks.

The divorce between central banking and regulation may have diminished the sensitivity of regulators to systemic risks – although there are counter-examples, such as the Federal Reserve Board, which is a supervisor. The hybrid central banking/supervisory structures created in some cases – such as Ireland and the Netherlands – did not show a good track record in diagnosing the emergence of risks. A further organisational problem was that agencies with overlapping responsibilities – as in the United States, and in Spain (for the *cajas*) – also seem to have shown striking risk blindness. Taking this together with issues discussed in the previous section, the issue of a clear agency mandate is evidently key.

3.5 Confluence, Coincidence and Impact

The recent literature, and even anecdotal evidence, leave some ambiguity about the extent to *which* pressures from the industry to *capture* regulators actually increased during this period. In a broad sense, all reports on the period suggest that regulators *bought into* market risk assessment to far too great an extent, and failed to criticise systemic risks as they built up in banks. The large amounts spent on lobbying activities by Wall Street firms are also well documented (ICFR, 2012). However, the drivers and influences described in this paper – along with evidence presented in the recent literature – do not in themselves substantiate a much greater vigour on the side of the industry in seeking and obtaining specific gains at the expense of the public interest.

In some countries, the commitment of regulators to an intrusive questioning of risk positions rather seems to have crumbled under the weight of these various, mutually-reinforcing influences. In some cases, at least, it seems that the root of the problem was an intellectual or moral failure to identify, follow-up, and contain concentrations of risk – with Northern Rock in the United Kingdom, and certain major lenders in Ireland, being clear cases in point. In Spain, reflecting local political factors, very risky property lending went unchallenged at the level of the cajas, although the major banks were successfully challenged on the potential use of *special purpose vehicles* to acquire U.S. debt instruments.

Rather than a quantum shift in *capture energy* on the side of the banks, it seems more as if economics, technology, ideology and politics reduced resistance to the risk assessments put up by the industry, and perhaps contributed to a failure of analytical diagnosis with regard to mounting systemic risks. This experience strikingly illustrates the general assertion by Baldwin and Cave (1999) cited earlier: Factors of different kinds may come together to trigger regulatory change; and, specifically, that powerful interests may be able to press home certain ideas more effectively against a background of technological advances.

The run-up to the crisis thus saw technology and economics interacting to change regulation of the financial sector, and it also saw these factors interacting with changes in ideology and with economic interests in a mutually-reinforcing manner. The path of this process seems, in retrospect, steeped in irony. In essence, an exaggerated faith in private markets contributed to new macroeconomic policy and regulatory regimes that were designed to avoid government-induced distortions and to promote stable and non-inflationary growth. Yet the outcome has been a deep and enduring recession, and, in the advanced economies, an economic, financial and public debt crisis of historic magnitude.

4 New Issues in Regulatory Capture

The aim of this paper has been to explore influences that affected regulatory philosophy and approaches in the run-up to the global and euro area financial crises, taking as a starting point the insights of the literature on regulatory capture. The wider issues that emerge from this analysis can be grouped under three headings.

4.1 The Analytical Framework

The concept of regulatory capture arose from a binary relationship between industry actors and regulatory agencies. It was not proposed as a comprehensive framework within which to explore all changes in regulation. Subsequently, it was enriched by the notion of ideological capture. Further complexity was added by the consideration of other interest groups in society; and at times the term capture has also been used to describe the self-interested behaviour of legislators and regulatory agencies.

As foreshadowed at the outset of this paper, there are problems in expanding the use of the term capture so broadly. This may have some expositional attractions – it is eye-catching to say that *financial regulation underwent ideological capture by proponents of efficient financial markets*. But such extensions of the term capture tend to overburden it. Among others concerns, the term is typically has a pejorative connotation (whereas the influence of ideas may be benign, as in the original consumerist example). It can also be confusing to say that a regulatory agency captures regulation for its own advantage, a phrase that could refer to many different aspects of agency behaviour and probably generates more heat than light. More fundamentally, the notion of capture is one-dimensional and transitive: it does not reflect the complexity and interactivity of various influences in the pre-crisis period.

