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# **Banking Supervision and Resolution: The European Dimension**

*Dirk Schoenmaker*

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## Banking Supervision and Resolution: The European Dimension

Dirk Schoenmaker\*

### Abstract

Both theory (game theory) and practice (recent financial crisis) indicate that national interests prevail in cross-border resolution. National authorities aim for the least-cost solution for domestic taxpayers. This results in an undersupply of the public good of global financial stability. International banks are increasingly run on national lines, as national supervisors force stand-alone subsidiaries to maintain separate liquidity and capital buffers in each jurisdiction.

To preserve the Internal Market in Banking, this paper proposes a supranational approach to banking supervision and resolution in Europe. The large cross-border banks would then be supervised directly by the European Banking Authority, and in case of liquidity and solvency problems, have access to the ECB and the newly proposed European Resolution Authority. The European Resolution Authority needs a fiscal backstop and a strong legal framework to be credible. The access to government funds could be based on *ex ante* burden sharing between participating countries. The legal regime could be provided by a new special resolution regime embedded in a EU Regulation giving powers to liquidate or resolve ailing banks in a timely and orderly manner on a EU-wide scale.

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\* Duisenberg school of finance and VU University Amsterdam

## A. Introduction

International banks have traditionally facilitated international trade and business of multinational companies. The client pull hypothesis (Grosse and Goldberg, 1991) argues that their international clientele provides an incentive for internationalisation by banks. The financial system of the foreign country might lack a level of sophistication that the bank's clientele desires.

Following the first and second financial crisis, the international business model of banks is under pressure. Bank rescue operations by governments were performed on a national basis in the first financial crisis of 2007-2009. US TARP funds were, for example, only available for US headquartered banks. European banks with significant operations in the US were not eligible. By the same token, their respective home government supported European banks. In case of truly cross-border banks, such as Fortis, the bank was split and resolved on national lines (Claessens *et al*, 2010).

The supervisory response to this national fiscal backstop has been to reinforce their national mandate, while paying lip service to international cooperation by non-binding Memoranda of Understanding (MoUs). In the second financial crisis starting in 2010, banks are required by their supervisors to match their assets and liabilities on national lines. So a French bank with liabilities in the US is required to keep matching assets in US, while having a US dollar shortage at home. The same tends to happen within Europe. When a Dutch bank is collecting deposits by Internet in Spain, the local supervisor is starting to ask for matching assets in Spain. Local holdings of liquidity and capital are sub-optimal (Allen *et al*, 2011). The Internal Market in Banking is being reversed. This reversal may in turn hamper the proper functioning of the wider Internal Market for Goods and Services and thus affect economic growth in Europe.

The current situation regarding the European banking system is not stable. The financial trilemma indicates that the three objectives of financial stability, cross-border banking and national financial supervision are not compatible (Schoenmaker, 2011). One has to give. The trilemma makes clear that policy makers have to make a choice on cross-border banking. While we were slowly evolving towards European financial supervision with the establishment of the new European Supervisory Authorities and the European Systemic Risk Board, the financial crises have thrown us back towards national supervision. The result of this national approach is the disintegration of the European banking system.

In this paper, we explore an alternative solution to the financial trilemma: moving financial supervision and resolution to the European level. As we have witnessed during the recent financial crises, the endgame of crisis resolution is driving incentives (Claessens *et al*, 2010). So, we have to start with cross-border crisis resolution in Europe. As long as we have national based crisis resolution (with some loose coordination), we keep conflicts between home and host countries preventing orderly resolution. Any move to European banking supervision would need to go hand in hand with European crisis resolution based on credible funding and legal arrangements.

This paper starts with the lessons learnt from the crisis: what did work, and what did not work. An example of a well-functioning European institution is the ECB. The ECB has been a strong, albeit lonely, fire fighter over the last four years. By contrast, national based supervisors and governments have resolved ailing banks on national lines. Next, we sketch a European supervisory and resolution regime. The heads of the European Banking Authority and the newly proposed European Resolution Authority should join and strengthen the fire brigade for the European banking system. Finally, we discuss the road towards the new regime. This roadmap includes an analysis of the need for political and fiscal union to support our fire brigade (see, for example, Marzinotto *et al* (2011) and Goodhart and Schoenmaker (2011)). We conclude that our proposed banking union is necessary for maintaining the monetary union as well as the internal market.

