

THIRD CHAPTER

Financial markets in Europe: From the Single Market to a Banking Union

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At a glance

The current situation

European financial markets are at a turning point. Down through the years, market integration has steadily increased. Since the financial crisis, there have been clear signs of a fragmentation of the banking systems. Banks are increasingly withdrawing into their domestic markets, which is evidence of the profound crisis of confidence in the European financial markets. At the same time, structural problems in the banking sectors have emerged and have become more pronounced owing to the crisis. Many banks in the countries in crisis carry non-performing loans on their books; the risks borne by governments and banks are closely interlinked; many banks are under-capitalized. Economic policymakers now face the threefold task of creating incentives to reduce high indebtedness, setting the right signals for a long-term structural framework for the financial markets, and quelling the acute flashpoints.

Working on the architecture for European financial markets

Since the beginning of the financial crisis, comprehensive reforms have been initiated with a view to creating a new architecture for European financial markets. These reforms run in the right direction: they envisage tougher capitalization requirements for banks, enabling banks to absorb risk rather than relying on the support of government financing. Moreover, uniform standards have been designed to make it easier to restructure large and internationally active banks that are distressed – and if necessary wind them down. In the future, the supervisory authorities will monitor macroeconomic risks more closely and be able to intervene and to impose macroprudential regulations. However, progress is far too slow with many of these reforms – and they do not go far enough. In particular, it has become evident that simply sharpening rules does not suffice if it is left to the respective countries to implement them.

Steps towards a Banking Union

For these reasons, initial steps have been taken toward putting a Banking Union in place. The goal is to place the responsibility for enforcing the new rules at the European level. This would make it easier to thwart the transfer of risks to the European level. Liability for bank risks and supervision of the banks would then be located in a single entity. However, the actual plans to realize a Banking Union have been limited hitherto to creating a Single Supervisory Mechanism under the aegis of the European Central Bank (ECB).

The Council of Economic Experts views a Banking Union as a logical advance of the Monetary Union and Single Market. However, it considers the plans to date neither mature nor duly secured by treaty. Above all, responsibility for restructuring needs to be transferred to an independent institution, and the required separation of monetary policy and supervision is not yet guaranteed. The Council of Economic Experts has therefore tabled a three-phase concept for the transition to a Banking Union: In the first phase, the necessary institutional and legal conditions would be created. In the second phase, banks would qualify for the transition to a Banking Union. And in the third and final phase, by when legacy assets on bank balance sheets must have been dealt with, a full and comprehensive Banking Union would commence.

Financial markets in Europe: From the Single Market to a Banking Union

251. The European sovereign debt crisis has shown that creating a Single Market for capital within the European Union (EU) has remained an uncompleted project. The EU Single Market is based on the idea of uniform regulations at the European level while leaving responsibility for implementing them to the national level. Banks' cross-border activities call, by contrast, for a pan-European supervisor and central authority to intervene in crisis situations. Otherwise, bank distress can have negative external effects for other countries without it being possible for anyone to intervene as swiftly as necessary in a crisis. In the Euro Area, the single monetary policy has additionally created incentives to defer problems in the banking sectors and simply shift the risk to the European level. Acute crisis management is therefore going hand in hand with extensive work on the architecture of the European financial market. Creating a Banking Union is meant to place responsibility for central aspects of supervision at the European level.

In principle, the Council of Economic Experts considers a Banking Union to be a meaningful complement to the Single Market and the EMU. However, careful groundwork must first be laid in order to ensure sufficient powers and suitable incentives at the European level. The European level must be vested with the authority to supervise, restructure and, if necessary, wind down banks. Moreover, liability and supervision must be at the same level. A Banking Union is not the key to overcoming the current banking sector crisis, as implementation of the necessary steps will take time. First, the necessary legal and institutional foundations need to be laid to even enable banks to join a Banking Union.

In the context of crisis management, care must be taken that the possible recapitalization of banks involves the corresponding transfer of control rights. Banks that do not have a sustainable business model must be restructured and, if necessary, wound down. Until supervisory and restructuring powers are transferred to the European level, the member states should themselves be liable for the bank recapitalization funds drawn down from the European Stability Mechanism (ESM).

I. Recent developments in the European banking industry

1. Increasing fragmentation of the Single Market

252. Until the start of the financial crisis, the integration of the European financial markets had progressed, not least owing to the introduction of the Euro. German banks had more than doubled their share of foreign assets from around 14 % of the balance-sheet total in December 1998 to just short of 30 % in December 2006, whereby 45 % of the exposures were from Euro Area member states. This attests not only to improved market integration but also reflects the emergence of excessive debt levels financed by importing capital from abroad.

253. Since the financial crisis broke, this trend toward greater financial market integration has been reversed. Instead, increasing market fragmentation is witnessed (European Central Bank, 2012a; Hildebrand et al., 2012; Rose and Wieladek, 2011), as reflected above all in the TARGET2 balances. In July 2012, foreign assets held by German banks had dropped to 22 %

of the balance-sheet total. In the interbank market, the share of cross-border transactions has declined, and increasingly domestic assets are used as collateral for refinancing operations with the European Central Bank (ECB); interest premiums for cross-border bank transactions have risen, and corporate interest rates differ in part sharply from one Euro Area member state to the next (Chapter II Chart 35).

254. Market fragmentation is an expression of the profound crisis of confidence in European financial markets. In addition, political and regulatory incentives have prompted banks to scale back foreign activities. As part of the European Union (EU) state aid procedures, banks face stipulations requiring the closure of foreign branch offices (Zimmer and Blaschczok, 2012; European Commission, 2009). The supervisors have evidently pushed for a greater focus on national markets; political pressure not to impair the provision of loans for the domestic economy might have played a role as well.

255. Whether increasing fragmentation will help stabilize the markets is not clear. In lesser integrated markets, there is less risk of being hit by a system-wide crisis. However, if there is a less tightly woven network of linkages between banks, then the banks are less able to share country-specific shocks (Allen and Gale, 2000). Moreover, information and price effects imply a risk of cross-border contagion without any direct contractual linkages between banks (Box 10).

Box 10**Financial institutions: Systemic risks and the threat of contagion**

Distress of a single bank can lead to contagion if it spills over to other banks and, ultimately, threatens the stability of the entire financial system. The risk an individual institution can have for the entire system is called its systemic risk (AR 2009 items 210 ff.). Both, direct and indirect channels of contagion need to be considered when identifying and quantifying systemic risks.

Direct contagion arises from interbank loans or credit default insurance (credit default swaps, CDS) (Allen et al., 2010). It is hard to measure direct links between banks empirically, given the lack of data on CDS contracts and interbank loans. Various empirical analyses confirm the importance of interbank loans as a channel of contagion (Cocco et al. (2009) for Portugal; Elsinger et al. (2006) for Austria; Degryse and Nguyen (2007) for Belgium and Iyer and Peydró (2011) for India). Using network models, the impact of the default of one bank on the entire system can be simulated. These models require an immense volume of data. Duffie (2011) therefore suggests asking banks directly on predefined stress scenarios. However, financial institutions probably do not exactly know what risk of contagion they constitute, and they have little incentive to disclose it.

Indirect channels of contagion arise through price and information effects. In particular, so-called fire-sales mechanisms have been studied in depth in recent years (Greenwood et al., 2011; Shleifer and Vishny, 2011, 1992; Wagner, 2011; Allen et al., 2010; Brunnermeier and Pedersen, 2009). If a bank is forced to sell assets to compensate for losses, then this can trigger a downward spiral of asset prices. Given the drop in price, other banks holding similar assets will then be forced to write down asset values. Information disclosures can have a similar effect (Acharya and Yorulmazer, 2003): If depositors regard the distress of Bank A as a signal that Bank B could get into similar difficulties, they will withdraw their deposits and will ipso facto leave

Bank B distressed solely owing to their negative expectations.

Indirect contagious effects through the fire-sales channel have been explored by Greenwood et al. (2011) in a simulation study for the European banking system. It shows that the systemic risk exerted by a single bank depends on its capitalization, the liquidity of its assets, and its size. Smaller banks that are not very diversified or liquid and are poorly capitalized can be important sources of systemic risk. Acharya and Steffen (2012) use the concept of “systemic expected shortfall” based on market data to define the systemic risk of individual banks in Europe. This concept implies that systemic risk depends on the capital requirement a bank has in a given stress scenario, relative to the banking system’s capital requirement (Acharya et al., 2010). The Co-Value-at-risk (CoVar) model developed by Adrian and Brunnermeier (2008) likewise uses market data (AR 2009 Box 8). An implicit assumption is that market prices embed sufficient information on contagion effects.

2. Structural problems in the banking industry

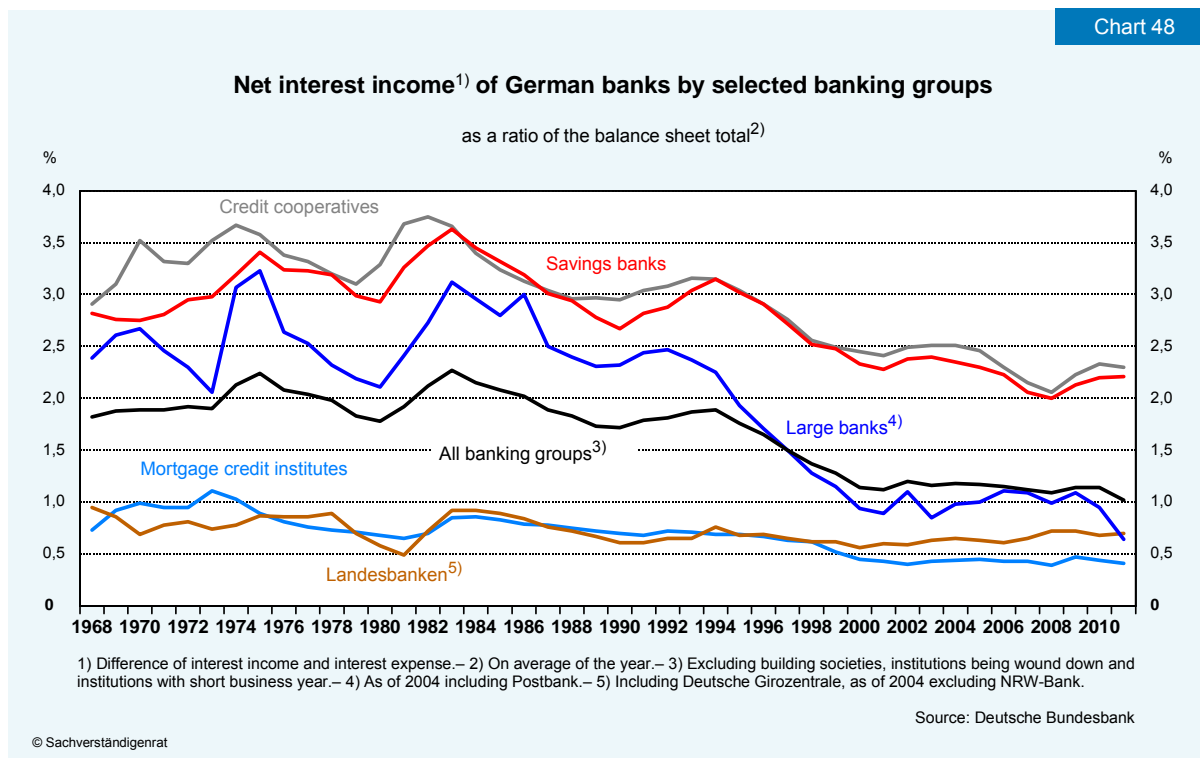
256. The sovereign debt crisis highlighted and aggravated existing structural problems in the banking sector. Moreover, the crisis has given rise to greater financial market regulation, which will threaten the economic viability of some banks. Policymakers should therefore now not only focus on short-term crisis management, but also on creating a suitable framework for solving the long-term structural problems in the banking industry and for allowing larger banks to become insolvent, if necessary.

257. These structural problems take different shapes:

(i) In order to be able to absorb losses without outside help, banks must have **sufficient capital buffers** and thus adequate profit margins – without assuming excessive risk. In Germany, profit margins differ across banking groups, and banks with low margins were especially hard hit by the financial crisis (Chart 48; Expertenrat, 2011). Since the crisis’ peak, European banks’ capital ratios have improved but the banks still have insufficient buffers to be able to absorb risks on their own (European Central Bank, 2012b). Policymakers must therefore address the challenging task of creating medium- to long-term conditions for banks to reduce their leverage while giving them an incentive not to disburse existing profits in the form of dividends. There is a need for transitional periods because raising capital requirements in the crisis would have procyclical effects and aggravate the crisis.

