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Banking Union: Time Is Not On Our Side*

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ABSTRACT

This paper reviews the various mechanisms and rules that has been proposed to build a banking union in Europe. We argue that the banking union is a promising solution to the Eurozone crisis because it completes the unification of the Euro currency, forms a solution to both the financial and monetary fragmentation of the Euro area financial markets and helps breaking the vicious circle created by domestic banking system impairments and the sovereign debt crisis. We underline not only the shortcomings and hurdles to reach a fully-fledged banking union, and the hazards created by the inconsistencies between their phasing-in in the sequential schedule decided by states. To reduce the loopholes induced by the sequential approach, we propose to implement a rule of shared-bailout during the transition period that consist in a loss-sharing rule among countries hosting an entity of a bank group and indicted in the living wills of the systemic banking companies.

Classification *J.E.L.* : G21, G28, H12, E58

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Introduction

The European banking union is a combination of provisions that forms a system: i) a single rulebook for the European financial market, ii) a Single Supervisory Mechanism –SSM– ; iii) a Single Resolution Mechanism –SRM– and iv) a single deposit insurance scheme. With its implementation, the supervision of the banking system and the resolution mechanism will no longer take place at the national level but at the European level (Goya et al., 2013; Beck, 2012). A unique supervisor will monitor all "significant" credit institutions of the Euro area and is assumed to ensure consistent and high quality supervision. This federal supervisor will also provide guidelines to the national supervisors so that the supervisory rules and practices used for smaller credit institutions will be uniform. The banking resolution mechanism refers to the set of rules that governs the treatment of impaired banks and the rules used to share the resulting losses in case of default. This resolution mechanism should therefore enable an orderly dismantling or closing down of insolvent banks and avoid the systemic effects of bank failure. The deposit insurance scheme is aimed at guaranteeing that one euro deposited in any European bank will be reimbursed to depositors in case of the failure of the bank without any haircut (up to a limit of 100,000 Euros). This completes the spatial unification of the deposit market since this implies that –to a bank customer– one euro in a –for example – Portuguese bank is perfectly equivalent to one euro in –for example – a German bank or to one central bank euro. Deposit insurance therefore is about providing certainty on the value of bank deposits to retail depositors.

The banking union is a key stabilizing mechanism of the prospect of the Eurozone.

Indeed there is no point in trying to promote confidence in the European banking sector by national policy measures when banking activities of most systemic European banks are managed across borders – that goes even beyond the European Union borders. It is also pointless to imagine keeping the singleness of the Euro currency without unifying the supervision of the credit institutions that issue most of the circulating means of payment (more than four fifth of the euro circulation are issued by commercial banks).

Banking fragilities and the sovereign debt crisis lead the Eurozone on the verge of the collapse by creating a negative feedback loop between the healthiness of a country banking system and of the domestic government that had to guarantee the (massive) domestic banks liabilities. Indeed given the size of banks as a percentage of each national GDP, the burden of bank resolution fall on the shoulder of national authorities in the pre-banking union situation. This mechanically implies that a fragile domestic banking sector impairs the state's creditworthiness. In turn, banks may be impacted by sovereign debt deterioration through two main channels. First, because banks invest in public debt securities, they may suffer from a degradation of the quality of their assets when the creditworthiness of sovereign is in doubt; Second any deterioration of the government creditworthiness reduces the credibility of the implicit government guarantee granted to each bank too big to fail, which in turn impact negatively their funding situation by increasing the interest rate they pay on the market. The aim of the existing architecture is to break this negative feedback loop.

Another expected advantage of the banking union will be the restoration of a higher level of financial and banking market integration. The subprime financial crisis had

triggered a serious recession of financial flows between countries. This reduction intensifies further when the subprime crisis turn into the Euro area debt crisis. The banking union is part of the comprehensive policy response aimed at reducing this financial and banking fragmentation by re-establishing the confidence of investors and allowing a more stable banking integration of the credit markets.

Finally, the banking union is also critical to strengthen the authority, credibility and independence of the supervisor of banks from any political pressure and bank lobbying.

The banking union is pressing matter and instrumental to ensure financial stability and to complete monetary union by correcting the original shortcomings of the design (Aglietta and Brand, 2013). Very few institutional reforms concentrate a so great potential in terms of structural benefits. But the banking union will revive the European Project only if the political will is not lacking. Up until now, significant progresses have been made but much more remains to be done. A serious concern is that the momentum of reforms will not subside as soon as the financial market pressure eases and the fear of a Euro area breakup cool down. The eroding political will is already discernable in the disappointing compromises on banking union recorded in December 2013. It makes no sense to promote banking union without agreeing the leap to a form of federalism. More precisely, the European currency will be complete only if the deposit insurance scheme and the resolution mechanism are effectively designed at a federal level.

Why does the European banking union convey so much hope?

Completing the Euro currency

The fate of the Euro could not be dissociated from the fate of the banking sector. The Eurozone crisis revealed the fragility of the compromises negotiated by the European governments during the 1990s. The shortcomings in the treaties have made the Euro a historically unique currency for two reasons. The banking union aims at correcting one of it.

First the Euro is unique because it is one of the few currencies in circulation that is not backed by a federal fiscal authority. The Euro is not built upon a State itself based upon the will of the people. The Euro is not grounded into the sovereignty of a unique state characterised by a coordinated decision making power. It is embedded into the 18 member states that choose to adopt it as their legal currency. As long as the Euro area has not adopted federal structures, it is an illusion to believe that a given claim on Italy is equivalent to a claim on Germany. The single currency may not be taken as irreversible before any political jump to some form of political federalism is not taken and borne by the European citizens. From that perspective, the banking union will not radically change the situation but if it ends up being completed by the launch of the single resolution mechanism and a single deposit insurance framework backed by a single resolution fund, it will force member states to move forward some sort of federalism and so it will truly consolidated the Euro area.

The financial crisis indeed revealed that not all Euros are equal. Even if Euro notes and coins have the same face value under the Treaties no matter where they are spent, the same does not apply to the bank deposits which account for four fifths of the outstanding money stock of the Euro area. Raising doubts may start to creep in on the

value of banking deposits because it may be altered dramatically in the event of a bank restructuring and by the government ability to provide a financial backstop in terms of resolution or deposit insurance. The consequences of such uncertainty can be dramatic as the March 2013 agreement on the restructuring of Cyprus banking sector testifies. This agreement acknowledged overnight that one euro in a Cyprus bank was worth less than one euro in any other Euro area member states (Méadel and Scialom, 2013).

This lack of fungibility between deposits and banknotes is a grave birth defect of the Euro and a properly designed banking union must precisely aimed at addressing this shortcoming.

The institutional original of this birth defect of the Euro has everything to do with the refusal to acknowledge that bank deposits were intrinsically part of the currency and as such, that their issuers must fall under the same regulatory and supervisory framework. In the Maastricht treaty of 1992 the governments and heads of state chose to separate artificially two forms of money despite that they should have been genuinely considered as one : the currency (coins and notes) on the one hand, and banking deposits on the other. The treaty then promoted the launching of an incomplete currency. As shown by the Cyprus case, the government that signed the treaty forgot that money is not a commodity but an institution, a set of rules that constitute a system and ensures the viability and consistency of decentralized economic decisions.

This mistake by the signatories was not made without information on its dangers. Rather, in the early 1990's, the experts' proposal – the so-called Delors' report for the establishment of a European monetary union – clearly states the need for a prudential and supervisory policy defined at the European level. The throes of intergovernmental negotiations have led government to step back on this proposal and led to an economic oddity: a federal monetary union but with a multiplicity of national banking supervisors, creating de facto a situation of a multiplicity of coexisting and segmented banking markets. Solutions are currently discussed. Their sustainability will depend on their consistency with the current architecture of the monetary union and on a good understanding of the key role of banks in today economies, so that the shaky compromise of the early 1990s can safely be considered as a characteristic of the past.