## **B. Lessons from the crisis**

### *1. What did work?*

ECB is the only European institution that has been highly effective during the 2007-2009 financial crisis and the 2010-2012 sovereign and banking crisis. After the failure of Lehman Brothers in September 2008 the inter-bank market effectively shut down. Amid significantly impaired markets and elevated counterparty credit concerns, demand for liquidity rose sharply while interbank lending declined rapidly. The ECB like other major central banks reduced its key interest rates to historically low levels. In addition, the ECB provided ample liquidity to European banks through a number of temporary non-standard measures, subsequently referred to as the Enhanced Credit Support. Due to uncertainty about the creditworthiness of other banks, the inter-bank market did not function properly.

Next to the Enhanced Credit Support, the ECB introduced the Securities Markets Programme in response to tensions in the euro area sovereign bond markets in May 2010. The spreads between the yields on ten-year bonds of some euro area governments (notably Greece, Ireland, and Portugal; and later Spain and Italy) and the German Bund yield increased sharply. Under the programme, Eurosystem interventions are carried out in the euro area public and private debt securities markets to ensure depth and liquidity in dysfunctional market segments and to restore the proper functioning of the monetary policy transmission mechanism.

The ECB effectively maintains the liquidity of the European banking system. Cross-border banks from out-countries have access to ECB liquidity through their branches or subsidiaries based in in-countries.

What are the key elements of success?

- clear line of command: president (and executive directors) in centre providing strong leadership;
- full engagement of participating members: co-decision of participating national central bank (NCB) governors in Governing Council (euro area members are in majority in Governing Council);
- clear mandate: monetary and financial stability of the euro area; however, the role of the European System Risk Board (ESRB), chaired and staffed by the ECB, is still being developed;
- *ex ante* burden sharing: benefits and costs are distributed over participating members according to an *ex ante* burden sharing rule (the so-called ECB capital key);
- strong legal backing: a supranational institution established by, and enshrined in, Treaty; independent from politics.

The ECB functions at the federal level as the Fed in the US with one important difference. The profits and losses of the Federal Reserve go to the federal state in the US, while these go to the participating member states in the ECB case.

### *2. What did not work?*

Potential bank failures were handled on national lines during the financial crises. Such failures can generate negative externalities by affecting other banks and the real economy. How, in a world with cross-border financial institutions, can trans-national externalities be addressed? National authorities inevitably place a priority on their domestic objectives (Herring, 2007). These objectives include safeguarding the domestic financial system and minimising the costs incurred by taxpayers for recapitalisation or insolvency. Guided by these objectives, national authorities typically only take into account externalities in their own national financial system while cross-border externalities are often ignored (Schoenmaker and Oosterloo, 2005). This leads to globally inefficient outcomes, as several theoretical analyses show (e.g., Freixas, 2003, Schoenmaker, 2011).

Whether or not there will be an undersupply of recapitalisation for cross-border banks depends on the overlap of national interests. When national interests diverge, there may be no motivation for cooperation. When national interests converge, there is a possibility of a joint solution for a failing cross-border bank. One key issue determining the overlap of national interests is whether the bank is systemically important in either or both of the countries involved. When the bank has asymmetric

positions, coordination problems can arise. Coordination failures can, however, also occur when the systemic relevance (and thus the potential level of externalities) is large in both the home and host countries. This is because other interests may still conflict, thus leading to overall coordination failures.<sup>1</sup>

The 2007-09 financial crisis highlighted the lack of an effective crisis management framework for cross-border financial institutions. While approaches differed from country to country, broadly speaking authorities either used public money to bail out banks or they sought to ring-fence a bank's assets within their territory and apply national resolution tools focused at the level of the entity within their territory rather than at the level of the cross-border group.

This country-by-country approach undermined confidence in the international financial system and enlarged competitive distortions while increasing bailout costs borne by taxpayers as well as legal uncertainty. The events surrounding the failures of Fortis, Lehman and the Icelandic banks in the 2007-2009 financial crisis illustrate how much damage the absence of an adequate cross-border resolution framework can do to the stability of the global banking system. By contrast, authorities reached a cooperative solution in the bailout of Dexia and the continuation of Western bank operations in Central and Eastern Europe.

Claessens *et al* (2010) review several major cross-border bank failures to examine (i) the causes of the failures; (ii) the reasons for international cooperation, or the lack of it; (iii) the inadequacy of national resolution powers, and (iv) the impact on global financial stability. Table 1 summarises their findings for the 2007-2009 financial crisis.