(ii) Recent years have seen a change in banks’ revenue and financing structures, leading to their greater **exposure to market risks**. As a ratio of the balance sheet total, interest income has fallen, while revenue from non-interest business has increased (Chart 49). Non-interest income is more volatile than interest income, hence banks’ revenues thus now entail greater risk (Brunnermeier et al., 2012; DeYoung and Rice, 2004). Moreover, in the case of financing through the bond markets, the proportion of secured financing has soared specifically among banks in the countries in crisis (European Central Bank, 2012b). Many banks in these countries are reliant on ECB financing at favourable terms. A regulatory regime must

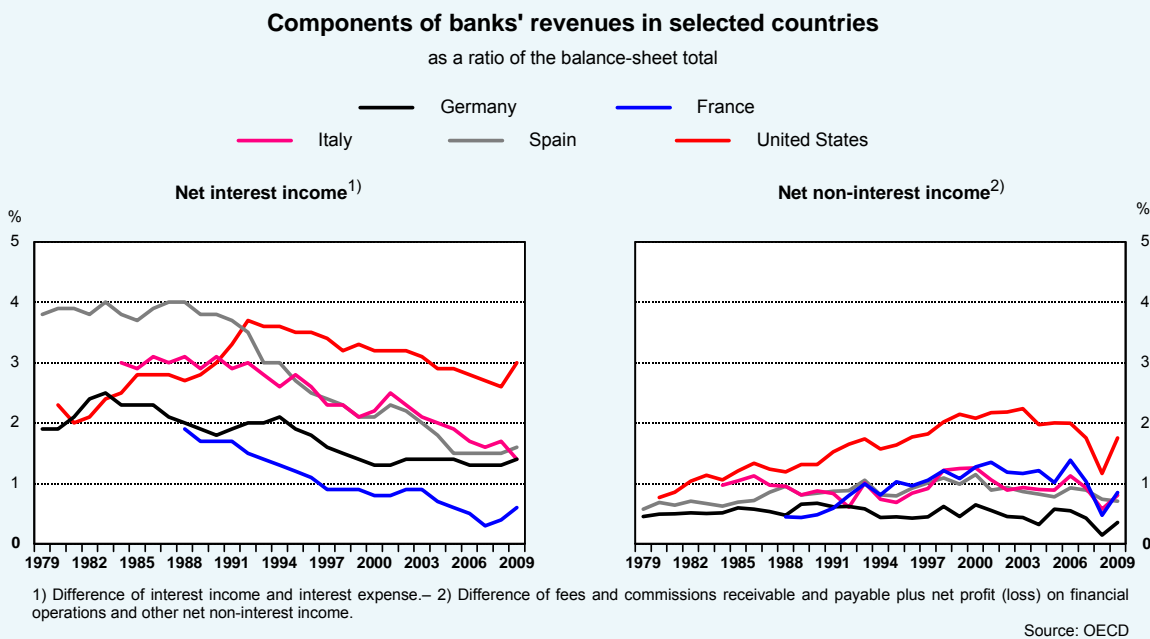
therefore be created that renders banks more impervious to market risk and reduces their dependence on ECB financing.



(iii) Government influence on banks (be it by a direct stake in a bank's equity or by political) can have negative effects. In the current crisis, the reciprocal **links between banks and governments** have actually got worse. Governments have shouldered far-reaching guarantees for (private) deposits (Panetta et al., 2009; Petrovic and Tutsch, 2009; Stolz and Wedow, 2010). Banks are increasingly holding bonds issued by their home country government, especially in the countries in crisis. On balance, depositors tend to view banks in the fiscally strong countries as being less risky than banks in highly indebted countries (Acharya and Steffen, 2012). Government guarantees, the full cost of which banks do not bear, create the wrong incentives. Studies of German banks, for example, show that the probability of a bank becoming distressed rises if it can expect a bail-out (Dam and Koetter, 2012). In the long-term, banks must provide financing for the real economy without resorting to public support schemes. Competition should not be distorted by subsidies for individual banks or banking groups.

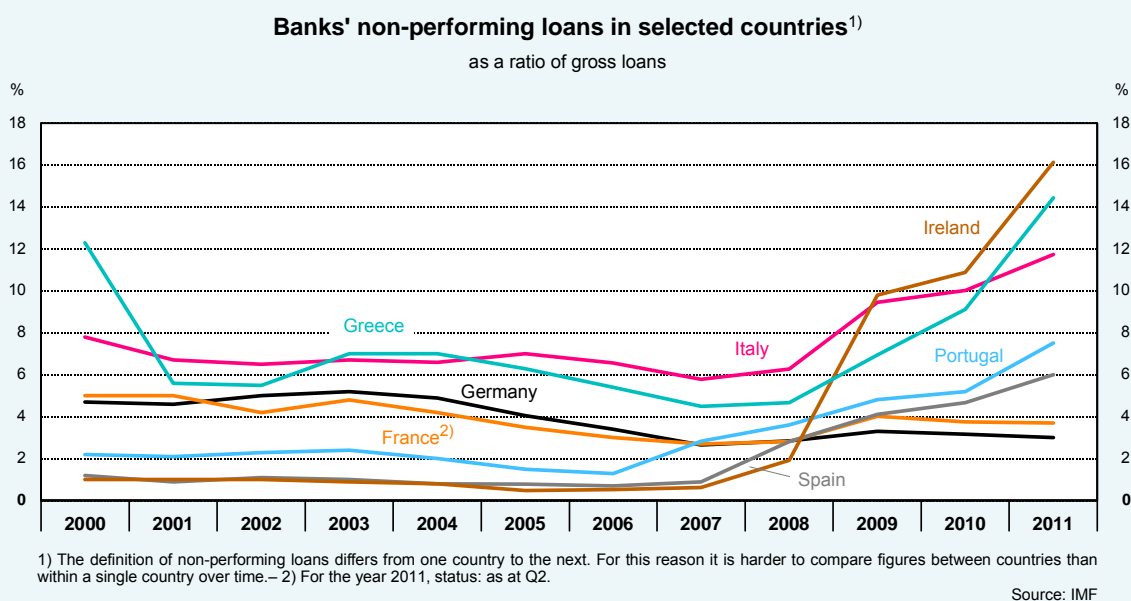
(iv) **Complexity and interconnectedness** of banks make effective restructuring harder in the event of a crisis. In the years prior to the crisis, financial institutions increasingly took up financing through the interbank market, enabling the short-term exchange of liquidity. However, at the same time, banks became more prone to systemic shocks. Moreover, globally active banks have complex international asset holdings. For example, the major German banks on average have branch offices in 40 different countries (Buch et al., 2011); even smaller banks hold assets, on average, in ten countries. Bank restructuring thus requires great coordination cutting across different legal systems. A restructuring and resolution regime for banks needs to be put in place to tackle this problem.

Chart 49



(v) The clearest expression of the problems in the European banking sector is the volume of **non-performing loans**, which climbed sharply during the crisis (Chart 50). Banks that are encumbered by non-performing loans cannot adequately support the necessary structural adjustments in the real economy. There is the risk of a Japanese scenario in which for many years unsolved problems in the banking sector impeded both investments and growth (Chapter II item 192). It is thus imperative that the problem of legacy assets be solved fast (SR Annex I item 58).

Chart 50



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3. Guidelines for crisis management

258. The problems in the European banking sector call for comprehensive reforms. Liability mechanisms in the banking sector need to be put back in place, and the insolvency of (larger) banks must in principle be possible. Supervision of banks must become more effective, and a suitable regulatory regime needs to be imposed to reduce the risks to the financial system as a whole. Reforms that are already under way are only making very slow progress and are hindered by the legacies of the past (item 262).

259. The acute crisis management must not wait until a new long-term structural framework has been created. In its Special Report of July 2012, the Council of Economic Experts outlined the cornerstones of effective crisis management (SR Annex I items 57 ff.). The backbone of the approach is to recapitalize banks and, at the same time, cede control rights to state agencies. Distressed banks should be restructured and if necessary wound down such that the banks remaining in the market have sustainable business models and can survive without government assistance. To the extent that banks can be restructured only by taking up common financial resources from the European Financial Stability Facility (EFSF) or the European Stability Mechanism (ESM), the respective government should be liable for the sums involved.

260. These principles have a direct bearing on the treatment of distressed banks in Spain, which filed for support for its banks from the EFSF. The conditions under which the relevant funds will be furnished were laid out in a Memorandum of Understanding (MoU) (Box 11). The actual implementation of the MoU is currently still under discussion.

Box 11

Recapitalizing Spanish banks

On 25 June 2012, the Spanish government filed for financial assistance from the European Financial Stability Facility (EFSF) to recapitalize its banks. On 20 July 2012, the Euro Area finance ministers agreed to this after the request had been examined by the European Central Bank (ECB), the European Banking Authority (EBA), and the International Monetary Fund (IMF). The terms were set out in a Memorandum of Understanding (MoU) with the Spanish government. Spain will thus receive a total of up to EUR 100 billion in financing, a figure intended to cover the maximum expected recapitalization requirement for the Spanish banking sector plus a safety buffer. The funds will be disbursed in several tranches, with the EFSF making a sum of EUR 30 billion available in advance to provide short-term coverage for Spanish banks' immediate financing needs. The financial resources will be paid out direct to the Spanish bank rescue fund Fondo de Reestructuración Ordenada Bancaria (FROB), which passes them on to the banks. The Spanish government is liable for repayment of the entire financial assistance received.

In line with the Euro Group's resolutions of 29 June 2012, the European Stability Mechanism (ESM) replaces the EFSF without, however, assuming the role of a senior creditor. Moreover, the resolutions envisage direct allocation of funds to distressed banks if a single supervisory mechanism has been established for banks in the Euro Area. This would also apply to Spain.

Since July 2012, the Spanish authorities have been devising restructuring and resolution plans for those banks that are already supported by the FROB. In mid-September, Spain's parliament enacted the legal framework to improve crisis management and establish a bad bank. The terms of the MoU refer either to individual banks (bank-specific conditionality) or to the banking sector as a whole (horizontal conditionality) because the financial assistance is exclusively to be used to recapitalize banks. Moreover, the MoU refers to Spain's obligation in the overall process to curb excessive deficits and to implement the recommendations made in the context of the European Semester (item 170). Although no additional conditions are set in this regard, disbursement of the tranches could be made contingent on fulfilment of these obligations. The European Commission together with the ECB and EBA will monitor implementation of these terms, while the Spanish authorities have committed to applying to the IMF for technical support.

Central elements of the **bank-specific conditionality** are first of all to define the capital requirements of individual banks, then to recapitalize them, and finally (to the extent that government finance is injected) to enforce their restructuring or winding-down, with the distressed assets transferred to an external bad bank. The capital requirements of the individual banks were evaluated by external auditors by means of a stress test and gauged to be around EUR 60 billion (status: 28 September 2012). The stress test was carried out for 14 banking groups including those already supported by the FROB, thus covering about 90 % of the Spanish banking industry, but excluding revaluations of Spanish treasury bonds. On the back of the stress test, after consulting the ECB and EBA, the Bank of Spain (Banco de España), and the European Commission then defines the capital requirement of the individual banks. The banks must submit plans how to cover the shortfall in capital from private and government sources. Possible coverage using private funds must be complete by 30 June 2013. If the sum is more than 2 % of the risk-weighted assets, the FROB must in addition float convertible bonds that are then converted into shares if the capital shortfall has not been filled by the respective deadline.

Banks that rely on government financing must devise restructuring or resolution plans. The objective is to put a long-term viable business model back in place and minimize the state funding required. The plans must state what assets will be outsourced to the external bad bank. Shareholders and owners of hybrid and subordinate debt instruments must be included among those covering the losses. Profit disbursements and variable remuneration on hybrid bonds shall be suspended and executive salaries capped. Banks that do not have a viable business model will be wound down. Only after the European Commission approves the plans can the banks be recapitalized through the FROB using funds from the EFSF/ESM. It has not yet been decided whether the FROB will possess effective control rights over the banks through the convertible bonds. A monitoring trustee who reports to the European Commission will be appointed to watch over implementation of the restructuring plans.

In the context of **horizontal conditionality**, capital requirements for all Spanish banks will be raised and the regulatory framework for the banking industry as a whole further strengthened; this will include application of the new capital definitions set in Basel III and improvement of the legal basis for crisis management in the banking sector. In particular, the FROB will be vested with the authority to wind down banks, and the Banco de España's independence as the banking supervisor will be bolstered.

261. On balance, the terms of the MoU are in line with the principles the Council of Economic Experts identified for short-term crisis management (SR Annex I items 56 ff.). The

individual steps for bank recapitalization, restructuring and resolution are set such that there can be guaranteed control by agencies that are sufficiently independent of political influence. Recapitalization using government funds is only the first step, to be followed by restructuring and, if necessary, winding-down. In particular, incentives were created for ensuring that creditors and shareholders participate suitably in the losses. The MoU states, for example, that losses incurred because of insufficient participation of creditors shall not be covered by EFSF funds but must be financed by the Spanish government.

In case of government recapitalization of a bank, the Spanish authorities should actually gain control of the bank in question – by acquiring shares or through sovereign measures. Conditionality imposed on the banks becomes all the stronger, the greater the need for government funds. This fact could prove to be extremely critical as there is an incentive for banks to develop recapitalization plans in order to avert the need for injections of government funds and thus a corresponding outside takeover of control. Another potential problem in the implementation phase is that it is initially up to banks to decide how to cover their shortfall in capital. In other words, there is the danger that banks will simply sharply cut back loan supply.

II. Working on the architecture of the European financial market

262. The financial crisis has exposed weaknesses in the international financial system's regulatory regime. In Europe in recent years, countless regulations have been initiated (AR 2011 items 256 ff., 269 ff.; AR 2010 items 252 ff.). Efforts to reform **banking regulations and supervision** are now continuing with the European implementation of the revised capital adequacy framework for banks (Basel III). Tasks and responsibilities are being defined for safeguarding financial system stability (macroprudential supervision). Moreover, the European Commission has tabled a legislative proposal for a harmonized **recovery and resolution regime** for distressed banks (items 293 ff.).

