BEYOND THE EUROPEAN BANKING UNION

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After briefly recalling the progress and especially the limits of European Banking Union, this paper seeks to describe and evaluate reforms to complete the new agreement. Two types of proposals are then discussed: strengthening banking regulation by engaging in the separation of activities and defining a macro-prudential policy at the Union. An alternative project would consist in reducing the share of intermediation in financing the European economy by increasing the size of the markets. But these views risk hitting the foundations of economic and social systems of continental Europe.

In light of the hopes aroused by the project for a European Banking Union (EBU), the compromise that was reached (yet to be validated) is cause for real disappointment. The goal was to reduce the fragmentation of the European financial space, which has been aggravated by the crisis, namely the divergence in financing conditions among EU member countries (especially in the euro zone). A single monetary policy cannot in fact accommodate such differences.

There have been lengthy explanations of the need to break the destabilizing spiral that has developed in different States between the weakness of their financial institutions and their public debt crisis. These are mutually sustaining: public finances are under pressure from the need to support troubled banks, while the deterioration in public debt is hitting the banks' balance sheets, suggesting that the possibilities for a bailout are problematic. To break out of this vicious circle, it was necessary to find ways to clean up the zone's banking systems and establish procedures to resolve the critical cases in an orderly fashion, but it was necessary above all to establish a "safety net" at the EU level to reduce the interdependence between the costs of State financing and the costs of the banking systems. More ambitiously, this initiative was viewed by some as a first step towards a fiscal union, or at least towards greater European solidarity.

It must be acknowledged that broadly speaking the banking union plan respects the way that it was originally laid out. It is the content of the union's mechanisms and the concrete conditions for its implementation that have been emptied of their original principles and intentions:

— The single banking supervision mechanism (SSM) entrusted to the ECB will quickly be operational. This represents real progress insofar as it will help standardize practices in this field, where the ECB should be less complacent than the national authorities, who are more inclined to protect their financial institutions. It should be noted that the ECB's jurisdiction will cover only the largest banks, *i.e.* approximately 130 of the 6000 banks in the EU. For other banks, the ECB will only monitor the supervision of national supervisory authorities. Germany will thus continue to exercise oversight on its regional bank network, which, though smaller, plays a unique strategic role in financing the country's economy.

The ECB will proceed from early 2014 to conduct an audit (the Asset Quality Review, AQR). This work is intended to result in in assessments (Fall 2014) that should then lead in 2015 to decisions on recapitalizing or even closing or decommissioning establishments. It is at this stage that the credibility of the supervisory mechanism will be decided. It will notably depend on how conclusions from the supervisor's observations and diagnoses on the situation of individual institutions will be drawn. This is precisely the purpose of the single resolution mechanism (SRM) which must also be in place to complete the SSM. It aims to unify both the decision-making procedures and the resolution process of troubled banks in the EBU.

— When a bank (under direct supervision of the ECB or with transnational activities) should be recapitalized, placed under administrative control or liquidated, the decision should be taken quickly (probably over a weekend) to avoid contagion. Two options were considered on this issue. The decisions could have been taken at the suprational level or left at the national level. Negotiations have resulted in an unduly burdensome compromise. First, the ECB shall notify the failure of the establishment to the Single Resolution Board. The Board will adopt a bailout or liquidation decision in executive session (8 members) if not appealed to the resolution fund, or in plenary session (23 members) otherwise. The decision will then be submitted to the Commission for approval (the Council has the final say in case of disagreement) before transmission to the national authorities for execution. It would have been desirable to make the process easier and quicker.

— Regarding the resolution of troubled institutions, the Bank Recovery and Revolution Directive (DRRB), adopted for all European Union countries, states that losses will be primarily absorbed by shareholders and creditors in a predetermined order. Only holders of less than € 100.000 deposits and secured debt holders will be protected. With these exceptions, shareholders and creditors participate in the bail-in amounting to less than 8% of the assets of the bank under resolution. If this is not sufficient, a public fund resolution would intervene for a maximum of 5% of assets. The aim is to avoid as far as possible to draw upon the taxpayers, that is to say, upon the public finances of the State concerned.

