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A Deposit Guarantee Scheme for the Eurozone

Six Prerequisites

Bert Van Roosebeke

The European Commission will soon put forward proposals for a Deposit Guarantee Scheme (DGS) for the Eurozone, as third pillar of the Banking Union. We set out a number of prerequisites which the Eurozone DGS should meet:

- ▶ The specific national risks of bank failures must be accurately priced in a Eurozone DGS.
- ▶ Banks must be obliged to back sovereign risks with own funds.
- ▶ Affected Member States must contribute financially to the compensation of depositors.
- ▶ Any Eurozone DGS must consist of "national compartments" or must otherwise entail a gradual mutualisation of means over time which is at the same time limited in amount.

Such national compartments, however, reduce the benefit of a Eurozone DGS. There is therefore no compelling case for a Eurozone DGS.

Essentials

According to economic theory, **a Eurozone Deposit Guarantee Scheme** (DGS), by comparison with (sub)national deposit guarantee schemes, **may** increase the pool of insured risks and **show a** comparative **benefit** because of better risk-spreading, higher efficiency and more robustness than existing (sub)national deposit guarantee schemes. However, this only holds true **where the following prerequisites are met:**

1. **The specific national risks of bank failures must be accurately priced.**
   This presupposes different financial target levels for the participating national deposit guarantee schemes or for each and every participating bank. Alternatively or in addition thereto, national deposit guarantee schemes may take out commercial excess of loss insurance.

2. **Banks must be obliged to back sovereign risk with own funds.**
   Sovereign exposure plays an important role in banks' balance sheets but is generally not backed with own funds. Without this, a Eurozone DGS may increase the linkage between sovereign solvency and that of the banks which runs counter to the very idea of the Banking Union.

3. **Affected Member States must contribute financially to the compensation of depositors.**
   This is necessary as Member States influence the size and risks of their domestic banking sector. Their financial participation in the compensation of depositors may avoid moral hazard.

4. **Moral hazard on the side of banks must be contained.**
   By contrast with (sub)national systems, a Eurozone DGS provides more incentives for banks to take risks and to externalise the costs of such behaviour to other members of the Eurozone DGS. National compartments within a Eurozone DGS, and limits on the mutual use of the financial means of those compartments, may alleviate this problem.

5. **Financial stability risks must be contained.**
   By comparison with existing (sub)national systems, a Eurozone DGS may considerably increase the risk of contagion. Depositors in uninvolved Member States may question the credibility of the DGS when its means are used to compensate depositors elsewhere. National compartments within a Eurozone DGS, and limits on the mutual use of the financial means of those compartments, may alleviate this problem.

6. **Distortions of competition must be avoided.**
   A Eurozone DGS must not distort competition, given the considerable differences in the financial endowments of existing (sub)national deposit guarantee schemes. National compartments within a Eurozone DGS, and a gradual mutualisation of means over time, may alleviate this problem. A full mutualisation should not occur before 2024.

Based on prerequisites 4 – 6, **any Eurozone DGS must consist of "national compartments"** or must otherwise entail a gradual mutualisation of means over time which is at the same time limited in amount. **Such national compartments,** however, **reduce the** comparative **benefit of a Eurozone DGS** vis-à-vis existing (sub)national deposit guarantee schemes. **There is therefore no compelling case for a Eurozone DGS.**

Kernpunkte

Der ökonomischen Theorie zufolge kann ein Einlagensicherungssystem für die gesamte Eurozone im Vergleich zu (sub-)nationalen Einlagensicherungssystemen einen größeren Pool an versicherten Risiken und einen komparativen Vorteil aufweisen. Grund dafür sind eine bessere Risikostreuung, höhere Effizienz und größere Widerstandsfähigkeit als bestehende (sub-)nationale Einlagensicherungssysteme. Das gilt allerdings nur, wenn folgende Voraussetzungen erfüllt sind:

1. **Die länderspezifischen Risiken von Bankenpleiten müssen akkurat bepreist sein.**
   Dies setzt unterschiedliche Anforderungen an die finanzielle Ausstattung der teilnehmenden nationalen Einlagensicherungssysteme oder unterschiedliche Beiträge für jede einzelne teilnehmende Bank voraus. Alternativ oder ergänzend dazu können nationale Einlagensicherungssysteme auch private „excess of loss"-Versicherungen abschließen.