On the whole, these regulations are in line with the principles of the EU Single Market to date and thus with the principles of minimum harmonization, home country control, and mutual recognition. At the European level, a regulatory regime is set to which national legislation shall adhere. The responsibility for supervision is entrusted to the national supervisors. With the exacerbation of the sovereign debt crisis, many of these reform efforts have been superseded by proposals focusing on stronger centralization of supervision in the context of a Banking Union (items 293 ff.).

1. Banking regulation and supervision

263. Increased capital requirements form the very heart of more stringent banking regulations. They are intended to render individual banks more stable and resistant to shocks (**microprudential regulation**). Capital requirements also play a key role in stabilizing the overall financial system (**macroprudential regulation**). The higher the equity capital banks carry on their balance sheets, the lower the negative impacts triggered by system-wide contagion (Box 10).

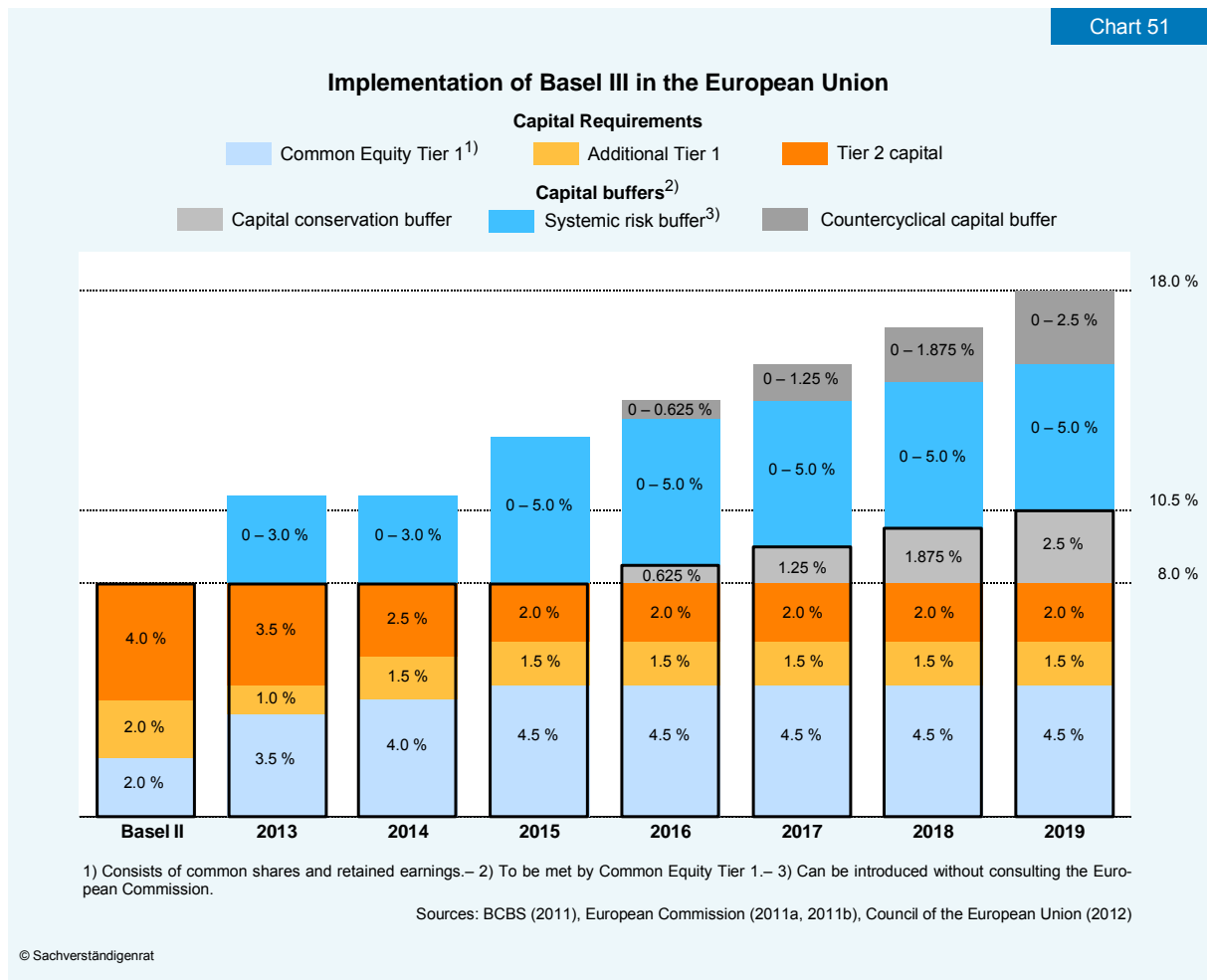
264. For higher capital adequacy ratios for banks (Basel III), the framework agreed by the Basel Committee on Banking Supervision (BCBS) in 2010, is now about to be implemented in Europe (AR 2011 items 275 f.; AR 2010 items 253 ff.). The European Commission has taken on board the key elements of Basel III in its proposals for legislation – issued as a Capital Requirements Regulation (CRR) and a Capital Requirements Directive IV (CRD IV). The translation of key components of banking regulations into a directly applicable regulation reduces the national scope for prudential discretion. Previous national discretionary rights have been reduced, contributing to the creation of a **Single Rule Book**. Although the European regulations are supposed to come into force on 1 January 2013, negotiations between the European Parliament and the Council of Ministers on the Commission’s proposals have not been completed.

Microprudential regulation

265. Regulations at the level of individual banks (microprudential regulation) are supposed to ensure that financial institutions possess a minimum level of liable equity capital as a ratio of their risk-weighted assets. Risk weights are set by means of the standard method or on the basis of the banks’ internal risk models.

The tighter capital adequacy ratios according to the Basel III framework bring three levers to bear: the minimum ratios to be met, the quality of the liable equity capital, and the risk weights to be applied. By the year 2019, minimum capital requirements will be raised from the current 8 % of risk-weighted assets to 10.5 %. These will then be supplemented by additional macroprudential capital buffers, meaning that the capital adequacy ratio can in total be as much as 18 % of risk-weighted assets (Chart 51).

266. Moreover, Basel III tightens the definition of regulatory equity capital. As of 2015, the Common Equity Tier 1 (CET 1) capital ratio must be at least 4.5 % (AR 2010 item 255). Expanded duties to deduct holdings of CET 1 instruments of other institutions limit the “multiple use” of equity in the financial sector. The CRR departs from the Basel rules in that it states that, under certain circumstances, investments in insurance companies need not be deducted from CET 1 capital (BCBS, 2012). Moreover, supervisory agencies are to be permitted to allow banks to not deduct investments in companies belonging to the same banking network. In other words, in Germany, credit cooperatives and savings banks would not need to deduct their investments in Landesbanken or cooperative central banks from their CET 1 capital. This flies in the face of the goal of creating harmonized rules, however.



267. The planned European regulations still deviate from Basel rules as regards the **risk weights** for certain asset classes. As regards **government bonds** issued by EU member states, the CRR maintains its zero weighting, meaning that even banks which calculate positive risk weights using their own internal risk models would not hold equity capital against their investment into government bonds (BCBS, 2012). The European Parliament suggests that the CRR be supplemented such that banks shall not carry “excessive volumes” of governments bonds from one particular country (European Parliament, 2012). Details are yet to be specified. In addition there is on-going discussion as to whether the risk weights for loans to small- and medium-sized enterprises should be lowered.

268. These debates highlight two basic problems when setting the risk weights. Firstly, the question what assets need to be covered by equity capital and to what extent is a highly political one. There are fears that higher capital adequacy ratios could push up financing costs for certain debtors. The relevant policy issue is, however, the extent to which higher bank capital helps reduce risks to the stability of the financial system. Overall, the welfare effects of higher capital ratios is likely to be positive (Admati et al., 2011). Secondly, there is much uncertainty when it comes to quantifying bank risk (Hellwig, 2009). The risk models banks use are correspondingly complex and thus not transparent for the supervisors. Extraordinarily elaborate calculations are needed to determine the risk weights for large banks (Haldane,

2012). Furthermore, the sheer scale of the regulations has grown considerably; while Basel I was 30 pages long, Basel II had 347 pages and Basel III is now at 616 pages.

269. Given the problems in defining the risk weights, Basel III introduces a **leverage ratio** that sets regulatory capital in relation to the sum of non-risk-weighted assets and off-balance-sheet items (AR 2011 items 289 ff.; AR 2010 items 262 ff.). In the course of implementing the leverage ratio in Europe, banks will first be obliged to report the leverage ratio to the supervisory agency as of 2013 and to disclose it to the market as of 2015. By contrast, the introduction of a binding floor for the leverage ratio has not been incorporated into the CRR. Although the European Commission champions the goal of deploying the leverage ratio as a minimum supervisory requirement, the CRR has to date lagged behind the Basel III agreements. According to Basel III, the leverage ratio shall constitute a compulsory element of minimum capital adequacy requirements in 2018 (Pillar 1 of the Basel Accord).

270. The leverage ratio has a decisive advantage compared to the capital requirements to date. It is largely immune to erroneous risk assessments and to any manipulation of risk weights. A leverage ratio limits the incentive for banks to systematically underrate the risks in their internal risk models (Blum, 2008). The example of Commerzbank shows the degree of discretion banks enjoy: in its annual report 2011, Commerzbank says it reduced the capital shortfall identified by EBA in its capital exercise, amongst other things, by re-evaluating the value of its risk-weighted assets by “updating the parameters” and relying on “improved data quality for loan collateral”.

One argument often brought forward against the leverage ratio is that banks’ business volume as the basis for the ratio cannot be quantified with sufficient accuracy given their off-balance-sheet activities. This argument is not compelling, as it would apply to the risks arising from such transactions as well. It has also been argued that introducing a leverage ratio results in risks not being duly considered. This is specious for supervisors should continue to monitor bank risk models. Moreover, to the extent that, with the introduction of a leverage ratio, banks would have more equity capital, they would themselves be incentivized to focus more strongly on their risks. Generally, both capital ratios based on risk-weighted assets and the leverage ratio can give banks an incentive to behave improperly. Only a strong set of instruments and incentives for the regulators to use these tools and their discretionary scope will in the final instance give rise to a sustainably stable banking system.

Macroprudential regulation

271. In line with Basel III, CRD IV introduces two new elements into capital regulations: a **capital conservation buffer** and a **countercyclical capital buffer** (Chart 51). The aim is to reduce the procyclical effects of the capital requirements. In upturns, loan supply is limited by higher capital requirements, which help in the subsequent downturn to absorb losses (cf. Gersbach and Hahn (2010)) for a theoretical discussion). If a bank falls short of the capital conservation buffer, the supervisor can restrict dividend payment and variable management pay.

While the capital conservation buffer is fixed, the countercyclical buffer is set by the national supervisory agencies. Banks with purely national operations have to meet the standards set for their country, while those with international operations have to meet the weighted average for all national capital buffers. In addition, minimum capital adequacy requirements in Europe can be fleshed out on a case-by-case basis by the respective jurisdictions. Thus, national supervisors can demand additional equity of up to 3 % (as of 2015: 5 %) of risk-weighted assets (AR 2011 item 276; Council of the European Union (2012)); standards that go beyond this have to be consulted with the European Commission.

272. European macroprudential supervision has since 2011 been entrusted to the European Systemic Risk Board (ESRB) (AR 2011 items 257 ff.; AR 2010 items 285 ff.). The task of the ESRB is to identify systemic risks and issue warnings and recommendations. It is up to national supervisors whether they deploy macroprudential regulatory instruments. To make certain they have a clear mandate to do so, the ESRB has recommended to member states that they establish national macroprudential regulators.

273. At the end of October 2012, German Parliament enacted a corresponding “Bill to Strengthen Financial Supervision”, which will come into force in early 2013. The law envisages amongst other things that a **German Financial Stability Board** be established at the Federal Ministry of Finance (BMF), which analogously to the ESRB will identify systemic risks and issue warnings and recommendations. The committee will be made up of three representatives each of the BMF, Deutsche Bundesbank, and the Federal Financial Supervisory Authority (BaFin) and (in a consultative capacity) the head of the Federal Agency for Financial Market Stabilisation (FMSA). Committee resolutions will in principle require a simple majority. Decisions on central instruments (warnings and recommendations) should be unanimously taken wherever possible. Where this is not the case, resolutions must have the agreement of the Deutsche Bundesbank representatives. Addressees are the German government, BaFin, and other German public agencies. The law also serves to strengthen BaFin’s independence of the financial industry and improves its ability to recruit qualified personnel.

Summary

274. The Council of Economic Experts believes the planned tightening of banking regulations is in principle suitable to easing the hitherto strongly procyclical effects of the capital adequacy rules for banks. However, the leverage ratio has distinct advantages compared to a risk-weighted capital adequacy ratio. It is a weakness of the European legislation that to date there are only plans for disclosure of a leverage ratio – and with a not inconsiderable time lag. Instead, a leverage ratio as an unweighted capital adequacy ratio should take center stage and not simply be deployed in a subsidiary manner alongside the risk-weighted capital adequacy ratio (AR 2011 item 293; Haldane, 2012; Wissenschaftlicher Beirat beim BMWi, 2010). In the medium term, banks should adhere not only to the risk-weighted capital adequacy ratios but also to a **leverage ratio of at least 5 %** of their business volume as defined in Basel III, i.e., including off-balance-sheet items (AR 2011 item 294).