**Table 1.** Six case studies

Case	Systemic in home country	Systemic abroad	Coordination	Short-term impact on financial stability
Lehman Brothers (USA and UK)	Yes	Yes	No	Substantial instability
AIG (USA)	Yes	Yes	Unilateral bailout of units in 130+ countries by U.S. government	May have prevented further deterioration in financial markets
Fortis (Belgium, Luxembourg, Netherlands)	Yes	Yes	Partly, improvised cooperation, "make do" solution. Bailout on basis of national entities, not for the Group as a whole	Enhanced stability in Belgian and Dutch banking system, but raised questions about how other cross-border SIFIs might be handled
Dexia (Belgium, France, Luxemburg)	Yes	No	Yes, joint solution based on proportions of shares held by governments & institutional investors in 3 countries	Enhanced stability
Icelandic Banks (Iceland)	Yes	No	No. Iceland protected only Icelandic depositors	Instability largely limited to Iceland (some unrest with retail depositors in foreign countries)
Central & Eastern European banking systems	Mixed	Yes	Yes, joint solution based on European Bank Coordination ("Vienna") Initiative	Enhanced stability in both Eastern & Western Europe

Source: Claessens, Herring and Schoenmaker (2010).

<sup>1</sup> See Herring (2007) for a full discussion of different kinds of national interests.

Also during the recent banking crisis, national interests erupted. In October 2011, banking supervisors across Europe assessed the need for extra capital to restore market confidence in European banks. An important detail is whether to present the shortfall in capital as an amount or as a ratio. To keep up bank lending (the ultimate aim of the recapitalisation), the shortfall should have been presented as a EUR amount and not as a ratio (Acharya *et al*, 2011). When presented as a ratio, banks may be tempted to cutting down assets (deleveraging) instead of raising capital. The European Banking Authority was keen to keep up bank lending preventing a credit crunch. Southern European bank supervisors were also keen to prevent banks selling sovereign bonds. But some (albeit not all) Northern European supervisors wanted to allow their banks to downsize and offload sovereign bonds. Ultimately, the European Banking Authority and the national supervisors agreed on a fudge. The shortfall was presented as a ratio (9% capital of risk weighted assets), while there was some wording suggesting that this ratio should be applied to the 30 September 2011 positions (indicating a EUR amount). The result was counterproductive. While the purpose of the recapitalisation was to regain confidence in the banking system, it led to widespread selling of sovereign bonds and deleveraging. This response is understandable from a bank micro perspective, but a disaster from a system macro perspective. There is also a leading role for the ESRB, which is responsible for monitoring and safeguarding the stability of the European banking system. Furthermore, there is anecdotal evidence that some national supervisors encouraged their banks to reduce their exposures to troubled sovereigns as well as to banks in these countries.

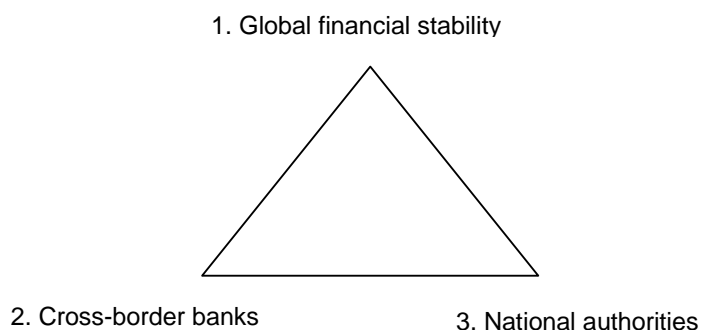
In sum, these experiences indicate that national supervisors and governments (accountable to national parliaments) tend to let national interests prevail over global financial stability.

### 3. The financial trilemma

The Freixas-model of cross-border externalities provides the theoretical foundation for the financial trilemma (Schoenmaker, 2011). The trilemma is that the three policy objectives —maintaining global financial stability, fostering cross-border financial integration, and preserving national authority — do not easily fit together. Figure 1 illustrates this financial trilemma. Any two of the three objectives can be combined with relative ease, but it is difficult to achieve all three. The financial trilemma forces policy-makers to make a choice. Maximising global welfare means considering global financial stability and other global objectives, such as reliability of financial contracting and efficiency of global allocation of funds. As cross-border financial integration progresses, policy makers will have less scope for independent policy-making, including fiscal independence.

Ultimately, the trilemma boils down to the issue of sovereignty. At one extreme, policy makers can hand over part of their sovereignty to foster global banking and global financial stability. At the other extreme, policy-makers can choose to impose restrictions on cross-border banking to preserve their full sovereignty (see Cerutti *et al* (2010) on the costs of ring fencing). The extensive international reach of European banks suggests that resolving the trilemma is most urgent for Europe.

