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Banking Union and a Single Banking Supervisory Mechanism - Monetary Dialogue -

COMPILATION OF NOTES



DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

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Monetary Dialogue October 2012

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Abstract

A major building block for the so called "*banking union*" is the banking supervision. The Euro Area Summit Statement from 29 June 2012 classifies the provision of such a single supervisory mechanism '*as a matter of urgency*'. On 12 September 2012 the Commission published a set of proposals for the establishment of a single supervisory mechanism. The notes in this compilation provide for a first evaluation of the Commission proposals.

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

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INTRODUCTION

A major building block for the so-called "*banking union*" is the banking supervision. The Euro Area Summit Statement from 29 June 2012 classifies the provision of such a single supervisory mechanism '*as a matter of urgency*'. This mechanism is a prerequisite for a possible direct recapitalisation of banks via the ESM: '*When an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalize banks directly.*¹

On 12 September 2012 the Commission published a set of proposals for the establishment of a single supervisory mechanism stating that '*[t]he set of proposals is a first step towards an integrated "banking union" which includes further components such as a single rulebook, common deposit protection and a single bank resolution mechanisms.*²

The notes in this compilation provide for a first evaluation of the Commission proposals.

¹ Euro area summit statement, 29 June 2012;
http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf.

² See: http://ec.europa.eu/internal_market/finances/committees/index_en.htm.



DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Europe's Single Supervisory Mechanism and the long Journey towards a Banking Union

Nicolas VÉRON

NOTE

Abstract

Problems in the banking system are a central dimension of the current crisis, and the establishment of a banking union is a necessary (though not sufficient) condition for an eventual crisis resolution that respects the integrity of the euro. The European Commission's proposal for the establishment of a Single Supervisory Mechanism and related reform of the European Banking Authority do not and cannot create a fully-fledged banking union, but represent a broadly adequate step on the basis of the leaders' declaration of 29 June 2012 and of the decision to use Article 127(6) TFEU as legal basis. In this context, the proposal rightly endows the European Central Bank with broad authority over all individual banks in the supervisory mechanism's geographical perimeter; however, the status of non-euro area Member States willing to participate in this mechanism, and the governance and decision-making processes of the ECB in this respect, call for further elaboration. Further adjustments are also desirable in the proposed reform of the EBA, even though they must probably retain a stopgap character pending the more substantial review planned in 2014.

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LIST OF ABBREVIATIONS

- BIS** Bank for International Settlements
- EBA** European Banking Authority
- ECB** European Central Bank
- ESM** European Stability Mechanism
- ESRB** European Systemic Risk Board
- EU** European Union
- FSB** Financial Stability Board
- QMV** Qualified Majority Voting
- SSM** Single Supervisory Mechanism

EXECUTIVE SUMMARY

While the economic and fiscal dimensions of the current crisis in the euro area have been at least partly identified early on, it has taken more time to reach a (still incomplete, but meaningful) consensus on the importance of dynamics in the banking sector in understanding the crisis developments. The “*doom loop*” between sovereign and banking credit conditions has been correctly identified as a key transmission channel that needs to be addressed to prevent further deterioration and to envisage eventual improvements. This makes it imperative for European policymakers to include the creation of a banking union in their broader vision for crisis management and resolution.

Given the intrinsic interdependencies between banking policy and fiscal policy, and the limitations of the existing common policy framework for fiscal matters, it is impossible to create this banking union in one single step. The creation of a Single Supervisory Mechanism (SSM) is an important move that will not complete the creation of a European banking union, but may be its cornerstone and could also, crucially and under the terms of the statement of 29 June 2012, enable the direct intervention of the European Stability Mechanism (ESM) and thus a major improvement in the effectiveness of Europe’s crisis management strategy as regards the banking aspects of the crisis.

As with fiscal policy, there are strong interdependencies between banking policy and monetary policy, which have motivated the choice of the European Central Bank (ECB) as central actor of the SSM and the use of Article 127(6) TFEU as legal basis for the SSM’s establishment. However, banking policy and monetary policy should and will remain two separate areas, which also justifies allowing the SSM to cover more EU Member States than only those participating in the euro area. The European Commission’s current proposal goes in this direction as it introduces the possibility of “*close supervisory cooperation*” between such Member States and the SSM, but a more inclusive approach that permits those Member States to become effective members of the SSM (and participants in its collective governance and decision-making) would be preferable.

The Commission’s proposal rightly endows the ECB with sweeping authority over all banks within the SSM’s geographical perimeter, which is a proper application of the principles of subsidiarity and proportionality given the policy aims of the SSM’s establishment. However, more decentralisation of decision-making may be sought as regards macro-prudential policy decisions; and safeguard mechanisms may be provided for non-euro area Member States participating in the SSM. In terms of governance and accountability, the Commission’s proposal would benefit from further elaboration, including: the creation of a more compact decision-making body for individual supervisory decisions, which should not be subject to diplomatic balances among Member States; more direct accountability to the Council and European Parliament, including as regards appointments; and more direct inclusion of non-euro area Member States participating in the SSM in the governance and decision-making, even if Article 127(6) TFEU implies that ultimate authority must reside with the ECB’s Governing Council.

Reform of the European Banking Authority (EBA) should go further than the current proposal to address legitimate concerns of non-euro area Member States, even if this comes at the price of slightly more difficult EBA decision-making at least until the review planned in 2014. Finally, a careful consideration of priorities in the legislative agenda of the coming months is suggested.

Background and Aims

On 29 June 2012, the Heads of State and Government of euro area countries issued a statement that started with *"We affirm that it is imperative to break the vicious circle between banks and sovereigns. The Commission will present Proposals on the basis of Article 127(6) for a single supervisory mechanism shortly."*¹ On 12 September 2012, the European Commission issued three documents (here referred to as the "Commission's proposals"):

- (1) a Communication titled "A Roadmap towards a Banking Union;"
- (2) a proposal for a Council Regulation based on Article 127 (6) TFEU, to create the Single Supervisory Mechanism with a central role conferred on the ECB; and
- (3) a proposal for a Regulation of the European Parliament and the Council to amend the 2010 Regulation establishing the EBA to adapt it to the creation of the SSM.

The purpose of this note is to assess the Commission's proposals and provide recommendations for the purposes of the ECON Committee's deliberations and of the European public policy debate. Given the complexity of the issue and the limited size of this note, some arguments have been summarised and, in several aspects, not all possible policy options have been specifically considered. Of course, the author stands at the service of the Committee staff and members for any further elaboration.

¹ Euro area summit statement, Brussels, 29 June 2012;
<http://europa.eu/rapid/pressReleasesAction.do?reference=DOC/12/7&type=HTML>

1. THE CONTEXT: SINGLE SUPERVISORY MECHANISM AND EUROPEAN BANKING UNION

The expression “*Banking Union*” is used here to refer to a policy framework that locates key instruments of banking policy at the European level to enable the formation and maintenance of an integrated European banking system. The notion that such Banking Union is an important and indispensable component of any strategy to prevent an unravelling of the euro area has gained remarkable momentum since April 2012, as reflected by the statement of 29 June 2012. However, the Banking Union agenda cannot be considered in isolation from the broader crisis resolution agenda. The late-June report by the President of the European Council “*Towards a Genuine Economic and Monetary Union*” (Van Rompuy, 2012) provides an important and relevant reference for this agenda, with four key dimensions or “building blocks.” These are now often referred to in the public debate as Banking Union, Fiscal Union, Competitiveness Union, and Political Union².

1.1. The long journey towards Banking Union

Banking Union, as defined above, constitutes a major overhaul of Europe’s financial and economic policy framework. The radical nature of this endeavour must not be underestimated, and it would be unrealistic to try to achieve it in one single move. The creation of the SSM, as outlined in the statement of 29 June 2012 and developed in the Commission’s proposals, can only be seen as the first step on a long journey that is set to include other changes to Europe’s institutional setting and policies, but also concrete crisis management actions that will have a major impact on the future structures of Europe’s banking system. The fact that the creation of the SSM does not immediately lead to a fully consistent and complete banking policy framework should be considered an unavoidable consequence of the ambition and complexity of the Banking Union project, and of its embeddedness in Europe’s broader fourfold agenda.