2. **Banken müssen verpflichtet werden, staatliche Ausfallsrisiken mit Eigenmitteln zu hinterlegen.**
   Staatsanleihen spielen eine wichtige Rolle in den Bilanzen von Banken, sind aber üblicherweise nicht mit Eigenmitteln hinterlegt. Ohne eine Hinterlegungspflicht kann ein Einlagensicherungssystem für die gesamte Eurozone die Verbindung zwischen der Zahlungsfähigkeit von Staaten und Banken verstärken. Das widerspricht aber genau der ursprünglichen Idee der Bankenunion.

3. **Betroffene Mitgliedsstaaten müssen sich finanziell an der Entschädigung von Einlegern beteiligen.**
   Das ist notwendig, da die Mitgliedsstaaten die Größe und Risiken ihres heimischen Bankensektors beeinflussen. Die finanzielle Beteiligung an der Entschädigung von Einlegern kann Moral Hazard vorbeugen.

4. **Moral Hazard auf Bankenseite muss begrenzt werden.**
   Im Vergleich zu bestehenden (sub-)nationalen Systemen beinhaltet ein Einlagensicherungssystem für die gesamte Eurozone größere Anreize für Banken, sich risikoreich zu verhalten. Sie können die entstehenden Kosten dann auf andere Mitglieder des eurozonenweiten Einlagensicherungssystems externalisieren. Nationale Kammern („compartments") innerhalb des eurozonenweiten Einlagensicherungssystems und Einschränkungen hinsichtlich der gemeinsamen Nutzung der finanziellen Mittel dieser Kammern könnten das Problem lindern.

5. **Risiken für die Finanzmarktstabilität müssen begrenzt werden.**
   Im Vergleich zu bestehenden (sub-) nationalen Systemen kann ein Einlagensicherungssystem für die gesamte Eurozone die Ansteckungsgefahren erheblich erhöhen. Einleger in nicht betroffenen Mitgliedsstaaten könnten die Glaubwürdigkeit des Einlagensicherungssystems anzweifeln, wenn dessen Mittel zur Entschädigung von Einlegern in anderen Mitgliedstaaten verwendet werden. Nationale Kammern („compartments") innerhalb des eurozonenweiten Einlagensicherungssystems und Einschränkungen hinsichtlich der gemeinsamen Nutzung der finanziellen Mittel dieser Kammern könnten das Problem lindern.

6. **Wettbewerbsverzerrungen müssen vermieden werden.**
   Vor dem Hintergrund erheblicher Unterschiede in der finanziellen Ausstattung der bestehenden (sub-)nationalen Einlagensicherungssysteme darf ein Einlagensicherungssystem für die gesamte Eurozone den Wettbewerb nicht verzerren. Nationale Kammern („compartments")

innerhalb des eurozonenweiten Einlagensicherungssystems und eine schrittweise Vergemeinschaftung der Mittel im Verlauf der Zeit könnten das Problem lindern. Eine vollständige Vergemeinschaftung sollte nicht vor 2024 erfolgen.

Jede Art von Einlagensicherungssystem für die gesamte Eurozone **muss daher**, nach Maßgabe der Voraussetzungen 4 – 6**, aus „nationalen Kammern" bestehen** oder auf sonstiger Art eine schrittweise Vergemeinschaftung der Mittel beinhalten, die gleichzeitig in ihrem Umfang begrenzt ist. **Solche nationalen Kammern verringern** jedoch den komparativen Vorteil **eines** Einlagensicherungssystems für die gesamte Eurozone im Vergleich zu bestehenden (sub-) nationalen Einlagensicherungssystemen. **Es gibt daher kein überzeugendes Argument für ein** Einlagensicherungssystem für die gesamte Eurozone.

