

GLOBAL AND EUROPEAN FINANCIAL REFORMS

ASSESSMENT AND PERSPECTIVES

Dominique Perrut

Banking Consultant in Paris, Associate Researcher at the University of Angers (Granem)

In response to the severe disruption of the financial system, the agenda defined by the Group of Twenty (G20), in 2008, has led to a new regulatory framework. These ongoing reforms outline a new organization, which could be called the *Global and Integrated Prudential Model*. Such a model is based on *global rules* defined by international standard setters and on the *integration* between the different parts of the prudential organization. In this context, a new prudential organization is being set up in Europe.

Henceforth, international coordination is underway, but questions remain. What could be the effects of the new rules on banking capital requirements, and, consequently, on the funding of the economy, not to mention the very structure of the financial system?

As for the EU, which very swiftly carried out an important recasting of its legal frame, the continent will henceforth have to face three challenges: first, the risk of regulatory competition from large countries, chiefly the USA; second, the need to improve the law-making and the complex supervisory system; and third, the building of the Banking Union aimed at overcoming the current euro area crisis.

Keywords: Central banks, Macro-prudential regulation, Banking regulation and supervision, Financial aspects of economic integration.

The first global financial crisis which began in 2007 brought severe discredit on all the Authorities, both national and global, responsible for foreseeing, controlling and managing financial changes. In response to the severe disruption of the system, the agenda defined by the Group of Twenty (G20) has led to reforms aimed at providing a new regulatory framework in order to improve financial stability (G20, 2008 and 2009).

These ongoing reforms outline a new organization, which could be called the *Global and Integrated Prudential Model*. Such a model is based on the one hand on *global rules* defined by international standard setters and, on the other, on the *integration* between the different parts of the prudential organization, mostly between macro and micro-prudential levels.

This paper will take into account, first, the lessons to be learned from the crisis; and, second, the new prudential framework in progress at the global level; an assessment of the new framework, which lays stress on the new banking standards (Basel III), is provided. Then, it will examine how, in this context, a new prudential organization is being set up in Europe. Last, this paper will offer an assessment of the strengths and the weaknesses of this EU framework. We shall see that the implementation of such a reform faces obstacles both inside the EU (with harmonization problems) and outside it (with the worldwide regulatory competition between areas, mostly from the United States). In such a context, the current European project towards an integrated Banking Union is to be seen as an attempt to get over such obstacles and over the current euro area crisis.

1. Post-crisis lessons and reforms: The emergent Global and Integrated Prudential Model

1.1. What lessons are to be learned from the crisis?

Numerous recent debates have been aimed at throwing light on the causes of the recent crisis and on the consequences of its management. Thus a sort of consensus has emerged, which can be summarized around four chief points.

a. Central banking inflation-targeted policies have been called into question

For three decades Central Banks have adopted the so-called inflation-targeted policies aimed at stabilizing inflation at a low level. Such policies were based on the belief that retail price stability would ensure the financial system's stability (Borio, 2011). On the contrary, experience has shown that in a liberalized financial system, retail price stability may well go hand in hand with strong

increases in asset prices (real estate or stock markets). Such bubbles were often the consequence of excess in credit growth, resulting from generous liquidity provision at low rates by central banks (Aglietta, 2011; Blanchard *et al.*, 2010; Eichengreen *et al.*, 2011; Goodhart, 2010b).

These monetarist-inspired policies were not in line with liberalized economies. Indeed, given the increased function of asset markets, which are fluctuating by nature, liberalized economies have become intrinsically unstable. Thus, throughout the so-called period of Great Moderation, monetary stability went together with financial crises. Such a diagnosis has led nowadays to a new approach to Central Bank monetary policy in order to take into account financial stability.

Regarding this new goal, we are bound to wonder what kind of instrument could be used to attain it. Indeed interest rate setting by central banks, which is nowadays almost the single anti-inflation tool, would not be efficient to counteract excessive credit growth (Goodhart, 2010b). Moreover, according to the Tinbergen rule, it seems difficult to try to achieve two different objectives with the same tool. A risk of conflict between the two goals would appear in such a case. For these reasons, a consensus now exists to achieve the financial stability goal through specific instruments.

The response brought by global standard setters, namely the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS), has consisted in creating a new tool (capital buffers) with a macro-prudential goal in the new banking framework (the so-called Basel III standard; see 1.2-a, hereafter). This new tool is considered to have a countercyclical effect to mitigate excessive credit raises and their consequences, namely inflation in asset prices.

b. The new features of systemic risk in a global economy

A prolific literature has recently addressed the question of systemic risk (EU Commission, 2009; ECB, 2009; Galati et Moesner, 2011; IMF, 2009). Systemic risk can be briefly described as “the risk of widespread disruptions to the provision of financial services that have serious consequences for economy at large” (FSB, 2011b). The very existence of Systemically Important Financial Institutions (SIFIs) can be seen as a chief cause of such a risk.

Usually, these institutions, mostly banks, were detected on the basis of a single criterion, namely their size, measured according to the total amount of their balance-sheet. The 2007-2009 financial crisis revealed that two other factors could increase systemic risk. These factors consist, on the one hand, of *liquidity problems of banks*, which are related with situations of excessive indebtedness (the latter being measured by the leverage ratio); and, on the other hand, of *off-balance-sheet relations between banks*, especially through credit insurance mechanisms, such as Credit default swaps (CDSs) (FSB, 2011b; BCBS, 2011b).

It was observed during the crisis that liquidity problems and off-balance-sheet relations were acting as dangerous channels leading to quick and wide propagation of financial shocks. The unrestrained development of complex securitization was based on products such as Collateralized Debt Obligations (CDOs) and Asset-Backed Commercial Paper (ABCPs), which appear as mere financial innovation concentrates. Thus, through the securitization process we could observe that the worldwide financial system, chiefly European banks, ensured the financing of the north-American residential real estate bubble.

Among SIFIs, the FSB has isolated a sub-category called global-SIFIs (G-SIFIs). These institutions are such that “their distress or failure would cause significant dislocation in the global financial system and adverse economic consequences across a range of countries” (FSB, 2011d). In order to identify Global Systemically Important Banks (G-SIBs), a study has been carried-out by the BCBS in cooperation with the FSB. This work led to detecting a set of 29 banking groups defined as G-SIBs. A combination of criteria was defined for such a selection, including, in addition to the size, new significant features such as interconnectedness, global cross jurisdictional activity, complexity and the lack of readily available substitutes (FSB, 2011b).

c. The “Too Big to Fail” principle led to considerable changes in the Lender of Last Resort function

The notion of Lender of Last Resort (LLR) appeared two centuries ago in economic literature, but this concept has never received a clear-cut definition (Ugolini, 2011). However, it can be agreed that, in its classical meaning, the LLR function is that of the

Central Bank when it provides emergency liquidities, according to Thornton-Bagehot's well-established rules, to a distressed bank facing a liquidity problem but which is not insolvent (Thornton, 1802; Bagehot, 1873; Humphrey, 1989). This kind of operation is aimed at avoiding a banking failure which could be contagious and therefore create damage to the financial system as a whole.

Nevertheless, for 25 years, in each of the OECD banking crises following the liberalization process, Authorities have rescued insolvent institutions. Such policies were adopted according to the well-known principle Too Big To Fail (TBTF). Indeed, it was agreed that, given their size, big financial entities could bring about, should they meet a failure, a severe disruption or even a collapse of the banking system.

As a consequence, the classical Thornton-Bagehot model was replaced by a new prudential scheme about thirty years ago. We call it the Hierarchical Prudential Model (HPM). It is based on two chief features: on the one hand, *the constructive ambiguity principle* (when the Central Bank adopts a discretionary, or ambiguous, attitude towards distressed banking situations); and, on the other hand, *safety nets* (comprising both *supervision*, which includes *prudential rules* and *surveillance*, and *solidarity and guarantee schemes* (Humphrey, 1992; Gardener, 1992; Perrut, 2010).

During the 2007-2009 financial crisis, the TBTF principle was set up as an intangible rule by G7 decision-makers, in October 2008, when they solemnly declared their commitment to avoid any failure of systemically important institutions (G7, 2008).