1.2. Banking Union, Fiscal Union, Political Union

In particular, there are strong interdependencies between Banking Union, Fiscal Union, and Political Union that rule out the possibility of completing a European Banking Union without considerable prior progress on the two other components, a condition that is currently not met. This, in a nutshell and as many observers have noted, is because a fully-fledged Banking Union requires an autonomous European resolution authority and a federal European deposit insurance system, both of which require some sufficient form of backstop from a European level of fiscal authority to acquire credibility³. The Fiscal Union that may provide such sufficient backstop, in turn, is difficult to envisage without a Political Union that would at least partly remedy the “*structural democratic deficit*” of the current EU institutions (Federal Constitutional Court of Germany, 2009).

In other terms, further progress on the path towards Fiscal Union, including a less limited and more robust framework for jointly issued securities than with the present ESM, and towards Political Union, including a political setting that would make it possible to back such joint issuance with a credible prospect of future revenue, is required for a completion of European Banking Union that would compellingly meet the Heads of State and Government’s objective “*to break the vicious circle between banks and sovereigns.*” Absent

² See, among others, Véron (2012a) on the fourfold agenda; Pisani-Ferry, Sapir, Véron and Wolff (2012) on banking union; Marzinotto, Sapir and Wolff (2011) on fiscal union; and Véron (2012b) on political union.

³ An early version of this idea was outlined in Trichet (2011). Pisani-Ferry and Wolff (2012) specifically explore the interactions between Banking Union and Fiscal Union.

such progress, the European interbank market will remain impaired by the perception of credit risk on some but not all of the sovereign securities that provide the collateral of reference; credit rating agencies will not be able to lift the “*sovereign cap*” that keeps the creditworthiness measure of banks at most equal to that of their home Member State; and the incentives that prompted many European banks to amass considerable portfolios of sovereign securities issued by their home Member State, and to engage in more abrupt deleveraging outside of the home country than inside, will remain largely in place.

In the author's assessment and on the basis of the statement of 29 June 2012, the Commission's proposals go about as far as possible in the direction of Banking Union at this stage, given these current limitations on other major dimensions of the European policy and political agenda.

1.3. SSM and a European approach to bank crisis management

The statement of 29 June reads “*When an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could, following a regular decision have the possibility to recapitalize banks directly.*” Thus, the effective establishment of the SSM is specified as a precondition for what in practice means a partial transfer of the responsibility for bank crisis management and resolution from the national to the European level through the ESM.

Such a transfer is arguably a necessary and urgent condition to address Europe's current banking system fragility⁴ and its delaying, all things equal, inevitably adds to the eventual cost of crisis resolution. By making it conditional on the effective establishment of the SSM, the Heads of State and Government have created an intriguing link between the parallel agendas of supervisory institution-building and bank crisis management. It could be argued that this condition was not indispensable and adds rigidity and delay to the overall crisis reaction framework. Conversely, it is understandable that the leaders would have desired the SSM to provide institutional continuity in a European bank crisis management and resolution process that promises to be complex and protracted. The Commission's proposals respect this sequence by not taking any specific position on the crisis management actions that may be considered once the SSM is in place.

1.4. The euro area, non-euro area countries, and the single market

The geographical perimeter of the SSM and banking union cannot be considered a settled question yet. The initial political initiative, as expressed in the statement of 29 June 2012, comes from euro area Member States, even though it was endorsed the same day by the European Council. But while the euro area crisis has clearly been the trigger for the move towards Banking Union, the treaty-enshrined aim of a single market for banking services, combined with significant levels of banking-sector integration between the euro area and non-euro area EU Member States, justify a consideration of all EU Member States in the discussion about the establishment of the SSM. This would imply a slightly different framework than in the Commission's proposal, which reserves SSM membership to euro area Member States and only allows an option of “*close supervisory cooperation*” for other EU Member States.

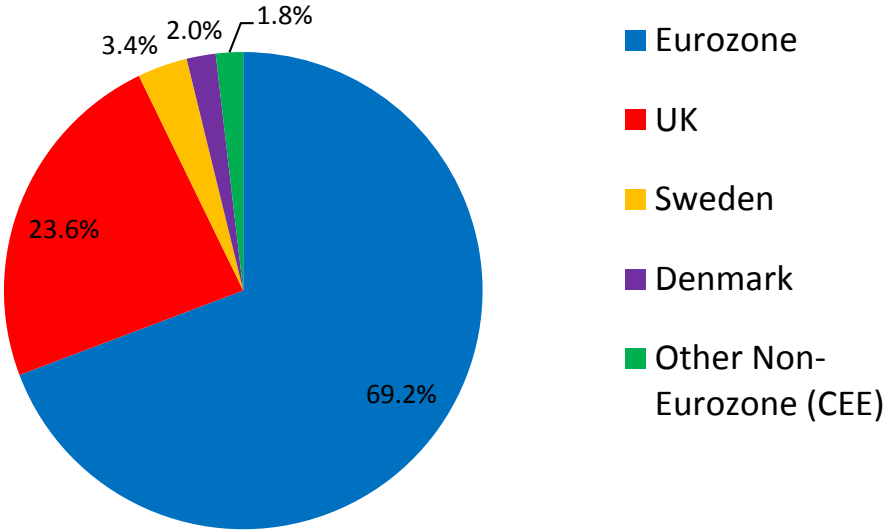
There are technical arguments in favour of having, as much as possible, a coincidence between the respective perimeters of Banking Union and Monetary Union⁵. However, given, on the one hand, the fact that the SSM falls short of a full Banking Union and in particular does not include at this stage a common system of deposit insurance, and on the other

⁴ An early advocacy of this approach is in Posen and Véron (2009).

hand, the fact that the euro area is open for membership to all EU Member States that comply with its admission criteria, the EU should adopt an approach that opens participation in the SSM to all Member States that desire it, with an adequate balance of rights and responsibilities. Inclusiveness and flexibility are in order – even though at least one EU Member State, the United Kingdom, has made it clear that it would not participate in the SSM.

It may be relevant in this respect to notice that while the euro area represents the vast majority of the EU’s banking assets, the UK represents the vast majority of banking assets in the rest of the EU, as illustrated by Figure 1.

Figure 1: Total assets of credit institutions in EU Member States (June 2011)



Source: ECB.

The euro area statement of 29 June 2012 refers to Article 127(6) TFEU for the establishment of the SSM. This article reads: *“The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the ECB concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.”* This implies unanimity of all EU Member States, i.e. each non-euro area Member State has a veto. Simultaneously, it implies that the European supervisor at the center of the SSM is the ECB itself, which potentially makes it more difficult to include non-euro area Member States into the Banking Union with adequate rights and responsibilities. This also potentially limits options in terms of the supervisor’s accountability to political authorities and the European public, and of ring-fencing the independence of monetary policy from the distinct constraints of supervisory policy. These aspects are further examined in the next section of this note.

⁵ This issue is further explored in Pisani-Ferry, Sapir, Véron and Wolff (2012).

2. SSM DESIGN BASED ON ARTICLE 127(6) TFEU

This section is based on the European Commission's *"Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions,"* COM(2012) 511, published on 12 September 2012.

2.1. Geographical perimeter

The proposal suggests that the geographical perimeter of the SSM is the euro area, and adds the possibility of *"close supervisory cooperation"* for those non-euro area Member States which desire it. As argued above, this may be seen as not inclusive enough given the possible legitimate aspiration of non-euro area countries to participate in the future Banking Union. The SSM must include all euro area Member States, as in the current proposal, but should also include the possibility of actual membership for other EU Member States that desire to participate, as some are likely to do. The SSM regulation may specify the process through which non-euro area Member States would voluntarily become part of the SSM, including possibly the adoption of adequate domestic legislation.

In the same spirit, the termination of SSM membership should be seen as a political rather than technical decision. As a consequence it should be subjected to a high threshold and be a responsibility of the European Council, rather than of the ECB as suggested in the current proposal (Article 6.5).

2.2. Mandate and powers

The proposal confers on the ECB broad powers to supervise banks based in the SSM's geographical perimeter, to access relevant information, and to take appropriate remedial action when necessary. This is appropriate and necessary to ensure the effectiveness of the SSM. The experience of the EBA in 2011-2012 suggests that the objectives of the SSM cannot be attained if the main supervisory authority remains at the Member State level. Furthermore, the proposal makes appropriate provisions to enable existing national supervisory authorities to carry out a significant share of the actual supervisory tasks and assessments, in an adequate relationship with the ECB so that the ECB retains ultimate authority.