The way in which actors and influences interacted in the run-up to the crisis points towards more subtle and dynamic interactions, which may best be explored in the *regulatory space* featured by Hancher and Moran (1989). And the complex nature of interactions within that space deserves deeper study in its own right. At a minimum, one has to see the relations between actors and influences as everywhere growing in complexity; as a *learning process*, very far from a static concept of regulation or a linear process driven by agencies; and at the extreme one might ask if they take on some features of a *regulatory game*.

4.2 Continuing Tensions in Regulation

Experience in the run-up to the crisis highlighted a number of tensions in regulation that are not new, but have gained in importance. These issues have recently been prominent in other industries also; and in some instances the financial sector experience has shed additional light on them.

A first issue is the difficulty in categorising and channelling the *consumer interest*. The Irish example cited above illustrates how immediate *consumer* and longer run *household* interests (including as tax payers) can diverge over a medium-term time horizon. This experience also highlights the challenge in finding effective channels for consumer representation, an issue that has often been prominent in, for example, utilities regulation.

A second issue is political influence. Here the experience with policy frameworks affecting the financial sector is troubling in several respects:

- In some countries, the effectiveness of financial regulation was impaired by political factors that official agencies internalised. Rajan reports this concerning social goals of housing finance in the United States; political *deference* is alleged in Ireland; and the fiscal benefits of boom revenues seems to have weakened political willingness to take *away the punch bowl* in several countries. In the U.K. the flagship industry statues of the financial sector may also have affected official attitudes to regulation.
- The macroeconomic frameworks and rules designed to safeguard, fiscal, financial and price stability were in some cases (including the U.K.) drawn quite narrowly. This is often a *quid pro quo* for taking important time-consistency issues (inflation, debt sustainability) out of the political arena, where myopia is a risk. Narrow authority is the price of delegation. However, the lack of peripheral vision in monetary and fiscal policy, which were part of the framework which should have assured the stability of financial markets, resulted in a neglect of destabilising trends in

credit, asset prices and capital flows. This was a regulatory failure in a broad sense.[7]

- The failure in many countries to introduce pre-emptive policies that would have moderated their financial booms provides a striking example of a political economy hazard that is featured in the regulatory literature. The benefits would have been diffuse over time and over segments of the population. The costs would have fallen immediately on potentially vocal interest groups. This suggests an inherent problem in pursuing financial stability policies, and it may raise a question whether pre-emptive financial policies need to be subject to some sort of pre-agreed triggering mechanism.

4.3 New Issues in Regulation

There are probably few truly new regulatory topics under the sun, but two issues deserve more attention in light of the crisis. Indeed, there have been reports (for example at the FLJS workshop referred to in footnote 1) that they are gaining importance in other industries also:

- Complexity: It was suggested above that the complexity of financial products and transactions may have decreased the relational distance between regulators and the industry, reducing regulatory independence – and perhaps also credibility. It seems that this feature of growing complexity has been registered in other industries as well, including utilities. Possibly, it may tend to constrain market entry and other forms of competition. Innovation and technology no doubt account for this in part; but there is scope to wonder about an endogenous tendency for industries to increase complexity as a means of dominating the regulatory debate or shutting others out.
- Interactivity: Regulatory arbitrage emerged at an early stage in the liberalisation of the financial sector. Subsequently, the interaction between regulators and adaptive financial markets seems to have taken on some features of a *game*. With very severe capital and liquidity constraints in the financial sector, this has implications for *shadow banking* – the migration of financial intermediation to channels that are less regulated and supervised. This experience may have relevance in other fields of regulation. The information and communication industry displays some of the same features of rapid adaptation; and utility companies are reported to *game* the system by loading profits on non-regulated products, leading to a more intrusive (and complex) analysis of costing by regulators.

More broadly, the importance of addressing such dilemmas in regulation is increasing. A distinctive feature of the crisis, in many advanced economies,

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[7] *Regulation is at times used in such a sense. The U.S. Congressional Budget Office noted that wide definitions would result in the definition of most federal actions as regulatory (CBO, 1976, cited in Mitnick, 1980).*

was the ensuing rise in public debts, which is unprecedented in peacetime. This has implications for the way governments may structure their activities in the future. Severe fiscal pressures mean that governments may choose to pursue economic and social goals through regulatory initiatives rather than spending programmes.