As a result of such developments, three major changes can be observed in the LLR function. First, *a doctrinal change* occurred, for the major principles of the prudential doctrine were clearly put aside (both the "Let insolvent institutions fail", of the classical model, or the "constructive ambiguity" principle in the HPM). Second, *a diversification among authorities* acting as LLR could be observed. Indeed, task-sharing took place between States, which chiefly guaranteed recapitalization operations, and Central banks, which provided banks with liquidity. Third, the toolkit used to conduct anti-crises operations was widened to *new instruments*. As for the States, operations expanded henceforth from capital furniture to guarantees, including bad banks (or defeasance structures);

as for the Central Banks, interventions included unlimited long-term liquidity provisions and sovereign debt purchases (4); moreover major Central Banks signed unlimited currency swap agreements with each other (ECB, 2011b; EU Commission, 2009), which outline a kind of International LLR function.

d. Consequences of the crisis management: moral hazard problem and collective costs

A huge moral hazard problem and considerable collective costs can be observed, as consequences of the decision-making to deal with the recent crisis.

The solemn declaration of the G7 leaders mentioned above led to important actions to rescue insolvent institutions and therefore to big amounts of capital furniture in order to fill the equity gap in distressed institutions. The very nature of such operations led to the commitment of States rather than of Central Banks.

Such bail-out operations brought two major consequences. First, a situation of considerably increased moral hazard appears as a direct consequence of the crisis management. Indeed, all systemic institutions could from now on consider themselves as protected against a failure given their size, whatever their misbehaviours. Such an improper situation creates a stimulus for new excessive risk-taking policies.

Considerable collective costs are to be seen as a second effect of the anti-crisis policy. According to the EU Commission, approved State aid in the EU in favour of the financial sector amount to € 4.100 billion, of which about € 2.000 billion were actually employed in 2008 and 2009. IMF sources state that EU bank losses reached a global amount of € 1.000 billion and 8% of EU GDP between 2007 and 2010 (EU Commission, 2011b). Thus, the emergency crisis management led to huge collective costs in order to refloat the financial sector. Therefore, the set-up of management and resolution regimes for financial institutions is to be seen as a priority among the ongoing reforms in order to preserve the economy, to avoid moral hazard and to protect taxpayers.

1.2. Global reforms in progress: the new banking standards and a framework for resolution regimes

An ongoing set of reforms is orchestrated by the G20 and the FSB. Two main components of this agenda consist of a new set of banking standards, the so-called Basel III framework, which is to be seen as the chief tool aimed at preventing a new financial crisis, and a set of guidelines for resolution regimes for financial institutions.

In conjunction with these global responses, each country or area has initiated a recasting of its legislative framework for financial activities. Thus, within the set of recommendations from the FSB regarding macro-prudential supervision, systemic risk observatories have been set-up in the USA, the UK, China, as well as in the EU as a whole (FSB, 2011d); (see hereafter, 2.1).

Reforms can also be observed concerning micro-prudential supervision, in Europe and in the USA where, within the 2010 Dodd-Frank reform, the organization, which is currently somewhat bureaucratic is to be redefined, especially regarding the supervisory task-sharing between authorities.

a. The new Basel III standard on capital, leverage and liquidity

According to capital ratio standards, banks are required to keep an amount of capital as a percentage of their exposures, risk-weighted with several methods. The Basel III framework, still in progress, will be implemented by banks between 2013 and 2019. The existing micro-prudential tool (the capital ratio) will be dramatically strengthened. A macro-prudential overlay will be added through capital buffers and new tools, entirely different from capital ratio, namely liquidity ratios (BCBS, 2010; 2011a, b).

Regarding *the micro-prudential level*, the strengthening of the prior capital ratio, namely Basel II framework (recently changed into Basel 2.5) comprises:

- A rise in minimum capital requirements with better quality;
- A wider risk coverage;
- A new tool called *leverage ratio*, non-risk based and including off-balance-sheet exposures; such an instrument aims to restrict bank indebtedness; it establishes a strict limit for

total exposures; the latter are required to remain under the level of core capital multiplied by 33.

In order to counteract both moral hazard and systemic risk, *the macro-prudential overlay*, which is entirely new, comprises, in respect of capital requirements:

- *A countercyclical buffer* in order to limit excessive credit growth; this tool will be monitored (between 0% and 2,5% of the exposures) by the supervisors;
- *An additional capital buffer* for Systemically Important Banks (SIBs), varying from 1% to 2.5% of the exposures; such an additional loss absorbency capacity for these banks is aimed at reducing systemic risk and, should a failure occur, limiting its effects on collective costs.

Moreover, *two liquidity ratios* (a short-term one and a long-term structural ratio) will be created with a worldwide harmonization. Such tools are aimed at avoiding new liquidity crises like the chronic ones we have been faced with since 2007.

b. The setting-up of a framework for financial crises management and resolution

During the recent crisis, Authorities ascertained the lack of a resolution process for individual failures. Such a lack compelled administrations to undertake emergency actions, which led to a moral hazard problem and to losses for the taxpayers.

A resolution regime for financial institutions is aimed at avoiding the triggering of a systemic crisis when a bank failure occurs, at protecting the taxpayer and at following the proper hierarchy between the creditors.

The FSB recently published a set of principles in order to guide the national resolution regimes which are to be established. FSB guidelines call for jurisdictions to adopt several measures (FSB, 2011a):

- Designation of a resolution authority to resolve insolvent institutions;
- Definition of specific principles for cross-border groups;
- Frames for recovery and resolution plans concerning SIFIs.

Several countries have already planned measures regarding these issues.

The EU Commission, for its part, published a communication in 2010 entitled “A European framework for crisis management in the financial sector”, and made legislative proposals, June 2012 (EU Commission, 2010c; 2012b).

1.3. Towards a Global and Integrated Prudential Model

The boost given by the 2008 G20 agenda and the take-over by the coordination of international institutions outline a new organization to ensure a sounder financial system. We would qualify such an architecture as the Global and Integrated Prudential Model. Indeed, such a framework is founded on two main features. On the one hand, the authorities’ determination to respond to financial globalization has led to a *global regulation*, which should be adopted in all countries. On the other hand, the acknowledgment of systemic risk and moral hazard calls for an integrated prudential policy. This forthcoming organization thus appears as a *third generation prudential model*, following the 19th century Thornton-Bagehot classical model and the post-WW2 Hierarchical Prudential Model, as mentioned before (see 1.1-c).

A new framework defined at the global level. The 2008 G20 programme (Washington Summit) for a global reform of the financial system is based on several principles: promoting sound regulation and financial market integrity; reinforcing international cooperation; reforming international financial institutions (G20, 2008).

This action-based programme was entrusted to the FSB whose task is to ensure, together with the IMF, the coordination of regulators and standard setters. The latter comprise:

- *sector-oriented regulators* (*banking*: Bank for International Settlements, BIS, Basel Committee on Banking Supervision, BCBS; *insurance*: International Association of Insurance Supervisors, IAIS; *security markets*: International Association of Securities Commission, IOSCO);
- *standard setters with broader focus* (International Accounting Standard Board, IASB, and US Financial Accounting Standard Board, FASB, regarding accounting standards) and *international organizations* (World Bank and OECD).

A new feature in this regulatory workshop is to be found in the will expressed from now on by some regulators (Basel Committee, IASB) to expand their standard setting status to that of supervisor of the complete and harmonized implementation of their standards. Such a policy is aimed at avoiding, on the one hand, situations of unfair competition between the countries and, on the other hand, the loss of credibility in standards, should their enforcement be disordered. Thus, the Basel Committee expressed its will to ensure the follow-up of the implementation of its framework, as it appears clearly in a recent comparative report on the implementation timetable among countries or jurisdictions for Basel standards (BCBS, 2011c); (see 1.4, hereafter).

An integrated prudential organization. Integration is indeed a new feature of the new prudential organization. This appears, first, in the setting-up of *coordination between micro and macro-prudential supervision*. Integration between these two levels is required by the new banking standards, which will entrust Central Banks (whose function is, *inter alia*, to look after money and credit) with the task of implementing macro-prudential measures such as the level of countercyclical buffers. A closer cooperation between Central Banks and supervisors will be necessary in this regard in order to make the transmission of such decisions to individual banks effective. EU supervisory reform will give us an example of such integration (see hereafter, 2.1-a).