However, the recognition that banks are the main source of monetary creation will be a pre-requisite. The main part of outstanding money is indeed bank deposits that are a debt owed by the banks to their depositors. In December 2012, demand deposits accounted for 83% of the monetary aggregate M1 –that comprises all the means of payments– while coins and notes accounted for a small 17%. The greatest share of the settlements of transactions is made by cards, checks and bank account transfers that must be understood as the circulation of scriptural money whose acceptability is based on an unwavering trust in its fungibility with coins and notes issued by the ECB or with any other bank money.

Thus, banks are very specific financial intermediaries because they are at the heart of the payment system and prove to be vital for the good end of trades and exchanges (Aglietta and Scialom, 2003). As such they contribute to the public good. This also generates the dual nature of banks. On one hand banks are private firms, so they aim at maximizing their profitability but on the other hand they are the key stakeholders of the critical infrastructure required to operate a decentralized market economy –i.e. the

system of payments. It is precisely because of their Janus nature, of this duality that the weakness of the Eurozone banks has the potential to burst the monetary union.

The monetary system stability is built upon the belief in the free conversion of deposits into notes and coins. In cases when there is doubt raised on the capacity of banks to operate settlement on behalf of others, public intervention is required to restore confidence in the bank's solvency. If there is any uncertainty as to the ability of public authorities, if required, to bail out one of its bank or its national deposit insurance, the monetary union is at risk. Thus the ability of governments to guarantee the value of the deposits lower than 100,000 Euros constitutes a key component of the Euro fate.

For all these reasons, the federal improvements achieved in the field of bank's regulation, supervision and resolution are not only technical provisions aimed at improving financial stability. They also help to consolidate the Euro. This is the main rationale for the building up of a European banking Union.

The main paradox of the European monetary project was then lies in the decision to assign at the national level the monitoring of the main money issuers, i.e. the banks, as well as the operations of the deposit insurance schemes that back the trust of the public in the banks payment instruments. With the introduction of the Euro, the newly created European System of Central Banks –known also as the Eurosystem– was not accompanied by a European System of Banking Supervisors that must have had taking charge of the monitoring of the banks. The governments of the member states have rather chosen to call on the principle of subsidiarity and then to maintain banking supervision at the national level. The Single Supervisory Mechanism (the first pillar of the banking union) will precisely change this.

In the founding Treaty, the absence of a European deposit insurance scheme conveys a purely technical approach to the monetary union and a deep misunderstanding of the relationship between money and public trust. This original denial has to be related to the refusal to acknowledge the political dimension of a single currency, which necessarily involves some form of fiscal federalism through the establishment of common deposit insurance. The first version of the Cyprus bailout plan, which violated this principle, has broken a taboo and undermined trust. The suggestion –even for a fraction of a second– that a government is allowed to renege on its promises and deny this guarantee was a crime against the stability of the European Union. In our fiat monetary system, currency is not pledged against precious metal but only against the absolute confidence in its future continuation.

So the European institutional architecture was flawed and suffered from an original stigma. By combining currency centralisation –a single currency– with a decentralisation of the supervision and monitoring of banks in a framework lacking any fiscal federalism and political union, the Eurozone was exposed to a significant risk of economic and financial instability. The weakness of banks of the Euro zone is then not only a mere financial problem but also a monetary issue as long as the subsidiarity principle prevails in banking supervision and resolution.

Paradoxically, the banking and sovereign debt crisis, which has revealed the shaky nature of the European institutional architecture, is a historical opportunity to remedy the original failure in the design of the monetary union. The advent of a European

banking union with its three main components paves the way not only toward a more stable finance but also toward a complete money.

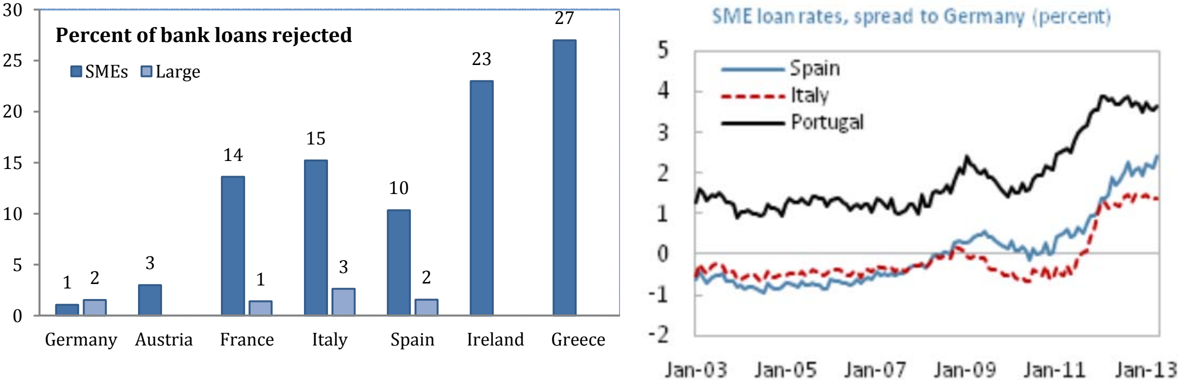
Tackling the fragmentation of the financial markets by creating a federal framework for the prevention and resolution of banking crisis

The European banking sector remains undercapitalized, fragmented and vulnerable to sudden financial market adjustments (EBA, 2013, ECB, 2013). The sovereign debt crisis exacerbated these problems and intensified the critical need for reforms to counter the financial fragmentation.

Credit rationing is significant in the countries that were the most impacted by the crisis, and small and medium enterprises firms were especially hurt by it, despite their being the backbone of the European economy. They represent 68% of the EU employment and almost 60% of the EU's GDP. Because of their strong reliance on the banking sector for external financing, they are paying a disproportionally high price for the banking distresses compared to larger businesses. According to the ECB survey on access to finance by small and medium sized enterprises, in 2013, more than 15% of the loans that Italian SMEs have applied for have been rejected by banks compared to a 10% rejection rate in 2010. In Spain the rejection rate levelled at 10% while it spikes at more than 25% in Ireland and Greece. Even more, the gap is widening with the German SMEs, whose rejection rate has decreased from 6 to 2%. And it is widening also compared to large companies that experienced similar credit rejection rate in the four biggest jurisdictions. This quantitative credit rationing impacting SMEs is aggravated by the fact that SMEs of crisis-affected countries paid higher interest rates than their northern counterparts.

As illustrated by chart 1, while Spanish and Italian SMEs paid the same interest rate than German SMEs in 2011, the gap levelled at more than two points in 2013. The private sector of crisis-hit countries now borrows less and at higher rates than the other member states, in particular those considered as safe heaven countries. As the ECB acknowledged, the crisis has reversed the financial integration process, leading to a fragmentation of the Euro zone.