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1 Introduction – The Banking Union's Missing Pillar

The Eurozone's Banking Union[1] is regularly described as a three pillar system, consisting of:

- Pillar 1: A Single Supervision Mechanism (SSM), with the European Central Bank (ECB) in charge of supervising the Eurozone's largest banks.
- Pillar 2: A Single Resolution Mechanism (SRM) with the Single Resolution Board (SRB) responsible for major bank resolutions in the Eurozone. The EU-wide instruments for bank resolutions are set out in the Bank Restructuring and Recovery Directive (BRRD). For the Eurozone, the Regulation on the Single Resolution Mechanism (SRM) defines the Single Resolution Board's competencies. An Intergovernmental Agreement (IGA) between Eurozone States defines how resolution costs are shared amongst Eurozone banks, via the Single Resolution Fund (SRF).
- Pillar 3: A Deposit Guarantee Scheme (DGS) for the Eurozone.

Whereas Pillars 1 and 2 have been established within the Eurozone, Pillar 3 has not. Rather than a Eurozone DGS, there is currently a set of EU-rules governing 28 national deposit guarantee schemes within the European Union.

Since 1994, EU-wide rules have existed on securing bank deposits, which were recently further harmonised: The Directive on Deposit Guarantee Schemes (2014/49/EU) introduced funding requirements, meaning that all banks will have to make ex-ante payments to their national deposit guarantee scheme. In some Member States (e.g. Germany) such ex-ante funding has been practiced for many years. In others (e.g. Italy) national schemes dispose of very little means as they have been financed ex-post. In such systems, the remaining banks make ex-post financial contributions to the DGS to finance claims by depositors whose deposits at another bank are no longer available.

Roughly speaking, there are two options for establishing a Eurozone DGS in Pillar 3:

- Option 1: A true "single" deposit guarantee scheme. Such a single system replaces all national deposit guarantee schemes within the Eurozone.
- Option 2: A "common" DGS for the Eurozone. National deposit guarantee schemes persist but are strongly linked, serving as financial backstops for each other in case of financial distress in any national scheme.[2]

Although the EU Commission[3] has recently spoken out in favour of a common DGS[4], its precise plans are not quite clear. "As a first step", the Commission aims to install a „joint reinsurance fund", which will contribute financially to national deposit guarantee schemes. The Commission explicitly mentions the risk of moral hazard at the national level, emanating from differences in the financial endowment of national deposit guarantee schemes. Whether or not the Commission is willing to take the next step of installing a single DGS, once financial differences between national schemes have subsided, remains unanswered. Opposition to such plans is fierce in some Member States.[5]

[1] Formally, the Banking Union is enshrined in EU-law. In practice, however, the Banking Union is a Eurozone project. Although non-Eurozone Member States may participate in the Banking Union on a voluntary basis, no such Member States has done so hitherto. As a consequence, in this paper, we will refer to the Eurozone, and not to the EU.

[2] This comes close to the idea of Gros (2013), Principles of a two-tier European Deposit (Re-)Insurance System, CEPS Policy Brief No. 287, April 2013. Gros however reduces the scope of his model to systemic crises.

[3] Commission Communication COM (2015) 600, On steps towards Completing the Economic and Monetary Union, 22 October 2015.

[4] Similar to the other elements of the Banking Union, this scheme would be open to non-Eurozone Member States joining the Banking Union.

[5] Cf. Bundestag-Drucksache 18/6458 approved by German Parliament on 5.11.2015, in which the Parliament calls upon the German Government to work against a Eurozone DGS in the Council.

2 The Importance of Deposit Guarantee Schemes

2.1 The Added-Value of Deposit Guarantee Schemes

Deposit guarantee schemes protect depositors' wealth (in the EU: up to € 100,000) from bank failures. At their core, they are a trust building mechanism that

- firstly, increases savers' willingness to deposit money at a bank at all and
- secondly, dissuades depositors from massively withdrawing deposits in uncertain times (bank run).

Given that deposits are an important source for financing bank lending, deposit guarantee schemes contribute to bank lending and hence to economic growth. Transformation of maturity, lot size and risk by banks is only possible where there is a critical amount of constant deposits.

Deposit guarantee schemes also contribute to financial stability: No bank is able to cope with a large number of depositors "running the bank", i.e. suddenly withdrawing liquidity. Given maturity transformation, only a small amount of depositors' savings is immediately available.[6] Deposit guarantee schemes therefore provide an important psychological element: in uncertain times, they aim to dissuade any depositor from trying to achieve a "first mover advantage" by being the first to withdraw deposits while the bank is still liquid.