275. The planned countercyclical capital buffer is a useful macroprudential policy tool, but it is certainly no panacea. It does not free supervisors of the duty to additionally bring discretionary power to bear: for example, dynamic provisioning such as was used in Spain before the crisis as a countercyclical regulation tool did not prevent price and credit bubbles. There is also the danger that national supervisory authorities are not sufficiently independent of national (political) interests. They will possibly act either too late or too hesitantly or even not at all. Therefore, it bears considering having a central institution such as the ESRB define the countercyclical buffer in order to take better account of the risks innate to the European financial system as a whole.

276. The foundation of the ESRB and of its German counterpart are both steps in the right direction. However, these bodies have only been granted very limited information and intervention rights. These agencies should thus be granted far better access to supervisory data. The goal must be for all institutions with supervisory functions to be furnished swiftly with the requisite information. It would likewise make sense to have the German Financial Stability Board be supported by an independent academic advisory council; proposals of this type have long since been put forward as regards German bank supervision (Hartmann-Wendels et al., 2009). Finally, when setting national macroprudential standards, there is a certain risk that monetary policy gets renationalized. For this reason, the framework for national macroprudential supervisory agencies should be designed to ensure national policy measures can be taken only in close collaboration with the European authorities.

2. Restructuring and resolution regime

277. The mechanisms for handling distressed banks proved to be insufficient during the financial crisis. Unlike the vast majority of past instances of bank insolvencies, it was now major banks with international operations that faced the threat of bankruptcy. This threatened the entire banking system. Owing to the complexity of contractual relationships, it was not possible, as in a normal case of insolvency proceedings, for all contractual payments initially to be suspended. This would be necessary for creditor claims to be weighed up against one another, and for a bank to slowly be wound down or restructured. Moreover, the existing depositor protection schemes would have been insufficient to cover losses. As a result, in Germany, a new institution was founded, the Financial Market Stabilisation Fund (SoFFin), which was then assigned the task of restoring or winding down the banks that had received government support.

278. What these problems have demonstrated is that specific procedures for restructuring and winding up banks are needed in order to mitigate the systemic impact of (pending) bank insolvencies and enable larger banks to exit the market. In the case of a financial institution threatened with extinction, restructuring focuses on preserving all of it or at least those parts critically required to maintain financial system stability. By contrast, in the course of resolution, which leads to a bank being dissolved, the assets will be individually liquidated and creditors paid off.

279. In 2010, **German bank insolvency law** was subjected to comprehensive revision. In the guise of the Restructuring Act, BaFin's prevention and crisis intervention powers were expanded, two independent procedures for restructuring banks (recovery and reorganization) were introduced, and a resolution fund set up to be financed from a bank levy. The Council of Economic Experts welcomed part of the Restructuring Act, such as the expanded powers for BaFin and the creation of the resolution fund (AR 2010 294 ff.). By contrast, the processes banks shall conduct at their own responsibility are at best redundant as there are hardly any incentives for banks to undertake such (AR 2010 items 295 ff.). Scepticism is in order as to whether the instruments created by the Restructuring Act suffice to ensure a suitable and orderly restructuring process of large banks with cross-border activities. The supervisory procedures are not straightforward, and there are no clear responsibilities involved (Hellwig, 2012). In an international context, sovereign acts by BaFin may not necessarily have any bearing on assets held outside Germany (Zimmer, 2010).

280. In June 2012, the European Commission tabled a directive that would set **uniform minimum standards** for handling distressed banks (European Commission, 2012b). The directive has three pillars: firstly, all national agencies would have a uniform minimum range of instruments for crisis prevention and intervention. Secondly, all member states shall have pre-financed funds with which to restructure and wind down banks. Thirdly, coordination mechanisms would be introduced to facilitate supervisory intervention against banking groups with cross-border activities. Member states would be authorized to furnish their agencies with specific instruments applicable to that country. Member states can also define which agencies will handle bank restructuring and resolution. In order to counter incentive problems, the directive opts for separate supervisory as opposed to resolution organizations to the extent that the two functions are handled by one and the same agency. Thus far, the Commission assumes the new regulations will not come into force until 2015.

Prevention and early intervention

281. The Commission's proposed directive suggests that every EU credit institution should present a **financial recovery plan** and update it on a regular basis. The plan should specify the steps that can be taken if the bank is in danger of becoming distressed. Moreover, the national resolution agencies should compile **resolution plans** for each bank that must likewise regularly be updated. An effort should be made to reduce possible obstacles to resolution, such as excessive complexity.

282. Preventative resolution plans can help enhance the transparency of large financial institutions, create incentives to reduce complex structures, and thus essentially increase the ability to ensure their resolution (AR 2010 item 293). However, the benefit of resolution plans made without any cause seems dubious in the least. While the requisite disclosure of information to the supervisory authorities can be meaningful, as it augments an exchange of data between the national supervisory authorities, it does not eliminate the fundamental information asymmetry between authorities and financial institutions. The former can hardly define weaknesses and obstacles to resolution in advance. Moreover, problems that may arise from the risk of contagion will remain hardly predictable (Box 10).

283. The proposed directive envisages preventative measures as soon as violations to regulatory standards are pending. This is comparable to the situation in Germany, where BaFin can take measures if it expects that capital adequacy or liquidity ratios will not be met. Moreover, according to the directive, a **special manager** can be appointed for one year at the most who takes over management of the bank if there is a threat to its solvency. The special commissioner under German supervisory law plays a similar role, albeit with responsibility only for specific business areas and without replacing management.

Instruments for restructuring and resolution

284. Sovereign powers accorded the resolution authorities form the core of the directive. These powers are supposed to enable **restructuring and resolution of ailing banks** while preserving the stability of the financial system. Similar to the Transfer Decree under German law, important functions of the threatened bank can be maintained. To this end, sections of the bank are spun off and control transferred to a new legal body, while the remainder enters standard insolvency proceedings. The usual insolvency proceedings then continue to be applied, for example if smaller banks that do not threaten system stability become distressed.

A bank may be restructured or wound down only if bankruptcy cannot otherwise be averted and if there is a **public interest** in averting bankruptcy. The proposed directive outlines various goals: averting a threat to the financial system's stability, protecting public finances, or protecting investors and clients. Hence, the conditions for winding a bank down are broader than under German law, which exclusively focuses on the threat to a bank's survival and the threat to financial system stability. Instead of pursuing a bundle of goals, it would make more sense to take financial system stability as the overarching goal. The reason is that the resolution of a bank entails massive intervention in ownership rights and should be performed only as the last resort.

285. As part of restructuring and resolution, the resolution authorities have four different **instruments** they can use. **Sale of the bank** and a state-owned **bridge institution** are tools for transferring ownership as a whole or in part to another legal body without requiring the owners' consent. By means of a **bail-in**, the authorities are empowered to transform a bank's liabilities into liable equity capital, again without the consent of the creditors affected. **Asset separation** enables the authorities to clean up a balance sheet by transferring impaired assets to an asset management vehicle. This latter instrument may be used only in conjunction with other resolution tools. This to ensure that a restructuring process is started and the shareholders and creditors incur the bank's losses.

286. A **bail-in** allows for a distressed bank to be recapitalized or a bridge institution to be provided with capital. At first, the original shareholders bear the losses. Thereafter, subordinate and finally unsecured debt holders incur losses, with the exception of deposits protected by deposit insurance schemes. To protect the financial system as a whole, the bail-in does not apply to short-term liabilities. For the same reason the authorities may exempt derivative contracts. In order to prevent any side-stepping of this, a quota of bail-inable liabilities is stipulated for banks. The directive assumes a transitional phase of several years.

Current plans have the bail-in instrument first coming into play in 2018 and only being applicable to new liabilities.

Financing restructuring and resolution

287. Generally, financial funds are needed to finance restructuring and resolution measures. Therefore, the directive suggests all member states be obliged to establish resolution funds at the national level, so-called financing mechanisms. These, like the German restructuring fund, are stocked in advance by contributions from banks. The sum to be paid in shall be determined by the relative size of the bank, its riskiness, its relevance to the system, and its “resolvability”. All member states shall commit funds totalling 1 % of the insured national deposits to the national financing mechanisms - within ten years of the directive coming into effect.

Given the fiscal costs of banking crises in the past (Box 11), such funds will hardly suffice for the foreseeable future. In Germany, the capitalization of banks by SoFFin alone required a sum of EUR 29.4 billion (FMSA, 2012). This amount does not include future losses from the resolved banks’ asset portfolios. As an example, calculating the volume of the fund on the basis of total bank liabilities to non-banks – which are more extensive than insured deposits - in 2007 such a fund would have had at maximum EUR 28.8 billion and hence would not have been able to cover the capitalization measures by SoFFin. While the directive envisages supplementary ex-post contributions, it will be difficult to raise such contributions in an acute crisis without further destabilizing markets.

288. Under certain conditions, the resolution funds shall be obliged to grant reciprocal loans, irrespective of whether the bank to be wound up is active in the country granting the loan or not. The financing of the resolution measures then relies on a whole array of different sources: first, contributions from creditors and shareholders, then national financing mechanisms fuelled by contributions from banks, (reciprocal) loans taken up by the financing mechanisms, and funds from the deposit insurance systems.

International coordination

289. To ensure better coordination of restructuring and resolution of banking groups with cross-border operations, the directive calls for specific **resolution colleges** made up of representatives of the national resolution agencies. These are analogous to the existing supervisory colleges (AR 2011 item 256). However, the colleges have no decision-making powers, let alone intervention rights of their own. As regards transnational coordination, the EBA’s role is initially limited to advising and supporting the colleges. The colleges can, in the case of dispute, call on the EBA as arbiter; then measures taken by individual agencies must be in line with EBA decisions. On balance, the European-level powers to restructure and resolve banks remain weak.

Summary

290. Overall, the German insolvency regime for banks concurs with the new European proposals. The European Commission's proposed directive actually goes further than the restructuring law in a few areas, such as on the bail-in (Table 21). In principle, the Council of

Table 21

Key areas in which the European Commission's proposed directive goes beyond the German Restructuring Act

	European Commission's proposed directive	Regulations of the German Restructuring Act
Prevention and early intervention	Obligatory preparation of recovery and resolution plans	No rules
	Reduction of obstacles to resolution	No rules
	Deployment of a special manager who replaces management	Special commissioner appointed for certain tasks, as a rule does not replace management
Restructuring and resolution	Several objectives of equal status: <ul style="list-style-type: none"> - System protection - Protection of public funds - Protection of depositors and clients 	Clear objective: system protection
	Compulsory participation of creditors in losses via bail-in	Intervention in creditor rights on principle require the creditors' approval Compulsory participation of creditors in losses possible in subsequent insolvency proceedings
Financing restructuring and resolution measures	National funds, pre-financed from banks' contributions	Restructuring fund, pre-financed by bank levy
	Mutual provision of loans by national fund	No rules
International coordination	Resolution colleges, made up of representatives of the national resolution agencies	No rules
	Inclusion of the EBA	No rules

Economic Experts considers the **bail-in instrument** as outlined in the directive to be **suitable** to restore the liability of debt holders (AR 2009 item 29). However, bail ins have the same downside as does conditional capital, since the contractual structure is complex and can set the wrong incentives. Initiating a bail-in can have a domino effect if the liabilities are mainly held by other banks (AR 2011 Box 11). The risk of contagion could at least be reduced by preventing banks from investing in debt eligible for a bail-in. Banks would then not hold debt that would expose them to a special risk of loss in the event of insolvency. This does not of course include the risks from other contractual relationships that the banks, like any other creditor, still have to bear.

291. In the opinion of the Council of Economic Experts, both the pan-European introduction of pre-financed resolution funds and risk-based contributions of banks are steps in the right direction. **However**, the reciprocal unconditioned obligation for the national financing mechanisms to **grant loans** is very critical. Moreover, the proposed directive considers drawing on the central banks for financing. National financing mechanisms granting loans are neither tied into the resolution process, nor are they able to monitor use of the financial resources. Unlike the current system, where the ESM can be drawn on for reciprocal support during a banking crisis, there is no strict conditionality. To this extent, the proposed directive would eliminate democratic control of the mutual assistance and the attendant risks.

The Council of Economic Experts warns against the reciprocal obligation to grant loans and the possible inclusion of central banks in the financing. Both features harbour the considerable risk of moral hazard at the member-state level. This is not duly weighed up in the proposed directive, which outlines no effective means of control and does thus not prevent future risk taking.

292. The European Commission's proposal can **at best** be considered a **first step** towards winding up a bank that has cross-border activities. In a crisis, the agreements made in the resolution colleges will hardly be binding, with the national agencies retaining the decisive powers. Moreover, there is the danger of these again acting without considering the financial stability in other member states. This problem is exacerbated by the fact that in a crisis the national resolution agencies have to agree on burden sharing before initiating measures. The very fact that national budgets are subject to decentralized control means clear rules have to be established in advance for fiscal burden sharing (item 312).