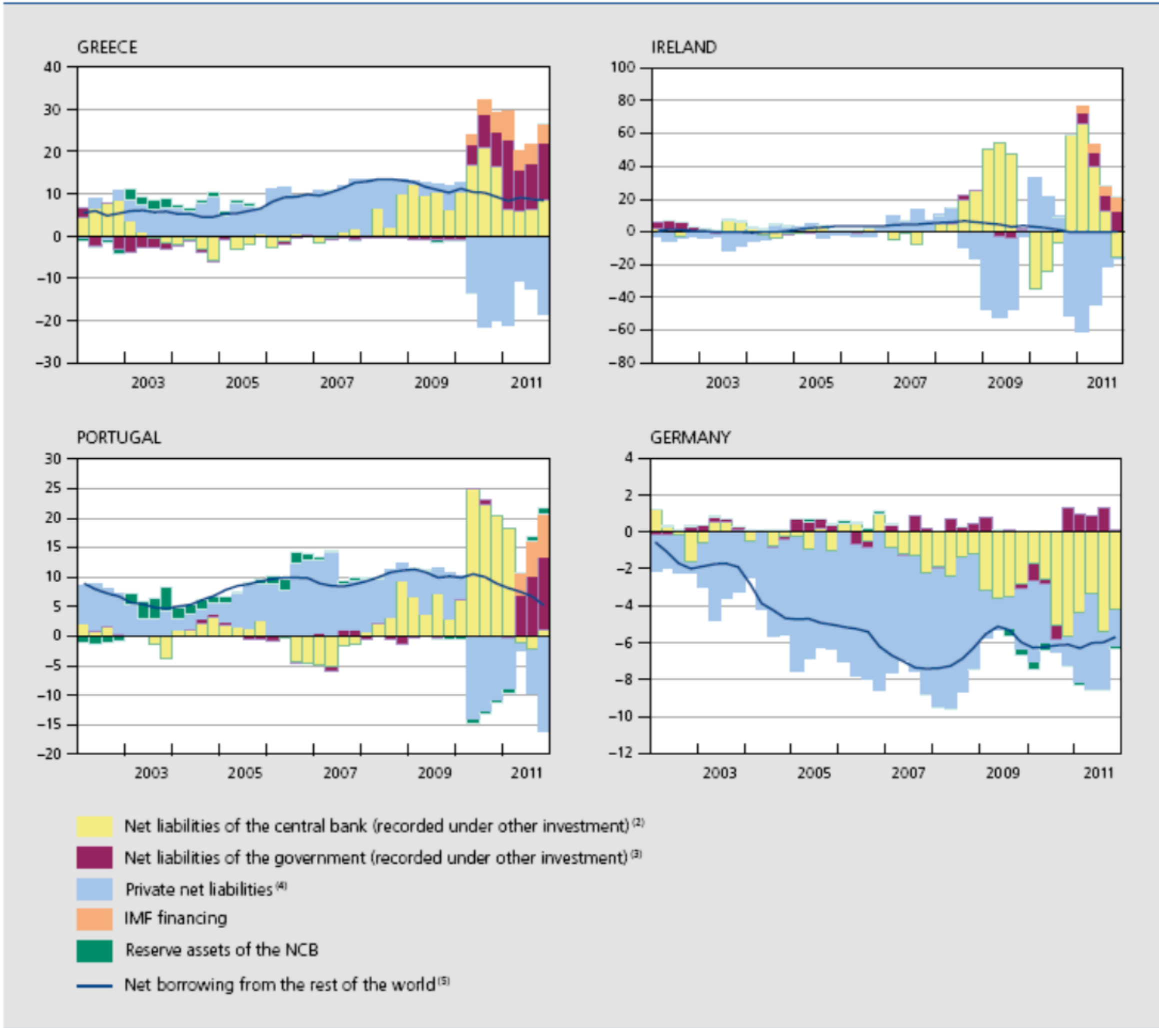
Figure 1 : SME Loans applications rejected by banks (left panel) and spread to the Germany of the interest rate on loans to SME in Spain, Italy and Portugal (right panel)



Source: ECB SAFE survey March 2014 Source: Al-Eyd and Berkmen, 2013, p. 9

A major reason for such a margin squeeze on funding conditions is the weaknesses of the banks in the fragile countries. Indeed, between 2010 and 2012, the banks of the most crisis affected countries are those that increased the most their provisions to cover loan losses and also increased the most the firm's funding cost. The very same banks suffer severely from the contraction of cross border capital flows among the countries of the Euro zone. This sharp decrease in private capital flows between core and peripheral countries reflects partly both the end of the housing bubble funding and the sovereign debt crisis. Nevertheless it is also the product of the choices by the banks of the less impacted countries to reduce their cross-borders exposures to private and public sectors of the most fragile countries. Doing so, they sharply contribute to the funding rationing of the real economy thereby worsening the crisis.

Figure 2: Public and private capital flows of Greece, Ireland, Italy, Portugal and Germany (Net borrowing from the rest of the world, 2002-2011)



Sources: Thomson Reuters Datastream and own calculations.

(1) Since the "errors and omissions" item is not shown, the sum of the financing flows is not equal to net borrowing from the rest of the world.

(2) Although this item covers more than just the positions in relation to TARGET2, the transactions under this item largely correspond to the change in the TARGET2 positions. The only exception to that seems to be Ireland: in that case it is therefore the TARGET2 positions that are used, and the data in this chart do not all come from the balance of payments.

(3) This item records the loans which countries conclude with the EFSF and the EFSM, plus the bilateral loans to Greece. In addition, this item also covers the deposits which the government holds in other countries.

(4) Private net liabilities are defined as the difference between the balance on the financial account and the net liabilities of both the central bank and the government, as recorded under the other investment on the financial account.

(5) Net borrowing from the rest of the world is defined as the sum of the current account balance and the capital account balance, with the opposite sign.

Source: Boeckx (2012, p. 20)

The resulting external financing gap has been filled by euro-system liquidity and subsequently by funding granted by the EU and the IMF as part of their financial assistance programs.

This persistent divergence between the sovereign and private domestic funding costs within the Euro zone greatly disrupted the monetary policy transmission channels. Indeed, as long as the sovereign and private funding costs differ notably between Euro-zone countries, the ECB monetary policy measures could produce uneven and even diverging effects between countries and thus increase the asymmetries between member states within the euro zone.

This failure of the Euro zone credit market is a major problem for the functioning of the monetary union. It has justified the non conventional measures taken by the ECB to alleviate financial market pressure on the sovereign debt markets of the most vulnerable countries i.e. sovereign bonds purchase program SMP on secondary market starting in may 2010, the long term refinancing operation at low interest rate, with a maturity up to 3 years (VLTRO) in December 2011 and February 2012 and the Outright Monetary Transactions program OMT with which the ECB declares its willingness to purchase potentially unlimited quantities of sovereign bonds in return for a strict conditionality, that is a commitment for benefiting countries to a program of reforms and fiscal consolidation. This conditionality imposed by a central bank is unprecedented and dramatically reflects the political vacuum that exists today at the European federal level.

Two main reasons explain the vicious circle between bank fragility and sovereign debt crisis during the Eurozone crisis.

On the one hand, there is a domestic bias in the sovereign bonds portfolio of banks that therefore lacks diversification. This trend became more pronounced with the deepening of the crisis. As a consequence, when sovereign ratings were downgraded, banks suffer a deterioration of the quality of their balance sheet. Domestic supervisors have supported this ring fencing – de facto renationalisation – of sovereign debt held by banks, believing it may make easier bank resolution. Thus, between November 2011 and April 2013, the amount of domestic sovereign debt held by French banks increased by 30%, the amount held by Italian banks increased by 60% and the trend is similar for the other countries. Banks have borrowed at the rate of 1% and have invested these funds in sovereign bonds at higher rates, comprised between 2 and 5%.

The other main reason for the appearance of the negative feedback loop between sovereigns and banks has to do with the governmental responsibility in bank bailout. In the absence of any significant contribution (bail-in) of bank shareholders and creditors and without any shared lifeboat device, governments bailed out domestic banks when they are perceived as systemic.