For EBU countries, the emergency fund should take the form of a single resolution Fund (SRF) constituted by contributions from all banks of the EBU. This mutualisation process is supposed to break through the vicious circle between bank failures and sovereign debt crises. But in reality this fund will be operational very gradually for 8 years from 2016; it will therefore reach the desired size (€ 55 billion or 1% of deposits and 0.2% of bank liabilities EBU) in 2024. In addition, pooling will also be realized after several stages: 40% the first year, 60% the second, 70% in the third ... Then, in 2018, a country will only be able to get about € 15 billion beyond the amounts contributed by its own banks. In 2020 the shared resources will amount to 28 billion and this amount should be compared to the 40 billion that Spain has taken from the European Stability Mechanism (ESM) to recapitalize some of its banks. It is expected that the SRF will have the capacity to borrow, but here again European partners have disagreements on the joint-guarantees for these borrowings. Therefore, pooling will be purely symbolic, which means that State intervention will remain necessary, thus failing to break the famous destabilizing spiral that the mechanism was supposed to neutralize. Note, moreover, that the Fund resolution will not even have begun when it will be necessary to draw the consequences of the ECB's AQR on whether to recapitalize or "resolve" a number of banks. But various estimates on the potential capital requirements, that would be needed starting from 2015, range from 50 billion to 300 billion euros.

If we add that pooling of national deposit guarantee systems was postponed *sine die*, it is clear that the construction of the EBU will not be the final step, or even a decisive one, towards the financial integration. It will weaken without really breaking the vicious circle between public debt and bank fragility, thanks to the single supervisory mechanism, and the "bail-in" from shareholders or creditors much more than to the set up of the Resolution funds, that was supposed to introduce a new solidarity, which is yet nearly non existing. If we want to progress in reducing the fragmentation of the European financial area, we will instead need to rely on a consolidation of banking regulation in its micro and macro dimensions. However, we should mention another idea, from different sources, was recently discussed: strengthening market's funding in Europe to circumvent the difficulties of financial intermediation (weak banking sector out of crisis). This view deserves to be discussed, because they seem to be naive and dangerous.

1. Completing banking regulation

In order for the Banking Union to achieve its goal of creating a more robust and homogeneous financial space, the supervisory mechanism clearly needs to enforce a set of coherent and effective rules. However, beyond the Basel III agreements, many questions need to be addressed in order to do this. Numerous examples could be mentioned (differences in calculating risk-weighted assets, the remuneration of trading operations, shadow banking etc.). But here we want to emphasize two points that merit special attention: first, the structural reform of the banking sector, and second, the institutional problem involved in the implementation of a macroprudential policy.

1.1. The separation of banking activities

There are many arguments for making a division between universal banks' market activities on the one hand (financing and investment) and their traditional commercial banking activities (intermediation) on the other. The point is not to repeat these arguments here,[1] but rather to emphasize the complementarity that exists between separation and the EBU's constituent mechanisms.[2]

The issue of banks that are "too big and too complex" to fail was in no way settled by Basel III. The additional capital that is to be imposed on systemic banks is not at all sufficient to contain the consequences if this kind of establishment fails. Recall in this connection that of the 29 banks classified as systemic, 12 belong to the European Union and eight to the euro zone. If they are allowed to remain in this state, regardless of the recommendations of the Liikanen report (but also those of the OECD Secretariat and the measures taken in the UK following the Vickers report), the operation of the EBU would be affected in several ways:

— First, in a systemic crisis involving two or three systemic banks, with balances that can reach 1000 billion euros (BNP's is 2000 billion), the fund could, because of its size, intervene for at most 2% of the liabilities of the banks concerned (and not 5% as expected). Furthermore, the planned "bail-in" (8% of liabilities) would be difficult to implement without causing a major shock; this should give pause to the body or bodies responsible for reaching a decision on resolution. It should be acknowledged that this could happen only in the case of significant losses, of around 10% of assets, and / or in the event of a systemic crisis. But to be truly credible the system needs to be able to withstand such situations, even if they are fairly unlikely. It is clear that given the mammoth size of today's universal banks, this credibility cannot be guaranteed.