Second, prudential policy is henceforth to be seen as a *complete cycle*, including several steps linked together:

- *preventive action.* This level is based upon precocious risk detection, which is the task of systemic risk observatories, and strengthened prudential rules (mostly within Basel III reform); monetary policy probably should also contribute to deal with excessive raises in asset prices;
- *crisis management.* Crisis, when they occur are to be faced by several players, namely, Central Banks and States (whenever a LLR function is required), and micro-supervisors to manage individual distressed situations;
- *crisis resolution.* Resolution frameworks are aimed at dealing with the failure of institutions in order to avoid systemic

risk, to spare collective costs and to comply properly with the hierarchy of the rights between creditors.

1.4. The new Basel III banking framework and the global reform: what are the consequences?

a. General remarks about the global reform

If we understand correctly the logic and direction of this new prudential model, we have to wonder about the consequences and dangers facing present developments. Moreover, would a legal separation between activities be an interesting regulatory solution?

Risk of a regulatory gap between financial sectors. The new ongoing regulatory framework will comprise different components, among which the new banking rules and the forthcoming rules on the so-called “shadow banking system” (SBS). Regarding this, we can say that the wider the gap in the regulatory structure (between banks and the SBS), the stronger the incentive will be for actors to develop less regulated sectors. Ben Bernanke has observed that such a gap was a cause of the recent crisis (Bernanke, 2012). Indeed, the different parts of the regulatory system cannot be dissociated from each other. Otherwise, the very causes of the recent crisis would only be reinforced by the new banking standards. Indeed, Basel III higher standards are to be seen as a strong incentive for giving a fresh impetus to the “originate to distribute” model, especially through securitization and new developments of the shadow banking system. G20 leaders are conscious of such a situation. During the Seoul G20 meeting, in 2010, the FSB was asked to elaborate rules in order to control the shadow banking system (FSB, 2011d).

Risk of disparities and time lags between jurisdictions for implementing the reform. To be sure, the global reform will not follow the same pace, depending on countries or jurisdictions, for two reasons. First, the desire to complete the G20's programme is probably not shared with equal intensity by all countries. From this point of view, the slowness in the finalisation of the Dodd-Frank reform may lead to a situation in which national regulations will be competing, thereby slowing down or even impeding any global reform. For instance, a gap between USA and EU jurisdictions about the implementation process of the new banking rules can be

found in a recent BCBS report. According to its recent will to supervise the implementation of its rules, the Basel Committee recently published, as mentioned before (see 1.3), a follow-up report on the implementation of its standards throughout the world. As for Basel 2.5 framework (published in 2009), the report shows that the EU set its deadline at the end of 2011 for the enforcement in all Member States. According to available information, all EU countries could comply with this timetable, whereas in the USA, proposals for regulations were still under discussion and still not yet published in October 2011 (BCBS, 2011c).

Second, the implementation of the reforms cannot possibly avoid some discrepancies among firms or countries, which will lead to disparities in competition. The process of implementation for Basel II (or 2.5), for instance, shows that a perfectly coordinated and homogenous approach between firms and countries is practically impossible.

Indeed, the first pillar of Basel II framework comprises three risk categories: counterparty credit risk, market risk and operational risk. For each category, a choice is to be made by the actors, under the control of the supervisor, among several options. As to credit risk, three options are available, the standardized approach, the Foundation internal-rating-based approach (FIRB) and the Advanced internal-rating-based approach (AIRB). Options must be made for each of the seven portfolios included in the Counterparty credit risk. Thus, even in the same country, under the same supervision, the implementation of Basel rules would not be exactly the same. In the Basel III framework, countercyclical buffers and liquidity ratio will make the process even more complex. Furthermore, banks will be put under a closer oversight from national supervisors whose discretionary powers would be extended (e.g. for defining the level of countercyclical buffers).

Capital ratio versus regulatory separation between activities. Within the *Basel capital ratio*, aimed at taking into account all specific risks of banks, the latter remain free to define their capital allocation between activities according to their strengths and strategies.

As for *legal separation between banking activities* no less than three projects for reforms are currently being discussed. First, the UK Vickers reform which chiefly consists in establishing a “ring fence”

to protect retail banking activities; second, the USA Volcker Rule aimed at establishing limits to proprietary trading; and third, the EU Liikanen report proposals mostly aimed at controlling proprietary trading and particularly “risky activities” (HLEG, 2012).

Basically, mandatory separation between activities is based on two doubtful, not to say erroneous ideas. First, there is the idea that investment banks would carry more systemic risks than retail banks. Therefore it would be necessary to protect retail banking (especially deposits) with a legal separation such as that required by the old USA 1933 Glass-Steagall Act. Nevertheless, during the recent crisis, we have seen that all banking businesses can lead to systemic risks.

Second, legal separation would protect against contagious effects between activities. However, if refinancing links were to remain between businesses, legal separation would be absolutely ineffective against systemic shocks. As it was recently ascertained, liquidity appeared to be a dangerous channel leading to the propagation of financial shocks.

Would a stricter definition of legal separation prevent such propagation? In this a case, a “Chinese wall” would forbid financial links between different activities (e.g, between retail and investment banking). The consequence would be the drying-up of interbank markets. Such a situation would lead to a dramatic lowering of bank lending to the economy.

However, should a *few highly speculative and risky activities*, like proprietary trading, be separated? A mandatory separation as well as a separation in financing could indeed avoid contagious effects. But such a legal separation should be accompanied by a huge capital surcharge, which would be the only effective tool in order to ensure a downsizing of this activity.

b. Direct consequences of the new banking standards (Basel III) on the bank balance-sheets

It is far too soon to have a precise idea about the effects of the new banking standards. Indeed, on the one hand, discussions are still going on about the very definition of some rules (especially concerning the short term liquidity ratio, LCR, as mentioned below). On the other hand, two monitoring exercises have been

carried-out by regulators (BCBS) and supervisors (European Banking Authority). We can only observe that such studies were led under restrictive assumptions. The Basel Committee (BCBS) led a monitoring exercise (using bank accounts as of 30 June 2011) on 212 banks, including 103 Group 1 banks (defined as being international and having a tier 1 capital in excess of € 3 billion), and 109 Group 2 banks (BCBS, 2012). This exercise assumes full implementation of the final Basel III package and takes into account systemic surcharge. But countercyclical buffers and firm strategies, aimed at bringing a response to the new rules, are not considered. The EBA monitoring exercise (EBA, 2012) comprises 158 banks, including 48 Group 1 banks, and follows the same criteria and methodological background as that of the BCBS. Despite these limits a few trends can be identified concerning the effects of the new banking rules.

- *Capital ratios: sharp increase in capital requirements and higher banking capital needs.*

Far higher capital requirements. Such an increase in the capital requirements appears both in the new definition of the Risk-Weighted-Assets (RWA) and in the capital rates required in proportion of these total exposures.

According to the BCBS monitoring exercise, Group 1 *Risk-Weighted-Assets* would increase by 19.4% (almost one-fifth) under Basel III rules, in comparison to current RWA (Basel 2.5).

Under the new framework, *Tier 1 requirements* (comprising mostly equity) for non systemic banks would rise from 4% of the RWA (Basel II rules) to a level ranging from 8.5% to 11% (the latter including the maximum 2.5% countercyclical capital buffers) according to Basel III standards (see Appendix A). For these non systemic banks, *total requirements* would rise from 8% (Basel II) to a level ranging from 10.5% (including 7% in equity shares) to 13% (including maximum capital buffers).

For systemic banks (subject to a systemic surcharge ranging from 1% to 2.5% of the RWA), *Tier 1 ratio* would reach a level ranging from 11 % to 13,5 % (with a full systemic surcharge and full countercyclical capital buffers). The *total requirements* would reach a level ranging from 13% (including 9.5% in equity shares) and 15.5% (including 12% in equity).

Under this new definition of RWA (with a new deduction system) and capital ratios (as percentages of the RWA), Group 1 *capital ratio Tier 1* would fall from 11.5% (current rules) to 7.5% (Basel III rules), *i.e.* a decline by 4.1 percentage points and over one-third (see Appendix B). Total capital ratio, for Group 1 sample, would fall from 14.2% to 8.6% (*i.e.* a decline by 5.6 percentage points and 41%).