**Figure 1.** The financial trilemma



Source: Schoenmaker (2011)

### **C. Sketching a European supervisory and resolution regime**

So far, solutions to the financial trilemma have been sought through international coordination of regulation and supervision. This is starting, however, from the wrong side. It assumes that what is needed is to make sure that supervisors *can* cooperate (by harmonising rules and agreeing on protocols), but it does nothing to assure that they *will* cooperate. Cooperation requires incentives, which in turn depend on who picks up the pieces if supervision fails to prevent failures. Without an understanding of the possible endgame – resolution – it is impossible to make a rationale choice about what needs to be supervised and who is in charge (Claessens *et al*, 2010). Only by having clarity on cross-border resolution – which includes not just the procedures to be followed, but importantly who will be providing financing and shouldering losses – will there be proper incentives for supervisory cooperation. The recent FSB report on Effective Resolution Regimes proposes “commitments” for cooperation between home and host countries (see Annex 1, FSB, 2011), but fails to provide incentives for cooperation or to impose sanctions on lack of cooperation. More generally, Goodhart (2011) discusses the problem of enforcing standards, including imposing sanctions, by international regulatory committees.

The incentives for cooperation must be structured correctly because “He who pays the piper calls the tune”. A legally binding mechanism for cross-border resolution (including burden sharing) may be needed to make it work. In the global setting, such a legal binding framework would be laid down in a Treaty or Convention. Cases in point are the Conventions for international burden sharing for nuclear incidents. In the 1960s a number of member countries of the OECD Nuclear Energy Agency agreed the Paris Convention and the Brussels Supplementary Convention to share the liability costs in case of a nuclear incident (Goodhart and Schoenmaker, 2006).

In the remainder of this section, we sketch the three bodies of the new European banking regime: the supervisor, the central bank and the resolution authority.

#### *1. The European Banking Authority*

The first body in the new banking regime is the European Banking Authority (EBA) on a new footing. Large cross-border banks in the EU should be licensed directly by the EBA; these are the so-called EBA banks (see section D below for a definition). The new European System of Financial Supervision allows specific powers to be transferred to the European Supervisory Authorities (ESAs). The European Securities and Markets Authority (ESMA) has, for example, received the power to supervise directly credit rating agencies. Similarly, banking directives and regulations could transfer the supervision of large cross-border banks from the national banking authorities to the EBA.

The EBA chair would need to get full powers over supervision of EBA banks. A question is how to structure the EBA and the national banking supervisors into an overall European System of Banking Supervisors. It would be instructive to examine other fields where national and European agencies are cooperating. In competition, the European Commission (DG Comp) and the national competition authorities (NCAs) in all EU Member States cooperate with each other through the European Competition Network (ECN). As European competition rules are applied by all members of the ECN, the ECN provides means to ensure their effective and consistent application. As for the enforcement of merger rules, general principles have been established to ensure an efficient division of work. The European Commission investigates mergers with a Community dimension.<sup>2</sup> Importantly, the European Commission decides on mergers with a Community dimension on its own, though it may ask information or seek advice from NCAs.

By contrast, the European Systems of Central Banks (ESCB) consisting of the ECB and the participating NCBs follows a more collegial approach. The Governing Council comprises both the

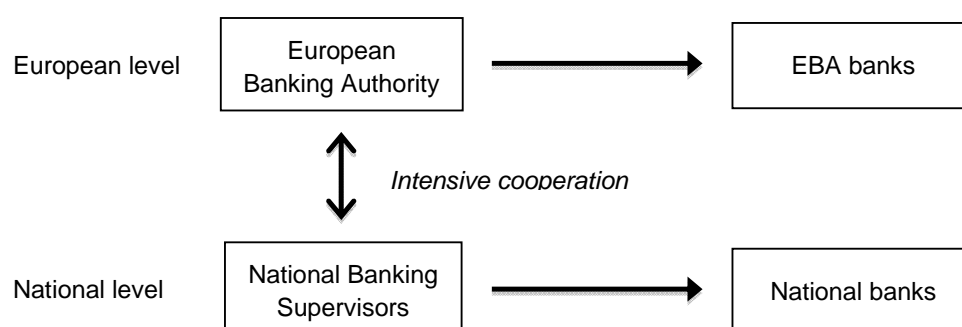
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<sup>2</sup> The main requirement for a merger having a Community dimension is that the combined aggregate worldwide turnover of the merging companies is over €5 billion and that the aggregate Community-wide turnover of each of at least two of the undertakings concerned is more than €250 million.

president and executive directors of the ECB as well as the NCB governors. As mentioned earlier, all Governing Council members operate on a euro area mandate, when deciding on the interest rate. The current set-up of the EBA is modelled on the collegial approach. All national banking supervisors participate in EBA's Board of Supervisors, which is chaired by the EBA chair (independent from national banking supervisors).