One possible exception, however, relates to macro-prudential policy instruments, including the ability to impose additional prudential buffers on banks with regard to national credit conditions. Article 4.1(d) of the proposal appears to centralise such decisions at the ECB level. While coordination by the ECB is certainly in order, further capacity for initiative by national authorities in this matter would be more consistent with the principles suggested by the European Systemic Risk Board (ESRB) in the context of the legislative discussion on capital requirements (ESRB, 2012).

Also, non-euro area Member States participating in the SSM may be granted a higher degree of autonomy from the decisions of the central supervisor than euro area Member States, to take into account interactions with their national monetary and fiscal policies, including the fact that they are not covered by the ESM. This could take the form of a safeguard clause that could be invoked, with due justification and an appropriate procedure, to limit the direct application of ECB decisions as currently set out in Article 6 of the proposal.

2.3. Banks brought under the SSM's authority

The proposal includes all euro area-based banks and credit institutions within the SSM's scope of authority. This is consistent with the Heads of State and Government stated aim *"to break the vicious circle between banks and sovereigns."* This aim cannot be attained if significant sections of individual Member States' banking systems remain within a purely national policy framework, even if these sections are composed of small or medium-sized banks. Thus, the Commission's proposal on this aspect is based on a rigorous application of the principle of subsidiarity in accordance with the stated policy objective.

2.4. Governance, accountability and independence

One lesson from the EBA experience is that governance arrangements matter highly to the success of a newly established supervisory authority at the European level. In this area, the Commission's proposal retains scope for improvement.

A debate has started over the desirable relationship between the SSM and the ECB. On the one hand, the ECB is widely viewed as a strong and credible institution, and it is understandable that this credibility should be leveraged to the benefit of the new SSM. Furthermore, there are multiple connections between monetary policy and supervisory policy, not least in the operation of the ECB's lender-of-last-resort function to the euro area banking system. Also, the use of Article 127(6) TFEU explicitly implies vesting the European level of supervisory authority in the ECB. On the other hand, supervision may involve individual decisions with high political impact and its medium-term compatibility with an independent conduct of monetary policy is open to question. This would suggest that the European supervisor may have some more autonomy vis-à-vis the ECB, and more accountability to political authorities at the EU level, than is the case in the Commission's proposal. An optimal response to all these considerations requires careful fine-tuning and institutional creativity.

A useful guiding vision could be to consider the medium-term relationship between the ECB and the SSM along the lines of that between the Bank for International Settlements (BIS) and the Financial Stability Board (FSB) in Basel, even though evidently with a very different set of institutional constraints and responsibilities. The BIS hosts and finances the FSB but there is considerable autonomy, and the more political nature of the FSB does not encroach on the independence of the BIS. Partly for reasons of expediency, the FSB started operations without an autonomous legal personality or independent funding, but there is now a discussion to modify these features. Similarly, and especially in a context of possible future treaty changes, in a longer-term perspective the ECB could be considered the incubator of a European supervisory function that may gradually gain autonomy. This however is not possible in the current step given the decision to base it on Article 127(6) TFEU.

At the present stage, improvements that may be considered could include:

- Identifying the supervisory function within the ECB under a specific name (such as *"European Banking Supervisor"*), which would mark its separation from the rest of the ECB's activities;
- Replacing the currently proposed (and confusingly named) *"supervisory board"* with a two-tier structure⁶:

⁶ A comparable setup with an Executive Board of nine members is proposed in Carmassi, Di Noia and Micossi (2012).

- A compact SSM Executive Board, comprising somewhere between five and nine members to make effective supervisory decisions affecting individual credit institutions in the European interest;
- A larger Prudential Council that would include representatives of national supervisors, including those of non-euro area Member States participating in the Single Supervisory Mechanism; the latter may have a reduced voting weight as a quid pro quo for their higher degree of autonomy as suggested above. The prudential Council would exercise oversight over the action of the SSM Executive Board on individual cases, and decide on broader matters of policy, such as the positions recommended by the ECB in the elaboration of binding technical standards at the EBA.

This setup would ensure the indispensable effectiveness of individual supervisory decisions that should not be held up by diplomatic balances, while safeguarding the interests and engagement of all participating Member States in setting supervisory policy. In turn, both the SSM Executive Board and the Prudential Council should be adequately subjected to the ultimate authority of the ECB's Governing Council.

- Making the appointment process for the members of SSM Executive Board more akin to that of the members of the ECB's own Executive Board (i.e., by the European Council after consultation of the European Parliament), while keeping the proposal's provision that the Chair should be one of the ECB's Executive Board members. However, it is unclear why the Vice Chair should be a central banker selected by and from the ECB's Governing Council (Article 19.2 in the proposal);
- Extending the possible length of tenure of the Board's members including its Chair, as the currently proposed maximum of five years non-renewable (Article 19.7) appears exceedingly short and not in line with international good practice.

3. EBA REFORM

This section is based on the European Commission's *"Proposal for a Regulation of the European Parliament and the Council amending regulation (EU) No 1093/2010 establishing a European Supervisory Authority as regards its interaction with Council Regulation (EU) No.../... conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions,"* COM(2012) 512 final, published on 12 September 2012.

The consolidation of the supervisory frameworks of at least 17 Member States under the authority of the ECB has a disruptive impact on the fledgling institutional balance of the EBA. It is unlikely that fully consistent responses to the corresponding institutional challenges can be found in the current phase of reform, and given the lingering uncertainty about major elements of Europe's future banking policy framework. Thus, it appears reasonable at this stage to adopt incremental, ad hoc adjustments that keep the functioning of the EBA viable if not optimal in the immediate future, and to delay any more fundamental changes to the planned 2014 review of the three European Supervisory Authorities. This is broadly the approach adopted in the Commission's proposal.

However, even under this *"stopgap"* approach, the Commission does not appear to have gone far enough to address the legitimate concerns of Member States that would not participate in the Single Supervisory Mechanism. In principle, authorities of SSM Member States that vote in the EBA's Supervisory Board retain their autonomy, but in practice, it is likely that coordination will be sought so that their votes are in line with policies adopted by the SSM as a whole. In particular, according to the proposal, it will be very difficult for non-euro area Member States to oppose a position that would be shared by all SSM Member States (even assuming that the geographical perimeter of the SSM is limited to the current euro area) in a decision made by qualified majority voting (QMV).

One way to overcome this obstacle would be to subject such decisions, including the approval of binding technical standards, to a higher threshold of majority than the usual EU QMV formula. Other similar further adjustments may be in order in other areas of the EBA's activity, including decisions on binding mediation, actions in emergency situations, and appointment decisions. All things equal, such adjustments may make it more difficult to reach the voting threshold and thus may have a negative impact on the quality of EBA decision-making, but this may be seen as an inevitable consequence of the creation of the SSM, at least until the 2014 review.

4. OTHER LEGISLATION CURRENTLY UNDER CONSIDERATION BY THE EUROPEAN PARLIAMENT

In its Communication COM(2012) 510 final *"A Roadmap towards a Banking Union"* published on 12 September 2012, the European Commission links the establishment of the SSM and EBA reform to the adoption *"before the end of 2012"* of three additional pieces of legislation, namely on Capital Requirements (proposal of July 2011), Deposit Guarantee Schemes (proposal of July 2010), and Recovery and Resolution Tools for Banks in Crisis (proposal of June 2012). It also indicates that *"the Commission envisages notably making a proposal for a single resolution mechanism which would govern the resolution of banks and coordinate in particular the application of resolution tools to banks within the banking union."* Furthermore, the conclusions of the High-Level Expert Group on possible reforms to the structure of the EU banking sector, chaired by Bank of Finland Governor Erkki Liikanen, are expected shortly and may give rise to additional legislative projects.