Higher capital needs. In terms of capital shortfall, the full effect of Basel III rules (including systemic surcharge) would lead to the following results, according to BCBS exercise (using data as of 30 June 2011). For Group 1 (see Appendix B and C):

- to meet the Common Equity Tier 1 (CET1) target (7%), the capital shortfall would amount to € 485.6 billion;
- then (assuming banks already hold 7% CET1 capital), to meet the Tier 1 capital target ratio (8.5%), Group 1 banks would need an additional € 221.4 billion;
- last, (assuming banks already hold 7% CET1 and 8.5% Tier 1 capital), to meet the total capital target ratio (10.5%), Group 1 banks would need an additional € 223.2 billion.

These estimates, which amount to a total figure of € 930.2 billion, do not include any countercyclical buffer.

Liquidity standards: towards a drastic reducing of banking transformation. As mentioned before (see 1.2-a), two liquidity ratios, still under discussion, are created in the Basel III framework. The first one, the Liquidity Coverage Ratio (LCR), is a short term ratio, aimed at ensuring that banks can withstand a 30-day stressed funding scenario. It is expected to be implemented by 2015. The second one, the Net Stable Funding Ratio (NSFR), is a long term structural ratio, designed to address liquidity mismatches. The NSFR should be implemented by 2018.

According to the BCBS monitoring exercise, the shortfall of liquid assets to comply with the LCR (on the basis of the June 2011 accounts) would amount to € 1.760 billion for the whole sample (Group 1 et 2, *i.e.* 212 banks). This shortfall represents approximately 3% of the € 58.500 billion total assets of the aggregate sample. As for the NSFR, the shortfall would amount to € 2.780 billion.

This amount represents the aggregate shortfall of banks that are below the 100 % NSFR requirement.

According to the press statement issued by the BCBS oversight body, namely the Group of Governors and Heads of Supervision, January 2012, the liquidity approach will not change, except for a few key points related with the LCR, currently under investigation.

Nevertheless, discussions which began two years ago are still going on. According to the European Commissioner M. Barnier, reserves (from Governors from the Bank of England and from the ECB) and even demands for revision (from the USA and Japan) are to be mentioned. Moreover, a Green book issued by the European Commission is expected on these topics, September 2012 (Barnier, 2012).

Regarding liquidity ratios, especially the long term one (NSFR), we observe that such a measure would strongly reduce banking transformation which is part of the function of commercial banking in order to finance the economy. Thus, the current Basel III project should be strongly mitigated in order to avoid, especially in the EU, a sharp lowering of bank lending to the economy.

c. What will be the consequences for using banks to fund the economy?

Bank strategies. Already, significant changes can be observed in bank strategies in order to deal with the new banking rules. Such measures range from: asset sales (according to BIS estimates, such asset sales from EU banks could amount to a level ranging from € 500 billion to € 3.000 billion over the next years); stopping non core businesses; reducing dramatically global exposures. For instance, according to its annual report, a major investment bank, UBS Group, has already decided to downsize its exposures sharply. The chief part of its risk-weighted assets, concerning investment banking, would be reduced by one third, namely a CH 130 billion decrease, between September 2011 (RWA: CH 400 billion) and the end of 2016 (RWA: 270 billion). Moreover, observers have pointed out that UK banks have begun a process aimed at reducing their assets (BIS, 2012a).

Bank asset-liability management. Furthermore, together with the increase of capital ratios, the implementation of the long term

liquidity ratio (NSFR) would have important consequences on the whole banking asset-liability management, both on the asset side (with an increased need for short term assets and for high quality securities), and on the liability side (with diversification of resources and more stable funding).

Risks for the financing of the economy. Thus two risks appear as possible consequences of the new banking framework. On the one hand, numerous questions are to be asked about the *conditions of funding the economy by banks*. A slowdown or a decrease in bank lending is to be feared. As a consequence, discrimination between companies, both in the volume and the cost of operations could appear, especially to the detriment of SME's which are the chief source of job creation. These rules could also lead to an increase in the cost of lending.

On the other hand, there could be a possible *crowding out effect* against the industrial sector for the collation of fresh capital and medium-term resources on the financial markets, which, apart from the States, will be solicited on a large scale by the banks to meet Basel III ratios over the next decade.

d. Towards a reshaping of the whole financial sector

The new Basel III standard probably results from the intent of BCBS regulators, namely major Central bank representatives, to reshape the whole financial sector.

Such a new organization would consist, on the one hand, in a downsizing of banks and of the banking system, whose function in the funding of firms would be reduced; on the other hand, in an increase of firm funding by financial markets and long-term investors (namely pension funds, insurance companies, hedge funds and private equity funds).

We may observe that the effects of such an evolution would converge with some alternative reforms discussed at the beginnings of the Basel III elaboration. Such alternatives comprised size limits for banks or limits related to with banking diversification.

Regarding this, the forthcoming redefinition of banking perimeters under Basel III, according to the criteria of specialization or capital requirements, is not far from some features of the UK Vickers ongoing reform.

However, these forthcoming changes could well go together with a new impetus given to the “originate to distribute” model, which appeared to be among the chief factors of the recent crisis. Indeed, capital surcharges and liquidity ratios will represent a strong incentive to boost the shadow banking system, through the securitization process. Global regulators, especially the FSB, have from now on to address a new challenge. Will they be able to define and ensure a consistent implementation of the whole G20 programme? Indeed, regarding the shadow banking system, its regulatory control is urgent in order to avoid the increased regulatory pressure on banks from leading to a new impulse to less regulated financial sectors.

2. The EU prudential framework: assessment, perspectives

The second part of this paper will examine, first, the EU prudential framework in progress, along with the global reform; second, it will discuss a few points concerning this reform; third, it will address a current issue, the so-called Banking Union for the Euro Area.

2.1. Recent changes in the EU prudential framework

Let us recall first that several EU institutional bodies were involved, during fall 2008, in dealing with the direct consequences of the crisis:

- decisions taken by *intergovernmental meetings* (European Council, Ecofin, Eurogroup), in coordination with international meetings (mostly G7 and G20) ;
- legislative or regulatory actions from the *institutional community “triangle”* (European parliament, Ecofin, Commission) ;
- *Eurosystem actions*, mostly aimed at providing banks with liquidity.

Then, the EU undertook a recasting of both its supervisory and its legislative frame for financial activities. This reform should be completed by the end of 2012 (EU Commission, 2010a; Perrut, 2012b).

a. The EU Financial Supervisory Reform

The revision of EU supervisory institutions was adopted in October 2010, and consists of:

- The creation of a macro-prudential oversight body;
- The set-up of three sector-oriented authorities, taking over from the so-called Lamfalussy supervisory Committees.

Both levels (macro and micro-prudential) are expected to cooperate through cross-representations and a Joint Committee.

Entrusted with *the macro-prudential oversight* of the EU financial system, the European Systemic Risk Board's main objective is to prevent and mitigate systemic risks. In this regard the ESRB must collect the information needed for its action, identify systemic risk, issue warnings and recommend measures when threats have been detected (EU, 2010). The president of the ESRB is the ECB president. Its Steering Committee comprises 14 members, including 7 ECB members and the 3 presidents of micro-prudential authorities. The General Board includes in addition the governors of the 27 national central banks. The ECB provides a secretariat and thereby "analytical, statistical, logistical and administrative support to the ESRB". Last, the ESRB does not have a legal personality.

The micro-prudential supervisory level, called the European system of financial supervisors (EFSF), which includes the ESRB, works as a decentralized network. While *national supervisors* carry-out their day-to-day operations, and *supervisory colleges* ensure the surveillance of cross-border groups, the *3 new European sector-oriented Authorities* (taking over the prior 3 Committees) are entrusted with the tasks of coordinating the implementation of European supervisory standards and ensuring a strong cooperation between national supervisors. Established since the beginning of 2011, these new bodies (European Banking Authority, EBA; European Securities and Markets Authority, ESMA; European Insurance and Occupational Pensions Authority, EIOPA) comprise chiefly the 27 representatives of the national public bodies entrusted with supervisory functions.

