Board of Academic Advisors at the
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- Chairman -

Prof. Achim Wambach Ph.D

Director of the Institute for Economic Policy,
University of Cologne
Albertus-Magnus-Platz
50923 Cologne, Germany

TEL +49 221 470 4433
FAX +49 221 470 5024
E-MAIL wambach@wiso.uni-koeln.de
INTERNET www.bmwi.de
AZ -

Dr. Philipp Rösler
Bundesminister für Wirtschaft und
Technologie
11019 Berlin

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On the Stability of the European Financial System

(Zur Stabilität des Europäischen Finanzsystems)

At its meetings of 28/29 June 2012 and 27/28 September 2012, the Board of Academic Advisors at the Federal Ministry of Economics and Technology discussed the developments in the financial system of the Eurozone, the decisions taken by the summit in Brussels on 28/29 June 2012, and the European Commission's proposal for a banking union dated 12 September 2012. In particular, the Board considered how the functioning of the financial system in the Eurozone / the European Union can be ensured while core objectives of the monetary union like price stability and fiscal stability can be upheld at the same time. The Board recommends that the approach to be taken be tailored to the particular features of the Eurozone. There should be a strengthening of the European institutions in the banking sector and it should be ascertained that appropriate decision-making procedures and the capital providers' rights to exert control do safeguard the optimal functioning of these institutions.

As a premise, the Board asserts that the supervision, the regulation and the handling of banks in financial distress can no longer be left solely to the individual member states.

It is vital for the Eurozone to aim at building a more robust banking system, as the Board already explained in its *Gutachten zur Reform von Bankenregulierung und Bankenaufsicht nach der Finanzkrise – Gutachten 03/10* (Expertise on the reform of banking regulation and banking supervision following the financial crisis). This is not only necessary to reduce the risk of banking crises, but is also a condition to ensure that future sovereign debt crises do not imperil the financial system as a whole. With a more robust system, the no-bailout principle would be strengthened and would gain in credibility in the medium term.

Experience also demonstrated that national supervisory authorities and governments hesitate to tackle the problem of banks in financial distress. Thus fragile banking structures, or structures that do not function any more, remain in place. The fact that the banks supply credit to the national economy and the state, and the ensuing interdependency are the cause of such hesitant behaviour.

However, the establishment of a Eurozone-wide – or even Europe-wide – authority for the supervision, the regulation and the solution of solvency problems of the banks in the Eurozone generates significant risks. First, Europe faces regional crises and should reorganize its financial system and settle it on a sustainable basis at the same time. Second, the envisioned new decision-taking procedures for such a Eurozone-wide authority can only have the desired effect if they are not misused to initiate transfers to the detriment of those countries whose banks have no solvency problems. These circumstances require a cautious approach and careful planning when establishing the necessary Eurozone institutions

In the following, we list the core parts of a first step for such an institutional development. We also identify possible problems.

Key objectives:

• To maintain the functioning of the financial system. To prevent banks from getting into financial distress and, if necessary, to tackle problems and to reorganize inefficient banking structures of the Eurozone,

• To strengthen the resilience of the financial system of the Eurozone and to establish a credible no-bailout principle,

• To guarantee a monetary policy that is primarily-oriented towards price stability, and to ensure its independence from fiscal policy,

• To avoid an increase of the tax-payers' burden.

Core parts of a first step

The establishment of a Eurozone-wide authority for the regulation and supervision of the banking system should not be abrupt. In view of the national banking systems' high degree of heterogeneity, the cautious proceeding we recommend is likely to take years. Furthermore, the European Union will have to clarify beforehand whether the envisioned establishment should comprise all EU member states or be restricted to the members of the Eurozone. Our suggestions start from the assumption that they will be applied to the Eurozone, but the system we suggest may be extended to the European Union.

1. *European banking supervision, more robust regulation, and the no-bailout principle*

In an initial phase, the banking supervision authority should be given the power to supervise all systemic and cross-border banks of the Eurozone. It should be able to investigate these banks' economic situation and to initiate their restructuring, if necessary. In a second step, medium-sized banks and those banks whose activity is limited to single state would be placed under the Eurozone-authority's supervision. During this second step, this authority would be exercised in co-operation with the national supervisory authorities.