These various legislative processes, however, should be considered with different degrees of urgency. A natural sequence would be to prioritise the legislation on capital requirements, not least because of the deadline of January 2013 for the start of implementation of the Basel III Accord. On the other aspects, it would be natural to envisage reconsideration in the new context created by the prospect of a European Banking Union. Specifically, the issue of Recovery and Resolution Tools could be examined together with the Commission's future proposal on a single resolution mechanism, which one would expect may be published in the course of 2013; and the reform of Deposit Guarantee Schemes may be delayed until a clarification of how the issue of Deposit Insurance is to be addressed on a supranational basis in the future Banking union framework. Such rescheduling of course would be without prejudice of the possible adoption of legislation on special resolution regimes and/or reform of deposit insurance systems in individual Member States, which may be imposed by circumstances on an emergency basis, and for which the above mentioned EU legislative proposals may provide a source of inspiration if not a binding framework.

5. CONCLUSION

It is to be hoped that a workable compromise for the initial establishment of the SSM based on Article 127(6) TFEU and corresponding EBA reform can be reached in the next few weeks. Energetic steps towards a resolution of Europe's current banking fragility are urgently needed, and the statement of 29 June 2012 makes the effective establishment of the SSM a precondition for such steps. The cost to Europe's citizens of further delay could be extremely significant, not only in financial terms but also in political and social ones.

This author's recommendation to the European Parliament would therefore be to provide its support for the bulk of the Commission's proposal while insisting on some necessary improvements, particularly as regards the accountability of the future European supervisory function within the ECB; inclusiveness of the Single Supervisory Mechanism vis-à-vis non-euro area Member States that desire to participate in the Banking Union; and further safeguards for non-euro area Member States in the ad hoc reform of the EBA pending more fundamental changes at the occasion of the 2014 review.

The establishment of the Single Supervisory Mechanism is only one step on a longer path towards European Banking Union, which itself cannot be considered in isolation from the challenges of Fiscal Union and Political Union. Losing the current momentum for the completion of this early step would be unfortunate, not only in itself but because it would reinforce the European public's and global investors' current doubts about the very ability of European leaders to make effective decisions. The statement of 29 June 2012 contains a promise of supervisory integration and centralised bank crisis management. Europe's leaders now need to deliver on this promise if they are to maintain, or regain, the trust of their constituents.

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DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Banking Union and a Single Bank Supervisory Mechanism

Anne SIBERT

NOTE

Abstract

This note considers why a banking union is an essential component of a well-functioning monetary union. I describe some the consequences of banking union for the euro area. I describe how the European banking union should be designed.

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EXECUTIVE SUMMARY

- It is now widely agreed that banking union is a necessary condition for the survival of the euro as the common currency of the Economic and Monetary Union. Impaired sovereigns cause their resident banks to be perceived as risky. The banks then face higher funding costs and they pass these on to resident households and firms. Impaired banks in need of recapitalisation in turn increase the riskiness of their sovereign. Banking union is a way to break this damaging feedback loop.
- Under the pretence of prudential regulation, national supervisors in the core euro area nations have imposed de facto capital controls on interbank flows of funds from the core to the periphery. If there were a banking union with the ECB in charge of supervision, it is unlikely that national supervisors would be allowed to do this.
- A likely outcome of banking union is the mutualisation of financial repression with the single supervisor persuading banks throughout the euro area to purchase more debt issued by periphery and soft core sovereigns than they otherwise would. This mutualisation, coupled with the recapitalisation of banks taking place through the ESM rather than the sovereign, means that banks will be much less exposed to their sovereign and much less apt to fail if their sovereign defaults. Moreover, if they fail the ESM will likely come to their aid. Thus, a major deterrent to strategic sovereign default – the collapse of the national banking sector – is removed or lessened by banking union.
- In addition to widespread agreement on the need for banking union, there is widespread agreement that the essential components of such union are a single supervisor, a single regulatory framework and a single bank resolution regime. In addition there is widespread support for a single deposit insurance scheme, but this is not essential. Another ingredient that may be useful, but that is not essential, is a common guarantee fund for term unsecured bank funding.
- In the long run the financial services industry may bear the burden of funding bailouts. But in the short run, tax payers will bear much of the burden. The tax payer funding, however, does not require fiscal federalism or a supranational tax authority. What is required are finite, capped amounts of money for specific purposes.
- In the short run, Member States of the euro area and any other EU Member States that are willing should be in the banking union; in long run it is desirable for all EU members to participate. The ECB should play the role of the single supervisor and in the short run it should supervise large and systemically important banks; it should delegate the supervision of small banks to the local authorities but it must retain the power to overrule national supervisors and to choose at any time to supervise directly any bank of any participating country. Independent institutions should run the bank resolution regime and the single common deposit guarantee facility. These institutions and the ECB should be substantively accountable to the European Parliament.
- The ECB's lack of accountability is unacceptable for an institution with such a political task as banking supervision. The solution to the problem of a monetary authority's need for independence and a supervisory authority's need for accountability is to separate the monetary authority from the rest of the central bank.
- Continued intransigence on the part of the German, Dutch and Finnish governments threatens to at best delay and at worst scupper banking union altogether. Without a banking union, the threat of a disorderly breakup of the euro area and the consequent risk to the European banking system is back in force.

1. INTRODUCTION

It is now widely agreed that banking union is a necessary condition for the survival of the euro as the common currency of the Economic and Monetary Union. The reasoning is straightforward. If a solvent bank becomes temporarily illiquid, it can borrow from the Eurosystem through the National Central Bank (NCB) in whose jurisdiction it is located. If the insolvent bank's liquidity problems are brought about by or exacerbated by an unanticipated loss in the liquidity of the financial assets that it holds, then the Eurosystem can further come to the rescue. The NCBs can act as the purchasers of last resort of these unexpectedly illiquid financial assets.

However, when a bank is insolvent or at imminent risk of insolvency it is the national sovereign, not the NCB, which plays the important role. If the bank is not systemically important, it can be allowed to fail: it can be liquidated or sold to a fiscally sounder competitor. If the bank is systemically important – that is too big or too interconnected to fail – then it must be recapitalised, and perhaps restructured, to restore its solvency. This crisis action requires overnight resolution: any disruption to the institution's operations can have serious implications for other financial firms and the financial system as a whole. The leisurely pace of the corporate insolvency process for non-financial firms will not do. A special resolution regime for banks, one that can fire the management and the board of directors, disenfranchise the shareholders and restructure the assets and liabilities of the bank, all without the intervention of the normal bankruptcy courts, must be created. It must be feasible to dilute or wipe out the value of existing shares. It has to be possible for unsecured creditors of the bank to be forcibly converted into shareholders of the bank or subjected to haircuts. It must be possible for the bad or impaired assets of the bank to be transferred to a *'bad bank'*, which may be capitalised with the resources of the unsecured creditors of the original bank. Finally, the resources of the tax payers must be available to strengthen the balance sheet of the failing bank.

The problem arises when a fiscally weak sovereign cannot provide a credible backstop for systemically important banks in its jurisdiction. In countries with a fiscally strong sovereign such as Germany, the banks – even ones that are believed to be insolvent or on the verge of insolvency – can fund themselves in the market on reasonable terms. This is because it is generally believed that the unsecured liabilities of these banks are backed by an implicit guarantee from the German sovereign. The consequence of this for the real economy is that since the German banks can borrow at reasonable rates, non-financial corporates and households in Germany can also borrow at attractive rates from the German banks. Banks in the jurisdictions of fiscally impaired sovereigns – those of Greece, Portugal, Ireland, Spain, Italy, Cyprus and Slovenia – do not benefit from the implicit guarantee that German banks benefit from. Even if their balance sheets and general financial health is stronger than that of the German banks, they will be able to borrow in the market, if at all, only at much higher rates than their German counterparts. This has a number of costs for the euro area as a whole. First it makes the playing field for banks distinctly not level, with a competitive advantage given to those with a strong sovereign. This is an undesirable feature in the EU. Second, if systemically important banks with fiscally weak sovereigns fail or even threaten to fail as a consequence of being unable to borrow at reasonable rates, then financial institutions, and perhaps the financial system as a whole, in the euro area and beyond may be harmed. Third, banks with fiscally weak sovereigns pass their higher funding costs on to the non-financial corporates, the non-bank financial institutions and the households in the periphery, harming its real economic performance.

In addition to weak sovereigns damaging their own banks, the experiences of Ireland and Spain indicate how weak banks can damage their sovereigns. As a consequence of the

unfortunate feedback loop between fiscally precarious sovereigns and impaired banks, the euro area Summit statement of 29 June 2012 leads with "*We affirm that it is imperative to break the vicious circle between banks and sovereigns.*"

2. SOME CONSEQUENCES OF BANKING UNION

Banking union has the desirable feature that it can lessen the correlation between the borrowing costs of sovereigns, resident banks and households and firms. It has some other consequences as well, both good and bad.