Both structures are recommended in the literature. Veron (2011) recommends following the dual competition approach, while Schoenmaker and Oosterloo (2008) propose the collegial central bank approach. When moving from the national to the European ticket for banking supervision, the prima donna problem needs to be addressed. As explained below, national authorities (supervisors and governments) are keen to preserve their national banking champions. Some chairs of national banking supervisors behave as prima donnas nourishing their national champions, leaving little scope for the chair of the EBA to be the (main) leader of the European banking supervisory community (see, for example, the experience of the bank recapitalisation described in section B). This suggests that the dual approach under which the EBA and national supervisors work complementary is to be preferred. Figure 2 illustrates the dual approach. The EBA would then have full authority over the EBA banks, while the national supervisors would continue to be in charge of the remaining national banks.

**Figure 2** Dual approach for supervising European banks



A final issue is the execution of day-to-day supervision. A system could be designed in which day-to-day supervision is done at the decentralised level under the responsibility of the centre (see Schoenmaker and Oosterloo (2008) for a full discussion). Examples of such decentralised systems are found in the US. The Office of the Comptroller of the Currency (OCC) is supervising through its four district offices, while the Federal Reserve System has located its supervisory powers at the twelve (regional) Federal Reserve Banks and not at the Board of Governors in Washington D.C. Turning to Europe, our proposed dual approach with a central supervisor for EBA banks and national supervisors for national banks would still allow for decentralised execution. The central supervisor can mandate national supervisors to execute part of the day-to-day supervision of the EBA banks, while keeping full authority. Nevertheless, the current strong national orientation of the national supervisors suggests that EBA should start to supervise the EBA banks itself. Once the national supervisors are able and willing to work on a European mandate,<sup>3</sup> EBA may devolve some parts of day-to-day supervision to them.

## 2. The European Central Bank

The second body in the new banking regime is the ECB. It has two tasks in safeguarding European financial stability: 1) monitoring stability trends and taking preventive actions; and 2) providing emergency liquidity assistance to European banks. The ECB is not yet fully equipped for the first task.

<sup>3</sup> See Hardy (2009) on a European mandate for national supervisors. A European mandate would give EU convergence and cooperation an operational dimension at the national level. It could also enhance the functioning of the new ESAs.

Since 2004, the ECB has published half-yearly Financial Stability Reviews, which provide an overview of the possible sources of risk and vulnerability to financial stability in the euro area. In addition, the ECB provides the chair and secretariat for the new ESRB, which is an independent EU body responsible for the macro-prudential oversight of the EU financial system. The ESRB contributes to the prevention or mitigation of systemic risks to financial stability that arises from developments within the financial system. It takes into account macroeconomic developments, so as to avoid periods of widespread financial distress. The ESRB also contributes to the smooth functioning of the Internal Market and thereby ensures a sustainable contribution of the financial sector to economic growth. But the legislative framework for the ESRB does neither equip the ESRB nor the ECB with macro-prudential tools. It can only give recommendations or warnings. To fulfil a leading role, such as on the recapitalisation of the European banking system from a macro-perspective (see section B), the ESRB/ECB needs to get macro-prudential tools. Otherwise, the ESRB/ECB may risk becoming a discussion forum about financial stability.

Turning to the second task, the ECB acts as lender of last resort (LOLR) to European banks. Before the crisis, the official doctrine was that LOLR operations to individual banks would be provided on the account of NCBs (Padoa-Schioppa, 1999). During the crisis, the ECB has provided LOLR operations to all euro area banks replacing the dysfunctional interbank market, working from a euro area monetary and financial stability mandate. Also banks from the out-countries with branches or subsidiaries located in the euro area have participated in the ECB LOLR operations. More generally, the reach of the ECB could go to all EU banks. The burden sharing, based on the ECB capital key (Schoenmaker, 2010), would then need to be broadened from the participating euro area members to all EU members. The General Council comprising all EU NCB governors would be the relevant decision-making body. The mandate would be EU financial stability in the provision of LOLR operations for EBA banks. National banks would continue to go to their NCB for LOLR operations.

### *3. The European Resolution Authority*

The central body of a European banking regime is the European Resolution Authority, as suggested by Posen and Veron (2009). Such a European Resolution Authority (ERA) should resolve (large) cross-border banks on a European scale, the so-called EBA banks. The ultimate decision (recapitalisation or (partly) liquidation) should be based on the impact on European financial stability. The ERA chair should be in charge to achieve orderly and timely resolution moving away from preserving national champions. Prompt corrective action is important to minimise deposit insurance losses and mandate supervisory action as capital declines (Nieto and Wall, 2006). As swift action may be needed, in particular before the bank is balance sheet insolvent, a special resolution mechanism (akin to the recently adopted Special Resolution Regime in the UK) is necessary. The Financial Stability Board (FSB, 2011) provides a good template for the key attributes of an effective resolution regime.