2.2 What Deposit Guarantee Schemes Can(not) Cover

Despite their general added-value, it is important to stress the limits of any deposit guarantee scheme. In the EU, for example, with a targeted financial endowment of 0,8 % of deposits by 2024 (Art. 10 para. 2, Directive 2014/49/EU), deposit guarantee schemes are absolutely incapable of preventing large scale systemic crises. If at all, they can (and should) only be expected to cope with isolated, institution-specific default.[7]

[6] In the EU, the Liquidity Coverage Ratio (LCR) introduces additional quantitative requirements regarding banks' capabilities to absorb liquidity shocks. (cf. cepInput07|2015, New Bank Liquidity Rules in the EU: A Blessing or a Curse?).

[7] Cf. Pisani-Ferry and Wolff (2012), The fiscal implications of a Banking Union, Bruegel PolicyBrief, Issue 2012/02.

3 Advantages and Prerequisites of a Eurozone DGS

In this chapter, we evaluate the advantages and caveats associated with a DGS for the Eurozone. Where necessary, we differentiate between a single Eurozone scheme (replacing all national schemes) and a common Eurozone scheme (in addition to national schemes).

3.1 Theoretical Advantages of a Eurozone DGS

3.1.1 Eliminating Member State Bias

It is often argued that the existing system of national deposit guarantee schemes causes a country bias among the Member States which distorts competition.[8] If some Member States are economically stronger than others, the credibility of the national deposit guarantee schemes will differ. Hence, banks based in the stronger Member States are in a better position to acquire deposits than banks in the weaker Member States.

With a common deposit guarantee scheme, the relevance of this problem will be reduced. Even though the EU Commission aims at "citizens [to] be certain that the safety of their deposits does not depend on their geographical location", this will obviously depend upon the details of risk and cost sharing amongst national schemes within a common deposit guarantee scheme. In a single deposit guarantee scheme, this problem will be eliminated altogether.

Whether this is a relevant problem in practice, is debatable. Banks may refuse to let people open bank accounts if they do not live in the country where the bank is established.[9] Also, the fact that only 3% of EU-citizens have an account abroad[10], points to the fact that, in any given Member State, competition for private deposits mostly takes place between domestic banks and domestic branches of international banks. Both types of banks are members of the same national deposit guarantee scheme. At national level, there is no distortion of competition in this respect which needs to be eliminated by a Eurozone DGS.

3.1.2 Better Risk Pooling

In theory, there is a second case for a Eurozone DGS. Institution-specific defaults are rare events causing high costs to the DGS (and hence to the participating banks). Insurance theory suggests that pooling such risks amongst a high number of insurance takers lowers the costs of insurance and increases the resilience (and hence credibility) of the insurance system.[11]

However, some of the Eurozone's peculiarities seriously call into question whether this theoretical advantage outweighs the problems related to a Eurozone DGS. In the following chapter, we identify six problems and deal with them in more detail.

[8] Cf. Commission Communication COM (2015) 600, On steps towards Completing Economic and Monetary Union, 22 October 2015, p. 13.
[9] Cf. http://europa.eu/youreurope/citizens/shopping/financial-products-and-services/bank-accounts-eu/index_en.htm
[10] SWD(2013) 164, p. 11.
[11] Cf. Baran, Bigus, Eckhardt and Van Roosebeke (2012), Alternatives to Investor Compensation Schemes and their Impact, Study for the European Parliament, November 2012, p. 35.

3.2 Prerequisites for a Eurozone DGS

3.2.1 Heterogeneity Issues

A common as well as a single deposit guarantee scheme for the Eurozone pools risks amongst a large group of insurance takers.[12] This works best where risks are homogenous. Risks across the Eurozone, however, are not homogenous, especially considering the importance of sovereign exposure in bank balance sheets. This poses a challenge to a Eurozone DGS, as such a scheme will only work efficiently if different risks are identified *and priced* as such, which might be politically delicate. Failing to do so would distort competition, as it would lead to low risk banks cross-subsidising high risk banks. This would in turn give rise to the risk of moral hazard, as every bank would have the incentive to take more risks.