This turn of events is full of irony. It is scarcely too cruel to say that the economic legacy of major failures in the field of regulation may lead governments to rely even more on regulation to secure their policy goals. The most obvious concern in the financial sector is that contingent liabilities will develop which, over time, further increase the public debt. High vigilance will be required in this setting to safeguard the public interest. All fields of regulation – not just financial regulation – are potentially at issue here.

5 Is EU Banking Union a Game-Changer?

It is clear, first of all, that there has been a major shift in ideas in the international community about financial regulation and about the circumstances in which the benefits of financial integration can be realised. Continental Europe, of course, was never a hotbed of hands-off regulation along Anglo-Saxon lines: but still, the euro area crisis has alerted policy-makers to the need for a more effective macro- and microprudential policy framework to avoid destabilising shocks from financial markets. This sea-change in official awareness is a first reason for some optimism that next time could be different.

Moreover, the supervisory and resolution set-up under banking union should change incentives in ways that are very relevant to the issues of regulatory capture raised in this paper. Several very promising aspects can be identified:

- By placing microprudential responsibilities at the level of the ECB, key assessments are removed to a greater degree from capture by national interests – and this includes national political as well as industry interests. *relational distance* is increased. This should address two major influences in the regulatory space that are potentially problematic (and can be mutually reinforcing).
- Similarly, the political economy of macroprudential action is substantially shifted to a level where the longer-run and area-wide gains from pre-emptive action can be better internalised.
- The ECB is uniquely placed to limit negative spillover effects across borders in the monetary union - including using the principle of reciprocity to avoid cross-border flows undermining national macroprudential measures.
- Moving responsibilities to a new body may also break up some of the agency culture problems of the past, and certainly sets out a very clear mandate for area wide supervision.

As regards some of the newer issues in regulatory capture that we identified earlier, *the proof of the pudding will lie in the eating*:

- One can expect that regulatory arbitrage and the gaming of regulatory systems will continue apace in the future, with the role of nonbanks growing as leverage and liquidity constraints bite on the banking system. Addressing these interactions will require close and effective cooperation between the ECB and the ESRB. Yet it is most important that the need for cooperation and coordination in the financial stability area does not *contaminate* the operating independence of the central bank in the monetary policy domain.

- Complexity will remain an issue that potentially jeopardises supervisory independence and distance, including as the technological habit evolves further: the ECB will need to build up outstanding technical expertise in this area, including on linkages to nonbank markets and flows under its broad financial stability mandate. Links between banks and securities markets will be a crucial area, and the behaviour of nonbank entities such as investment funds may raise financial stability issues that the central bank cannot ignore.

Finally, it is impossible to divorce the effectiveness of prudential and financial stability policies from the macroeconomic setting in the euro area. In terms of the literature on capture, changes in the economic habitat may create new opportunities and new gains from risk-taking, regulatory arbitrage, and innovation designed to defeat regulatory constraints. Debt-financed imbalances are, we have seen, a particular hazard in this regard – and they may create their own defensive interest groups, at the national and perhaps the EU level.

Going forward, one can see here a recurring concern. When euro area member states experience country-specific shocks, they may develop wide imbalances – particularly where mismatched monetary conditions during a boom foster financial and real estate market exuberance (echoing the experience in Ireland and Spain). Emerging rapidly, such imbalances are likely to be debt-financed, and accompanied by sizable swings in the nontraded goods sector. Financial stability questions may reemerge. The EU Macroeconomic Imbalances Procedure is designed to address such imbalances, but it is not clear how forward-looking this is, and the content of advice so far seems mainly concerned with structural policies.

In the future, macroprudential policies can also be brought to bear to try to dampen such debt-financed imbalances within the euro area. This is a potentially very important area, but when booms get underway, it does depend on overcoming the well-known arguments of lobbyists that *this time is different*. Moreover, the evidence on using macroprudential policies in a time-varying or cyclical way is not conclusive. Possibly national fiscal policies may also need to be used to dampen country-specific imbalances. These are issues for the future, but they deserve careful preparation in the present.