Such a shift of power from the member countries to Eurozone-level has to go hand in hand with improvements in regulation, information exchange and with a strengthening of the entire banking system of the Eurozone. In particular, the risks for the sovereign debtors' securities should be accounted for with appropriate risk-weighting in the banks' accounts. There should also be a general, gradual raise of the banks' capital adequacy (cf. *Gutachten zur Reform von Bankenregulierung und Bankenaufsicht nach der Finanzkrise – Gutachten 03/10*).

The resilience of the Eurozone's financial system should be increased not only to avoid the macroeconomic disruption that is usually caused by banking crises – or at least to reduce the frequency of such disruptions. It is also the condition for an improvement in the functioning of the entire monetary union. If banks are more robust, they are less easy to misuse for enforced state-financing, and they are less likely to ask the state for a support that might lead this state into financial trouble. Robust banks are less menaced by default and valuation risks from loans to highly-indebted Eurozone members. Such resilience would give more credibility to the no-bailout clause pursuant to Art. 125 of the TFEU. As a matter of fact, it would allow its enforcement in the first place.

Thus, the enhancement of resilience is as important as the shift of authority over banking supervision – and these two developments must be tackled together.

2. *Tackling individual banks in financial distress and banking crises*

The new authority we suggest will have to launch a restructuring procedure whenever a bank that was placed under its supervision encounters difficulties. Because of their interdependency, national supervisory authorities and governments would hesitate to take drastic measures. For this reason, banking supervision in the Eurozone should be complemented by a restructuring procedure that can be initiated by the European supervisory authority and that follows common rules.

The Board addressed the issue how the problems of individual banks in financial distress should be addressed, as well as the issue of banking crises (see its letters dated 10 October 2008 and 23 January 2009). The approach recommended in these two letters could also be used at Eurozone level. The losses caused by a restructuring should be primarily borne by the shareholders, and then by the creditors. The affected banks could also obtain additional liable funds, either from participation in bank equity or through a temporary fiduciary takeover. Viable parts of the bank should be sold, and the other parts restructured or closed.

3. *No European-wide deposit insurance at the moment*

Even if banking supervision and regulation might be advantageously complemented with a limited-deposit insurance scheme, the introduction of a uniform insurance system for the Eurozone is not advisable at the moment. It would mean that the individual deposit insurance systems would find themselves liable for substantial claims coming from outside their own area, claims which might exceed their capacity. Specifically, as the value of the banks' deposits would be guaranteed mutually, the deposit insurance systems could be used indirectly to cover defaults from an individual country, if the banks had granted credit to the state or purchased its securities. This might induce highly-indebted member states to call on this mutual liability, which would harm fiscal discipline.

4. *Securing the function of the new European authority*

In a monetary union, such a new supervision authority might be misused by individual members or by a group of members. One could be tempted not to transfer controlling rights to the Eurozone authority, but to ask for its help nevertheless to resolve one's banking system problems. What is more, a group of members can form a majority to exhaust the common resources. Thus, the use of public funding can reach excessive levels and imperil the fiscal stability of all member states.

These dangers can be countered at two levels. First, banking supervision should be made largely independent from the influence of individual states. Second, if in an extreme case, public funding is needed to tackle the problems of banks in financial distress, the capital providers' controlling rights should be strengthened. There are various ways to do this through decision-making rules. The votes can be weighted according to the member states' capital shares, for instance. If regional banking crises occur, it makes sense to give the decision power on recapitalisation and restructuring to the representatives of those countries that do not need any support. Finally, it remains crucial to grant veto rights to the member states when it comes to providing funding for bank restructuring.

5. *Separation of banking supervision and monetary policy. Securing the independence of the European Central Bank*

Of course, state measures to safeguard the stability of the financial system cannot be fully separated from monetary policy. The central bank acts as the lender of last resort for the banks, and the effects of monetary policy depend on the functioning and stability of the banking system. To determine its policies, the central bank would have to rely on information about the situation of the banks and the financial system provided by the supervisory authority.