2.1. Improving the Allocation of Funding

It would appear that the problem of residents of countries with fiscally weak sovereigns facing higher borrowing costs than residents of countries with fiscally strong sovereigns could be at least ameliorated by arbitrage. Subsidiaries of multinational banks that are located in countries with fiscally weak sovereigns would send funding to the parent company which would use the funding itself if it is located in a country with a fiscally weak sovereign or it would allocate the funding to its subsidiaries in countries with fiscally weak sovereigns. However this process is being hindered by NCB supervisors and regulators in countries with fiscally strong sovereigns who, under the guise of regulatory prudence, are imposing de facto capital controls and preventing this process from happening.

A typical example is the following. A branch of an Italian multinational bank makes loans to corporate clients in South Tirol in Italy at rates that are 350 bps higher than the rates that its Austrian subsidiary charges on the same types of loans with similar risk characteristics to corporate clients in North Tirol and East Tirol in Austria.¹ The reason for the difference in the interest rates is that the Austrian subsidiary of the Italian bank has a highly credible backstop in the form of an implicit sovereign guarantee from the Austrian sovereign; the implicit guarantee provided by the Italian sovereign to the Italian parent bank is worth much less.

When the Austrian subsidiary tries to take advantage of the interest rate differentials by sending funds to its Italian parent, it is stopped by the Austrian supervisors and regulators. Under the pretence of prudential regulation, national supervisors in the core euro area nations have imposed de facto capital controls on interbank flows of funds from the core to the periphery, including flows between subsidiaries of the same cross-border bank and flows between subsidiaries and their parent. In addition to the resulting inefficient allocation of lending, the monetary transmission mechanism in the euro area, working through interest rates, is hampered if bank funding costs and bank lending rates primarily reflect differences in sovereign credit risk (and possibly also differential euro area exit risk) rather than the decisions taken by the ECB on official policy. If there were a banking union with the ECB in charge of supervision, it is unlikely that national supervisors would be allowed to obstruct the flow of funds.

2.2. Mutualisation of Financial Repression and Strategic Sovereign Default

Sovereigns in periphery countries have attempted to meet their borrowing needs by leaning on their resident banks to purchase their newly issued debt. Banks have not found this to be too much of a hardship because the heavily subsidised lending rates offered by the ECB's LTROs have made for an attractive spread.² Once the ECB is the sole supervisor, individual sovereigns may find that they are less in a position to influence the behaviour of their banks. The periphery and soft core sovereigns, however, may still need banks to purchase more of their newly issued debt than they might otherwise be inclined to. A likely outcome is the mutualisation of financial repression with the single supervisor persuading

¹ See Buiter (2012a) and (2012b).

² See Sibert (2012).

banks throughout the euro area to purchase more debt issued by fiscally shaky sovereigns than they otherwise would.

Buiter (2012b) points out a related consequence of banking union: strategic sovereign defaults should be more common. Currently, resident banks are heavily exposed to their sovereign and a sovereign default is likely to entail a collapse of the national banking system. With a banking union in place banks will be much less exposed to their sovereign, both because of the mutualisation of financial repression described above and because recapitalisation of banks takes place through the ESM rather than the sovereign. Thus, banks are less apt to fail if their sovereign defaults. In addition, if they do fail the ESM will likely come to their aid. Thus, a major deterrent to strategic default – the collapse of the national banking sector - is removed or lessened by banking union.

3. DESIGNING A BANKING UNION

In this section I consider some of the desirable features of a banking union and some of the problems associated with creating one.

3.1. What should a Banking Union include?

In addition to widespread agreement on the need for banking union, there is widespread agreement on what the essential components of such union are:³

- A single supervisor, a single regulatory framework and a bank resolution regime for banks and other highly leveraged financial institutions that are engaged in duration, liquidity and credit risk transformation. As the ultimate sanction, the single supervisor should have the power to revoke banking licenses. The bank resolution regime should have a European Bank Resolution Authority (EBRA), a bank resolution fund and a bank recapitalisation fund.

In addition there is widespread support for

- A single deposit insurance/guarantee scheme and fund for insured retail deposits. This scheme should also cover redenomination or convertibility risk in the event of a euro area exit.

Unlike the first set of ingredients, this component is not essential. If there is a depositor run on a bank, the central bank can act as a lender of last resort. Preventing depositor runs is desirable, but their possibility need not threaten the banking system.

A possible additional ingredient that may be useful during the years following the large-scale bank debt restructuring that is likely to occur in the middle of this decade is

- A common guarantee fund for term unsecured bank funding.

The ECB will fill the role of the single euro area supervisor. Temporarily, it will have to operate within the 17 distinct national regulatory regimes. A single regulatory regime for all euro area Member States' banks will have to be introduced as expeditiously as possible.

3.2. Fiscal Dimensions of a Banking Union

A major difficulty in setting up a single supervisory body and a single resolution authority is the fiscal consequences. It must be decided who should be protected when a financial institution fails. There is widespread agreement that depositors should be protected, at least up to a point, and that shareholders should lose their money. However the fate of senior unsecured creditors is more controversial. In favour of protecting senior bond holders are a fragility argument – a creditor run based on self-fulfilling expectations is a possible equilibrium outcome – and adverse-selection arguments. Against protecting senior bond holders is the argument that creditor runs can be dealt with by having a lender of last resort instead of insurance and a moral hazard argument that the expectation of being bailed out leads to reduced incentives on the part of senior bond holders to collect information about and to monitor the behaviour of the financial institutions that they lend to. However, as the senior bond holders tend to be insurance funds and pension funds, rather than hedge funds, the euro area may opt for some limited protection for senior unsecured debt holders. It is important however, that the rules should be clear. A legal framework that leaves the question open can only lead to acrimony, especially if euro area

³ See Buiter (2012b) for a discussion of these issues.

tax payers are asked to bail out bond holders of predominantly one or a few Member States.

Perhaps more thorny than the issue of who should be bailed out is the question of how much euro area tax payers should pay for bailouts. Tax payer bailouts are obviously wildly unpopular, even when the tax payers are bailing out their own jurisdiction's banks. They are likely to be even less popular when they involve bailing out foreign banks. Nevertheless if financial intermediation yields social benefits as well as benefits to the financial services industry then it is reasonable for tax payers to bear some of the costs of keeping it functioning. Also, if the tax payers are also the voters than they bear ultimate responsibility for electing policy makers who will ensure that it functions properly. Bearing some of the burden for any regulatory or supervisory failure ensures an interest in this issue. The tax payer funding, however, does not require fiscal federalism or a supranational tax authority. What is required are finite, capped amounts of money for specific purposes. In the long run the bank recapitalisation and resolution fund may be mostly or totally funded by involuntary insurance contributions from the industry (both providers and customers), however for the foreseeable future it will have to be jointly and severally fiscally backed, say up to EUR 500 billion. The deposit guarantee fund should also be mostly or totally funded by the industry. It has to be backed, however, by a joint and several guaranteed fiscal facility. The size will depend on the size of the insured deposit limit, which should probably be lowered from its current EUR 100,000.00 level to something about half that size.

Bank resolution is a specialist task requiring different expertise than that used for providing liquidity to sovereigns and restructuring sovereign debt. Thus, this role should be taken from the ESM and given to an independent agency similar to the Federal Deposit Insurance Cooperation (FDIC) in the United States.

A major difficulty in setting up a single supervisory body and a single resolution authority is the tension between efficiency and property rights that is inherent in the design and implementation of any bank resolution regime. If a failing bank's business is to continue without interruption then it is best for the resolution authority to seize it before it actually fails. But, if the firm has not yet failed then there is a chance, however small, that it might not have failed without the government's intervention. In this event the intervention amounts to confiscation. The problem is complicated by the difficulty in assessing when a financial institution is insolvent, especially in periods when asset markets are dysfunctional and the market price of an asset is far below what its reasonably expected present discounted value if it were held to maturity. Government takeovers of financial institutions can lead to animosity and extensive and long lasting litigation even when the resolution authority and the majority of the shareholders share a nationality; the problem is exacerbated when they do not.