6 Conclusions

The decades before the financial crisis saw a progressive shift away from the tightly regulated financial regimes of the early post-war period. This shift involved deregulation; re-regulation in ways that eventually became very dependent on market risk assessments; and also the basing of macroeconomic and financial policy regimes on an assumption that market behaviour was efficient and ultimately self-stabilising. At the end of this process, the global and euro area crises resulted in severe and protracted damage to output and employment, and a rise in the public debt unprecedented in peace time. Faith in markets had gone too far.

The growing influence of market techniques of risk assessment, and in some countries the move away from intrusive forms of supervision, was probably not mainly driven by a quantum jump in the vigour of industry efforts to capture regulators. In the short-term, of course, these trends served industry interests. But what changed was more subtle. It included a somewhat extreme shift in ideas about private markets and the distortive role of government; new currents in economics and then technology, which undermined some forms of regulation and also spawned innovations that greatly increased complexity; and political influences – not least a disinclination to look behind the superficial benefits of financial booms. Something much more complex than industry capture in a 1970s sense.

The main lessons of the experience concern the need to regulate the financial sector more effectively and to adjust macroeconomic policy regimes to help dampen destabilising swings in private sector behaviour. But the experience also underscores some wider issues, relevant to the theory and practice of regulation in finance and in other industries. Old issues concerning consumer interests, political influence, and inherent problems in pre-empting boom-bust cycles; and new issues arising from complexity and interactivity in regulation. It is the latter issues that reinforce the case for thinking about regulation less in terms of capture and more in terms of dynamically interacting influences in a regulatory space.

In Europe, the creation of a banking union, and the role of the ECB as a single supervisor, presents an opportunity to change the incentives affecting actors in the regulatory space. It will create greater distance from national banking industries, and it will benefit from a clear mandate with a cross-border scope of opersations – including in the macroprudential domain. At the same time, this set of changes clearly entails potential challenges of co-operation and co-ordination in a world where financial markets feature shifting institutional perimeters and regulatory arbitrage, and where financial stability is influenced by many official and private sector actors.

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Helmut Ettl currently is the Executive Director of the Austrian Financial Market Authority (FMA). Previously, he had worked 13 years for the Oesterreichische Nationalbank in different positions: Economist in the Foreign Research Division in the field of preparing EMU, Assistant of the Governing Board, Deputy Head of Banking Analysis and Inspections Division, subsequently Head of Banking Analysis and Inspections Division. In 2008, he was appointed Executive Director of the FMA. In addition, he is Member of the Board of Supervisors of the European Banking Authority and in 2014 he became Voting Member of the Supervisory Board for Banking Supervision at the European Central Bank.

Ernest Gnan

Ernest Gnan has been head of the Economic Analysis Division of the Oesterreichische Nationalbank in Vienna since 1999. He is a member of the European Central Bank's Monetary Policy Committee, and is also an adjunct professor at Webster University in Vienna, teaching courses on economic analysis. During 1998, Ernest Gnan served as deputy head of the Foreign Research Division of the Oesterreichische Nationalbank, and from 1995 to 1997, as an economist in the Secretariat of the Foreign-Exchange Policy Sub-Committee at the European Monetary Institute (a forerunner of the European Central Bank). He is a former national expert in the Directorate General for Monetary and Financial Affairs at the European Commission in Brussels, and a former investment fund manager at Genossenschaftliche Zentralbank in Vienna. Ernest Gnan received a master's degree in commercial sciences and a Ph.D. in Economics at the University of Economics and Business Administration in Vienna.

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Andreas Ittner

Andreas Ittner was appointed Vice Governor of the Oesterreichische Nationalbank (OeNB) on July 11, 2013, and is responsible for the Executive Directorate Financial Stability, Banking Supervision and Statistics. Ittner joined the OeNB in 1983. He was a member of the OeNB's Governing Board from September 2008 prior to his appointment to the post of Vice Governor. In his capacity as Vice Governor, Ittner is the accompanying person of the Governor at meetings of the Governing

Council of the European Central Bank (ECB). In addition, Ittner holds numerous national and international functions related to banking supervision, e.g. in the General Board of the European Systemic Risk Board (ESRB), the Board of Supervisors of the European Banking Authority (EBA) and in the Supervisory Board of the Austrian Financial Market Authority (FMA). Previous positions at the OeNB include that of Director of the Financial Stability and Bank Inspections Department.