However, this overlap between monetary policy and financial stability policy would breed serious conflicts of interest if the European Central Bank were given the power to supervise banks and to decide how to address the problems of banks in financial distress – although this might seem the simplest solution from an operational point of view. A merger of banking supervision and monetary policy would generate particularly manifest disadvantages in the Eurozone. Unlike a national central bank, the European Central Bank has no direct fiscal partner. The temptation to tackle widespread bank problems with expansionary monetary policy, emergency loans or so-called unconventional measures such as the buying-up of securities of sovereign or other debtors would be considerable. This would impair the functioning of monetary policy and its objectives. It would also have negative effects on the banks' position towards risk, as they would expect rescue by the ECB rather than closure by the supervising authority.

The best-possible monetary policy is based on giving the central bank a mandate for price stability, so that through its monetary policy, its response to fluctuations in real activity or to the fragility of the banking sector is conservative.

A merger of the supervision of banks with monetary policy in the Eurozone would generate a supranational authority burdened with the duty to keep competing objectives in balance, and holding such an important cluster of powers such that it should be put under permanent, democratically-legitimated control.

Should this responsibility for Eurozone-wide banking supervision be transferred to the European Central Bank, for political reasons, for instance, and despite the disadvantages of such a transfer, it would be necessary to ensure strict separation of the two sectors, be it in terms of staffing or organisation. In such a case, the suggestions for the safeguarding of the new Eurozone authority’s function would have to be applied to the European Central Bank.

However, such a transfer would be genuinely problematic. Inevitably, the Executive Board and the Council of the ECB would be forced to make compromises between their mandate for monetary policy and their mandate for banking supervision. Were the ECB to be given responsibility for banking supervision, it would be forced to reach agreements with the national finance ministers on questions of bank rescue. This would also impair its independence.

The Chairman of the Board of Academic Advisors
at the Federal Ministry of Economics and Technology

Prof. Achim Wambach, Ph.D.

The following members of the Board of Academic Advisors at the Federal Ministry of Economics and Technology have prepared this letter

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Professor für Wirtschaftspolitik
CER-ETH – Center of Economic Research
at ETH Zürich, Schweiz

Professor Dr. Dres. h.c. Knut Borchardt
Em. Professor für Wirtschaftsgeschichte und
Volkswirtschaftslehre an der Universität München

Professor Dr. Manfred J.M. Neumann
Em. Professor für Wirtschaftliche Staatswissenschaften,
insbesondere Wirtschaftspolitik,
an der Universität Bonn

Professor Achim Wambach, Ph.D. (Chairman)
Professor für wirtschaftliche Staatswissenschaften
an der Universität zu Köln

Members of the Board of Academic Advisors at the Federal Ministry of Economics and Technology

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an der Universität zu Köln

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und Wirtschaftspolitik an der Universität Mannheim

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Em. Professor für Wirtschaftswissenschaften
an der Humboldt-Universität zu Berlin

Professor Axel Börsch-Supan**,** Ph.D.
Direktor des Munich Center for the Economics of Aging (MEA)
am Max-Planck-Institut für Sozialrecht und Sozialpolitik, München

Professor Dr. Dres. h.c. Knut Borchardt
Em. Professor für Wirtschaftsgeschichte und
Volkswirtschaftslehre an der Universität München

Professor Dr. Friedrich Breyer
Professor für Volkswirtschaftslehre
an der Universität Konstanz

Professor Dr. Christoph Engel
Direktor am Max-Planck-Institut zur Erforschung von Gemeinschaftsgütern
Professor für Rechtswissenschaften an der Universität Osnabrück

Professor Dr. Armin Falk
Professor für Volkswirtschaftslehre
Lehrstuhl für Rechts- und Staatswissenschaften an der Universität Bonn
Abteilung für Empirische Wirtschaftsforschung