As many countries are now in the process of introducing special resolution regimes, Avgouleas, Goodhart and Schoenmaker (2012) argue that there is a window of opportunity to introduce an international resolution regime instead of partly compatible national resolution regimes.<sup>4</sup> In the European context, a pan-European resolution regime could be introduced by Regulation. A special resolution regime laid down in a EU regulation would ensure application to the European-wide operations of a bank. Such a Regulation would provide a European mandate and override national legislation. Next, the ERA chair can only be effective if he or she can overrule national banking supervisors and/or resolution authorities, which may care about preserving national champions (Boot, 1999). It should be noted that fully compatible national resolution regimes might still be fraught by the same (diverging) national interests. The crux is a EU-wide resolution regime.

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<sup>4</sup> The European Commission is currently working on a European template for national resolution regimes, which would be ideally compatible. Implementation in national legislation is likely to lead to partial compatibility and may thus hamper effective cross-border resolution.

Finally, an option is to combine European resolution with European deposit insurance for the same group of EBA banks.<sup>5</sup> The European Resolution and Deposit Insurance Fund would be funded through risk-based premiums. The fund should have a fiscal backstop, as discussed in the next sub-section.

#### 4. Funding

An important element of the new banking regime is the funding of the resolution authority. While there is no need to maintain a separate fund in peacetime, arrangements should be in place to guarantee automatic access to funds if and when needed. Private sector solutions to deal with ailing banks are the preferred route. Only when the systemic impact of the failure of an EBA bank would exceed the cost of recapitalisation, recapitalisation should be considered. It is a government task to provide the fiscal backstop for the recapitalisation of ailing banks. As the deep pockets in the EU are available at the level of the nation states, burden sharing is needed to muster the required funds. Goodhart and Schoenmaker (2009) suggest to making *ex ante* burden sharing arrangements, as *ex post* negotiations on burden sharing during a crisis do not work.

An open issue is whether to apply burden sharing on a general basis (EU wide according to a predetermined key) or a specific basis (country specific according to a location key, such as the geographical spread of a bank's assets). LOLR and deposit insurance would naturally be based on general burden sharing, as the monetary income (on the basis of the ECB capital key) respectively the insurance premiums (on the basis of the insured deposits key) are pooled. As for crisis resolution, a smooth transition from LOLR to resolution suggests general burden sharing. Alternatively, one can think of a mix of general and specific burden sharing. The general part considers financial stability as a public good, while the specific part looks at the location specific benefits (e.g. the stability effects of Nordea in the Nordic-Baltic region).

There are proposals to have tax capacity for a European Minister of Finance raising a budget of about 2% of European GDP (Marzinotto *et al*, 2011). While this 2% budget could cover most eventualities, there may be exceptional circumstances in banking resolution where more is needed (the deep pockets of government). Examples are the fiscal backstop to a new European Deposit Insurance Corporation (EDIC) and the resolution of one or more large cross-border banks. In that case, the European minister of finance should be able to share the burden amongst participating members based on an *ex ante* burden sharing arrangement.

Summing up, the new European supervisory and resolution regime can be thought of as the European banking fire brigade. The three commanders of this European banking fire brigade consist of the heads of the European Banking Authority, the European Central Bank and the European Resolution Authority. Their fire engine is fuelled by the European Resolution Fund (funded by national governments according to a pre-arranged burden sharing key). Figure 3 illustrates the new European supervisory and resolution regime.

**Figure 3** The European banking fire brigade



#### D. How to get there?

The big question is how to adopt the new regime. This is first and foremost a political issue. EU Member States would need to hand over supervisory and resolution powers of their large cross-border banks to the European level. This is obviously politically very sensitive. Nevertheless, the political

<sup>5</sup> By contrast, the FDIC provides deposit insurance for nationally chartered banks (the equivalent of our EBA banks) as well as state chartered banks (the equivalent of our national banks).

choice is between keeping European banks serving the needs of business and citizens in the Internal Market for goods and services, and moving to national banks reversing the Internal Market.

### *1. Transferring banking powers*

The Regulations establishing the European Supervisory Authorities (ESAs) require the European Commission to review the general functioning of the ESAs as well as the overall structure of the European System of Financial Supervisors by early January 2014. That would be a logical time to consider moving supervisory powers over the large cross-border banks from the national banking authorities to the EBA. If the sovereign and banking crisis in Europe would deepen, an earlier supranational solution for the budget side (sovereigns) as well as the banking side might be needed (Goodhart and Schoenmaker, 2011).