Elke König

Elke König has been serving as President of the German Federal Financial Supervisory Authority (BaFin) since 2012. Dr. König received Post Graduate degree on the Subject of Accounting and Doctorate in Political Science in 1976 from University of Cologne and in 1972 she received a MBA in Business Administration from University of Cologne. In 1980, she started working for the auditing firm KPMG, focussing on audit and advisory services for insurance undertakings, she became Authorized Officer of KPMG, in 1986 and in 1988, she became Director/Partner of KPMG. In 1990, she changed the company to become Member of the Senior Management of Münchner Rückversicherungsgesellschaft and in 2002 CEO of Hannover Rückversicherung AG and E+S Rückversicherungs AG, Hannover. From 2002 to 2010, Elke König served also as Member of the Executive Advisory Council, and as Chairperson of the Advisory Council from 2006 to 2009. Before joining the London-based International Accounting Standards Board in 2010, she became Member of the Supervisory Board of Deutsche Hypothekenbank AG (May 2009 to December 2010).

Hans-Helmut Kotz

Hans-Helmut Kotz is a Senior Fellow at the Center for Financial Studies as well as a Program Director of the SAFE Policy Center, both at Goethe University, Frankfurt. He is also a Resident Fellow at Harvard's Center for European Studies as well as teaching in Harvard's Economics Department. Moreover, he is on the Economics Faculty at Freiburg University, where he received the 2010 University Teaching Award. In addition, he serves as a Senior Advisor to McKinsey & Co., to UniCredit AG and is on the Supervisory Board of Eurex Clearing AG. Between May 2002 and April 2010, he was a Member of the Executive Board of Deutsche Bundesbank, in charge of Financial Stability, Markets and Statistics as well as a member of committees of the Bank for International Settlements, the Financial Stability Board and the OECD, where he was chair of the Financial Markets Committee. He was also the German Central Bank Deputy for the G7 and the G20 process. Between 2002 and 2005, he served in a personal capacity as a Member of the European Parliament's Expert Group on Financial Markets. He has published widely and is involved in a number of academic institutions, e.g., member of the Board of the Konstanz Seminar on Monetary Theory, the scientific councils of the Revue d'Économie Financière, Paris, as well as the Hamburger Weltwirtschaftliches Institut (HWWI), Hamburg.

Peter Mooslechner

Peter Mooslechner became a member of the Governing Board of the Oesterreichische Nationalbank on May 1, 2013. Born in Bruck an der Glocknerstraße (Salzburg) in 1954, he studied economics at the Johannes Kepler University Linz (JKU), where he also received his doctoral degree in 1981. After having worked at the JKU's Institute of Public Finance, Peter Mooslechner held a research position at the Austrian Institute of Economic Research (WIFO) from 1981 to 1996, exploring currency-, balance of payments- and money and credit-related topics. In 1996, he joined the OeNB as Head of the OeNB's Economic Analysis Division. In 1999, he was promoted to Director of the Economic Analysis and Research Department. Peter Mooslechner represents the OeNB in numerous national and international bodies (e.g. on the Board of the Austrian Economic Association (NOeG) and in the International Relations Committee (IRC) of the ECB). Peter Mooslechner has taught economics at a number of Austrian universities (Linz, Innsbruck, Salzburg and Vienna University of Economics and Business) and has published extensively on a broad spectrum of economic policy issues. His recent research has dealt with microeconomic aspects of household wealth and debt, economic policy during the financial crisis and monetary and exchange rate policy in Eastern and Southeastern Europe.