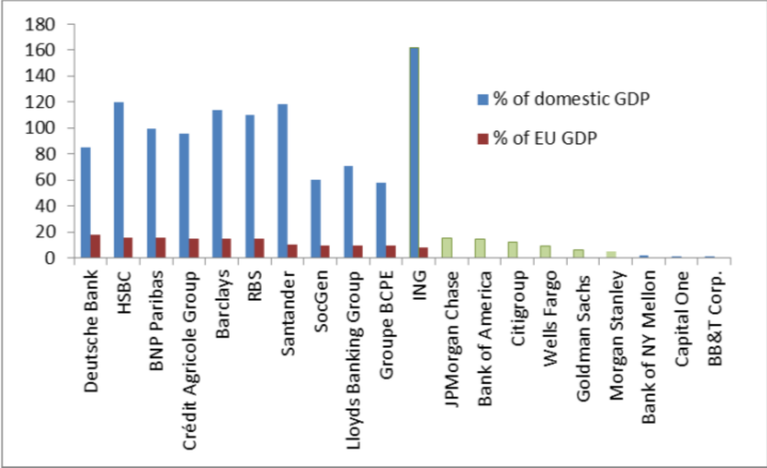
Systemic banks are particularly an acute problem in Europe. In a context of sovereign debt crisis, the major international European banks of the euro zone are too big to save at the domestic level. As documented in the Liikanen Report, the size of the European banking groups has increased substantially during the 2000s. The financial crisis does not alter this trend. It rather exacerbated it. The total assets of the major banking groups are often close to the equivalent of their domestic GDP. It levelled at about 80%

of the German GDP for Deutsche Bank; 120% of the UK GDP for HSBC, 100% of the French GDP for BNPP, 120% of the Spanish GDP for Santander…

In such a situation, governments are mechanically lead to support those systemic banking groups to the extent that their failure would lead to the collapse of the domestic banking system as a whole. But at the same time because of their weight, some government are clearly unable to bail out their domestic banks on their own without undermining their solvency. The Cyprus experience provides a good illustration of this problem. The Cyprus state, even if it had not been in a so deteriorated fiscal situation, simply could not rescue its domestic banking system, because the total balance sheet of banks represents eight times the country GDP. This explains why the Cyprus banks rescue package required the joint involvement of the European Union and the IMF.

In a banking union, banks would be supervised at the European level and their size will become proportionate to the European economy. So, the banking union provides a consistent framework when the resolution funds and the deposit insurance schemes are dealt with at the same level and on the same scale.

Figure 3: Size of the biggest European banks as percentage of their national GDP (blue bars) and as % of the European GDP (red bars) compared to the size of the biggest U.S. banks as percentage of the U.S. GDP (green bars)



Source: Liikanen report (2012)

However, the banking Union is not a miracle solution for the problem of the excessive concentration of the European banking sector. In France the five largest banking groups account for nearly 50% of the banking total assets.[1] Even in countries where concentration is traditionally lower, it has increased in the recent times. In Germany for instance, banking concentration increased from 15% to 30% between 1997 and 2010 (Liikanen Report). This concentration is a key systemic risk factor. It justifies the banking union but it also calls for a specific competition policy for the banking industry in order to reduce one of the main roots of systemic risk.

An ambitious design for the banking union– that is the full realization of the three pillars consisting in the single supervisory mechanism, the single resolution mechanism and a

[1] The number underestimated the true value since they were computed non-consolidated financial statements.

federal deposit insurance – addresses the two fundamental issues previously raised. It completes the single currency and gives a solution to the issue of the too big, too complex and too connected to fail banks.

Today, the banking union had been stopped in the midstream. It will be set up gradually in a sequential manner. More precisely, the speed of progresses on the various components raises serious issues of its consistency and compatibility. The single supervisory mechanism under the auspices of the ECB is adopted and gradually set up in 2014. Finding an agreement on the single resolution mechanism has been proved difficult to reach in December 2013. It had been improved painfully in March 2014 and remains unsatisfactory particularly with regards to the timing and deadline chosen for the full implementation of the resolution fund. The eight years transition period is a true challenge and the project would probably be put again on the drawing board. Finally, for the moment, the question of the federal deposit insurance scheme is not on the agenda.

A SEQUENTIAL PROCESS VULNERABLE TO A CLEAR LACK OF POLITICAL WILL

The principles of the project of banking union has been agreed upon during the June 2012 European summit of the heads of states under soaring sovereign yields triggered by huge financial market stress. The institutional response to the financing stress obeys a sequential process. In other words, the various steps implied by the implementation of the components of the banking union –which should have been logically interlocked – are loosely connected. This leads to wonder whether the strong political determination exhibited in 2012 may not –or more properly is not about to– unravel in a quieter context and hence leads government to renege on their promises. The catch 22 associated with the banking union project is that the relief expected from its implementation is hugely dependent on the details of each mechanism but that the governments seem willing to act and design an effective and consistent solution only under the pressure of soaring sovereign yields. Given that the sequences of the whole banking union project are spread over a long period, this makes the effectiveness of the whole process highly permeable to climb down and shaky compromises. In this paragraph we describe the details of the two main mechanisms discussed so far to deal with impaired banks – the single supervisory mechanism and the single resolution mechanism – and discuss the hazard that may appears during the transition period that will extend to 2023.

The single supervisory mechanism

The European Council on 29 June 2012 and the statement of the heads of states and government of the Euro area were a "watershed moment" not only for the resolution of the crisis –especially in Spain and Italy– in the short run but also and above all because it represents an important political step towards the adoption of a single supervisory mechanism (SSM) instead of a loose coordination of banking supervisors. The final Statement of this European Council focused on two essential points: the launch of a Banking Union and the possibility for the European Stability Mechanism to directly recapitalize banks under certain conditions.

The decision to transfer the banking policy from the domestic to the European level has a strong political dimension. A single supervisory mechanism (SSM) permits a systemic

approach to banking risks supervision and management especially for cross-borders activities. It also helps to identify and prevent excessive build up of risks that generate hidden financial vulnerabilities. By strictly imposing a consistent implementation and uniform application of financial regulations across the member states of the European Union, by reducing the domestic market distortions and the impact of bank lobbies on supervisor and hence the risk of capture, the Single Supervisory Mechanism constitutes a powerful device to fight the financial fragmentation.

Starting in 2014 the ECB will be the single supervisor of any significant credit institutions in the Eurozone and of the banks of any other countries of the Union if they decide to join the SSM on a voluntary basis. More precisely, it is expected that the ECB directly supervises 130 of the 6000 credit institutions of the Euro area while keeping the right to take the upper hand over the domestic supervisor of the (smaller) banks that are not under its direct control, provided it considers it necessary.

In order to prepare for this new task, the ECB needs to be able to make an accurate diagnosis on the strengths and weaknesses of the banks that fall under its supervision. This explains why the ECB is engaged in an Assets Quality Review (AQR) of the banks. In this tricky process, it is assessing the quality of each bank balance sheet as well as of its off balance sheet exposure, the adequacy of the risk weighted assets i.e. the denominator of the Basel 3 capital ratio, the vulnerability to liquidity and funding shocks and so the stability of the bank's funding structure and more generally the banks resilience to shocks. In other words, the AQR amounts to a review of the viability of the bank business model and of their governance structure. This review of the bank soundness is difficult but will be critical in fostering the ECB legitimacy and credibility as a banking supervisor.

Some of the central elements of the ECB balance sheet assessment and of the stress test exercise have been communicated by the European Banking Authority and the ECB on 29 April 2014. The tests have been made much more rigorous than the 2011 ones.

The EBA tests, which cover 124 banks, sketched out a fictional crisis of confidence bursting on the bond market, heightened by flight from emerging markets, and triggering recessions across the world. More precisely, the adverse macroeconomic scenario and the induced financial shocks include a sharp rise in bond yields, and envisage a three-year cumulative drop in EU output amounting to 2.1% of GDP per year, when the corresponding assumption in the EBA stress tests was a fall of 0.4% spanned over two years. That 2.1% fall in GDP per year implies a 2016 GDP lower by 7% compared to the "baseline" scenario, under which the economy evolves according to the most recent forecast by the European Commission. Among the knock-on effects are a jump in EU unemployment to 13 per cent by 2016, compared with the 10.1 % of the official forecasts. House prices fall more than 20 per cent compared with levels they would otherwise have hit in 2016. Banks face jumps in bond yields of as much as 380 basis points in Greece and 137 basis points in Germany under the scenario.