In contrast with the ESRB, these authorities have legal personalities. They are independent from political powers but are nevertheless expected to report to them. Moreover, these new bodies have binding powers on financial institutions. However, as

we shall see, these powers can only be applied in a few cases and according to complex proceedings.

Their mandate, which is extremely wide, can be summarized around two quite distinct axes:

- Elaborating a single set of rules and principles, that is to say *a common supervisory culture*;
- Solving conflicts regarding individual cross-border institutions (controlled by supervisory colleges).

b. The recasting of the legislative framework

According to a well-known “spill-over effect”, the launching of the euro, in 1999, gave a fresh boost for completing the single market of financial services with two programmes. First the Financial Services Action Plan (1999-2004) which produced 39 legal measures, and, second, the Financial Services Policy (2005-2010); (EU Commission, 2005).

From 2008 on, the crisis required emergency responses, which were followed-up by the will to reform the legislative framework for financial activities. This programme was to be completed before the end of 2011, in order to ensure a transposition in all EU member states in 2012. This plan is founded on three principles (EU Commission, 2010a; 2011a).

Enhanced transparency. This part includes: a regulation concerning credit rating agencies (CRAs), adopted in 2009; a legislative proposal on derivative markets (already published) and the improvement of the Markets in Financial Instruments Directive (MiFID), whose proposal is under discussion by the legal system.

Enhanced resilience and stability of the financial sector. This section comprises chiefly two points. First, as yet unpublished legislative proposals, in order to set up a complete set of tools for the prevention and resolution of failing banks. Second, proposals for the revision of the Capital Requirement Directive (CRD IV), published in July 2011 (a directive and a regulation), in order to take into account the Basel III framework.

Protection of the consumer. Regarding this issue, measures have been taken on short selling and credit default swaps; moreover, the

revision of guarantee schemes (concerning depositors, investors and insurance policy holders) has been completed or is in progress.

2.2. An assessment of the EU ongoing reforms

Let us examine, first, several issues raised by legal changes in the EU, second, questions related to supervision.

a. Legislative process: some improvement, but weaknesses and questions remain

In the close aftermath of the strong impulse given to the single market of financial services, in 1999, the European Council and Ecofin ordered a study on the regulation of European security markets. Published in 2001, Lamfalussy's report sets out a devastating criticism of the legal European system. Indeed, the paper regrets deeply the lack of basic common rules and doubts whether the existing legislative system would be able to produce such a corpus. It reads as follows: "the current regulatory system is not working". Moreover, the criticism turns into a flame-thrower to attack such a system, arguing that it is feeble and slow while technology changes at a fast pace. As a consequence, new EU laws are already out-of-date when implemented. Last but not least, the diagnosis underlines the lack of any control from the EU to ensure an effective and consistent implementation of rules in all the Member States (Committee of Wise Men, 2001). The core proposal of the report consists in associating regulatory and supervisory committees in the legislative process. Such recommendations led to the setting up (between 2002 and 2004) of sector-oriented committees (for security markets, banking and insurance).

These committees bring together national supervisory and regulatory bodies. They are aimed at improving the rules and, on the authority of legislative institutions, defining implementation measures.

The goal of improving the quality of legislative work has been reasserted in the Financial Services Policy programme (2005-2010) with a formula: "*better lawmaking*". Several means such as: the law recasting technique (making laws more simple, legible and up-to-date), impact assessments (cost-benefits studies), open consultations and controls for the effective application of community

rules, were used to reach such an objective (EU Commission, 2005).

Recently, in 2010, a *Smart Regulation* principle was presented in a communication of the E.C. According to this paper, the whole regulatory “*policy cycle*” must be taken into account, “from the design of a piece of legislation to implementation, enforcement, evaluation and revision” (EU Commission, 2010b).

After such attempts, we have to question the quality and the effectiveness of EU rules. As to the *improvements*, we can observe that the intensive legal work carried-out by the EU in the field of financial services since 1999 is aimed at providing the Union with a modern set of rules, consistent and constantly updated. In addition, legislative responses to address the crisis have been fast and effective, with the ambition of taking over immediate measures to ensure a whole framework for financial security. The recasting technique offers clearer and more legible rules. Follow-ups are frequently conducted. Before the proposals, synthetic green papers presenting clear questions are provided for wide consultation by all the players (see for instance: EU Commission, 2012a).

Nevertheless, weaknesses and questions remain. During the “Lamfalussy process review”, in 2007, remarks were made about the lack of sufficient delegation of power from the legal system to the committees, while it was the very purpose of the “comitology” reform (ECB, 2007). However, we can observe that henceforth the chief directives frequently go together with delegation for implementation measures.

The 2004 Market in Financial Instruments Directive (MiFID), implemented at the end of 2007, raises a number of questions. Indeed, the MiFID is to be seen as *the hard core of the financial market regulation*, whose infrastructures are subject to extremely fast technological change. Reports from market observers state that numerous advanced technologies are used by players, namely investment banks, in order to circumvent the rules, thus create glaring disparities between investors (Vauplane, 2011). What are the reasons for such unfair practices? Do they proceed from unclear, imprecise rules or from the lack of a proper supervision?

Last, is there effective control of national implementation of EU regulation, in order to ensure a consistent set of rules throughout

Europe? Eleven years after Lamfalussy's report, such a question should be seriously documented.

b. The supervisory reform : a complex organization, numerous tasks, limited binding powers

Like several large countries (USA, UK, China, *inter alia*), the EU as a whole has created a *macro-prudential oversight body*, the ESRB. This body, which has no binding powers or legal personality, depends entirely on the EBC for its technical and administrative support.

According to reports published before it was set up, this body was expected to derive its influence from its reputation (High Level Group, 2009). However, given the dependency of the ERSB on the ECB and the ECBS (within the Steering Committee and the General Council, respectively), we consider that such a body will be mostly a place for exchange and consultation, especially between the ECB and the ECBS, on the one hand, and micro-prudential authorities, on the other hand.

In contrast to the ESRB, the *new micro-prudential authorities*, already have a history because they took over prior supervisory committees that were set up almost ten years ago in the aftermath of Lamfalussy's report. Several attempts have been made to strengthen these bodies, in order to allow them to cope with the enlargement of their mandate. They have been entrusted with powers a little more binding (such as the so-called approach "comply or explain", which compels an institution to justify itself if it does not comply with a prescription).

Before being upgraded into Authorities, it was considered that these sector-oriented committees were mainly acting as "informal mediators" (CEPS, 2009). Moreover, the increase in the number of bodies and committees (4 Lamfalussy's committees and 3 Authorities, henceforward), which create risks of overlapping, is to be mentioned (for instance, between European Banking Authority and ECB's Banking Surveillance Committee).

The recent upgrading of the supervisory committees into Authorities provides these bodies with extended capacities, owing to their legal personality and binding powers. However, two limits are to be noted. On the one hand, the decision-making process will

remain difficult because of the collegiate governance. On the other hand, binding procedures that could be undertaken against a financial institution or a national authority (the latter being represented within the new EU Authorities) are complex and, obviously, somewhat tricky.

The specialization of these bodies according to each financial sector (banking, insurance, security markets) has been discussed. Indeed, one might wonder if choosing a single supervisor for all financial businesses would not have been a better solution. However, such a specialization can be seen as preferable, given the specific features of each business, namely concerning rules, national organization and even the very nature of risks (by contrast with insurance, banks have to address systemic risk).

In order to cope with the *supervision of cross-border banking groups*, especially when crises occur, the EBA is supported by two tools, as mentioned, supervisory colleges and memoranda of understanding. *Supervisory Colleges* (there are about 120 SC in the whole EU) bring together, for each cross-border banking group, the authority of the home country (where the registered office of the group is established), which is the *lead supervisor*, and authorities of all the host countries (where subsidiaries or branches are situated). According to field testimonies, hostile situations can be observed in those colleges, between host and home supervisors. Moreover, several reports have pointed out the lack of effectiveness of supervisory colleges to deal with crises of cross-border banking group such as Dexia or Fortis (Pisani-Ferry and Sapir, 2009).

European *memoranda of understanding* (either multilateral or bilateral) are signed between authorities of banking supervision, central banks and finance ministries in order to offer guidelines for financial crises situations. It appears that such agreements were not helpful during the recent crisis (EU Commission, 2010d).