Danièle Nouy

Danièle Nouy is the Chairperson of the Supervisory Board of the Single Supervisory Mechanism at the ECB, where she has been since 1 January 2014. Ms. Nouy brings almost 40 years of experience in banking supervision. After her studies at the Panthéon-Assas University, she started her career as supervisor of French credit institutions for the French Banking Supervision Commission of Banque de France. She worked 20 years for Banque de France and gained substantial experience in the field of banking supervision in several posts e. g. Head of Research of the Department of the French Banking Commission (Commission Bancaire), Director of Supervision of French Banks – Commission Bancaire, Associate to the Secretary General of the Commission Bancaire. In 1996, Ms. Nouy became Deputy Secretary General of the Basel Committee on Banking Supervision to become Secretary General in 1998. From 2010 to 2013, she returned to France as Secretary General of the Commission Bancaire and then from 2010 to 2013, Ms. Nouy became Secretary General of the French Prudential Supervision and Resolution Authority.

Ewald Nowotny

Ewald Nowotny is the Governor of the Oesterreichische Nationalbank (OeNB) and a Member of the Governing Council of the European Central Bank (ECB). Before taking on his current position in September 2008, Ewald Nowotny held a number of high-level positions in financial institutions. He was CEO of the Austrian BAWAG P.S.K. banking group from 2006 to 2007, served as Vice-President and Member of the Management Committee of the European Investment Bank (EIB) in Luxembourg from 1999 to 2003, and, between 1971 and 1979, was first a Member and then President of the Governing Board of Österreichische Postsparkasse (P.S.K.). Moreover, from 1992 to 2008, Ewald Nowotny served on the supervisory boards of several banks and corporations and was a member of the OeNB's General Council from 2007 to 2008. Ewald Nowotny was born in Vienna, Austria, in 1944. He studied law and political science at the University of Vienna and economics at the Institute for Advanced Studies (IHS) in Vienna. In 1967, he received his doctorate in law from the University of Vienna. He served as a professor at the University of Linz and at the Vienna University of Economics and Business, where he was also Vice-Rector for Financial Affairs. Ewald Nowotny was Vice President of the Austrian Economic Association and is a Member of the University Board of the Vienna University of Economics and Business.

Thierry Philipponnat

Thierry Philipponnat started after graduating from the Institut d'Etudes Politiques de Paris and training as an economist (Diplôme d'Etudes Approfondies en économie) a career in finance in 1985. He held successively the following positions: corporate banker at BFCE (Banque Française du Commerce Extérieur), options and convertible bonds trader for O'Connor & Associates, head of structured products at Exane, executive director in charge of equity derivatives for French-speaking Europe at UBS, deputy-head of equity financing structuring at BNP Paribas, and global head of equity derivatives of Euronext.liffe. As part of this last activity, he was member of the executive committees of both Euronext (Paris) and LIFFE (London). In 2006, Thierry Philipponnat crossed into the NGO world, campaigning and lobbying on behalf of Amnesty International, with a particular emphasis on the impact of the financial sector on human rights. He was later elected as an Executive Board member of Amnesty International France. In 2010, Thierry Philipponnat was selected by a cross-party group of Members of the European Parliament to develop Finance Watch (www.finance-watch.org) as an organisation advocating for public interest in financial regulation. He was appointed as the first Secretary General of Finance Watch the following year and has led the organisation since then. Since December 2013, Mr. Philipponnat has also served as a member of the College of the AMF, the French financial markets regulator.

Doris Ritzberger-Grünwald

Doris Ritzberger-Grünwald was born in Vienna (Austria) in 1961. She obtained her Master's degree in social and economic sciences from the University of Vienna in 1985, completed the Program in Economics at the Institute for Advanced Studies (IAS) in Vienna in 1987 and obtained her Doctoral degree in social and economic sciences from the University of Vienna in 1991. Following a period as research assistant at the IAS from 1987 to August 1988, she joined the Oesterreichische Nationalbank in 1988, where she started as an economist in the Economic Analysis Division and then moved to the Foreign Research Division. After an interim position as assistant to a Member of the Governing Board she returned to the Foreign Research Division as special adviser, to be promoted in 2000 to the post of Deputy Head of Division. From June 2002 to April 2013, she served as Head of the Foreign Research Division. In May 2013, she was appointed as the OeNB's chief economist (Director of the Economic Analysis and Research Department). Her fields of policy-oriented research include monetary policy, economic growth, convergence issues, inflation, the enlargement of the European Union and the European Monetary Union, with a special focus on Central, Eastern and Southeastern European Countries. She is a member of the Monetary Policy Committee of the European Central Bank and an Executive Board Member of the Joint Vienna Institute.