It is possible and even likely that the exercise will turn out to reveal hidden banking fragilities. In that case, the ECB will have to take its responsibilities and force those banks to recapitalize their equity and/or to recognize impairment losses. European banks will have six to nine months to cover capital shortfalls that will be uncovered by the forthcoming stress tests and on-going asset quality review. In the worst cases, the

ECB will have to notify its diagnosis to the resolution authority, which will have to decide on the initiation of a resolution process (bail-in, defeasance, spinning off of certain activities etc.).

If the assessment given by the AQR and the bank stress tests indicate that a recovery or a resolution process must be initiated for a systemic bank, the ECB will be the institution legally in charge of deciding this. More precisely, and following the agreement of the 20 March 2014, "The ECB supervisor will trigger the whole process, being responsible for deciding whether a bank is on the brink of failing. The Resolution Board may ask that the ECB takes such a decision and if the ECB declines to do so, then the Board itself may take the decision. The ECB is therefore the main "triggering" authority but the Board may also play a role if the ECB is reluctant or hesitates to act".[2]

The timing of the implementation of the Single Resolution Mechanism is then entirely constrained by the moment at which the devolution to the ECB of the Single Supervisory Mechanism. The issue is that the timing of the implementation of those two critical pillars of the banking union is likely to be inconsistent.

The Single Resolution Mechanism

The finance ministers of the EU countries agreed on the 19th December 2013 on the details of a Single Resolution Mechanism to timely deal with the treatment of impaired banks and then limit the contagion risk within the financial and banking sectors. The European parliament expresses major reservations on the willingness of the governments to keep their hands on the "so-called" unique resolution mechanism by favoring a system in which a resolution of an individual bank could be started only following an intergovernmental decision.

Additional decisions were therefore discussed and taken in March 2014, following a new round of negotiations of Finance ministers with representatives of the members of the European parliament (MEP). This allows some new steps favoring the uniqueness of the decision process under the auspices of the European commission. All in all, the decision making process envisioned in the proposed SRM appears to be very complex and does not include any credible public or mutualized backstop in the near future. In the next eight years, the status quo will therefore prevail.

The ECB will be granted with the responsibility to signal if a bank faces a critical situation that requires a recapitalization, a recovery or a resolution process. It will be initiated by the ECB but organized by the single resolution board, which consists of representatives of the ECB, the European Commission and of the relevant domestic authorities (that is of all the countries in which the bank in resolution has established its headquarters, branches and/or subsidiaries).

The single resolution board will be responsible for deciding and implementing the bank resolution schemes of any bank that fall under the direct jurisdiction of the ECB. The national resolution authorities will have to implement the resolution of any of the other

[2] http://www.europarl.europa.eu/news/en/news-room/content/20140319IPR39310/html/Parliament-negotiators-rescue-seriously-damaged-bank-resolution-system

banks using the instructions of the 24 members of the single resolution board (SRB). The SRB will monitor the resolution process. Should a national authority not comply with a decision by the board, it will be allowed to address executive orders directly to the troubled bank.

Such banking resolution framework assigned to federal level, equipped with the legal tools required to minimize the resolution cost for taxpayers through the losses absorption by shareholders and uninsured creditors (bail-in) while maintaining financial stability could prove a very powerful incentive to revive market discipline.

The December 2013 and March 2014 improvements of the agreement establish a common resolution fund (CRF) that will be build up over eight years starting in 2015 and funded by levies on banks. The complete mutualisation of the Funds is only expected for 2023. During the eight years transition period the fund will remain structured with national compartments that will progressively be merged over time. The common resolution fund will be involved only if residual losses remain after the bail in activation and /or if banking restructuring need a medium term support.

The sheer size of the fund (55 billion) seems very low compared with the State aids and guarantees during the peak of the global financial crisis. The guarantees granted by the French government to the banking sector during the Subprime crisis amounted to 413 billion of Euros (Alpha Value, 2013), of which 320 billion were pure refinancing guarantees (using the vehicle of the *Société de Financement de l'Economie Française*), 40 billion accrued to temporary recapitalizations and 53 billion went to the French part of Dexia (6 bn in fresh capital and 47 other billion in financial guarantee). In Germany, the same aid leveled at 480 bn, in Ireland at 400 bn, in the United Kingdom at 363 bn, in the Netherlands at 220 bn and in Spain at 130 bn. During the most pressing part of the transition period – the one that will follow the publication of the ECB assessment – nothing is planned.

In other words, the negative feedback loop between banks and their sovereigns will not be broken, even though a break is urgently needed to restore the equal financing condition across the Eurozone. This explains why Martin Schulz, the president of the European Parliament declared in a speech on 19th December 2013:

> "During the transitional phase, in which a resolution fund funded by levies on banks might not yet be ready for action or perhaps might be too small for very large banks or several of them, we wish to see a solution which could involve the ESM backing the resolution fund as an insurer of last resort. (...) What we are heading towards instead of a single resolution fund is a fund with national money pots. That means that, at least for the next 10 years, the home countries will remain liable. Ultimately, the taxpayer will once again have to come to the rescue after all. That contradicts the fundamental idea of the Banking Union, which is that banks should come to the rescue of banks!" [3]

A common backstop is all the more required that the goal is to make the banking union credible in a context in which the rules governing burden sharing among creditors (bail-in) will not be operational before January 2016. A "hole" was therefore created in the

[3] http://www.europarl.europa.eu/the-president/en/press/press_release_speeches/speeches/sp-2013/sp-2013-december/html/address-to-the-european-council-by-the-president-of-the-european-parliament-martin-schulz

timing by the gap between the AQR disclosure by the ECB in October or November 2014, followed by a six to eight months period during which banks will have to comply with the ECB recommendations. After this deadline, the single resolution mechanism will be mobilised for the remaining impaired banks.

The complete mutualisation of the CRF is scheduled for 2023. This is a major improvement compared to the December inter-governmental agreement; even though this still appears remote when one think to the pressing nature of banking problems. The MEPs indeed succeed to speed up the mutualisation of the fund resources (40% during the first year, 60% during the second year and 70% during the third, the residual share being linearly abound during the last 5 years). Upon completion, the CRF will have the right to borrow on the financial markets; its bonds will benefit from the status of mutual debt on the European banking sector. But the possibility to lean the fund against the European Stability Mechanism (ESM) was rule out after the firm objection of Germany. In other words, no truly federal backstop is scheduled to operate in case of a major crisis that could deplete the CFR resources. The ESM will be allowed to help only for the residual losses, once bail in clauses and/or if the bank resolution requires a medium-term support.

The timing is therefore hazardous given the ECB assessment of the Fall of 2014 and the launching of the Single Resolution Fund in January 2015, with only a gradual mutualisation of resources and the implementation of the bail in clause in January 2016 – to comply with the European Directive on bank recovery and resolution, which establish the principle of a first line of losses absorption by uninsured creditors (bail-in) prior to the resolution fund contribution (a fortiori prior to the taxpayers).. Starting in 2023, the CRF will be fully operational, and could be asked for contribution up to the limit of 5% of the bank liabilities and only after the involvement of shareholders and uninsured creditors for the absorption of the losses in the confine of 8% of the liabilities. In the worse cases, when losses exceed these two thresholds and so when private sector involvement (bail in and CRF contribution) is not enough, a bailout could be considered.