Professor Dr. Hans Gersbach
Professor für Wirtschaftspolitik
CER-ETH – Center of Economic Research
at ETH Zürich, Schweiz

Professor Dietmar Harhoff, Ph.D.
Professor für Betriebswirtschaftslehre
Vorstand des Instituts für Innovationsforschung,
Technologiemanagement und Entrepreneurship
an der Ludwig-Maximilians-Universität München

Professor Dr. Dr. h.c. mult. Martin Hellwig, Ph. D.
Direktor am Max-Planck-Institut zur Erforschung von Gemeinschaftsgütern und
Professor an der Universität Bonn

Professor Dr. Dr. h.c. Helmut Hesse
Präsident der Landeszentralbank in der Freien Hansestadt Bremen,
in Niedersachsen und Sachsen-Anhalt i.R.
Honorarprofessor für Volkswirtschaftslehre
an der Universität Göttingen

Professor Dr. Roman Inderst
Professor für Finanzen und Ökonomie
an der Universität Frankfurt/M.
House of Finance

Professor Dr. Otmar Issing
Mitglied des Direktoriums der Europäischen Zentralbank i.R.
Frankfurt/Main

Professor Dr. Günter Knieps
Direktor des Instituts für Verkehrswissenschaft
und Regionalpolitik; Wirtschaftswissenschaftliche Fakultät der
Albert-Ludwigs-Universität Freiburg

Professor Dr. Dr. h.c. Wernhard Möschel
Professor für Bürgerliches Recht, Handels- und Wirtschaftsrecht
an der Universität Tübingen

Professor Dr. Manfred J.M. Neumann
Em. Professor für Wirtschaftliche Staatswissenschaften,
insbesondere Wirtschaftspolitik,
an der Universität Bonn

Professor Dr. Manfred Neumann
Em. Professor für Volkswirtschaftslehre
an der Universität Erlangen-Nürnberg

Professor Dr. Axel Ockenfels
Professor für Wirtschaftliche Staatswissenschaften
Staatswissenschaftliches Seminar
an der Universität zu Köln

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Professor für Statistik und empirische Wirtschaftsforschung
an der Friedrich-Alexander-Universität Erlangen-Nürnberg

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an der London School of Economics

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Honorarprofessor an der Hochschule für
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an der Ludwig-Maximilians-Universität München

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an der Ludwig-Maximilians-Universität München

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Professor für Nationalökonomie und Finanzwissenschaft
an der Universität München

Professor Dr. Roland Vaubel
Professor für Volkswirtschaftslehre
an der Universität Mannheim

Professor Dr. Jürgen von Hagen
Professor für Volkswirtschaftslehre an der Universität Bonn
Direktor am Institut für Internationale Wirtschaftspolitik, Universität Bonn

Professor Dr. Carl Christian von Weizsäcker
Em. Professor für Volkswirtschaftslehre
an der Universität zu Köln

Professor Dr. Christian Watrin
Em. Professor für wirtschaftliche Staatswissenschaften
an der Universität Köln

Professor Dr. Ludger Wößmann
Professor für Volkswirtschaftslehre insb. Bildungsökonomik
an der Ludwig-Maximilians-Universität München
Bereichsleiter, Humankapital und Innovation
ifo Institut für Wirtschaftsforschung, München

Professor Dr. Dr. h.c. mult. Hans F. Zacher
Em. Professor für öffentliches Recht an der Universität München,
Em. Wissenschaftliches Mitglied am Max-Planck-Institut
für Sozialrecht und Sozialpolitik in München

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Professor Dr. Claudia M. Buch
Professor für Wirtschaftstheorie,
insbesondere Geld und Währung,
an der Universität Tübingen

Professor Dr. Dr. h.c. mult. Wolfgang Franz
Präsident des Zentrums für Europäische Wirtschaftsforschung Mannheim
Professor für Volkswirtschaftslehre
an der Universität Mannheim

Professor Dr. Eberhard Wille
Professor für Volkswirtschaftslehre und Finanzwissenschaft
an der Universität Mannheim