In addition, new Authorities are entrusted with the task of improving the legislative process, owing to their field experience, especially regarding the definition of implementation measures foreseen in the directives. They are also expected to promote a common supervisory culture and practice in order to ensure a consistent implementation of EU rules. A common basis of this kind for supervision is needed to avoid regulatory competition.

2.3. Towards a banking union for the euro area

a. The vicious circle of debt and the lack of integrated anti-crisis mechanisms

The so-called euro area crisis erupted in spring 2010, with Greek public debt problems. Since then, contagious effects towards other countries (Ireland, Portugal, Spain) have been observed. Two and half years later, the crisis is still not under control. A consensus is now emerging about the causes of such a lasting crisis. Indeed, public finance unbalances and acute banking problems are now creating a vicious circle (BIS, 2012; IMF, 2012; Merler and Pisani, 2011, 2012). Such a situation results from the strong links existing between banks and States, for two reasons.

On the one hand, the euro area lacks an integrated framework for addressing individual banking crises. In such a situation, each member state remains responsible for rescuing its own national banking sector. Given the size of the banking sector, rescue operations, when they occur, have important consequences on public budgets. Thus, the need for bank recapitalization leads to public unbalances.

On the other hand, European banks hold portfolios comprising a high proportion of sovereign bonds as a percentage of their total assets. Indeed, public bonds held by European banks amount to 41.5% of the risk-weighted assets (RWA, according to Basel Committee methodology) in Germany, December 2010, and to 20% and more in France, Italy and Greece (Merler and Pisani, 2012). The breakdown of these public bond portfolios shows a strong concentration upon domestic public debt. As a matter of fact, domestic public bonds amount to more than 70% of the total public bond portfolios held by German banks, September 2011. The percentage rises to more than 80% in Spain, Ireland, Italy and Portugal. Since then, whenever doubts are raised about the solvency of member states, fears lead immediately to impairments of bank public bond portfolios and to bank downgrading by rating agencies.

Moreover, we have to recall that the euro area lacked a public finance solidarity mechanism, at least until 2010. Such a lack created a factor of uncertainty for market operators. Indeed, it was to be feared that a national public finance crisis would lead to the

failure of a euro member state. Such worries were expressed, as early as 2009, through the sharp rise in the spreads between public bond interest rates among euro area countries.

b. A global response to the crisis of the EMU

During the European Council (EC), June 2012, EC President Van Rompuy presented a report entitled “Towards a genuine EMU”, following discussions with the Eurogroup, the ECB and the EU Commission, and comprising proposals (European council, 2012a).

These proposals consist of a building block approach to make the EMU stronger over the next decade. The latter comprises four blocks: an integrated financial framework (the so-called “Banking Union”); an integrated budgetary framework; an integrated economic policy framework (to promote sustainable growth); ensuring democratic legitimacy and accountability (such a goal would be reached through: a better involvement of the European parliament, EP, in EU procedures; and a better cooperation between national parliaments and EP).

Conclusions of the EC meeting invite the President of the EC to develop, in close collaboration with the same institutions, a specific and time-bound road map for the achievement of a genuine Economic and Monetary Union before the end of 2012. The Euro area statement, June 2012, and the Commission proposals under Article 127 (on the prudential tasks the ECB can be entrusted with), September 2012, are to be taken in account for that purpose.

c. What kind of “Banking Union”?

Among the four block approach of the European Council (EC) report, the integrated financial framework still has to be precisely defined before the end of 2012, according to recent Commission proposals, September 12, EC Interim Report, October 12, and meetings. The financial block, or the so-called Banking Union, can be examined through four items (EU Commission, 2012c).

Integrated supervision. This level would be entrusted to the EBC, according to Article 127(6) of the Treaty (TFUE). This article foresees that specific tasks may be conferred upon the ECB by the

European Council, concerning policies relating to the prudential supervision of credit institutions. The scope of institutions concerned by such a function will surely raise tense debates in the next months. This scope would surely comprise, among the 6.000 existing banks, systemic banks, international banks and banks receiving public support. It could also comprise all the other European banks, according to the last proposals from the EU Commission, September 12.

A part of the supervisory tasks, such as the protection of the consumer, would remain decentralized at the level of national supervisors. According to the recent EU Commission proposals, the organization of the ECB should be redefined in order to ensure that monetary policy, under the control of the Council of Governors, and prudential policy, entrusted to a Supervisory board, are strictly separated.

A European deposit insurance scheme. This mechanism would be integrated at the euro area level. It would include banks overseen by the European supervision.

A European resolution scheme. Such a scheme would be funded by contributions of banks and would also be integrated at the euro area level for banks concerned by the integrated supervision. Both the deposit insurance scheme and the resolution scheme could be set up under the control of a common resolution authority.

The European stability mechanism (ESM) as a backstop. In order to give sufficient credibility to these two mechanisms (deposit insurance and resolution schemes), the ESM could act as a fiscal backstop. (European Council, 2012–1). The ESM could also intervene on public debt markets and in order to recapitalize banks. Regarding this, the Euro area statement, 29 June, only gives general principles, which should be formalized in a memorandum of understanding.

Thus, EC proposals for the euro area are based upon two inter-connecting ideas. On the one hand, it is necessary to break the vicious circle between banks and states. The direct recapitalizing by the EMS would be the proper response to such a situation. On the other hand, such a solution requires that a preliminary step would

be achieved, consisting of an integrated supervision and common deposit insurance and resolution schemes.

d. Discussion

Global remarks about European Council proposals “Towards a genuine EMU”. The EC fourfold building block approach can be seen as a medium term political package aimed at strengthening the EMU. This programme announces a step forward in order to address two of the chief weaknesses of the EMU when it was launched—namely, the lack of budget coordination and the lack of centralized banking supervision. However this plan has two shortcomings.

First, the target of the so-called “Democratic legitimacy and accountability” block appears to be very limited. Certainly, the intention to include the European Parliament and national Parliaments “at the level at which the decisions are taken” is to be welcomed. However, it is to be deeply regretted that this block does not offer the slightest idea of any other institutional reform. As a matter of fact, the European institutional framework, whether at the global or euro area level, has become extremely complex. Such a situation cannot but hamper the effectiveness of the European process and its understanding by citizens. Clarity should be seen as a necessary component of democracy and accountability.

Second, it should be noted that the project for a Banking Union does not take into account the question of reforming banking structures. Such a reform could contribute, together with the new banking standards and the resolution plans, to making the system sounder. Indeed, this topic is analyzed in the recent Liikanen report, October 2012, mandated by the EU Commission, February 2012 (HLEG, 2012). However, proposals made in the document about banking structures are somewhat timorous and indefinite, even concerning the core measure on trading activities.

Remarks about the Banking Union. As mentioned above, these proposals will remain under discussion until the end of 2012. Nevertheless, a few questions can be raised and remarks made regarding the project of a banking union. As a preliminary remark, we are bound to observe that such a project is, de facto, an

acknowledgement of the limits of the recent reforms both of the supervision (2010) and deposit insurance.

What should be the scope covered by the banking union? This question is one of paramount importance given the fact that, as we saw before, the different blocks of the project of the Banking Union would be applied to the same coverage of institutions.

According to the Commission recent proposals, all the euro area banks should be subject to the integrated supervision from the ECB. Such coverage would be enforced according to three steps: first, it would concern all banks receiving public support (1 January 2013); second, the most significant systemically important banks (1 July 2013); third, all the banks from the euro area (1 January 2014). To argue about such a wide coverage, the Commission points out that last bank failures were observed in non-systemic banks. Nonetheless, these failures have created “significant negative impacts on the financial stability of Member States” (EU Commission, 2012c).

Yet German leaders expressed a clear opposition to such an extension of the ECB supervisory tasks. In their view, the ECB is not provided with sufficient means in order to ensure such control. They also consider that a proportion of about 90% of the banking assets in the euro area is held by about 200 banks.

Another concentration indicator can be found for the whole EU in ECB data as of December 2011. The latter show that 37 banks (out of 4.713) hold total assets amounting to € 26.780 billion (out of € 44.820 billion), which represent 60% of the total banking assets.