— On the other hand one could question whether it is possible or fair to share risks that vary so greatly in magnitude. All the banks will contribute to the resolution fund according to some of their characteristics and notably their risk profile. But the definition of such variables is very tricky and will be a source of conflicts

1. For a presentation of these arguments *cf.* for example J.-L. Gaffard and J.-P. Pollin (2013).
2. Besides, it's one of the objectives of the Barnier's proposal on structural reform of EU credit institutions (see European Commission, 2014a).

between different types of banks and between countries. For example, the systemic institutions are generally universal banks that are more dependent on short-term market financing and subject to market risks (the liquidity and volatility of asset prices) with extremely high values. In their case, the deposits (lower in proportion) are neither an indicator of risk nor a good indicator of size. What then is the sense of an insurance fund that groups medium-sized commercial banks together with universal banks that operate in numerous segments and countries? How functional will a European fund be that includes countries like France, which has a banking system where systemic institutions dominate, and others such as Germany that instead have a system composed mainly of medium-sized and small banks?

— Moreover, the feasibility and credibility of the resolution process depend on the ability to liquidate a defaulting bank in pieces. However, when the interweaving of activities is (deliberately?) complex and opaque, it is very difficult in practice to break these up. So dismantling the institution will then involve a loss in value that renders this costly, perhaps too costly to be acceptable. A clear separation between different types of activities thus helps to reduce the size of the regulated entities and to reduce the costs of bank resolution.

— In a somewhat different vein, within universal banks there are inevitably cross-subsidies that act as barriers to optimal pricing and fair competition. It is likely that before the crisis the high profitability of market activities led to under-pricing credit; it seems, however, that since the crisis the losses racked up by the financing and investment banks (or their lowered profitability) have been partly reflected in loans and other services for captive customers (SMEs, professionals and individuals) in retail banking. Nevertheless, the existence of integrated banks (commercial + investment and financing) poses problems very similar to those found in other commercial networks (transport, electricity, telecommunications). The issue of banks' access to services that they do not produce themselves (a commercial bank wishing to hedge or to enable its clients to do so) is posed in the same terms as in these other industries, and its solution should follow the same principle of third-party access to networks as have been adopted there. This is why it is so surprising that the European Commission, which has been very, sometimes overly concerned with the application of this principle, especially in the case of rail transport and electricity, has until now never thought this might also concern the banking industry. How has it come to pass that the relatively timid separation of activities being proposed (Barnier project) is under fire, while the dismantling of integrated operators was imposed in certain network industries with no real opposition?

1.2. The relationships between micro and macroprudential policies

After a little thought and procrastination, the ECB has convinced itself that the single monetary policy could not be exercised without getting involved in cleaning up Europe's banking systems. Moreover, the central banks gained experience during the crisis of how useful it was to the proper performance of their mission to have microeconomic information about the state of the financial institutions.

Indeed, the crisis has also changed the conception of the goal of monetary policy. It is now considered necessary to add an objective of financial stability to the traditional objectives, and as a consequence to expand central banks' policy instruments. In addition to monetary regulation strictly speaking, this means adding macroprudential policy, whose mission is to monitor changes in the level and terms of financing, changes in asset prices, and so forth. But this seriously complicates the task of central banks, not only because they will have to coordinate the use of a broader range of instruments, but also because they will probably need to share (or at least coordinate) their new mission with other actors.