3.3. The Scope of the Single Supervisory Mechanism (SSM)

The Single Supervisory Mechanism (SSM) is the term used to describe the mechanism under which the ECB assumes its proposed supervisory authority. Pisani-Ferry et al (2012) describe the key issues that have to be resolved in deciding the scope of the SSM. I list these issues and comment briefly on each.

- (1) *Which EU countries should participate in the banking union?* Experience has shown that a banking union is critical to the proper function of a monetary union. Moreover, as discussed in Section 2.1 the unimpeded flow of capital within the European Union also requires a banking union. Consequently, in the short run the 17 euro area Member States as well and any of the remaining 10 EU but non-euro

area Member States that are willing to participate should join. However, in the long run it is desirable for all EU members to participate, but some countries, such as the United Kingdom, may not wish to be part of any EU banking union and some, such as Sweden, may find it unappealing to take part when they have no voting rights at the ECB.

- (2) *To which categories of banks should it apply?* A small staff and lack of experience probably means that initially only a limited number of multinational and systemically important banks can be supervised. In the short run the National Supervisory Authorities will continue to supervise local and less important banks. However, the experience of Spain suggests that small and medium size banks can be the source of significant problems. Therefore the ECB should supervise all large and significantly important banks. It might delegate the supervision of small banks to the local authorities but it must retain the power to overrule national supervisors and to choose at any time to supervise directly any bank of any country participating in the SSM.
- (3) *Which institution should do the supervision?* The only real candidate is the ECB. The EBA is, unfortunately, an EU27 institution, which means that it cannot credibly and effectively manage an arrangement that will apply only to the euro area and any volunteers from among the other 10 EU members. The ECB will also benefit from a detailed knowledge of area banks in its role of lender of last resort. It has been suggested that supervising fragile banks may lead the ECB to adopt a more dovish monetary stance than it otherwise would. The problem can be lessened by having one set of policy makers within the ECB make monetary policy and having another set of policy makers act as supervisors. This would be a natural separation as the roles require different expertise and different levels of accountability.
- (4) *Which institution should deal with resolution?* An independent institution similar to the FDIC in the United States. Such an institution requires different expertise than that at the ECB and to allow the ECB to do this would be to concentrate too much power in one unaccountable institution. Likewise, the deposit guarantee facility and fund should be a separate independent agency, distinct from the ECB.
- (5) *How centralised should the deposit insurance system be?* A single scheme with limited protection and with a common insurance fund should replace the ambiguous EU Directive on Deposit Guarantee Schemes. In principle the scheme should be funded by ex ante compulsory insurance payments made by both depositors and depository institutions. To be credible it needs to be backed initially by the ECB and, ultimately, with a joint-and-several guaranteed fiscal guarantee. The deposit insurance scheme should ensure against the redenomination risk associated with euro area exit to protect against the contagion arising from fears of a Greek exit.
- (6) *What kind of fiscal backing would be required?* See Section 3.2.
- (7) *What governance framework and political institutions would be needed?* The ECB as supervisor is undertaking a political role and must be accountable in this role to the European Parliament. Accountability should include not just the ECB's limited notion of formal accountability but also substantive accountability: it should be possible for the European Parliament to punish (that is, fire) ECB policy makers who engage in bad or incompetent behaviour. The European Bank Resolution Authority

and Fund and the deposit guarantee facility and fund should also be formally and substantively accountable to the European Parliament.

3.4. Accountability and the SSM

The ECB was designed in response to bad European monetary policy in the 1980s. To protect monetary policy from opportunistic politicians, the institution has virtually no substantive accountability. There are no negative consequences for the members of the Executive Board or for the other members of the Governing Council if the European Parliament is dissatisfied with their individual or collective performance. They cannot be fired or have their pay docked. In addition, the institution has scorned formal accountability: little information is provided about procedures, processes, actions, interventions and decisions. The reporting obligations to the European Parliament are derisory: quarterly '*dialogues*' in which questions that are viewed as uncomfortable are deftly avoided in the knowledge that there is unlikely to be a follow up.

The ECB's lack of accountability, which would be extreme even for an institution which is charged solely with monetary policy, is completely unacceptable in a democratic society for an institution with such a political task as banking supervision. The ability to close down banks by revoking their license is the ability to reassign property rights. The Governing Council must not be allowed to do this in an arbitrary fashion, without deigning to explain and secure in the knowledge that they are untouchable.

The solution to the problem of a monetary authority's need for independence and a supervisory authority's need for accountability if it is to be viewed as legitimate is to separate the monetary authority from the rest of the central bank. Accountability should be imposed on the ECB as a supervisory body and as a body that has taken on a fiscal policy role in its Securities Markets Programme. The pretence that monetary policy is being made by the entire Governing Council should be abandoned. Instead, it should be formalised that a small subset of the Governing Council (call it the Monetary Policy Committee) chooses the policy rate. Make the chairman of the Monetary Policy Committee a different person than the head of the central bank, exclude the members of the Monetary Policy Committee from political decisions and given them the amount of independence appropriate for monetary policy makers.

4. CONCLUSION

September 2012 saw three positive policy developments in the euro area. The first was the 6 September announcement of the ECB's Outright Monetary Transactions (OMT) framework. As long as a country is respecting the conditionality attached to an appropriate EFSF/ESM macroeconomic adjustment or precautionary programme, the ECB stands ready to undertake the sterilised purchase of an unlimited amount of its one-year to three-year maturity sovereign debt in the secondary market. This should remove the threat that a compliant participant in a suitable programme can be involuntarily forced out of the euro area and should, thus, alleviate or eliminate the exit contagion risk for fiscally weak, but cooperative, sovereigns.

The second bit of good news was the 12 September ruling by the German Constitutional Court that, with only minimal additional conditionality, the ESM and the fiscal pact on member countries' budget limits is consistent with the German constitution. The third positive news item was also on 12 September when voters in a general election in the Netherlands gave the pro-European centre-right party a narrow victory over the pro-European centre-left party, defying a pan-European trend towards a weakening of the centre, a strengthening of extremist political parties of the left and right and the growth of anti-euro sentiment.

Unfortunately, even before the month of September was over, this good news was overshadowed by a rash of bad news about banking union. Germany is offering resistance to the idea of a single banking supervisor, wanting instead to maintain its apparently rather dubious quality supervision of its regional, local and cooperative banks.⁴ The finance ministers of Germany, Netherland and Finland have argued that the ESM should not be allowed to mutualise the costs of legacy recapitalisation. This is unreasonable as it assumes that the legacy losses of banks are solely the responsibility of the country in which they are resident and not at all the responsibility of the supervisors of the banks located in the core countries that made the loans to the periphery banks. Continued intransigence on the part of the German, Dutch and Finnish governments threatens to at best delay and at worst scupper banking union altogether. Without a banking union, the threat of a disorderly breakup of the euro area and the consequent destruction of the European banking system is back in force.

⁴ See Buiter (2012a).

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DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

How should a European Banking Union work?

Karl WHELAN

NOTE

Abstract

This paper discusses arguments for banking union in Europe and outlines how such a union could be implemented. While there are some arguments for a common bank supervisor across the EU, such a proposal is unlikely to ever work. The absence of a monetary policy and exchange rate tool for euro area members makes banking crisis more threatening for these countries and strengthens the argument for a common bank supervisor backed by common deposit insurance and resolution funds. The ECB is the best placed institution to play the role of common supervisor due to its position as the lender of last resort to banks. The paper notes that current discussions on banking union leave the euro area a long way away from a coherent and workable banking union.

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1. INTRODUCTION

After a long period in which banking crises were a fairly rare occurrence in modern economies, the banking sector has been central to the macroeconomic problems confronting global policy makers since the middle of 2007. Within the euro area, the costs of rescuing the banking sector contributed to large run-ups in sovereign debt burdens and the risks of sovereign default now pose a serious threat to the solvency of banks. The euro area leader's summit statement of June 29 this year provided an official acknowledgment that it was *"imperative to break the vicious circle between banks and sovereigns."*

The summit's communiqué continued that *"When an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalize banks directly."* However, despite lots of discussions since June 2012 (including detailed proposals from the European Commission) there is still very little clarity as to how far European governments are willing to move towards a banking union that genuinely meets their commitment to break the vicious circle.