We may consider that the supervisory reform should only concern about 100 banks comprising banks with public support, systemic banks and cross-border banks.

Centralized supervision would offer one important advantage which would be to ensure an harmonized implementation of banking rules, especially of the new Basel III framework (which is transposed in EU by the CRD IV directive and the CRR regulation). Indeed, the current approach would leave some important powers to national supervisors (like the decisions about the enforcement

of the countercyclical buffers) and therefore could lead to a kind of regulatory competition through the euro area.

What form of task-sharing will exist between the ECB and the current supervisory system? The current supervisory system comprises national supervisors and the new supervisory architecture, examined above (see 2.1). The latter consists of a macro prudential level, chiefly entrusted to the ECB, and a micro-prudential level entrusted to the 3 sector-oriented authorities bringing together national supervisors. These two levels work together through the European System of Financial Supervisors.

Questions must be raised about the relations between the EBA and the ECB to achieve the new prudential tasks entrusted to the ECB. According to the Commission proposals, voting arrangements within the EBA should be adapted, in order to avoid giving an automatic majority to euro area representatives.

As for the task-sharing, in our opinion, the ECB should manage only prudential supervision over a small number of banks, *i.e.* all the banks belonging to the 3 categories mentioned above. The remaining supervisory tasks (protection of the consumer, control of the enforcement of the EU rules...) should be ensured by the existing authorities (national supervisors and European Banking Authority).

We are bound to observe that this new forthcoming reform, with its different levels (supervision, deposit and resolution schemes, ESM) is likely to make the current system even more complex. This forthcoming multi-level supervisory process should be simplified and clarified in order to become: technically clear and understandable by citizens; efficient and not excessive (centralized supervision of all banks is not relevant); and able to take quick decisions.

3. Conclusion

Aimed at addressing the first global financial crisis with a global regulatory reform, the G20 agenda outlines a new prudential architecture, which is global and integrated. Such a goal is ambitious. Henceforth, international coordination is operative and functioning, but questions remain. Is there the same strong will in all

countries to ensure a complete achievement of the G20 programme? What could be the perverse effects of the new rules?

Regarding the new banking rules on capital and liquidity, it is to be feared that such a reform would lead to a decrease in the funding of the economy, especially of SMEs which create jobs. These new rules will probably give a strong impulse towards the reduction of banking functions in the financial sector and an increased role for other actors. What is at stake is the entire reshaping of the financial sector. Will the global regulators be able to define a consistent framework in order to control all financial actors and to ensure its complete implementation? Such is the chief post-crisis challenge in order to avoid, on the one hand, regulatory circumventing through the shadow banking system, which would only repeat recent misconduct, and, on the other, regulatory competition between the chief areas.

As for the EU, which very swiftly carried out an important recasting of its legal frame, the continent will henceforth have to face three challenges. The first is outside the EU and results from the risk of regulatory competition from large countries, chiefly the USA. The second is inside the EU and is the result of the complex organization of the legal and supervisory system. We are bound to wonder if the challenge of creating a set of harmonized rules and practices in all the countries can be met without improving such an institutional framework.

The third challenge is related to the redefinition of the Economic and Monetary Union around four blocks. A chief element of the latter covers all of the sensitive issues in the debate over Banking Union, the precise shape of which still has to be defined. Leaders should soon be able to move on to a new stage in the integration of anti-crisis measures.

Yet important features remain unclear and still under discussion. The definition of a new, clear and efficient frame will be a decisive test of the ability of EU decision-makers to overcome the current political and financial crises. These are technical issues, but what is at stake is a central political question: will the EU leaders ensure the “sustainability” of the European process?

Two tasks lie ahead, the redefinition of world standards and the European financial reform. These post-crisis programmes are

aimed at bringing the liberalized financial system into line with social and economic needs. It seems that EU citizens have a compelling duty to watch developments in these two areas very carefully.

References

- Aglietta M., 2011. "La rénovation des politiques monétaires", Complément A, in *Banques centrales et stabilité financière*, Rapport du CAE.
- Bagehot W., 1873. *Lombard Street: A Description of the Money Market*, London: H.S. King; reprinted, Homewood, III:Richard D. Irwin, 1962.
- Bank for International Settlements, 2012a. *Quarterly report*, March.
- Bank for International Settlements, 2012b. *82nd Annual report*, July.
- Barnier M., 2012, Interview, *Les Échos*, September 1st.
- Basel Committee on Banking Supervision, 2010. *Basel III: International framework for liquidity risk measurement, standards and monitoring*, December.
- Basel Committee on Banking Supervision, 2011a. *Basel III: A global regulatory framework for more resilient banks and banking systems*, <<revised version, June.
- Basel Committee on Banking Supervision, 2011b. *Global systemically important banks: Assessment methodology and the additional loss absorbency requirement*, June.
- Basel Committee on Banking Supervision, 2011c. *Progress report on Basel III implementation*, October.
- Basel Committee on Banking Supervision, 2012. *Results on the Basel III Monitoring exercise as of 30 June 2011*, April.
- Bernanke B. S., 2012. *Federal Reserve Bank of Atlanta Financial market Conference*, Stone Mountain, April 9th.
- Blanchard O.J., G. Dell'Ariccia and P. Mauro, 2010. "Rethinking Macroeconomic Policy", *IMF Staff Position Note*, 10/03, February 12.
- Borio C., 2011. "Central banking post-crisis: What compass for uncharted Waters?", *Bis Working Paper*, 353, September.
- Borio C. and M. Drehmann, 2009. "Towards an Operational Framework for Financial Stability: 'Fuzzy' Measurement and its Consequences", *BIS Working Paper*, 284.
- Brunnermeier M., A. Crocket, C. Goodhart, A. Persaud and H. Shin, 2009. "The Fundamental Principles of Financial Regulation", *Geneva Reports on the World Economy*, CEPR, 11, January.

- Center for European Policy Studies, 2008. *Concrete Steps towards More Integrated Financial Oversight, The EU's Policy Response to the Crisis*.
- Committee of Wise Men on the Regulation of European Securities Markets, 2001. *Final Report*, Chaired by A. Lamfalussy, Brussels, February 15.
- Davis E. P. and D. Karim, 2009. "Macro-prudential regulation, the missing policy pillar", *Keynote address at the 6th EUROFRAME Conference*, London, June.
- Eichengreen B. *et al.*, 2011. "Rethinking Central Banking", *Brookings Institution*, Washington.
- Euro Area, 2012. *Euro Area Summit Statement*, June 29.
- European Banking Authority, 2012. *Results on the Basel III Monitoring exercise as of 30 June 2011*, April.
- European Central Bank, 2011a. *Financial Integration in Europe*, May.
- European Central Bank, 2011b. "The ECB's non-standard measures: impact and phasing-out", *Monthly Bulletin*, July.
- European Central Bank, 2011c. "The new EU framework for financial crisis management and resolution", *Monthly Bulletin*, July.
- European Council, 2012a. *Towards a genuine EMU*, Report by the President, June 26. EUCO 120/12.
- European Council, 2012b. *Conclusions*, June 28/29, EUCO 76/12.
- European Council, 2012c. *Towards a genuine EMU*, Interim Report by the President, October 12.
- European Commission, 2005. *White paper: Financial Services Policy 2005-2010*, Brussels.
- European Commission, 2009. *European Financial Integration Report 2009*, Commission Staff working Document, SEC (2009) 1702 final.
- European Commission, 2010a. *Regulating financial services for sustainable growth*, Communication, COM (2010) 301 final.
- European Commission, 2010b. *Smart Regulation in the EU*, Communication, COM (2010) 543 final.
- European Commission, 2010c. *An EU Framework for crisis Management in the Financial Sector*, COM (2010) 579 final.
- European Commission, 2010d. *Communication: Towards a Single Market Act*, COM(2010) 608 final.
- European Commission, 2011a. *Regulating financial services for sustainable growth, A progress report*.
- European Commission, 2011b. *Press release on CRD IV*, July 23.
- European Commission, 2012a. *Green paper: shadow banking*, COM (2012) 102 final.