At the European level, a Systemic Risk Board (ESRB) exists since 2011, but its recommendations are not binding.[3] So, the formulation and implementation of macroprudential policy still takes place mainly at the national level. And it turns out that the bodies that receive the opinions of the ESRB and are responsible for macroprudential policy differ in their status and competence from one country to another: in France, for example, the Board reports to the Ministry of the Economy, whereas it is connected to the

3. It is worth pointing out that the ESRB's authority covers not only the banking system but extends to the entire financial system (non-bank financial institutions, financial markets) of the members of the European Community.

central bank in the UK, and in Belgium and the Netherlands is simply integrated into the central bank.[4] It could obviously be considered paradoxical that while the microprudential is currently shifting up to the supra-national level, the macroprudential remains within the competence of the Member States – especially since it is perfectly clear that the macro-financial imbalances in the euro zone arose much more out of growth in private sector debt in the countries of the periphery. It now seems clear that differentiated macroprudential policies managed at the European level would have made it possible to modulate the divergent effects of the single monetary policy and of uncontrolled capital flows. At the very least, these national policies need to be coordinated, including with the central bank.

Overall, the institutional arrangements intended to bring financial stability to Europe (and especially the euro zone) create interdependencies between monetary policy, the single supervisory mechanism (for the larger banks), the ESRB and the national authorities responsible for macroprudential supervision. This tangled and perplexing web leads to real scepticism about the possibilities of ensuring coordination between all these bodies. Obviously, things cannot remain like this, so it is necessary to consider either:

— giving the ECB responsibility for all macroprudential policy, which would reinforce its power, perhaps excessively, and would require in return reconsidering its independence;

— or reforming the ESRB by granting it real decision-making power.

2. The false solutions of disintermediation

In reality the fragmentation of the European financial area does not date from the crisis. As far back as March 2007, in its first report on financial integration in Europe, the ECB had already noted (on the basis of indicators of prices and quantities constructed for the occasion) that the equity markets and especially the banking markets were not very integrated.[5]

4. *Cf.* E. Nier et *al*. (2011).
5. *Cf.* ECB (2007).

The crisis simply added a little height to the obstacles to banking integration that were already in place eight or nine years after the launch of the euro. In its March 2007 report, the ECB regretted the insufficient presence of cross-border banks and of mergers and new banks of this type.

The ECB suggested making Europe's financial systems more integrated and more efficient by developing the capital markets, that is to say, through a shift towards the "Anglo-Saxon" model: a system dominated by markets rather than by intermediation.[6] This position is highly debatable, but it is nevertheless re-surfacing today under fairly similar arguments: the disintermediation of financing would help to both minimize the adverse effects of the banks' weaknesses and more easily unify the European financial area.[7] This could take the form of renewed securitization (in which case it would involve a banking disintermediation) or greater access to capital markets. In either case it would mainly affect SME-ETI financing, insofar as the disintermediation of large companies has already existed for a long time.[8] This position is neither realistic nor desirable.

2.1. Stimulate the securitization of credit?

A desire to revive or rather to give a new impetus to securitization may seem to be a surprising and dangerous idea, given that it is well-known that it was a crucial ingredient in the crisis. However, there are various options for making this type of product more secure: reducing its complexity, improving transparency (by increasing the securities held by issuers), homogenizing securitized portfolios, etc. On the other hand, this kind of sale of credit is likely to improve the liquidity of the banks issuing these products, and perhaps their capital ratios as well, thereby reducing financing costs.[9]

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6. *Cf.* J.-P. Pollin (2010).
7. This position is expressed in particular by B. Coeuré (2013), J. Viñals (2013), A. Sapir and G. Wolff (2013). It seems that this proposition also inspired the recent communication of the European Commission on the long term financing of European economy (see European Commission, 2014b).
8. We will not discuss here the securitization of mortgage loans since the crucial issue is to restart lending to business.
9. Also note that with the exception of the United Kingdom, the use of securitization is the practice in countries where the banking system is weak, i.e. the Netherlands (for 17.5%), Italy (12%) and Spain (11.5%).