III. European responsibility in the framework of a Banking Union

1. Proposal for a European Banking Union

293. Efforts to create a new architecture for financial markets rest on the basic principle that control and liability remain at the national level. However, the financial crisis has highlighted the risks associated with purely national supervision. Therefore, there is a debate at the European level on creating a Banking Union (President of the European Council, 2012). This **concept of a Banking Union** hinges on institutions and the related financing mechanisms being transferred to the European level. Accordingly, at the end of the road towards Banking Union, there would be centralized bank supervision, uniform mechanisms for the restructuring and resolution of banks, a common resolution fund and a single European deposit insurance system. The ESM would be utilized as a fiscal back stop if the resources in the resolution fund and the deposit insurance scheme are insufficient.

294. The Euro Group heads of state and government in part included the presidents' concept of a Banking Union in their summit resolutions of 29 June 2012. They called on the European Commission to table proposals for a **Single Supervisory Mechanism involving the ECB**. As soon as this supervisory mechanism is introduced, the ESM shall be able to recapitalize banks directly. Then countries whose banks are recapitalized will no longer be liable for repayment

of ESM funds; instead, default risks are borne by the ESM and thus the countries providing the guarantees.

295. In September 2012, the European Commission submitted a proposal for a Single Supervisory Mechanism. Moreover, the Commission suggested changes to the EBA Directive in order to harmonize the coordination rules for the EBA with the Single Supervisory Mechanism (European Commission, 2012a, 2012c). The other elements of the Banking Union were not affected by these proposals.

The draft regulation stipulates that the ECB will supervise all banks in the Euro Area, possessing almost all bank supervisory powers, in particular information rights, investigative and audit powers, and sanction powers. The national agencies would be obliged to support the ECB in preparing and implementing legal acts and would be bound by ECB instructions. Member states outside the Euro Area could voluntarily take part in the Single Supervisory Mechanism (opt-in).

296. According to the draft regulation, bank supervision and monetary policy will be separated in operational terms. The supervisory competencies will be entrusted to a new management body that reports to the ECB Governing Council. This body consists of a chairperson and a vice-chairperson as well as one representative per national bank supervisory authority. The chairperson will be chosen from the ranks of the ECB Directorate, the vice-chairperson from the ranks of the ECB Governing Council. The ECB President may not be made chairperson of the supervisory body. The ECB's supervisory arm will then be accountable to the European Parliament and the Council of Ministers. The ECB will create a separate budget for bank supervision, financed by a charge paid by the banks being supervised.

297. The Commission suggests that supervision by the ECB will be introduced on a step-by-step basis: In the first step (through 1 January 2013), all banks that have already filed for state assistance will be placed under ECB supervision. In the second step (through 1 July 2013), they will be joined by all major banks, with a corresponding list being compiled by 1 March 2013. In the third step (as of 1 January 2014), all banks shall be included. This more than ambitious schedule has been diluted by the European Council resolutions of 18 and 19 October 2012 which state that the legal framework will be resolved this year and operational implementation will start in the course of 2013.

298. The summit resolutions of 29 June 2012 already refer directly to the idea of bringing the Single Supervisory Mechanism under the legal aegis of article 127 para. 6 TFEU. Thus, the ECB can be assigned "specific tasks (...) concerning policies relating to the prudential supervision of credit institutions". However, opinion is divided whether the regulations of article 127 TFEU cover the wide-scale transfer of supervisory competences to the ECB and to what extent a conflict between supervision and monetary policy arises (Herdegen, 2012).

2. Arguments in favour of European bank supervision

299. Centralizing supervisory authority in Europe means departure from the principle of subsidiarity, and therefore requires justification. Banking risks that require regulation do not stop at national borders. For this reason, optimal coordination between national and international supervision and the potential for regulatory competition has long been an item of discussion (Pistor, 2010; Baltensperger, 2003; Sinn, 2003).

In the past, the Council of Economic Experts has repeatedly called for bank supervision at the European level (AR 2011 item 259; AR 2010 item 286). A key lesson to be learned from the European sovereign debt crisis is that purely national supervision leads to regulatory forbearance in banking, and that the mechanisms coordinating national supervisors do not function sufficiently well. For the reasons listed below, banking supervision should thus not remain purely at the national level.

300. As regards the risks of national supervision for monetary policy, the crucial issue is that in a single currency area risks can be shifted onto the central bank. If banks are distressed in one part of the currency area, be it owing to lax supervision or to unexpected shocks, then it may be in an individual country's interest not to support the banks itself and restructure them, but to shift the burden onto the European level. Delayed action by national supervisory agencies can force the central bank to intervene. In the final instance, the central bank has an interest in preventing bank crises and financial contagion by granting banks access to refinancing loans. Among other things, the development of the TARGET2 balances in the Euro Area shows that the ECB has by virtue of refinancing policy and by easing collateral requirements become a substitute for parts of the interbank market (items 125 f.), and it has refinanced also distressed banks.

A central bank should operate in a banking system subject to a single supervisor. There were thus voices during the early days of the EMU advocating that greater centralization of supervisory functions was necessary to reduce the risk of lax regulation (Kahn and Santos, 2005, 2002). If the supervisory and lender-of-last-resort functions cannot be unified at once, then as a first step a uniform supervisory framework should be created. During the crisis, the ECB de facto assumed the role of the lender-of-last-resort thereby reversing the optimal sequence: in the ideal case, a central bank as the lender of last resort should provide refinancing only for illiquid banks and should not intervene if banks are insolvent. In practise, it is not easy to draw such a fine line between illiquidity and insolvency. Precisely for this reason, it is necessary to devise effective procedures for handling distressed banks.

301. Conflicts between fiscal policy and bank supervision: The crisis unveiled conflicts of interest between fiscal policy and supervision. As experience in Ireland and Spain shows, distressed banks can place a massive strain on government budgets. At the same time, there are incentives for governments to influence the banks' lending policies. Empirical studies in Germany show that election tactics indeed affect bank lending (Englmaier and Stowasser, 2012). National supervisors are presumably less able to withstand pressures from the policymakers than their supranational counterparts. Empirical evidence from the United States

in fact shows that supervisors operating at the federal level use stricter criteria than those at the state level (Agarwal et al., 2012; Box 13). Last but not least, national supervisors are probably more likely to tolerate banks holding bonds issued by national governments (financial repression).

302. Linking micro- and macroprudential supervision: Since the lines dividing micro and macroprudential regulation and supervision cannot always be clearly drawn, both should be located on the same level. Capital adequacy regulation of banks can serve as an example. The more equity capital a bank has the more stable it is. At the same time, a violation of the capital adequacy ratios of a single bank or a banking group then triggers less severe systemic effects (Box 13 page 179). Since macroprudential supervision has a bearing on the financial system as a whole, it should be located at a supraordinated level.

In other words, macroprudential supervision is an important complement to a single monetary policy. Monetary policy can in the final instance influence only the general price level and the aggregate provision of loans within a currency area. The central bank cannot directly counteract credit bubbles and diverging price trends in individual market segments, e.g., as observed in the Spanish and Irish real estate market prior to the crisis. At the same time, overheating in individual market segments reduces financial stability and thus the efficacy of monetary policy. At the same time, policy can itself be the cause of financial system instability, if for example low refinancing interest rates lead to increased risk taking of banks (Borio and Zhu, 2008; Rajan, 2005).

Risks from assigning supervision to the central bank

303. While centralizing supervision in Europe is desirable, the question must then be whether supervision should be located **inside or outside the central bank**. One argument for involving the central bank is that it is in need for supervisory information about the banks taking part in the central banks refinancing operations. In turn, through its monetary policy operations, a central bank has access to key information that can be useful for supervision. A central bank is, therefore, especially equipped for macroprudential supervision. Yet, a regular and extensive exchange of supervisory information would help make information available to the central bank without it having to be assigned additional tasks in the field of microprudential bank supervision.

304. The arguments against assigning supervisory functions to the central bank are weightier by far.

Firstly, having supervision and monetary policy under one and the same roof creates conflicts of interest. For example, a central bank that also assumes supervisory functions may shy away from raising interest rates if this could cause banks' financial situation to deteriorate. Such conflicts of interest undermine central bank independence. If a central bank is tasked with different and possibly conflicting goals without also having the requisite tools to achieve these goals, then there is a considerable risk that monetary policy will be instrumentalized for supervisory and thus essentially for fiscal goals. The summit resolutions on a Banking Union

can be read to mean that supervisory powers will be ceded to the European level just to enable direct bank capitalization through the ESM, while the European level will not be vested with actual intervention rights (item 298). However, that would be vital in order to be able to restructure or wind up banks. If this precondition is not met, then each respective member state should continue to be liable for its banks.

Secondly, the ECB has no direct fiscal institution as its counterpart. In this sense, monetary policy in the Euro area differs from monetary policy in a single country. This creates an additional risk that monetary policy, being forced to rescue ailing banks, will be abused for fiscal goals.. An independent financing mechanism needs to be established that in the event of a crisis can be used to make fiscal resources available. Responsibility and control must be structured such that the member states cannot shrug financial responsibility and fob it off on the European level - by arguing that the European supervisor has failed and the community must therefore be liable.

Thirdly, central bank independence requires operation outside the usual democratic controls. By contrast, a supervisory authority must be accountable to democratically legitimated bodies. The European Commission's proposal attempts to solve this conundrum by making the ECB accountable to the European Parliament and the EU Council – albeit only as regards its supervision of banks. It would, however, be better from the outset to locate supervision with an independent agency that is subject to democratic control.

305. The resolutions made at the June 2012 summit set the basis for European bank supervision involving the ECB. In the opinion of the Council of Economic Experts two preconditions would have to be met though. Firstly, supervisory powers should be transferred to the European level only if at the same time a central, independent restructuring agency is established (SR Annex I item 65). Plans to date have been vague in this regard. The European Commission has merely tabled a proposal for a Single Supervisory Mechanism. Since the restructuring and resolution measures, including financing, would remain the prerogative of the member states, at the present point in time implementation of the proposal for the Single Supervisory Mechanism must be rejected.

Second, the Commission's proposal does not sufficiently take into account possible conflicts of interest between monetary policy and bank supervision. Monetary policy actions and supervisory functions must be clearly separated in terms of personnel. There are plans to create a separate supervisory body for bank supervision and to keep bank supervision and monetary policy operationally separate. Yet, the ECB Governing Council still remains the decisive body that can delegate individual duties to the supervisory body and decides on the resolutions the latter prepares. The role of the supervisory body is therefore subordinated to monetary policy. This is also reflected in its membership, consisting of representatives of the supervisory agencies and the ECB. From the view of the Council of Economic Experts, contrary to the Commission's proposal, the chairperson of the ECB supervisory body should be someone who is not at the same time a member of the ECB Executive Board or the ECB Governing Council. At the very least, there must be a guarantee that the supervisory body's

chairperson participates in ECB Governing Council meetings only in an advisory capacity. The chairperson should moreover not be bound to follow ECB Council's instructions. Ideally, prudential decisions should be taken by an expert body that is not captured by national political interests.

Article 127 para. 6 TFEU can hardly be construed as covering either the transfer of restructuring powers to the European level or the adequate separation of monetary policy and supervision inside the ECB. The Council of Economic Experts is therefore of the opinion that initially the necessary legal foundations have to be laid, which presupposes a change to the European treaties. It would thus be consequential not only to expand the conditions under which the ECB can assume supervisory functions, but instead to locate bank supervision in a European institution completely independent of monetary policy. One avenue would be to expand the EBA's scope. Alongside the clear separation of monetary policy and supervision, this would also enable a European supervisor from the outset to be able to cover countries outside the Euro Area, too.

What should be the reach of European supervision?

306. There are two reasons for creating a European supervisor: firstly, the banks' cross-border activities in the EU Single Market and secondly the fact that in common monetary area any risks assumed by the banking sector can be shifted to the central bank. This raises the issue of what the optimal reach of a European supervisor should be, both regionally and as regards the banks to be covered. The answer depends not only on the reach of the single currency. Risks from the US sub-prime market spread to banks worldwide, largely independent of whether a currency was pegged to the US dollar. At present, there are considerable risks of the crisis in the Euro Area spreading to the East European countries that are not EMU member states.

307. European supervision should thus in principle span all EU countries and the Single Market; after all, the ESRB and EBA both already have such a broad footing. EU member states that are not part of the EMU should be granted the opportunity to opt into the Banking Union under unequivocal terms. For these countries to have an incentive to do so, they must, however, be tied in as equals to the supervisor's governance structures and have a sufficient say. Otherwise, the Banking Union would ipso facto spell a division of the Single Market. The above conditions are hardly in place judging by the Commission proposal to date, according to which the ECB Governing Council would ultimately be the body responsible for bank supervision. Here, the limitations by basing the Single Supervisory Mechanism on article 127 para. 6 TFEU become evident again.

308. Last but not least, there needs to be a decision on **which banks** would be supervised by a European supervisor. Taking its cue from the EBA, the new supervisor could be limited to large, systemically important, banks. Two reasons speak against such a choice. Firstly, the concept of systemic importance is not clearly defined. A major bank that is linked to many other banks is without doubt of greater relevance to the system as a whole than is a small, locally active bank. However, smaller banks can still be systemically important if they are

more or less equally exposed to a specific macroeconomic risk (Greenwood et al., 2011). The US Savings and Loans (S&L) crisis in the 1980s and the current crisis among Spanish Cajas are good examples, as the banks concerned would not have been covered by the usual criteria for what counts as “systemic importance”.