The design of a solution for this problem depends on the exact design of the Eurozone DGS:

- Option 1: If a single DGS were to be installed in the Eurozone (and the existing national DGS dismantled), the first-best solution would be an institution-specific risk analysis, leading to an individual calculation of each bank's contribution to the fund.

- Option 2: If a common DGS were to be installed in the Eurozone, in which the existing national deposit guarantee schemes were in some way linked up to each other, e.g. via "re-insurance", as recently suggested by the EU Commission[13], the appropriateness of a common financial target level of 0,8 % of covered deposits must be questioned. Indeed, some national deposit guarantee schemes do need a higher target level. This is necessary given considerable differences in risk exposure amongst the national deposit guarantee schemes, not least due to differences regarding sovereign risks in bank balance sheets. Alternatively, deposit guarantee schemes may choose to take out commercial excess of loss insurance[14]. This insurance covers losses that exceed a certain threshold ("liability floor") up to another specified threshold ("liability cap")[15]. Thus, where the incurred damage is below the liability floor, the insured DGS is solely responsible for compensating a depositor. Where the incurred damage is between the liability floor and the cap, the DGS has to indemnify up to the amount of the floor and the insurance will pay compensation for all losses in excess of the floor amount. Where the losses exceed the liability cap, the insurer pays for all damage between the floor and the cap. Whether floors and caps apply per annum, per case or per contract duration is a matter for negotiation.[16]

Prerequisite 1: In a Eurozone DGS, the specific national risks of bank failures must be accurately priced. Given different risks in national banking sectors, different financial target levels must be imposed on national deposit guarantee schemes. Alternatively, national deposit guarantee schemes may take out commercial excess of loss insurance.

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[12] In case of a single scheme, the insurance takers are all Eurozone banks. In case of a common scheme, the national schemes are insurance takers.

[13] Commission Communication COM (2015) 600, On steps towards Completing Economic and Monetary Union, 22 October 2015.

[14] National deposit guarantee schemes should be left the choice to reach the individual financial target either by higher ex-ante bank contributions or by concluding an excess of loss insurance.

[15] If such insurances are to ensure appropriate funding by the deposit guarantee schemes, the details of such insurances should be subject to approval by the common deposit guarantee scheme.

[16] For more details and an application to investor compensation schemes, see Baran, Bigus, Eckhardt and Van Roosebeke (2012), Alternatives to Investor Compensation Schemes and their Impact, Study for the European Parliament, November 2012, pp. 19.

3.2.2 Sovereign Exposure Issues

Preventing the economic problems of banks from jeopardizing the creditworthiness of Member States (and vice versa) has been one of the main drivers for establishing the Banking Union. However, as of today, many banks hold large portfolios of sovereign bonds of their respective Member State. The current European prudential rules do not entail an obligation for banks to cover these sovereign risks with own funds.

In some Member States, a Eurozone DGS may in fact increase a depositor's trust in the safety of their deposits. The likely consequence is that ailing banks will have an incentive to use this liquidity to increase sovereign exposure as this exposure yields high returns without absorbing scarce own funds. This runs counter to the very idea of the Banking Union as it intensifies the link between banks and states.

A Eurozone DGS would thus lead to an even stronger link between sovereign solvency and the solvency of the banking sector, as all Eurozone banks would be forced to finance reimbursement costs caused by sovereign defaults. The resulting costs to those banks would also incentivise them to increase sovereign risk.

Prerequisite 2: Banks must be obliged to back sovereign exposure with own funds. Otherwise, a Eurozone DGS strengthens the vicious circle between banks and states and runs counter to the very idea of the Banking Union.

3.2.3 Moral Hazard Issues: Member States

Despite common supervision by the European Central Bank within the Single Supervision Mechanism (SSM), national governments are still in a position to exert influence - via general economic and specific tax policy - on the size and risk of their national banking sector. Against this background, a Eurozone DGS might enable, and thus induce, Member States to internalise the benefits of a large or risky national banking sector (e.g. high tax revenues) and externalise the costs thereof to the Eurozone DGS.

It is not impossible to solve this problem. It is best contained by holding the Member State in question liable in the event of default by way of significant national financial contributions, before using any financial means of the Eurozone DGS.