The single resolution mechanism should favor a shortening of the resolution period that are closely related with the final costs of bank resolution. During the last decade, all rescues of financial intermediaries – LTCM, Bear Sterns, Northern Rock, Hypo Real Estates, Merill Lynch, Citigroup, RBS, etc… – had been completed in a very short period (between one night and two days) and not after long negotiations whose details are disclosed too quickly to the public. The SRM is supposed to allow this reduction of the period that lead to decide on the resolution of a bank, something that is necessary to the containment of the contagion. But as Martin Schulz underlined in his speech on the 19th of December (see supra) the initial agreement did not allow this quick reaction because of the primacy of the inter-governmental body on the community body. This leads him to declare that:

> "Instead of an independent decision-making body which can act swiftly, the Member States are to retain the power of decision. The Financial Times has calculated that up to 9 bodies and 126 people would be involved in deliberations on a case. This is comparable to dealing with an emergency admission to hospital by first convening the hospital's Board of Directors instead of giving the patient immediate treatment! The criterion is clear: if a bank cannot be wound up within a weekend in order to prevent a run on the banks, the system is too complicated. After all, we are talking about a 'single' resolution mechanism, not a 'multiple' resolution mechanism. In other words,

> the Commission must play a central role here, rather than untransparent bodies with untransparent interests – otherwise it will ultimately be a case of 'Operation successful, patient dead'."[4]

The March 20 agreement improves somewhat this provision. Indeed the CRF will be held and managed by the Single Resolution Mechanism. The financial contribution of the Fund to the resolution will be decided by the restricted committee of the SRM in the limit of 5 billions of Euros – year-on-year – and after the deduction of the liquidity need. This lead the MEP Philippe Lamberts to declare that "The role of the member states, and hence the ability to turn the decision to resolve a bank in to a haggling had been limited mostly to the biggest –systemic – banks (via the 5 billion threshold). In concrete terms, if Deutsche Bank or BNP Paribas would have to be declared in resolution, the governments will be involved in the decision making process. We find this unfortunate; the systemic banks are cross-border in their activities, they should stay transnational when it comes to restructure or liquidate them".[5]

We do subscribe entirely to this analysis: the resolution mechanism should not be the domain of the inter-government decision but should fall under the federal level. The resolution of a bank is a crisis period and is characterised by an extremely complex and technical procedures with massive redistributive effects. That said, the resolution procedure must not be left to the decision of the sole politicians and to the sole national interests, because it must be freed from any of the various lobbies that harm his efficacy.

A proposal to help a smooth management of the transition period

The December 2013 compromise amended in March 2014 sketches the outlines of the resolution mechanism, as it is supposed to work after 2023, but at the expenses of the pressing issues linked to the hinge between the assessment phase (AQR s and stress tests) and the period during which the restructuring and resolution will remain in the national domain. During this period, hazards will show up and letting banks be resolved at the national level is clearly the worst case situation (Schoenmaker and Siegman, 2014). The countries will have to adopt domestic rules for the restructuring and resolution of banks in line with the European Directive on bank recovery and resolution. There is a pressing need to implement this directive or to adopt transitory laws with the aim of activating the bail in procedures by the uninsured creditors, so that at the end of the asset quality review of banks by the ECB it can be possible – likely – that the fragile, impaired banks are singled out and enrolled in a receivership or even resolution.

Some are betting on a lenient ECB when it will have to assess the solvency of some of the systemic bank, so that the area will not experienced another destabilizing factor at a time when bank resolution remains in the national domain. But such a bet can prove to be extremely risky and ultimately costly since the ECB will therefore bring into play its reputation – as a supervisor but also as a central bank. Indeed if a bank were to fail soon after the end of the AQR assessment by the ECB, the ECB credibility would be seriously impaired.

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[4] http://www.europarl.europa.eu/the-president/en/press/press_release_speeches/speeches/sp-2013/sp-2013-december/html/address-to-the-european-council-by-the-president-of-the-european-parliament-martin-schulz

[5] Our translation from French: http://www.greens-efa.eu/banquesresolution-unique-12081.html

One has to keep in mind that the choice of the ECB as the supervisor of the systemic bank instead of the European banking Authority hinges largely upon the failure of the stress test that the EBA had conducted. Many banks failed just after having succeeded at the EBA stress tests. For example in July 2010 the Irish banks passed the tests successfully, only to be bailed out four months later. The year after, Dexia also pass the test but experienced an acute liquidity crisis that lead to its resolution.

The reputation of the ECB will then crucially hinges upon its assessment of the quality of the bank assets, and this assessment will have to be designed broadly to include the viability of the business model, including its vulnerability to the liquidity crisis, its governance structure and the choice of the valuation model for its portfolio of derivatives.[6] This transitory period will then be excessively hazardous for the Euro area because while the banking union aimed at breaking the negative feedback loop between sovereign and banks, during the forthcoming years, the government will stay in the frontline in the resolution procedures of the impairments of their own banking system.

What would happen, should an Italian bank mainly exposed to the Italian sovereign debt be diagnosed as having to be recapitalized? Aren't we going toward a new phase of tensions on the sovereign debt market?

In the most conservative case, the banking system must potentially be able to use the resources of the European Stability Mechanism. In June 2013, the Eurogroup reached an agreement on the creation of a direct instrument to recapitalize impaired banks up to a maximum of 60 billion – without requiring an amendment of the treaty but with the unanimous consent of the member countries. To avoid reviving the negative feedback loop between banking risk and sovereign risk, this agreement is still to be finalised for the cases in which the burden of the resolution will fall upon the shoulders of a single country. This provision is not entirely satisfactory for at least two reasons. First the amount that can be mobilised fall under the same criticism than the one rose when discussing the size of the endowments of the CRF: it is likely to turn out short of cash. One must not forget that between October 2008 and October 2011, the European commission approved about 4,500 billion of Euros of government aid (direct aid and all kind of guarantees) to the European banking sector, amounting to 37% of the EU GDP. Second, the ability to resort to the ESM will probably have a reassuring impact but will provide few or no incentive to reduce risk-taking behaviour, neither at the company level, not at the state level.

We therefore propose an alternative solution for the transition period. It consists in a rule to share the losses incurred because of banks resolution. This rule will offer the advantage of pushing the Eurozone member states into a situation of greater mutual help. The issue is no less than preventing the reappearance of the negative feedback loop between banks and sovereign fragility *during* the transition period.

To achieve a better – and smoother – management of the hazardous transition period, the best solution is that states commit to an ex-ante sharing rule of the losses of banks in resolution. This rule will introduce a middle ground solution in the bailout of impaired

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[6] Le Leslé, (2012) shows how the funding structure of the European banks reliant on the very-short-term resources of wholesale funds is a source of financial fragility. See also Acharya and Steffen (2013).

banks in between the bail-in of creditors and the mutual assistance organized by the CRF – when it will be operational.

The scenario for this transitory period will be as follows. Once the bail in of shareholders and uninsured senior creditors will be activated, and if the resolution authorities are short of cash in a period during which the CRF will not be operational, a natural possibility to cover losses of impaired banks will be to introduce a common component to make credible the whole system. One possibility is to commit to a predefined and explicit rule of loss sharing between the various countries involved in the resolution procedure (Avgouleas, Goodhart and Schoenmaker, 2010). Such a rule to share losses would help to avoid what former bank of England governor Mervyn King noticed when he appropriately remarked speaking about the way banks are helped when they are in distress: "global banks are international in life but national in death". Yet banks bailout by the country of origin of the mother company benefits to all the countries in which the bank had operations.

Let us be more precise on this new proposal. Each country, as soon as it hosts at least one subsidiary of a banking group will commit – and the information will be inscribed in the living will of the banking group – to contribute a given percentage –to be defined – of its own GDP to the bailout of the cross-border group for the part of the losses that will not be absorb by the bail-in rules. If this contribution is set at 3% of the GDP, this will levelled the size of the available funds at about 400 billion of Euro.