- European Commission, 2012b. *Proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms*, COM (2012) 280/3.
- European Commission, 2012c. *A roadmap towards a Banking Union*, COM (2012) 510 final.
- European Union, 2010. *Regulation (EU) 1092/2010, Establishing a ERSB*.
- Financial Stability Board, 2011a. *Key Attributes of Effective Resolution Regimes for Financial Institutions*, October.
- Financial Stability Board, 2011b. *Reducing the moral hazard posed by systemically important institutions*, October 20.
- Financial Stability Board, 2011c. *Macroprudential policy tools and framework*, October 27.
- Financial Stability Board, 2011d. *Overview of progress in the Implementation Recommendations for Strengthening Financial Stability, Report to G20 leaders*, November 4.
- G7, 2008. "Leaders Statement", *Washington*, October 10.
- G20, 2008. "Declaration, Summit on Financial Markets and the World Economy", *Washington*, November 15.
- G20, 2009. "Leaders Statement", *London Summit*, April 2.
- Galati G. and R. Moessler, 2011. "Macroprudential policy – a literature review", *BIS Working Papers*, 337, February.
- Gardener E. P. M., 1992. "Banking Supervision", in *The new Palgrave Dictionary of Money and Finance*, Ed. Newman P., Milgate M., J. Eatwell.
- Goodhart Ch. A. E., 2010a. "The changing role of central banks", *BIS Working Papers*, 326, November.
- Goodhart Ch. A. E., 2010b. "La surveillance macro-prudentielle", complément B, in *Banques centrales et stabilité financière*, Rapport du CAE.
- High-level Group on Financial Supervision in the EU, 2009. *Report*, Chaired by J. de Larosière, February.
- High-level Group on reforming the structure of the EU banking sector, 2012. *Final Report*, Chaired by E. Liikanen, October 2.
- Humphrey T. M., 1989. "Lender of Last Resort : the Concept in History", *Federal Reserve Bank of Richmond Review* 75, March-April : 8-16.
- Humphrey T. M., 1992. "Lender of Last Resort", in *The new Palgrave Dictionary of Money and Finance*, Ed. Newman P., Milgate M., J. Eatwell.
- IMF, 2009. "Detecting Systemic Risk", chapter 3 in *Global Financial Stability Report*, April.
- IMF, 2012. *Global Financial Stability Report*, April.
- Kindleberger C. P., 1989. *Manias, Panics and Crashes : A History of Financial Crises*, Basics Books.

- Merler S. and J. Pisani-Ferry, 2011. "Who's afraid of sovereign bonds?", *Bruegel policy contribution*, February.
- Merler S. and J. Pisani-Ferry, 2012. "Une relation risquée : l'interdépendance entre dette bancaire et dette souveraine et la stabilité de la zone euro", *Revue de Stabilité financière*, Banque de France, April.
- Perrut D., 2010. "Do the new financial regulations for the European Union offer good responses to the current crisis and forthcoming challenges?" *Communication at the 7th EUROFRAME Conference*.
- Perrut D., 2012a. "Quelle banque centrale pour l'Europe de demain?", www.atlantico.fr, January.
- Perrut D., 2012b. "Financial regulation after the subprime crisis: lessons and reforms", Robert Schuman Foundation, *Policy paper*.
- Pisani-Ferry J. and A. Sapir, 2009. *Banking crisis Management in the EU: An Interim Assessment*, Bruegel.
- Schinasi G. J. and E. M. Truman, 2010. "Reform of the Global Financial Architecture", *Peterson Institute for International Economics*, Working Paper, September.
- Thornton H., 1802. "An Inquiry into the Effects of the paper credit in Great Britain", F. H. Hayek ed., *Mac Kelley*, (1978).
- Ugolini S., 2011. "What do we really know about the long-term evolution of central banking ?", *Norges Bank Working Papers*, 15.
- Vauplane H. de, 2011. "Révision de la directive MIF", *Revue Banque*, February.

Appendix A

Table. Capital requirements, as a percentage of risk-weighted assets

	Basel III				Basel II	
	Min	Conservation buffer ¹	Countercyclical buffer	SIFI surcharge ²	Total ³	Min
Common equity	4.5	2.5	0–2.5	1–2.5	7–12	2
Tier 1 ⁴	6				8.5–13.5	4
Total (Tier1 + Tier 2)	8				10.5–15.5	8

1. Buffer that restricts distributions if the capital ratio falls below 7%.

2. SIFIs will be placed in buckets according to their systemic importance, whereas non-SIFIs will receive a zero surcharge. An empty bucket will be added on top of the highest populated bucket to provide incentives for banks to avoid becoming more systemically important. If the empty bucket becomes populated in the future, a new empty bucket will be added with a higher additional loss absorbency level applied.

3. A SIFI operating at the peak of the financial cycle could be required to hold up to 12% of common equity against risk-weighted assets under Basel III. Under the Basel II definition of common equity, the ratio of common equity to risk-weighted assets would be roughly 15% for the same bank.

4. Common equity plus additional Tier 1 capital.

Source: BIS, 82nd Annual Report 2011/2012, 2012. Table VI.B

Appendix B

Table. Aggregate capital ratios and capital shortfalls

	Fully implemented requirement, in percent		Actual capital ratios, in percent		Capital shortfalls, in € billions	
	Minimum	Minimum plus capital conservation buffer	Current	Basel III	Minimum	Minimum plus capital conservation buffer [*]
Group1						
CET1	4.5	7.0	10.2	7.1	38.8	485.6
Tier 1	6.0	8.5	11.5	7.4	66.6	221.4
Total	8.0	10.5	14.2	8.6	119.3	223.2
Group2						
CET1	4.5	7.0	10.1	8.3	8.6	32.4
Tier 1	6.0	8.5	10.9	8.6	7.3	16.6
Total	8.0	10.5	14.3	10.6	5.5	11.6

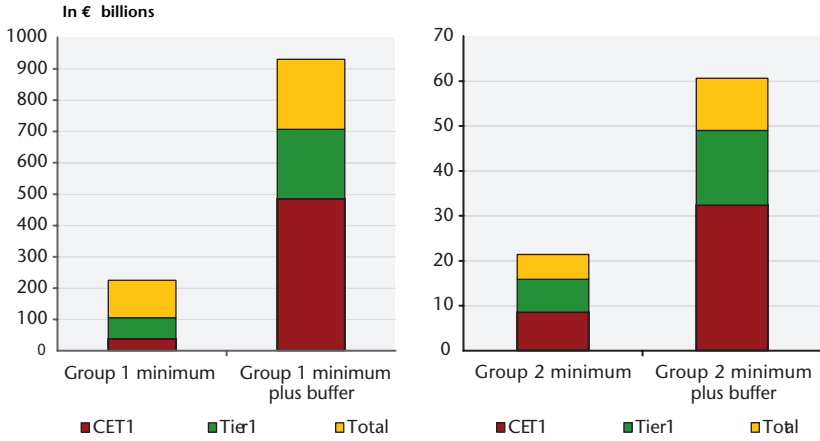
The shortfall is calculated as the sum across individual bank where a shortfall is observed. The calculation includes all changes to risk-weighted assets (eg definition of capital, counterparty credit risk, trading book and securitisation in the banking book). The Tier 1 and total capital shortfalls are incremental assuming the higher tier capital requirements are fully met. See below for details.

*The shortfalls including the capital conservation buffer also include the capital surcharges for 28 initial G-SIBs as applicable.

Source: BCBS, 2012, Results of the Basel III monitoring exercise as of 30 June 2011.

Appendix C

Figure. Estimated overall capital shortfalls, participating Group 1 and Group 2 banks



Source : BCBS, 2012, Results of the Basel III monitoring exercise as of 30 June 2011.

EXIT STRATEGIES
STRATÉGIES DE SORTIE DE CRISE

Financial crisis, economic adjustment and a return to growth in the EU	277
John FitzGerald	
How to restore sustainability of the euro?	303
Kari E. O. Alho	
The European Redemption Pact: An illustrative guide	341
Hasan Doluca, Malte Hübner, Dominik Rumpf and Benjamin Weigert	
Good and bad equilibria: What can fiscal (and other) policies do?.	369
Pier Carlo Padoan, Urban Sila and Paul van den Noord	
The European Monetary Fund: A systemic problem needs a systemic solution	389
Stephan Schulmeister	