However, if we stick to the securitization of SME-ETI loans, which are the most strategic, it is clear that the market is virtually nonexistent. For Europe as a whole, the volume issued in 2012 came to only 45 billion euros out of a stock of securitized loans of 158 billion.[10] Furthermore, a large proportion of this volume (approximately 60-70%) was retained by the issuing banks to be used as collateral on the repo market, and especially for their refinancing with the ECB. By comparison, note that in this same year issues of securitized mortgages came to 224 billion euros and transactions 1000 billion.

The idea of reviving securitization is actually based on the assumption, probably a false one, that in the future new regulations will make it more difficult and more expensive for banks to finance SMEs. But there is no evidence for this. Nor is there any evidence that the return demanded by investors on securitized loans (after taking into account the price of the operation and the lack of market liquidity) is lower than the cost of bank financing. Banks today clearly prefer refinancing these loans by recourse to ECB funds or on the interbank market rather than through securitization. And when interest rates rise, it is likely that the inertia of the cost of bank financing, due in particular to the large scale of deposits, will increase the comparative advantage of intermediation.

The best way to facilitate SME-ETI financing is undoubtedly to make the banking system sound again. If it is necessary to go further to improve access to credit for certain businesses, this might be done by using special channels to encourage the refinancing of these loans with the central bank or by giving them public guarantees. But there is little evidence that securitization can help in this area.

2.2. Promoting the development of market financing

One way to overcome the weakness of the banking sector is to promote the use of direct financing. In support of such a shift in the European financial systems, it can be argued that the weight of bank assets in the euro zone is almost triple the level of GDP, while this weight in the United States is only 70%.

10. These figures are found in H. Kraemer-Eis *et al.* (2013).

But the idea that it might be possible to use a few incentives and/or regulatory adjustments to substitute market financing for intermediated financing and facilitate a recovery in financing and thus investment is very simplistic. This is because, first, in the euro zone the difficulties SMEs face in accessing credit affect only a few very countries that were hit hard by the crisis (Greece, Portugal, Italy and Spain), together with the Netherlands.[11] It is very doubtful that it would be possible in these countries to create or develop markets for these SMEs to obtain financing more easily and at a lower cost. Elsewhere the problem of access to credit is virtually non-existent. So it is difficult to see how shifting the financial system towards a "market-oriented" model would represent significant progress.

It is true that financing the capital of start-ups or young companies is a serious problem. But this is a very different issue since the activity of capital investment does not much concern the banks strictly speaking. It primarily involves the intermediation of "business angels", specialized funds or spin-offs from large companies. And it must not be forgotten that equity markets are only marginally a source of capital. They serve, above all, to evaluate companies, to facilitate mergers and acquisitions and to ensure the liquidity of investments made by venture capital funds. This is undoubtedly important for the development of innovations, or at least some of them, but it has almost nothing to do with the motivations for the change suggested for Europe's financial systems or the essential problem it poses.

From this point of view it is essential to understand that there are institutional complementarities between the structure of the financial systems and the economic and social systems in which they operate. A "market-oriented" system demands greater mobility in the allocation of production factors (and thus more job instability) and lower social protection (which is replaced by private insurance). An intermediated system, on the other hand,

11. *Cf.* on this point the ECB survey on access to credit for SMEs-ETIs in the euro zone (ECB, November 2013). For the zone as a whole, more than 70% of companies that requested a loan obtained it in whole or in large part. This rate is however on the order of 40% in Greece and the Netherlands, and a little over 60% in Spain and Italy. But it is on the order of 90% in Germany and Austria and 80% in France, Belgium, and Finland. All data is from between April and November 2013.

promotes lasting cooperation between firms and their employees, their suppliers, and so forth, as is illustrated by the well-known Mittelstand, which is often used as an example of an organization in which coordination is based to a large extent on non-market relationships. These dissimilar financial systems give rise to different kinds of models of innovation and development, but it is not possible to establish an *a priori* hierarchy between them in terms of efficiency.

What a paradox it would be if the construction of Europe's banking union were ultimately to lead to the negation of continental Europe's economic and social model.

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