It could be interesting to discuss further whether it is worth having the percentage of the contribution of a country to the financing of the resolution of an impaired cross-border bank increasing in the number of subsidiaries or branches hosted. This shared bail-out, interim between the bail-in activated in 2016 and the full activation of the common resolution fund CRF in 2025, would keep the member states united in front of the banking impairment of cross-border banks. This unified cooperation has the advantage of giving the appropriate incentives toward a stricter monitoring and a less accommodating supervision by the national authorities of the countries in which the group is conducting business. Compared to the current situation, and prior to the moment at which the common resolution fund will be able to use all its funding capacity, this rule of shared bail-out will allow to force cooperation among national authorities and hence will likely disconnect the link between banking fragility and sovereign risk premia since the country of origin of a international bank will no longer be the only one to absorb the losses of the residual losses of any bank resolution that may result from the limit imposed on the bail-in of senior uninsured creditors. Another side effect will be to convince the governments that the banking union cannot be separated from scheme of resources sharing, and will then incentivize them to act much more carefully and then internalize early on the potential negative consequence of bank risk on the fiscal situation.

Once the rule will be clearly defined, the financial market will be able to evaluate very accurately the consequence for the fiscal deficit of the various scenarios of bank losses. This loss-sharing rule will make it easily predictable the losses borne by the states and then avoid a renewed negative feedback loop between banks and sovereigns. Starting in 2023, and progressively before that date, the priority of the various devices used to deal with banks impairment will be modified. At the "cruising speed", the bail-in of senior uninsured creditors will come first for loss absorption, then the common resolution fund

would come second, and in cases of any other residual losses, it would be possible to use either the shared bail-out rule or to use federal funds – if any will federal step had been taken before that date.

BANKING UNION AND THE REFORM OF THE BANKING STRUCTURE

Within the framework of bank resolution mechanism, one can expect that the requirements for the living wills of the bank will have the effect of simplifying the capitalistic structure of the biggest groups, through its impact on the incentive to incorporate subsidiaries rather than using a branch structure. With the goal of easing the resolution and in order to preserve the payment system from the unintended consequences of banks failures, the banking group has to draft contingency plan for a potential breakup. This must spontaneously incentivize them to ring-fence each activity in a subsidiary that is economically sustainable independently from the other part of the group. This simplification will be strongly favoured if the next European parliament promote a comprehensive genuine reform following the line proposed by the Liikanen report (Giraud and Scialom, 2013) or the proposal made by European commissar Barnier on January the 29th of 2014.

Among the motive for implementing change in the structure of the banks and on top of its expected simplifying impact on organization structure, lies the terms of loss sharing (Gambacorta and Van Rixtel, 2013; Scialom, 2012). Indeed as long as one agree that the banking union implies some form of mutual assistance under the form of a common insurance (through the common resolution fund, some scheme for deposit insurance or a fiscal backstop), this insurance can logically benefit only to banking groups holding similar risk profiles. This is all the more true that the common resolution fund will be funded by contributions proportional to the deposits, and will ultimately represent at least 1% of all insured deposits.

This choice of this specific rule to compute the contribution of banks to the common resolution funds constitutes an argument in favour of the reorganization of the structure of banking group. Indeed it implies that the banks collecting more deposits will contribute more compared to the size of their balance sheets and off-balance sheets exposures. Those contributions will be much higher than the contributions of systemic banks that rely more on the gross funding market with the aim of financing their trading activity. In terms of incentives, this contribution rule is everything except virtuous since the most virtuous banks in terms of funding structure – the one with a high proportion of deposit – will contribute more to the funds. The French government defended this contribution rule that favoured the most the big systemic banks, even though France is the country with the highest number of systemic banks characterized by fragile funding structure. The choice made is therefore in conflict with all basic principles of insurance economics and it becomes acceptable only if accompany by a reform of the banks structure.

The subsidiarization can have a favourable impact on financial stability if it helps to simplify the equity structure and to reduce the size of the banks. Though, one must not overestimate its impact because they will be influenced by all the precise provisions that will apply to the subsidiarization – differentiated rules for capitalisation and liquidity depending on the part of the group considered, provisions related to the intra-group relations, provisions to limit – or not – their relationship with the shadow banking

sector. The subsidiarization that accompanied the internationalisation of the banking group during the last decades – and more specifically their spreading in the fiscal and regulatory-free heaven – is a call for cautiousness with regards to our expectation on its potential simplifying impact if not accompanied by binding rules. The subsidiaries can themselves be subsidiaries of subsidiaries, etc... If the identification of the first-line subsidiaries is in itself easy the one of those of second or third rank is more challenging.

Moreover the size-reduction impact of subsidiarization of a bank group is not mechanical, even though the increase in funding cost of trading activities generated by the suppression of the implicit guarantee on them is clearly an argument in favour of a positive size-reduction impact. Banks' trading activities can in itself be cut again so as to relocate some of the activities inside non-banking entities. The consequence will surely be a reduction of the size of the banking groups but a parallel increase of non bank entities (shadow banks), with the implied transformation of the share of the economy financing made by banks versus non banks: Banks would then experience a reduction of their financing of non financial firms while non banks will experience a symmetrical increase. If the reduction of the size of the banks constitutes a positive contribution to a reduced financial instability, the corresponding expected boom in shadow banking activities would go clearly in the reverse sense. This explains why the regulation and supervision of the shadow banking sector and its relation with the banks shall be a top priority on the European Union agenda. The reform of the banking structure is an additional complementary measure of the banking union, but one that is clearly not sufficient to master an enlarged finance.

As for the impact of the banking union on the location of banks and their cross-border activities, we can expect the single supervision to actually increase cross-border activities inside the Eurozone thanks to the unified and homogenized supervisory treatment, independently of the jurisdictions. The tightening of the supervision that will characterize the banking union – the ECB being interested in establishing its legitimacy as a supervisor and in being watchful while acting diligently – could favoured the cross border activities outside the Euro area, especially if the banking group tries to escape the supervisory tightening by setting up subsidiaries in countries with laxer rules. In both cases, and independently of the motivations, the size of banking groups may not be significantly impacted – even if intra-group frontiers may be hugely impacted. The overall consequence is that the banking union will likely not have an impact on the systemic banks.

SOME PROGRESSES, BUT STILL (TOO) MANY UNANSWERED QUESTIONS

The devolution to the federal level of the supervision and the resolution mechanism implies that the EU method forms the juridical basis of the banking union. If the European parliament is heard on this crucial point, the single supervisory mechanism that is embedded in a resolution procedure decided and managed at the level of the union will likely reduce the close links between the banking industry and the supervisors and therefore the risks of capture and leniency of the monitored banks by the supervisor. This reduction in capture is a necessary condition to set up the ECB credibility (Valiante, 2014).

Only the significant banks –the biggest of the Euro area – will be directly supervised by the ECB as part of the SSM. The assessment of the significance lies on three criteria, the

total value of the assets, the share of the banks in the (national) GDP and the cross-border activity.

The ECB still has to clarify the guidelines used to apply the single supervision but the rule book already decided the direct supervision of banks with total assets greater than 30 billion of Euro or if its share as percentage of the GDP exceeds 20% or if he already had benefitted from the government or EU support –through the EFSF or the ESM. We also already know that the three biggest bank of a country will fall under the ECB supervision. Without completely excluding the ECB of the supervision of smaller banks, this supervision will be done "locally", where the national supervisor will be involved.