There are a series of unresolved questions about the implications of June's summit. The first set of questions relate to how the single supervisory mechanism is supposed to operate. Should it be limited to supervising only the largest banks or be tasked with overseeing all banks? And which organisation should be charged with this task: The ECB or a new supervisory body?

Probably more important, however, is the lack of clarity about an essential element that needs to accompany a common supervisory mechanism: The sharing of bank-related risks. This risk sharing is necessary to honour the summit's commitment to break the vicious circle between banks and sovereigns. It is also necessary for a common supervisory approach to work. If national governments are responsible for recapitalising banks, they are unlikely to accept having outside supervisors insist on recapitalisation requirements.

Unfortunately, despite the apparent acceptance of the linkage between supervision and risk sharing in the June statement, the recent joint statement from the German, Dutch and Finnish finance ministers suggests that some Member States are now seeking to place severe limits on the extent of risk sharing. This development threatens to undermine progress towards breaking the vicious circle acknowledged by the leaders in June.

The rest of this paper is organised as follows. Section 2 discusses the arguments for harmonising banking regulations, deposit insurance and resolution regimes and why there is a strong argument for a common bank supervisor in the euro area if not the EU. Section 3 discusses the ideal structure for the common supervisory approach. I argue that this structure should involve the ECB as supervisor for all banks as well as a common European deposit insurance and resolution fund as recommended by Gros and Schoenmaker (2012). Section 4 then assesses where we currently stand in relation to the banking union discussions.

2. WHY HAVE A BANKING UNION WITHIN THE EURO AREA AND NOT WITHIN THE EU?

The phrase “*banking union*” has been widely used in European policy circles in recent months but it is not always clear what this term means or who it would apply to. Before discussing broader concepts of banking union, I first want to focus on the narrowest possible definition of such a union: The idea that the same set of banking rules and regulations should apply across the same area. I then discuss the arguments for a common supervisor and conclude that this approach should be applied to the euro area but is unlikely to work for the EU as a whole.

2.1 The need for Harmonisation across the EU

The first way in which Europe’s banking sector differs from those in more integrated economic unions is the absence of a common rule book for banking regulations. Within Europe’s single market, with its free movement of capital, disparities in banking regulations can cause important distortions and can potentially magnify risks associated with the banking sector.

Consider, for example, the role played by bank capital regulations. Currently, methods for calculating bank capital differ widely across different EU Member States. This type of disparity could allow banks from certain countries to take greater risks and perhaps out-compete banks from other areas when looking for business as they are allowed to expand more aggressively. This kind of disparity can also lead to pressure from banking representatives to “*dumb down*” regulation to the weakest level allowable while still complying with EU regulations. The range of different methods used to calculate capital ratios also contributes to confusion during crises as investors find it difficult to compare observed capital ratios for banks across the EU when deciding whether to make debt or equity investments. A common rule book will benefit transparency and the safety of the financial system.

In the same way, regulations relating to bank liabilities also need to be harmonised across Europe. If one country in the EU decides to offer its depositors better insurance conditions than others, funds may move towards that country’s banks and again there may be pressure on other countries to imitate these measures, perhaps placing too much financial risk on taxpayers. The absence of a harmonised approach to bank liabilities was a complicating factor in the EU during the financial tensions of late 2008. For example, in September 2008, the Irish government passed a near-blanket guarantee of the liabilities of its domestic banks. For a short period, this guarantee led to an inflow of funds into these banks and raised pressure on other EU Member States to issue liability guarantees. Only later did it become clearer that the Irish guarantee was an expensive mistake.

Harmonisation should also be extended to policies on bank resolution. If shareholders and bondholders believe they are less likely to lose money on a failed bank in one country because the government is more likely to bail them out, then banks in that country will have a lower cost of funds and may be more able to expand rapidly; such banks may also take greater risks because of the moral hazard problems induced by the implicit promise of a bailout from the government.

2.2 Arguments for a Common Supervisor

Accepting the case for harmonisation of banking rules across the EU, there are a number of reasons to argue that this should be supplemented by a common EU bank supervisor.

- **Supervisory Culture:** Even with a *“single rulebook”* in place, differences in supervisory practices could lead to important disparities in how these rules are applied. For example, one country could choose to enforce rules via an aggressive interventionist approach in which supervisors conduct regular visits and ask probing questions about bank operations, while another country could choose to have a poorly-funded regulator that relies on a *“light touch”* or *“principals-based”* approach to enforcement. A single supervisory body across the EU that would have a common approach to supervision would increase the likelihood of the rules and regulations are being enforced in the same way throughout the EU.
- **Financial Stability:** Europe’s banking system today is a patchwork of institutions with a wide range of inter-linkages. Cross-border banks are an obvious source of inter-linkages but the linkages relating to funding are perhaps more profound. Banks throughout the euro area receive large amounts of funding from depositors or investors from other countries or from the euro area Member States as a group in the form of Eurosystem funding. As Schoenmaker (2011) argues, these linkages mean that the implications of bank failures may not be taken fully on board by individual countries, so that policy interventions fail to consider fully the implications for cross-border financial stability.

On their own, however, these reasons have not yet been sufficient to convince European governments to agree to have a common bank supervisor. There are a number of reasons for this.

First is the **difficulty of separating banking supervision from the fiscal costs** associated with dealing with failed banks. A system in which a centralised European supervisor can insist that a bank be shut down or recapitalised at the expense of taxpayers in that bank’s home Member State is one that is likely to be fraught with tensions. With national governments *“on the hook”* for the fiscal costs associated with financial failures, it is hard to see how they can be asked to give up national control of supervision. This makes the question of who supervises banks a highly sensitive question. To work, it is likely that **shared supervision will have to be combined with shared risk**.

Second is **the heterogeneity of the banking sector** across EU Member States. In particular, countries with large and complex financial sectors, such as the UK, are unlikely to want to pass over regulatory control of such a key sector of their economy without assurances that it would remain unharmed. Conversely, the rest of the EU may have reservations about entering into a risk-sharing arrangement involving sharing losses generated by large institutions operating in the City of London.

For these reasons, a full banking union at an EU level is not something that is likely to occur at any point in near or medium-term future. However, the debt crisis in the euro area has raised a new and separate argument for banking union.

Many countries in the EU now have high levels of public debt. This has raised questions about whether they can cope with banking failures. These doubts can produce important negative feedback effects. Doubts about the capacity of the sovereign to cope with a banking crisis can raise yields, negatively affecting fiscal sustainability and damaging the balance sheets of banks that hold sovereign debt. Doubts about the ability of governments to ensure the safety of deposits or equally-ranked creditors can lead to deposit flight, which contributes to a credit crunch, thus weakening the real economy, which in turn raises further doubts about fiscal sustainability.

Crucially, unlike countries outside the euro area such as the UK, euro members do not have access to their own National Central Bank that can step in to purchase bonds to avoid default. This is still the case even after the announcement of the ECB's Outright Monetary Transactions (OMTs) programme, as that programme is partial, highly conditional and comes after a precedent has been set in Greece that euro area Member States can be put through an orderly sovereign default. Designed in this fashion, banking weakness is likely to lead to a threat of default across a number of euro area Member States.

Any proposal to share the costs of banking recaps across Member States is bound to be controversial. While one can think of theoretical arguments in which such *"risk sharing"* acts as a kind of insurance policy that benefits all Member States, the reality is that we have a pretty good idea which countries have the weakest banking systems and are thus most likely to benefit from the introduction of the risk sharing element of a banking union. Citizens of Member States that would be responsible for funding recapitalisations in other states are understandably unhappy about this prospect. Still, without risk sharing of this type, the vicious circle identified in the June 2012 statement will continue.

The relationship between risk sharing and common supervision is a two-way street. Not only is an external supervision without risk sharing unlikely to be acceptable to Member States, it is also the case that risk sharing is unlikely to work without a shared and trusted supervisory mechanism. Indeed, it is the June summit's commitment to take some initial steps towards risk sharing between euro area countries that are providing the impetus for the common supervisory mechanism, a fact acknowledged by the European Commission which has stated¹:

'an integrated supervision is necessary to make sure that all euro-countries can have full confidence in the quality and impartiality of banking supervision, opening the way for the European Stability Mechanism (ESM) to directly recapitalize banks that fail to raise capital on the markets.'