Once the decision is taken to transfer the supervisory powers on the large banks to the EBA, the relevant Banking Directive (2006/48/EC) needs to be changed. The EBA would then be the “competent” authority for authorising and supervising the large banks. The EBA would need a clear and unambiguous set of supervisory standards to execute its powers. The European Commission is already moving to a single rulebook for the prudential requirements based on maximum harmonisation. To ensure a truly single set of requirements the single rulebook will be contained in a Regulation (COM/2011/0452), which is directly applicable throughout the EU. In the run up towards full transfer of supervisory powers for the large banks to the EBA, the national supervisors can already start to converge supervisory practices, such as culture of supervision and Pillar 1 and 2 approaches, under the leadership of the EBA. This would be akin to stage 2 of EMU, where the European Monetary Institute (EMI) stimulated and monitored convergence of monetary practices. This would require a collegial approach, which is more common among central bankers than supervisors.

The next question is whether we should go for a compulsory or a voluntarily regime. McCahery *et al* (2010), for example, propose an opt-in model, in which banks can choose to ask for a European license. Such an opt-in model may be useful to ease in the new regime. It also follows the US model where banks can choose between a national (i.e. federal) license from the OCC and a state license from the relevant State Banking Supervisor. Nevertheless, the proposal is to move to a compulsory regime for the large cross-border banks for two reasons. First, the difficulty of resolving cross-border banks by the home country on its own suggests a supranational approach by EBA (see section B). Second, national supervisors may be tempted to preserve their national champions. The EBA chair would be able to overcome the national interests in supervision and crisis resolution, as discussed in Section C.

The proposal would be to require all banks above a certain size to apply for authorisation at the EBA. In 2009, there were nearly 8,400 banks in the EU. These banks can be segmented into three groups (De Haan *et al*, 2012). The first, very large, group of banks consists of small banks operating in a region of a country. In particular Germany and Austria have many small savings and co-operative banks, most of which have assets of less than €2 billion. The second group consists of medium-sized banks with assets ranging from €2 to €100 billion. These banks often operate on a countrywide scale. The third group are the large banks having assets up to €2,000 billion. They usually do (a significant) part of their business abroad. Following this grouping, all banks with assets of €100 billion or more would be subject to EBA supervision. We call these banks the EBA banks. There are currently about 50 banks across the EU with assets over €100 billion.

### *2. Transferring resolution powers*

If and when supervisory powers for the EBA banks are transferred to the European level, deposit insurance and resolution should be simultaneously organised at the European level for these EBA banks. Interestingly, the European Commission (2011) considers the possibility of creating a European Resolution Authority by 2014. The creation of a single European Resolution Authority would be the third step in the European Commission’s action plan. The first step concerns a legislative proposal for a harmonised EU regime for crisis prevention and bank recovery and resolution, including a common

set of resolution tools and reinforcement of cooperation between national authorities. As a second step, the European Commission will examine the need for further harmonisation of bank insolvency regimes, with the aim of resolving and liquidating cross-border banks under the same substantive and procedural rules.

The new European Resolution Authority as well as the European Deposit Insurance Corporation could be established by EU Regulations, akin to the establishment of the ESAs. It is an open question whether the two functions of resolution and deposit insurance should be integrated into a European Deposit and Resolution Authority. Perhaps we can learn from the US experience post Dodd-Frank, where the Dodd-Frank Act assigned resolution powers for large banks to the FDIC.

Supervisors and central banks are suspect to forbearance. A bank is temporarily assisted under the (often vain) assumption that the bank can recover. It is therefore important to put a limit on the time and amount of resources spent on a bank. The US FDICIA legislation includes mandatory prompt corrective action and limitations on Federal Reserve Bank advances to undercapitalised banks. Similarly, the EBA would need to operate under a prompt corrective action scheme. Moreover, rules are needed to ensure that the ECB is not keeping banks open too long with (temporary) liquidity assistance.

Finally, there is a transitional issue for deposit insurance. There is an emerging consensus for pre-funded deposit insurance with risk-based premiums. The transfer of funds from national deposit insurance funds to a new European Deposit Insurance Fund will be troublesome, because not all countries have pre-funded schemes. But this problem may be not that severe in practice, since most pre-funded schemes are currently more or less exhausted because of payouts during the on-going financial crisis.