Michael Spindelegger

Michael Spindelegger is an Austrian politician. He has served in the cabinet of Chancellor Werner Faymann as Finance Minister of Austria since 2013; additionally, he is Vice Chancellor since 2011. Spindelegger is also the leader of the Austrian People's Party since 2011. From 1977 to 1978 he served for one year in the Austrian Armed Forces, being trained as a reserve officer. From 1978 he studied law at the University of Vienna, and received a doctorate in law in 1983. From 1982 to 1983, Spindelegger was an Assistant Lecturer and Researcher at the Institute of Criminal Law, University of Vienna. From 1983 to 1984, he worked as a judge's assistant at several Courts of Law in Vienna, and from 1984 to 1987 as a civil servant for the Federal State of Lower Austria. From 1987 to 1990, he worked for Austrian Defense Minister Robert Lichal, and between 1990 and 1994 for a number of companies in Austria and Germany, including Siemens. From 1992 to 1993, Michael Spindelegger was Member of the Federal Council of Austria. From January 1995 to October 1996, he was Member of the European Parliament. From December 1993 to March 1995, and since October 1996, he is member of the National Council of Austria (Nationalrat). Between October 1996 and October 2006, he was his party's Speaker on Foreign Affairs, and head of the Parliamentary Committee on Foreign Affairs. From 1991, Mr. Spindelegger was the deputy federal chairperson of the ÖAAB and since 2009 has been federal chair. From January 2000 to January 2007, he was Member of the Parliamentary Assembly of the Council of Europe, and from January 2002 to October 2006 head of the Austrian delegation. From March 2000 to October 2006, he was Vice Chairman of the Austrian People's Party. On October 30, 2006 he became Second Speaker of the Austrian Parliament. He held this office until November 2008. Between 2008 and 2013, he served as Foreign Minister of Austria, in April 2011 he additionally took over the post of Vice Chancellor. He was elected Austrian People's Party Chairman in May 2011.

Sonja Steßl

Sonja Steßl is currently State Secretary in the Ministry of Finance of the Republic of Austria. Ms. Steßl studied law at the Karl Franzens University Graz from 2000 to 2005, which was followed by a court traineeship at the Higher Regional Court Graz. Before becoming Member of the Austrian Parliament in September 2009, she started her professional career as Management Assistant at Joanneum Research Forschungsgesellschaft mbh in 2006. From 2008 to 2009, she was employed with EFKOK AG in the Legal Department. In 2009, she started to work for the NanoTecCenter Weiz Forschungsgesellschaft in the field of company organisation and quality management (leave of absence since December 2013).

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Andreas Treichl

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Bank. Over a period of 15 years he worked in Brussels, Athens and Vienna for Chase Bank in various management positions – including credit and corporate clients. In 1994, Mr. Treichl became Member of the Management Board of Erste Österreichische Sparkasse and in 1997 Chairman of the Board. In this position he is responsible for Strategy & Participation Management, Group Secretariat, Group Communications, Group Investor Relations, Group Human Resources, Group Audit, Group Brands and Employees' Council. He managed the bank after the merger with GiroCredit when it went public. Under his leadership, the bank, which had been a purely local savings bank up to then, expanded into a leading financial services provider in Central and Eastern Europe with a focus on retail and SME clients. Andreas Treichl is the Chairman of the Board of Curators of MAK Museum of Applied Arts, Vienna, Member of the boards of the International Monetary Conference (IMC) and of the Institute of International Finance (IIF), and also a member of the Trilateral Commission European Region

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The Economics Conference hosted by the OeNB is an international platform for exchanging views on monetary and economic policy as well as financial market issues. It convenes central bank representatives, economic policy decision makers, financial market players, academics and researchers.

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