All in all about 130 banks – for a combined share of 80% of the Eurozone banks total assets – will be supervised by the ECB, rather than the six thousands initially forecasts. Because the biggest banks potentially generate the highest systemic risk, they naturally must be supervised by the ECB. But size is not the only risk factor for systemic and banking concern. Many of the impaired banks of the Euro area are rather middle-sized compared to the size of their country economy. But those are the ones that bore the maximum risk. One has just to remember the Dexia case in France and Belgium, the German *Landesbanken* that had huge exposures to subprime or the Spanish saving banks – the *Cajas* – that financed too many useless or underutilized infrastructure projects.[7] Often these banks are politically connected, which surely altered the efficiency of their decision projects. The differentiated and potentially asymmetric supervisory regime of the European banks may therefore not be very helpful to limit the excessive risks of middle-sized banks that may use their national political connection to ask for the indulgence of their national supervisor. The ECB is allowed to step in the local supervisory process – if it judges it necessary. But the reform creates an asymmetry between big and smaller banks that is worrying (Bignon, Breton and Rojas-Breu, 2013).

Three other issues remain unaddressed.

First the opacity of the structure of the European cross-border banks generates major obstacles to the cross-border resolution of banks and forms a major source of cross-border jurisdictional conflicts. The failure of Lehman brothers is a case in point. The failure of its subsidiaries had been very costly and excessively complex because the legal structure of Lehman did not coincide with its operational and functional organization. The operations conducted by its subsidiaries legally independent, were indeed closely financially intertwined. As a consequence the subsidiaries proved in great troubles in terms of funding when the parent company filed for bankruptcy.

The European cross-border banks operate in general using subsidiaries in host countries despite a close functional and operational integration between the various subsidiaries and the parent company. In other words, those subsidiaries are operated as if they were branches, which means that they are intrinsically linked with the parent company although they are legally separated and independent entities under the host country jurisdiction. This implies that the same issues that impeded an orderly resolution of Lehman Brothers will apply to any other resolution if it is organized at the national level. This will be the case during the transition period before the full

[7] See Legrain, "Europe's Bogus Banking Union", Project Syndicate, April 8, 2014, http://www.project-syndicate.org/commentary/philippe-legrain-shows-how-far-the-new-framework-for-supervision-and-resolution-falls-short.

implementation of the single resolution mechanism. These conflicts will be intensified if the structure of the bank is opaque and integrated, that is if a bank with subsidiaries is operated de facto as a bank with branches.

Requiring that subsidiaries have to be operationally separable from the parent company at short notice, say 24 or 48 hours can minimize this type of conflict between jurisdictions. New Zealand applies this type of separability rule (European Shadow Financial Regulatory Committee, 2013). In concrete terms, and in order to make effective this rule, one needs each subsidiary to be able to manage independently of the parent company every key function such as the information system, the risk management, participation to the payment system and access of depositors to their deposits.

Such a separability rule is critical to stop the systematic bailout of subsidiaries by government afraid of the potential intra-group contagion risk triggered by the failures of one of the subsidiary of an integrated banking group. To be operational, this rule and the condition for its activation must be detailed in the living will of the banking group. By so doing, it will have a strong influence on the simplification of the structure of the banking groups.

Secondly, what about the scope of the supervision? Does it include the regulated non-banking companies such as insurance, investment funds and exchanges? Must we understand that the banking union – that cast doubts at least partly on the current architecture of the supervision scheduled as it was adopted in 2011 as recommendations of the Larosière report – protect the supervisory right of the European Insurance and Occupational Pensions Authority and of the European Securities and Markets Authority, contrary to the prerogatives of the European Banking Authority who will have its say in the production of the regulatory law but will in no way be involved in supervisory tasks?

Finally, by giving to the ECB another mandate of micro-prudential supervision, the banking union will force the ECB to be more involve than before in the prevention of financial instability. It will have more precise pieces of information on situation of banks that are its counterparties in the monetary policy operations, allowing thus to intervene much earlier in case of fragility. The public and academics have blamed the central banks for having neglected their original mandate, which was precisely to block monetary and financial crisis.

Endowed with the pieces of information needed on banks' balance sheets, the ECB will be able to fully use the legal provisions to increase the margin call with its assessment of the quality of the counterparty or of the assets that it has issued. The treaty – at the level of the national central banks, already allowed this option. The single supervision will then allow coordinating the common action regarding the counterparties. Thus the ECB will no longer have its eyes on the sole price stability in the Euro area, and it will have to pay attention equally to the financial stability, on the same footing than monetary stability.

It however remains that giving the micro-prudential task to the central bank is not the only way to act in favor of financial stability. The central banks are also the best-situated institutions to manage the macro-prudential policy of monitoring globally credit and the

financial system. Many acknowledge today the need for a single macro-prudential policy, in addition to the micro-prudential monitoring, so that it can be possible to prevent the building up of systemic risk in its temporal dimension – by reducing the scale of the financial cycle through the avoidance of the apparition of the credit and asset prices bubbles – but also in its horizontal dimension – by avoiding contagion from one impaired bank to the other systemic banks.

One may wonder whether it will be possible to broaden further the scope of the ECB mandate to the macro-prudential dimension without reviving the lively debate and the severe stresses on the democratic accountability of this institution. The banking union is undeniably a step in the right direction in terms of micro-prudential supervision, but because it weighs on the sole independent and credible institution that the Euro area was able to create, it also sentences the Euro area to move forward much more slowly on the macro-prudential dimension – despite its equal importance in its function of preserving the financial stability of the area.

Third, a last grey area remains in the banking union project: the deafening silence on the third component, the European deposit insurance (Schoenmaker and Gros, 2012). This component is a vital part to preserve banks from depositors panic and hence to suppress the most visible and violent of distrust against the bank money. This dimension is linked to the incomplete nature of the Euro as it was originally designed. The European directive on deposit insurance safeguards the deposits up to 100,000 Euros but the principle is implemented at the national level and is structured such that it can absorb isolated bank failures and not a systemic banking crisis for which the help of the public subsidies is required. But again, the credibility of a deposit insurance fund is a function of the assessment of the government solvency that guarantees the credibility of the claim. Indeed as the history of the Saving and Loans crisis in the United States has shown at the end of the 1980s and beginning of the 1990s, a deposit insurance scheme can itself become insolvent and then require a financial bailout. The same story as the one on the Single Resolution Mechanism is here at play: without any financial federal backstop, the credibility of all the architecture of the European banking union is at risk.

CONCLUSION

The banking union is a crucial step for the longevity of the Eurozone, but the banking union will keep its promises only if national governments stop trading off their willingness to resolve the Euro crisis with their attempts to protect the market share of their national banking 'champions'. On this dimension the agreements secured in Brussels in march 2014 to create the Single Resolution Mechanism are frustrating since they generate a high level of uncertainty on the efficacy of the mechanism, especially during the transition period that will last up until 2023.

An awkward period will start with the ECB assessment of the solvency of the biggest banks of the zone during the Fall of 2014. At that moment, it will publish the results of its Asset Quality Review of banks balance sheets and of the stress tests at a time when none of the solution decided to deal with the resolution of impaired banks will be fully operational. The bail-in rule will be activated at the end of 2016 and the Common Resolution Fund funded by the banks will be fully operative only in 2023. The lack of

some form of a common financial backstop during the transition period had the potential to reinvigorate the malign relation between sovereign debt crisis and banking fragility once the ECB will signal which banks need more equity.

To fill the gap during the transition period, we proposed in this paper to implement a rule of shared-bailout consisting in a loss-sharing rule among countries hosting an entity of a banking group and indicted in the living wills of the systemic banking companies. This rule would act as device to discipline the country that host the subsidiaries of cross-border banking group and thus would give the appropriate incentive to monitoring of those banking companies. We also proposed a rule of separability of the subsidiaries incorporated outside of the country of the parent company so as to limit the intra-group exposure –contagion– and to minimize the type of costly jurisdictional conflict that the failure of Lehman Brothers had exemplified. Finally, it is noteworthy that the banking union is not the answer to any banking and financial problems. During the phasing-in of its implementation, many other issues need to be addressed, among which one may note the appropriate banking structure to promote a sustainable growth, the size of the banking system and the regulation of the shadow banking sector.

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