Secondly, dividing the banking system up in line with the “systemic importance” yardstick would create incentives to structure a bank such that it comes under purportedly laxer supervision. All banks should, therefore, in principle be treated equally. Should the European supervisor come up against capacity limits, then the prudential functions could be delegated to national authorities bound by its instruction. The European Commission’s proposal for a Single Supervisory Mechanism envisages the inclusion of all banks in the Euro Area and the delegation of current supervision to national agencies, with the European supervisor retaining full responsibility. It thus goes in the right direction.

3. Reasons for European restructuring and resolution powers

309. Since structural problems in the banking industry can impact negatively on financial system stability, a Banking Union cannot be limited to prudential supervision. State institutions must intervene swiftly in the event of the insolvency of a bank with cross-border operations. If the corresponding mechanisms have to be developed ad hoc, as was necessary in the case of the Belgian/French/Luxembourg Bank Dexia, this results in uncertainty, intervention gets delayed, and there is risk of wrong decisions being made.

Often there is considerable national opposition to restructuring and winding down banks. In the current crisis, for example, problems in the banking systems of several European countries were allowed to drag on, with negative effects on the stability of the European banking system as a whole (Advisory Scientific Committee of the ESRB, 2012). Moreover, structural problems in the European banking system have in the past often only been tackled after outside pressure was exerted or at the insistence of the European Commission for Competition. These are less exposed than national institutions to the danger of potential political influence or considerations. The arguments here are similar to those in favour of European supervision: powers for restructuring banks should likewise be entrusted to a **European restructuring agency** (AR 2011 item 263).

310. Possibly the strongest reason against a European-level restructuring agency is that this could violate the **principle of subsidiarity**. In the final instance, decisions on the restructuring and potential resolution of banks require knowledge of the structure of the bank in question and the specific legal framework. The better the supervisor knows the ins and outs of the banking sector, the better it can assess the actual status of a bank. Another reason in favour of decentralized decision-making is that fiscal resources are required. Were decisions to be taken on the European level that have a financial impact on the countries concerned, then costs and risks could be transferred without the parties involved having a joint say. Ultimately, the issue is at what level the risk of regulatory capture is lowest: the costs of such influence are higher at the European level, but at the same time the revenue rises as a favourable decision by the regulator affects a larger market.

In order to take account of the conflicts of interest between central and decentralized decisions, analogue to supervision, a **federalist structure** should be adopted. A central European restructuring agency can transfer certain functions to nationally active restructuring agencies that are independent of the prudential supervisor. In order to be able to establish the associated structures, the restructuring directive should be implemented as swiftly as possible (item 280). The national authorities would in principle have to follow instructions from the European Restructuring Agency, although the latter would not be empowered to prevent restructuring procedures initiated by the national agencies. The precondition for this is a full exchange of information between the national and European restructuring bodies. Following the procedure of prompt corrective action as is applied under US prudential law (Box 13 page 179), automatic restructuring procedures should be initiated at the European level to a greater extent than up to now.

Financing restructuring and resolution

311. In the past, it was not possible to finance the costs of banking crises without recourse to fiscal funds (Box 12). The distributional consequences of banking crises are much more pronounced if countries have recourse to the fiscal resources in other countries, e.g., through the EFSF or the ESM. Therefore, mechanisms should be designed ex-ante, which specify the sources of funds to be used as part of restructuring and resolution processes, together with a fiscal burden sharing mechanism.

Box 12

Costs of systemic banking crises

Systemic banking crises come at high fiscal and macroeconomic costs. Laeven and Valencia (2012) have studied these costs on the basis of data on systemic banking crises since 1970. A banking crisis is considered to be systemic if there are bank runs and banks get wound up, while the state has to intervene by injecting substantial liquidity, providing guarantees, buying up problematic assets and nationalizing banks. The fiscal costs are the government's direct outlays for recapitalizing the banking system. The macroeconomic costs are the cumulative deviation of real GDP from the long-term trend beginning in the year a banking crisis breaks out and in the three subsequent years (GDP shortfall).

In the systemic banking crises from 1970 to 2011, the fiscal costs were on average 6.8 % of the GDP of the country concerned (Table 22). The GDP shortfall came to 23 % of real GDP. The countries were encumbered to very different degrees by the costs of the crises: in one quarter of the countries, the fiscal costs were at least 15.4 % of GDP. By contrast, in one quarter of the countries, real GDP did not lag behind the trend. The countries that were affected by a systemic banking crisis in the wake of the global financial crisis had to use on average 4.2 % of GDP to cover bank recapitalization; the costs to the real economy came to 25 % of GDP and were above the long-term median.

Table 22

Costs of systemic banking crises

	Fiscal costs ¹⁾	Output loss ²⁾	Increase in public debt ³⁾
1970 – 2011			
1 st quartile	3.1	0.0	– 1.1
Median	6.8	23.0	12.1
3 rd quartile	15.4	43.4	25.4
No. of crises ⁴⁾	87	129	131
1970 – 2006			
1 st quartile	3.5	0.0	– 7.1
Median	10.0	19.5	10.8
3 rd quartile	17.5	46.3	23.8
No. of crises ⁴⁾	62	104	106
2007 – 2011			
1 st quartile	2.3	14.0	9.1
Median	4.2	25.0	18.0
3 rd quartile	7.7	38.0	28.1
No. of crises ⁴⁾	25	25	25

1) Government expenditure relating to bank recapitalization as a percentage ratio of GDP.– 2) Percentage cumulative deviation of real GDP in the year the systemic crisis broke and the three subsequent years from the trend prior to the outbreak of the crisis.– 3) Percentage difference in the debt level as a ratio of GDP in the third year after the crisis broke and the debt-to-GDP ratio in the year prior to the crisis breaking .– 4) The data are not completely available for some cost variables.

Key: Fiscal costs, output loss and increase in public debt are each arranged in ascending order. The 1st quartile (median, 3rd quartile) is the value that is not exceeded in one quarter (half, three quarters) of the crises. For example the fiscal costs of the crises that took place in the period between 1970 and 2011 amounted in one quarter of the cases at most to 3.1% of GDP (upper section of the table, column “Fiscal costs”, 1st quartile). Half the crises in this period exhibited fiscal costs of less than 6.8% (median). Three quarters of the crises entailed fiscal costs of less than 15.4% (3rd quartile), and thus the fiscal costs in one quarter of the crises were more than 15.4%.

Source: Laeven und Valencia (2012)

All in all, systemic banking crises entail significant fiscal costs and cause a sharp drop in GDP. These figures do not capture possible revenues from future profits of banks; yet they give an idea of the direct fiscal outlays necessary. In the crises since 2007, debt levels have increased sharply, with the mean rise being 18 percentage points for countries with systemic banking crises.

312. There is thus a need for a financing mechanism in the framework of restructuring banks. Ideally, a European restructuring agency should be financed through a **bank levy** that is calculated based on the systemic risk a bank poses. To the extent that funds are required at the European level for restructuring banks, the corresponding control functions need to be transferred to the European level, too. Otherwise, there would be an incentive at the subordinate level to apply lax criteria for restructuring and to mutualise the resulting costs. Should additional funds be needed for a European restructuring agency, these can be sourced through the ESM. Because non-EMU members do not participate in the ESM a process is

needed to provide fiscal resources for the non-EMU countries wishing to participate in the Banking Union.

The structure of the German bank levy, which has been charged since 2011, is unlikely to internalize fully the systemic risk a bank poses. It is calculated on the basis of banks unsecured liabilities, and it rises progressively the greater the latter are. The levy is also imposed on derivative transactions. At the same time there is a ceiling capping the bank levy to a sum of 20 % of the annual profits as reported according to the German Commercial Code (HGB); state-owned development banks are exempt from the levy. At EUR 590 million, the revenue from the levy in 2011 was meagre, the reason being among others comparatively low bank profits, meaning the profit ceiling was quickly reached. Indeed, the levy rates are probably too low, as to act as an incentive device that forces banks to internalize any implicit state guarantees for the banking system (AR 2010 item 239). These limitations should be considered when designing a European bank levy.

Establishing a European bank resolution fund will take some time, such that it may be necessary to rely on fiscal resources until enough has been paid into it. If fiscal policy remains at the national level (items 176 f.), the financing of restructuring measures must not be allowed to fail owing to fiscal autonomy. The specific-sharing model (Goodhart und Schoenmaker, 2009) is one way of defining clear burden sharing rules in advance. In such a model, only those countries share in the financing in which a bank requiring support was active. The costs could be allocated by a key that can, for example, be geared toward how large the share of a bank's assets in a particular country is.

4. Preconditions for introducing a European deposit insurance scheme

313. The third element of a Banking Union is a pan-European deposit insurance scheme. At present, the deposit insurance systems in Europe are conferred to national borders and, in Germany, to the individual pillars of the banking sector. Pan-European deposit insurance could therefore deliver better diversification of risks across national borders.

Two further aspects would favour introducing European deposit insurance in the context of a Banking Union. Firstly, ill-designed insurance premia can create incentives for banks to assume risks. If the national level were to retain sole jurisdiction for deposit insurance, risks could arise that in the final instance the European level itself faces. Secondly, deposit insurance funds play a key role in restructuring and insolvency proceedings for banks. They act as creditors on behalf of the insured depositors and protect the latter against losses. It needs to be borne in mind that deposit insurance is designed to protect banks against liquidity risks and prevent a bank run. It is not intended to preserve banks from becoming insolvent.

314. However, introducing European deposit insurance would entail considerable risks in the current situation for two reasons. Firstly, a central deposit insurance scheme requires that prudential and restructuring powers be transferred to the European level. Otherwise there is the danger that banks shift risks to the European level as well. Given all the open issues

outlined above and the political resistance to such a transfer of powers, this precondition for a pan-European deposit insurance scheme will not be met in the near future.

315. Secondly, the fact that banks carry legacy assets on their balance sheets with a high proportion of non-performing loans makes it harder to introduce a pan-European deposit insurance scheme. Were a Europe-wide deposit insurance scheme already in place today, the resulting risks would be mutualised and would not be the responsibility of the single member states. This would be tantamount to providing insurance after the damage has been done. Inadequate supervision at the national level and incentives for banks to assume too much risk would then receive retroactive support.

316. An effort must be made at the national level now to ensure that existing deposit insurance schemes do not incentivize excessive debt accumulation. The insurance premiums must be aligned as closely as possible to a bank's actual risk profile; uniform criteria for this must apply in all member states as envisaged in the directive on a deposit insurance schemes that has not yet been enacted (European Commission, 2010). After all, introducing deposit insurance has an upside and a downside. On the one hand, it reduces the risk of a bank run and enables liquidity risks to be diversified; on the other, it increases incentives for banks to take more risks (Box 13). Risk-adjusted insurance premiums are meant to prevent this. The scholarly literature includes several methods for setting the premiums. Applying the method in Duan (2000, 1994), then there should have been a risk-adjusted premium for deposit insurance in Germany for the period 1991 through 1998 of on average 6.17 basis points – more than double the actual premium (Laeven, 2002).

Box 13**Deposit insurance, prudential supervision and bank restructuring in the United States**

The question as to which shape the individual elements of a Banking Union should optimally take cannot be answered conclusively based on theoretical literature. A glance at how things are done in other countries, especially the United States, is rather useful in this context. There, financial institutions are supervised by federal or state bodies (Table 23). At the federal level, banks are licensed and supervised by the Office of the Comptroller of the Currency (OCC), which reports to the US Treasury Department. Until 2011 the Office of Thrift Supervision (OTS) likewise operated under the aegis of the Treasury Dept. and was, among other things, responsible for issuing licenses for S&L corporations. The OTS was criticized for lax supervision of the American International Group (AIG), for example and, as of 2011, has reported to the OCC. The Federal Deposit Insurance Corporation (FDIC) plays a key supervisory role. It is a federal deposit insurance fund and as part of its activities exercises supervisory powers on behalf of its members'.

Table 23

Levels of bank supervision in the United States¹⁾

Financial institution	Supervisory agency
Bank with a federal license	Office of the Comptroller of the Currency und Federal Deposit Insurance Corporation (FDIC) ²⁾
Savings bank with a federal license	Office of the Comptroller of the Currency ³⁾ und FDIC ²⁾
Bank holding company	Federal Reserve
Cooperative banks	National Credit Union Association (NCUA) ²⁾
Bank with a license to operate at the state level, that ...	
– voluntarily belongs to the Federal Reserve System	Federal Reserve and supervision at the state level
– that is not part of the Federal Reserve System	FDIC ²⁾ and supervision at the state level

1) Status: October 2012.– 2) The FDIC manages a deposit insurance fund on behalf of banks and savings banks, while the NCUA manages a deposit insurance fund for cooperative banks– 3) Until 2011: Office of Thrift Supervision.