Prerequisite 3: Affected Member States must contribute financially to the compensation of depositors. This is necessary as Member States influence the size and risks of their domestic banking sector. Their financial participation in the compensation of depositors may avoid moral hazard.

3.2.4 Moral Hazard Issues: Banks

Some of the existing national deposit guarantee schemes have established complex and segregated internal risk-management systems. Amongst others, this holds true for cooperative banks, banks with institution guarantee systems (e.g. Sparkassen in Germany) as well as a series of private banks. These risk-management systems have been set up based on the self-interest of the respective deposit guarantee schemes. Up to now, there has been an obvious financial interest for those deposit guarantee schemes to minimise the likelihood of a member defaulting. In a Eurozone DGS, in which the costs of reimbursing depositors may be externalised over a larger number of banks, incentives for such internal risk-management systems may no longer be present to the same extent.

This risk might, to a certain extent, be contained by designing the Eurozone DGS along the lines of Option 2, i.e. by creating a common Eurozone DGS which consists of national compartments and by limiting the mutual use of the financial means of those compartments. However, such a design again hinders the realisation of the theoretical advantages of risk-pooling in a Eurozone DGS.

Prerequisite 4: By comparison with existing (sub)national systems, a Eurozone DGS provides more incentive for banks to take risks and externalise the costs of such behaviour to other members of the Eurozone DGS. National compartments within a Eurozone DGS, and limits on the mutual use of the financial means of those compartments, may alleviate this moral hazard problem.

3.2.5 Financial Stability Issues

Linking hitherto isolated national deposit guarantee schemes to one another leads to the risk of contagion. In the event of a default in Member State X, financial or reputational risk may spread amongst national deposit guarantee schemes and cause bank customers in Member State Y to withdraw deposits, aggravating the problems for the DGS in Member State Y. This problem may in turn even spread to other Member States.

This risk might again be limited by designing the Eurozone DGS along the lines of Option 2, i.e. by creating a common Eurozone DGS which consists of national compartments and by limiting the mutual use of the financial means of those compartments.[17] However, such a design hinders the realisation of the theoretical advantages of risk-pooling in a Eurozone DGS.

Prerequisite 5: By comparison with existing (sub)national systems, a Eurozone DGS may considerably increase the risk of contagion. Depositors in uninvolved Member States may question the credibility of the DGS if its means are used to compensate depositors elsewhere. National compartments within a Eurozone DGS, and limits on the mutual use of the financial means of those compartments, may alleviate this problem.

3.2.6 Competition Issues

There are enormous differences in the financial endowment of national deposit guarantee schemes. Whereas some deposit guarantee schemes have built up a financial reserve via ex-ante payments into the scheme by banks, other schemes have opted for an ex-post financing of defaults. These differences will continue to be relevant for many years to come, as Directive 2014/49/EU only requires a financial endowment of 0,8 % of covered deposits in each national DGS by 2024.[18]

Establishing a Eurozone DGS before 2024 would inevitably raise the question of how to prevent the "unfair" mutualisation of means from causing serious distortions of competition. The same question arose, in a milder form, regarding the establishment of the single resolution fund (SRF). In the SRF, this problem was tackled by establishing "national compartments" whose means are mutualised only gradually over time.[19] A similar scenario could also be applied to a Eurozone DGS.

Prerequisite 6: A Eurozone DGS must not distort competition, given the considerable difference in the financial endowment of existing (sub)national deposit guarantee schemes. National compartments within a Eurozone DGS and a gradual mutualisation of means over time may alleviate this problem. A full mutualisation should not occur before 2024.

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[17] A similar solution has been chosen with respect to the single resolution mechanism (SRF).
[18] Art. 10 para. 2 Directive 2014/49/EU.
[19] Cf. Art. 1 SRM-Regulation (EU) No. 806/2014 and Art. 4 Intergovernmental Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund (SRF).

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Authors:

Bert Van Roosebeke is head of the cep Financial Markets Department.

cep | Centre for European Policy
Kaiser-Joseph-Straße 266 | 79098 Freiburg | Germany
Phone +49 761 38693-0 | www.cep.eu

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