### *3. Political accountability*

The heads of the three banking authorities (EBA, ECB, ERA) would all need a political counterpart at the European level (see Marzinotto *et al* (2011) and Goodhart and Schoenmaker (2011) for a full discussion of political and fiscal union). The idea of a European minister of finance has its *raison d'être* in the need for enforcement of the Stability and Growth Pact. The intergovernmental approach has clearly failed, as EcoFin ministers followed the principle of non-intervention: ministers would not interfere with each other on the understanding that each of them would not be touched when they ran into problems. The Euro Commissioner (in his new capacity of European minister of finance) would have full supranational powers to impose sanctions if a country transgresses the fiscal deficit rules. The Euro Commissioner would also be the counterpart for the ECB president. In any country, the Minister of Finance and the Central Bank President are *de facto* choosing the appropriate monetary-fiscal policy mix. When the central bank is operating on an independent basis, the appropriate mix can emerge tacitly.

A second power for the European minister of finance would be in the area of European banking. While the chairs of the European banking and resolution authorities can be accountable to the European Parliament, these chairs need a political counterpart in the setting of banking policies and overall accountability. Moreover, the European minister of finance needs to decide, if needed, on taxpayer's money for bank resolution.

### *4. Two speed Europe*

The Euro Minister of Finance will need his budgetary oversight powers only for the euro-zone members. He is therefore likely to start overseeing euro-zone banking supervision. The Banking Union, proposed in this paper, is both needed for maintaining the monetary union and the internal market. The statement by the Euro Area Heads of State or Government at 9 December 2011 provides for a variable geometry (European Council, 2011). The new legal framework will encompass the 17 euro-zone members and up to 9 non euro-zone members. The UK Prime Minister has exercised its veto and decided not to join. So, the new Banking Union is most likely to start for EBA banks

headquartered in the euro-zone. The solvability of the sovereigns and the banks are interlinked in the on-going euro-area financial crisis. The new Banking Union is key to the euro's survival (Veron, 2011) and therefore much needed in the short term.

But the ultimate goal should be to operate at the EU level since the Internal Market for Banking operates EU-wide. Financial services policy is as important for the UK (with the City as the premier financial centre for Europe and beyond) as agricultural policy for France. France has informal leadership on agricultural policy. It is difficult to outvote France on agricultural matters. Such a political arrangement could only work for financial services, if the UK would be prepared to play the collaborative game (and not to demand unanimity in particular financial services domains as it did at the December Summit).

The aim of our proposal is to keep the Internal Market on Financial Services. The financial system can then continue to support the real economy in an efficient way and thus foster economic growth. By contrast, an Alleingang of the euro-area in financial services would force a split in the EU's financial system. This may end up in an internationally competitive financial centre outside the "European" framework and a more traditional financial system inside the "European" framework. This is clearly a lose-lose situation: London may lose some business from its European neighbours, while the remaining European countries face a less dynamic financial system (Goodhart and Schoenmaker, 2011).

As with the advance to Economic and Monetary Union (EMU), the short-term solution is to go ahead and to form a coalition of the willing, that is the euro-zone members and the willing outs. The UK can then opt out of the new Banking Union. But most EBA banks have large operations in London. Deutsche Banks conducts, for example, one third of its business in London. The FSA (and its successor, the Prudential Regulation Authority) can work as shared supervisor with the EBA to ensure effective supervision of the London operations of the large EBA banks.

#### **E. Concluding remarks**

If policymakers seek to enhance global banking, then the international community must provide a higher and better-coordinated level of fiscal support than it has in the past (Obstfeld, 2011). Capital or loans to troubled financial institutions (as well as sovereign countries) imply a credit risk that ultimately must be lodged somewhere. Expanded international lending facilities, including an expanded IMF, cannot remain unconditionally solvent absent an expanded level of fiscal backup.

The same point obviously applies to the European framework. If policymakers want to preserve the Internal Market in Banking, then the institutional framework must be improved on the following lines:

- Supervision: The European Banking Authority must get the cross-border banks under its supervisory wings. Supervision would then move from a national mandate (with loose coordination) to a European mandate.
- Lender of last resort: The European Central Bank is *de facto* operating as the lender of last resort for the European banking system.
- Resolution: A European Resolution Authority should be established to resolve troubled cross-border banks. *Ex ante* burden sharing rules are needed to raise the required funds for resolving cross-border banks (Goodhart and Schoenmaker, 2009).
- Deposit insurance: Deposit insurance for cross-border banks should be based on a European footing.

As suggested by Allen *et al* (2011), the latter two functions can be combined within some kind of European equivalent of the FDIC. The EU would then get a European Deposit Insurance Fund with resolution powers. The fund would be fed through regular risk based deposit insurance premiums with a fiscal backstop of national governments based on a pre-committed burden sharing key.

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