It is mainly the FDIC that is responsible for assuring customer deposits with US financial institutions; cooperative banks have a separate deposit insurance scheme. At present, insurance for deposits is capped on USD 250,000 per client. Members of the FDIC pay an insurance premium that is related to the bank's risk profile and the amount of deposits insured, whereby the total fund volume is limited and comes to 1.5 % of the deposits insured. In the event of a crisis, should the fund volume not suffice, the FDIC can draw on a US Treasury Department credit line of up to USD 100 billion and, in exceptional cases, of as much as USD 500 billion. When calculating the risk premiums, the financial institutions are subdivided into four risk categories, which are however regarded as too broad (Acharya, 2009). Premiums for large and complex financial institutions are calculated separately.

To supervise banks, the FDIC makes use of a prompt corrective action clause (PCA) that has been introduced to prevent regulatory forbearance. PCA foresees clearly-set threshold values that force the supervisor to intervene in a timely fashion. Financial institutions are thus subdivided into five groups by degree of capitalization (Table 24). Banks in the best group have to meet the conditions for all three risk-weighted capital adequacy ratios. Should the bank in question fall into one of the three lower groups, the FDIC must automatically intervene. In the final category, the FDIC must within 90 days take over the bank and then wind it up, unless the FDIC and the federal or state supervisor unanimously vote against doing so (Spong, 2000).

Table 24

Bank classification under Prompt Corrective Action

%

Capitalization level	Total risk-based capital ratio	Tier 1 capital ratio	Tier 1 leverage ratio
Well capitalized	≥ 10	≥ 6	≥ 5
Adequate	≥ 8	≥ 4	≥ 4
Undercapitalized	< 8	< 4	< 4
Significantly undercapitalized	< 6	< 3	< 3
Critically undercapitalized		Tangible equity ¹⁾ ≤ 2	

1) Equity capital less intangible assets.

Source: Spong (2000)

The impact of introducing deposit insurance with non-risk-adjusted premiums in 1933 with the foundation of the FDIC is discussed in DeLong and Saunders (2011). They show that the deposit insurance led to higher risks. This finding is corroborated by studies on the S&L crisis in the 1980s (Akerlof and Romer, 1993; White, 1993; Brewer and Mondschean, 1994; Benston and Kaufman, 1997).

317. In addition, in the course of the crisis, banks and governments have become ever more interlinked. Disentangling risks of banks and states can be achieved firstly by mutualising risks either in part or temporarily, as is the intent behind using the ESM to recapitalize banks subject to clear conditions (SR Annex I item 62). Secondly the regulatory regime must incentivize banks in the long term to reduce their holdings of government bonds. Higher capital requirements can also help increase banks' ability to bear risks and prompt them to shift fewer risks to the government safety net, such as the deposit insurance scheme (for an historical view, see Alessandri and Haldane (2009)).

5. Need for more extensive reforms

318. The costs a distressed bank pose for guarantee schemes and tax payers depends on how large the bank's risk buffer is and on its risk-taking incentives. The focus must not only be on centralizing supervision but also on ensuring bank regulation is such as to render crises less likely. This can be achieved by lowering bank leverage. Moreover, the mechanisms by which management and supervisory board members of banks can be held liable should be strengthened.

Yet, the proposals for a Banking Union are based on the existing regulatory regime. Given the complexity of current capital regulation and the need to assess banks' internal risk models, a central supervisor will hardly be in a position to assess banks' risk models without relying on support from national prudential supervisors. It therefore makes sense in the context of the Banking Union to **reform the regulatory regime for bank equity capital**. The leverage ratio the Council of Economic Experts advocates would have the additional advantage (item 270 of being applicable without the supervisor needing any detailed knowledge of the banks' risk models.

Ensuring greater stability of the banking system also requires breaking the close link between banks and governments. This will require adjustments to banking regulations. Currently, supervisory regulations encourage banks to invest in government bonds. Government bonds need not be covered by equity capital or, if so, then to a far lesser degree than loans to the private sector. Furthermore, we are still waiting to see the actual definition of the new ratios governing regulation of liquidity risk, which will come into force at the earliest in 2015 (AR 2010 items 264 f.). Currently, the plan is that government bonds will constitute a large portion of the liquid assets required to be held on the balance sheet. This would be counterproductive as it would further strengthen the link between banks and governments (AR 2011 item 248). This privileged role of government bonds must be abolished if bank risk is to be less exposed to government risk.

319. Moreover, at present there is some debate on **measures that go further** with a view to stabilizing the banking industry. The expert group set up by the European Commission to outline reforms to the EU's banking structure and chaired by Erkki Liikanen released its final report in early October 2012 (HLEG, 2012). Key among the group's recommendations are the obligatory separation of proprietary trading from other important business fields; the group suggests it should be possible to assign additional activities to the trading unit when compiling the recovery and resolution plans of a bank. The report also includes various recommendations on improving bail-in instruments, a stronger role of capital adequacy ratios that are insensitive to risk weights and improvements of liability and surveillance mechanisms. In large part, these suggestions are in line with those tabled by the Council of Economic Experts. The group's proposal for an obligatory separation of proprietary trading and other highly risky trading activities from a bank's other trading operations resembles the suggestion a British expert commission made in 2011 (AR 2011 item 278).

320. By contrast, the Council of Economic Experts is critical of suggestions where certain bank activities that are determined *ex ante* should be separated organizationally from one another. If a separation of specific bank business fields is to enhance the industry's stability and efficiency, then at least three preconditions need to be met: firstly, there must not be especially pronounced synergies between the fields; secondly there must be no strong diversification of risk, and thirdly the separation must be practicable. The Council of Economic Experts doubts that these conditions hold (AR 2011 item 280; AR 2010 item 277). What the current sovereign debt crisis most certainly demonstrates is that traditional fields of banking, such as real estate or state financing, can entail high risk.

321. Regulatory reforms should, therefore, focus on reducing the banking industry's exposure to risk *per se* and in particular on raising banks' capital buffers. Explicitly defined minimum capital adequacy requirements are by their very nature necessarily derived from the past and in many cases are a matter of interpretation. Hence, they encourage regulatory arbitrage, something that a rigid application of the rules cannot sufficiently consider. The current supervisory regime therefore envisages including discretionary scope in the supervisory review process (2nd Pillar of the Basel Accord). Even before the sovereign debt

crisis broke out, supervisors could definitely have identified certain erroneous trends and drawn conclusions from this. The existing scope of discretion must therefore at least be consistently used going forward.

IV. Summary of the Council's Proposal

322. The sovereign debt crisis in Europe has revealed critical shortcomings innate in the Single Market for capital. Both private borrowers and public-sector entities have taken on excessive debt; banks and governments have become dependent on each other. Regulatory weaknesses have incentivized the accumulation of excessively high debt. Banks were not required to maintain sufficient equity capital, and capital adequacy regulations had a procyclical impact. In many cases, the bank supervisors did not sufficiently constrain the risks on banks' balance sheets effectively. Despite there being a single monetary policy, responsibility for supervising and restructuring banks was left at the national level. In this way, there were incentives to shift risks to the European level.

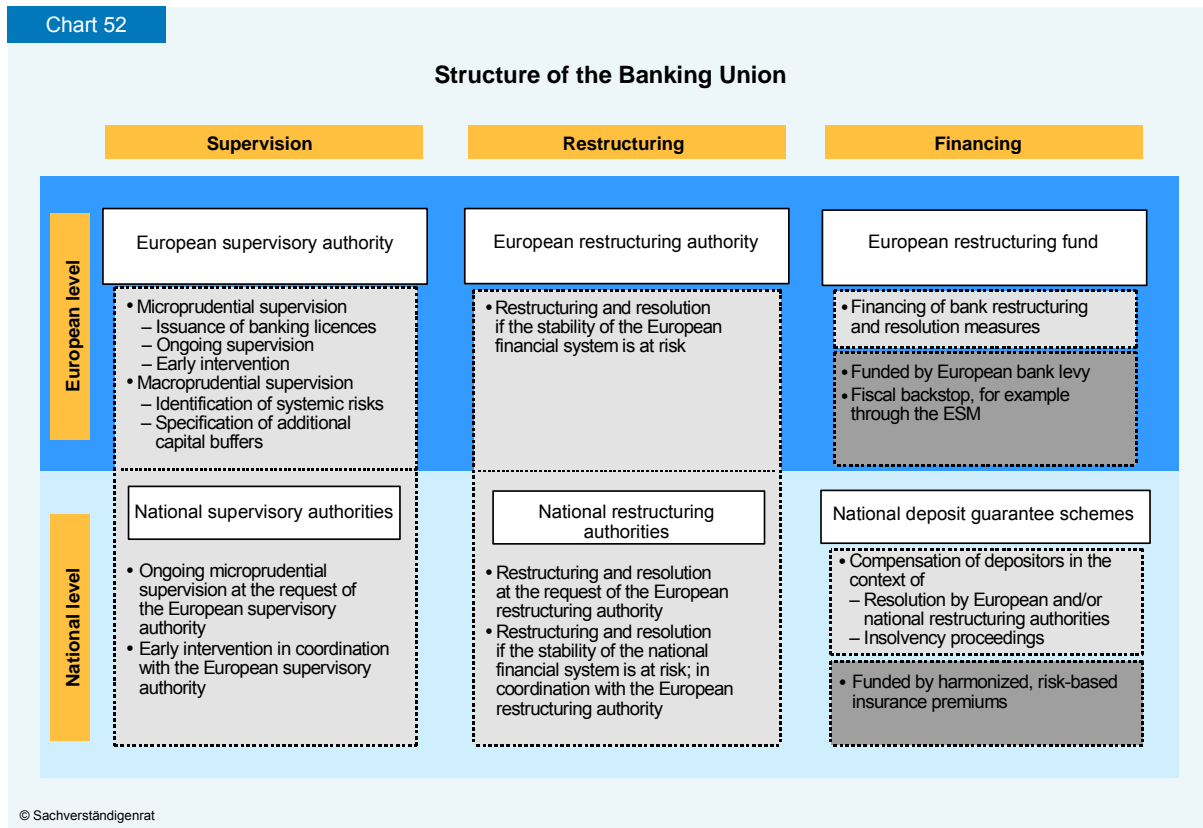
323. The proposals for a Banking Union and for establishing a Single Supervisory Mechanism currently being discussed are intended to overcome these shortcomings. Essentially, a Banking Union is a necessary complement to the Single Market for capital. In the Single Market, if a bank in one country is distressed, this can have a negative effect on other countries, something a European supervisory system could help obviate. This effect is all the stronger if, owing to the single monetary policy, risks impact on other countries. That said, a Banking Union remains primarily a long-term project that can by no means solve the current problem of private and public debt overhang.

1. Cornerstones of a Banking Union

324. A European supervisor should cover **all banks**, while it could delegate authority to national supervisors. In an ideal case, **all countries** in the Single Market, meaning the member states of EU-27, should participate. It must therefore be both possible and appealing for countries outside EMU to **opt in** to the Banking Union. A European supervisor requires a clear mandate, and there must be a clear division of powers between the national and European levels (Chart 52). The present system of supervisory colleges leaves supervision at the national level and has proven fairly ineffective in times of crisis. It is therefore problematic that policymakers envisage a similar principle applying in future for the resolution colleges for banks.

325. **Assigning supervision to the ECB entails considerable risks to the independence of monetary policy.** These are all the more severe, the more extensive national scope remains as regards both the application of prudential standards and the restructuring and resolution of banks. The ECB runs the risk of being in charge of supervision, on the one hand, and yet not having sufficient instruments of intervention and control, on the other. In crisis situations, it may come under pressure to deploy monetary policy tools for tasks that are actually of a fiscal nature.

Chart 52



While it has been decided politically to assign supervisory tasks to the ECB, this must be tied to two conditions: firstly, restructuring and resolution powers must be assigned to a European restructuring agency working independently of the ECB. Secondly, sufficient precautions must be taken to keep monetary policy and supervision separately, both institutionally and in terms of personnel. The Council of Economic Experts believes these conditions are not in place, so that before anything else happens the relevant contractual foundations need to be laid. The Council of Economic Experts is in favour of entrusting pan-European supervision to a body different from the ECB. In this way, monetary policy would be clearly separated from banking supervision. Moreover this would support the establishment of a single European supervisor for the entire single market.

326. A European restructuring agency should be part of any Banking Union. There must be clear rules governing its financing through the ESM and a bank levy. For the foreseeable future, central fiscal resources will not be available. There is far too little willingness to transfer fiscal policy powers to the European level, and the incentives for again passing the bucket on to monetary policy are still too great. Should additional fiscal means be required, then there will be a need for a predefined burden sharing mechanism (item 312). Irrespective of the financing structure chosen, it must be ensured that liability and control are closely interlinked.

327. Preconditions for the introduction of **European deposit insurance** are central European competencies covering the supervision, restructuring and resolution of banks. These will not be in place for the foreseeable future. The introduction of pan-European deposit insurance would mutualise risks without at the same time establishing sufficient central

surveillance mechanisms. A single liability mechanism would undermine efforts to use stricter bank regulations and fiscal debt brakes to restrict borrowing. However, uniform standards for national deposit insurance schemes are necessary in order to take risk taking of banks duly into account.

328. Further adjustments should be made to the European financial market architecture to enhance banks' resilience and lower the cost taxpayers face for distressed banks. In particular, in the medium term, an **obligatory leverage ratio** of at least 5 % should be introduced and the **privileged role of government bonds** in banking regulations should be **abolished**

329. All supervisory institutions must have immediate access to **comprehensive information** on banks and their interlinkages. The US system in which all data from banks' financial statements are publicly available at short notice (call reports) could be the model adopted. In earlier annual reports, the Council of Economic Experts has called for a central credit register to be established (last in AR 2010 item 156). Moreover, the relevant supervisors should be able to access confidential data at the level of the individual banks.

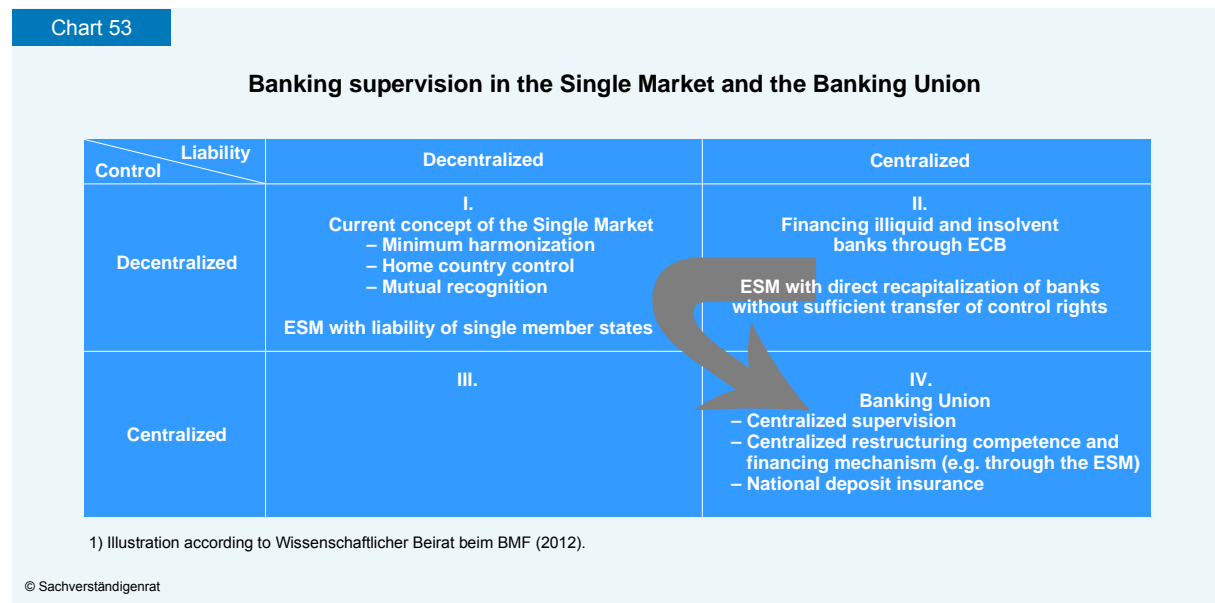
330. Stable and efficient financial markets require complementary **reforms**, which go beyond creating a Banking Union and improving the regulatory regime. The crisis has underscored the risks of excessive debt. Improving incentives to take up equity capital in the market could lessen the scale of future debt crises. Potential difficulties implied by the introduction of a leverage ratio for the financing of municipals should be resolved at the fiscal level and not by diluting bank regulations. The Council of Economic Experts has presented proposals in this regard (items 377 f., 402 f.).

331. There are four reasons why the cornerstones of the Banking Union are not compatible with article 127 para. 6 TFEU. Firstly, only "specific tasks (...) concerning policies relating to the prudential supervision of credit institutions" can be conferred on the ECB. It is not clear whether a sweeping and permanent transfer of supervisory powers to the ECB is possible in the first place. Secondly, it is not clear whether central powers in the restructuring and resolution of institutions are covered by the current treaty. Thirdly, given that in the final instance it is the ECB Governing Council that is responsible for supervisory decisions, there is an insufficient separation from monetary policy. Fourthly, and relating to this, any opt-in by other EU member states is factually excluded as they are not represented in the ECB Governing Council and therefore have no decision-making rights. In short, without EU treaties being changed to enable the foundation of a real Banking Union, any reform based on article 127 para. 6 TFEU will remain piecemeal and harbour the risk of an unstable and not fully viable regulatory framework.

2. Concept for the transition to a Banking Union

332. Like fiscal policy, European bank supervision is caught between two polar cases (item 175; Wissenschaftlicher Beirat beim BMF, 2012). There are two constellations in which liability and control coincide (Chart 53). The first corresponds to the original concept of the Single Market (case I), whereby the individual member states are responsible for both bank

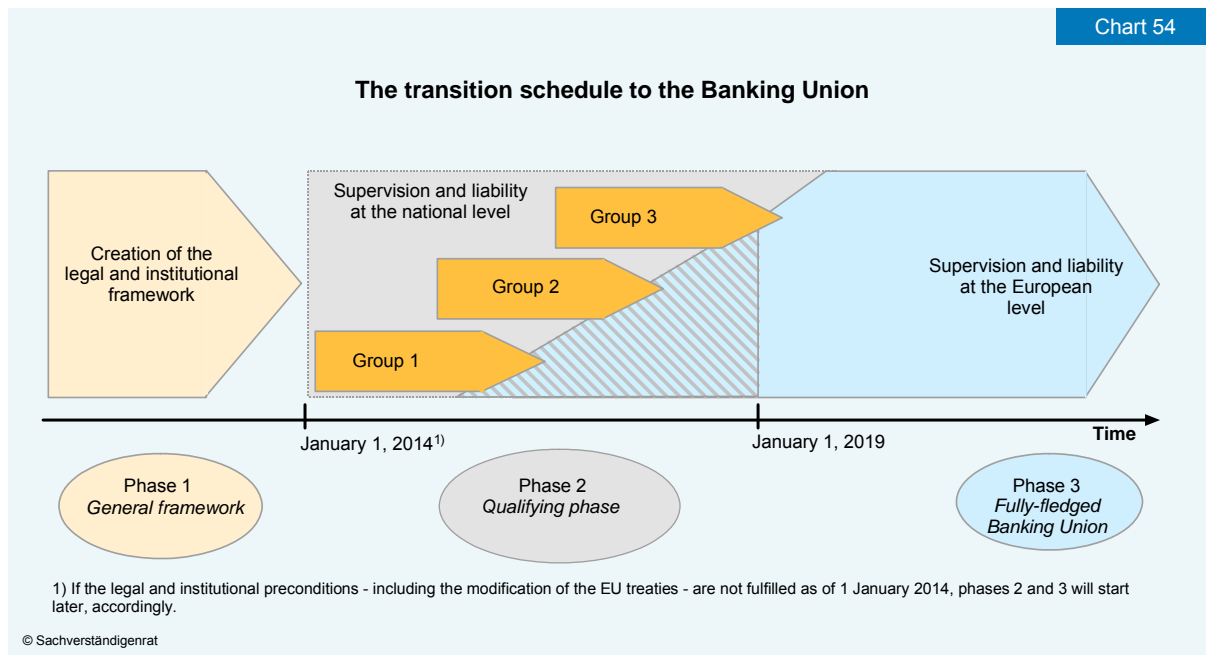
supervision and any costs of a distressed bank. The second scenario is the Banking Union (case IV).



333. During the crisis, liability was increasingly shifted to the European level. Illiquid or possibly insolvent banks have been kept alive by ECB refinancing. Yet supervision and control of these banks remains decentralized. A direct recapitalization of banks using the ESM's resources, i.e., without liability by the member state in question, would lead to the separation of liability and control. The goal of a transition regime to a Banking Union should therefore be to reduce the elements of joint liability.

At present, two obstacles block the path to a Banking Union. Firstly, legacy assets burden bank balance sheets. Secondly, transferring supervisory and control functions takes a considerable time. New institutions have to be created, legal structures adjusted and adherence to them ensured, the European resolution fund has to be filled up, and bank risks need to be separated from sovereigns.

334. Below we present a strategy of how transition to a Banking Union could succeed (Chart 54). The concept hinges on two ideas: firstly, liability and control will at all times be kept at the same level; secondly, legacy assets will not become a shared liability. The transition concept is divided into three phases: the creation of the legal framework and foundation of the requisite institutions; a qualifying phase; and a third phase in which all banks in the market require a European banking licence.



Phase 1: Creating the legal framework and setting up the institutions

335. In a first phase, the binding long-term legal framework for the Banking Union and the transition regime would be quickly agreed on. Then the legal conditions would be created in the member states and the European institutions would be set up. In particular, changes to the European treaties are necessary to enable the concept for a sound Banking Union proposed here to be translated into law. Ideally, this phase should be complete after one year.

During this phase, financial institutions should already agree to supervisory information to be shared by the national and new European authorities. At the same time liability for bank risks should be moved back to the national level (case I, Chart 53). To the extent that conditions in the financial markets permit, the ECB should consider tightening refinancing conditions and relating these more than to date to the solvency of the individual bank in question (SR Annex I item 68). Attention should be paid to assure that these tougher terms are not undermined by easy access to ELA loans (item 141).

Phase 2: Banks qualification process

336. In the second phase, banks can qualify for entry into the Banking Union. Banks themselves or the national supervisors could file the applications for admission to the Banking Union. In order to prevent delays in the applications, a deadline would be set as of which only banks with a European banking licence can operate in the market. Qualification for admission includes a thorough re-evaluation, by outside experts, of the bank's assets (including government bonds) and complete fulfilment of the Basel III requirements. Moreover, admission to the Banking Union would set the track for achieving the leverage ratio as per Basel III of at least 5 % as called for by the Council of Economic Experts (AR 2011 item 294).

337. The European agencies can admit a bank to the Banking Union as soon as it had successfully passed the qualifying process. Thus, banks join the Banking Union one after another. As long as admission has not been granted to the Banking Union, supervision and liability remain at the national level. To ensure the European agencies do not get overwhelmed by the admission procedures for possibly several thousand banks, banks should initially be subdivided into several groups by size. First, the larger banks, such as those currently monitored by the EBA, should enter the qualifying process for the Banking Union. They would be followed by mid-sized banks and, finally, by the smallest banks. There would be a specific transition phase for each of these groups (Chart 54). The criterion according to which the banks are grouped would refer to a past period to prevent any manipulation.

338. The restructuring and resolution of systemic financial institutions is not probable at present owing to the great uncertainty in the financial markets and risks of contagion. For this reason, systemic banks presumably expect that if they get distressed, the government will step in to save them. There is the danger that systemic banks that seem to be in a hopeless situation would during the transition phase have an incentive to gamble for resurrection. For this reason, during the transition phase, those banks that are not yet in the qualification phase should be monitored not only by the national supervisors but also by the European supervisor established in Phase I. In particular, the European agency should subject large banks with cross-border operations to strict supervision as swiftly as possible. An additional need for capitalization could be identified by means of stress tests. In order to prevent a deleveraging of assets, the new supervisor should make certain that additional capital requirements are set by demanding a certain nominal amount of capital.

339. Some might object that the gradual entry of banks into the Banking Union could lead to destabilizing shifts of deposits between banks. However, during the entire process, deposit insurance would remain at the national level. Explicit guarantees for bank deposits should thus not change if banks obtain a European banking licence. The regulatory framework would in principle be identical for all banks as well. There would be differences across banks, in contrast, as regards solidity of the respective sovereign behind the bank. This is a significant source of uncertainty precisely for banks in the countries in crisis. If anything though, the structured transition to a Banking Union under clearly defined terms should lessen this uncertainty.

340. It may be necessary during the transition phase to restructure banks. Those banks that do not successfully qualify or for which no application for admission to the Banking Union has been filed by the deadline set for the specific group, should be subject to compulsory restructuring and if necessary wound down. Should there be a need to draw on fiscal resources to a degree that financially overwhelms the member state in question, the latter could file for financial support from the ESM. Provision of the financial support would be contingent on a bank-specific conditionality similar to the MoU for Spain. The country affected would thus be liable for the funding from the ESM for recapitalizing the banks in question. The restructuring process would, moreover, be monitored by the European restructuring agency. Here “recapitalization” would thus not mean the unconditional use of

government funds to salvage moribund banks. Instead only those banks would remain in the market that have a long-term viable business model.

Phase 3: Transition to a fully-fledged Banking Union

341. Following Phase 2, supervisory authority over all banks would be vested in the European prudential supervisor. The European restructuring agency would be in charge of restructuring and resolution processes; it could resort to financing from the European resolution fund (drawing on the ESM), and if necessary on pre-defined burden sharing procedures. Thus, the European level would be liable for and would supervise all the banks remaining in the market (case IV, Chart 53). If Phase 1 is completed on time within one year, Phase 3 could commence as of 2019, the year in which the new regulations under Basel III have been completely phased in.

342. With the realization of this three-phase model, “healthy” banks would be strongly incentivized to file as swiftly as possible for admission to the Banking Union in order to send a positive signal to the markets. This would boost confidence in these banks and revitalize the interbank market, which has mostly come to a halt. “Weak” banks would fear that bad assets would come to light. Banks that by the deadline have not qualified for the Banking Union should then be restructured and, if necessary, wound up. Shareholders would thus be encouraged to prevent the subsequent loss of their capital and insist on sound business policies. Moreover, it could be a negative political signal for a government if its banks did not qualify for the Banking Union.

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