Of course, an agreement in principle to sometimes share risk is one thing. Figuring out how to make this agreement work in practise is a different thing.

¹ See European Commission (2012a).

3. HOW SHOULD A EURO AREA BANKING UNION WORK?

As of now, we have few details about how a common bank supervisor would work. Here I discuss three aspects of these decisions: Who should supervise, how many banks should they supervise and which additional institutions are required.

3.1 Who supervises?

The 29 June 2012 euro area summit statement proposed that “[...] an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area [...]”. The exact level of ECB “involvement” was unspecified but the European Commission has subsequently proposed a regulation that would confer the key supervisory tasks for all euro area credit institutions on the ECB.² Despite these proposals, some European politicians have argued that the ECB should not be given enhanced supervisory powers.³

I support the Commission’s proposal to give the ECB responsibility for supervising banks in the euro area. However, I disagree with the Commission’s rationale for this decision. A detailed Frequently Asked Questions (FAQ) document (European Commission, 2012a) lists a number of reasons why the ECB should be given this role, including its expertise in financial stability analysis. However, the Commission has also emphasised the need to separate monetary policy and banking supervision tasks. The proposed regulation discusses this issue as follows:

‘Monetary policy tasks will be strictly separated from supervisory tasks to eliminate potential conflicts of interest between the objectives of monetary policy and prudential supervision. To implement the necessary separation between both tasks and ensure appropriate attention to supervisory tasks, the ECB will ensure that all preparatory and executing activities within the ECB will be carried out by bodies and administrative divisions separated from those responsible for monetary policy.’

I think this emphasis on the importance of separating supervisory and monetary policy tasks is misplaced. The question of whether central banks should be involved in bank supervision is an old chestnut that academics have debated for many years and practice in the years before the global financial crisis swung somewhat towards separate bank regulators.⁴

In my opinion, the global financial crisis has swung matters decisively back in favour of central banks playing a key role in supervising banks. During a crisis, the central bank’s lender of last resort role is crucially important. The communication difficulties between the UK Treasury, the FSA and the Bank of England during the Northern Rock crisis in 2007 illustrated some of the problems that can occur when there is incomplete co-ordination between the lender of last resort and the bank supervisor. The 1997 removal of banking supervision from the Bank of England is now being reversed.

The crisis in the euro area has led to a breakdown in European interbank markets as well as the longer-term bank funding markets. This has left much of the banking system heavily dependent on the ECB for its funding. There is no point in pretending that this role of lender of last resort is completely independent of monetary policy as it has led to very substantial money creation, with the Eurosystem’s balance sheet now exceeding EUR 3 trillion in size. Key monetary policy operations, such as the Long-Term Refinancing

² See European Commission (2012b).

³ See for instance, <http://www.reuters.com/article/2012/09/22/us-germany-banking-supervision-idUSBRE88L04S20120922> and <http://uk.reuters.com/article/2012/09/20/uk-eurozone-banier-germany-idUKBRE88J0S820120920>.

⁴ See Goodhart and Schoenmaker (1995) and Peak, Rosengren and Tootell (1999) for two pre-EMU examples of papers that debated this question.

Operation (LTRO), are working directly through their effects on the banking system and are providing support to large numbers of weak banks.

In practice, the ECB is already playing a central role in dealing with failing banks because the ECB Governing Council must make decisions about whether to provide liquidity to these banks against eligible collateral or, as has become fairly common, in the form of Emergency Liquidity Assistance (ELA). In addition to formalising the ECB's role in resolving failing banks, the new approach to supervision should see a removal of the current distinction between the risk associated with ELA relative to regular Eurosystem loans. If the ECB Governing Council decides that the Eurosystem must act as a lender of last resort to a bank, then the risk associated with non-standard loans should be shared among all states, rather than falling only on the bank's local Member State.

Overall, I believe that an official role for the ECB in supervising banks will help provide a far more efficient set of procedures for diagnosing problems with banks and then diagnosing the correct mix of solvency and liquidity measures required to resolve these problems.

3.2 How many banks?

The June summit statement about establishing *"an effective single supervisory mechanism [...] involving the ECB, for banks in the euro area"* does not specify anything about excluding some banks from this supervision. The Commission's proposed regulation clearly states that the ECB should supervise all euro area credit institutions.

Still, there have been strong objections from Germany to the idea that the ECB should supervise all banks. In particular, the German Finance Minister, Wolfgang Schäuble, has proposed that the ECB should only supervise larger *"systemically relevant"* banks.⁵

The argument for applying a common supervisory mechanism to only larger banks appears to be based on the idea that the problem being solved by the common supervisor is the systemic risks to financial stability posed by these banks. I think this argument is incorrect. Large banks are not the only threat to financial stability. The European Commission have defended their proposal for extending common supervision to all banks on the grounds that *"small banks can also cause problems."* I think the correct argument is more subtle. It is that collections of small banks with similar characteristics can often act in the same way so that the sector as a whole can occasionally presents a threat. This has been a familiar story running from small bank failures during the Great Depression, the Savings and Loans debacle of the 1980s or the problems with Spanish cajas and German Landesbanken. Leaving banks below a certain threshold out of the common supervisory framework would be a serious mistake.

German objections to the ECB supervising all 6000 banks in the euro area have also focused on the practical implementation problems associated with the ECB taking over the supervision of so many banks all at once. I believe these practical implementation difficulties are overstated and that the true reasons for German objections are more likely related to the unwillingness to have highly politicised small German banks come under European supervision.

An analogy with the common monetary policy is relevant. One could argue that taking over running monetary policy operations supplying liquidity to 6,000 different banks and involving the work of tens of thousands of central bank staff would lead to severe implementation problems and require a huge centralised staff. In practice, most of the day-to-day work of the Eurosystem is still done in the National Central Banks and the ECB itself operates as a form of centralised secretariat rather than a huge bureaucracy. In the same way, even if the ECB becomes the official supervisor of all euro area banks, the majority of

⁵ See news story here <http://www.reuters.com/article/2012/09/03/us-eurozone-banks-schaeuble-idUSBRE88204U20120903>.

day-to-day supervisory tasks would remain with local supervisors, with the head office staff at the ECB designing common policies and taking the key decisions in relation to specific problem banks.

3.3 Needed: A Euro Area FDIC⁶

As discussed above, it is clear that to operate effectively, a common supervisory mechanism needs to be combined with a common and shared approach to the risks associated with failed banks. The European Commission have proposed a harmonised approach to deposit insurance and a common bank resolution framework.⁷ However, for a banking union to work effectively, I believe it is best to combine these two elements together to produce a euro area version of the US Federal Deposit Insurance Corporation (FDIC). Gros and Schoenmaker (2012) discuss such a proposal in detail, labelling their proposed body the European Deposit Insurance and Resolution Authority (**EDIRA**).

While the June 2012 euro area summit statement could be interpreted as indicating that the euro area's leaders are taking some first steps towards accepting the need for sharing the costs associated with failing banks, the question of shared deposit insurance is even more controversial. This is because the sheer scale of the total amount of insured deposits (euro area residents have bank deposits of over EUR 17 trillion) suggest that a common insurance scheme would involve states taking on enormous risks.

In practice, **deposit insurance and bank resolution** are just **two sides of the same coin**. The safety of deposits is protected by ensuring that banks remain solvent. Thus, the costs associated with deposit insurance schemes such as the FDIC's are simply the capital shortfalls that occur at failed banks. Well-organised bank resolution procedures that minimise the costs to the taxpayer of failing banks are the best way to make sure that deposit insurance schemes cost as little as possible.

Indeed, given the high debt levels across the euro area as a whole, it is important that banking union proposals don't end up inflicting unacceptably high debt levels on every Member State that participates in the euro. This is why the most efficient way for a banking union proposal to work is for the ECB as a central supervisor to work hand in hand with an EDIRA to resolve failing banks in a way that minimises public costs.

One final point observation in relation to resolution schemes is that the flip side of well-designed bank resolution procedures that minimise the cost to the taxpayer (via the implementation of bail-in procedures for unsecured creditors for example) is that non-deposit "*bank runs*" featuring banks losing access to unguaranteed funding will undoubtedly be an occasional feature of such regimes (even the best-run supervisory system cannot guarantee the absence of bank failures). This makes the central involvement in supervision of the lender of last resort, the ECB, all the more essential once such proposals are introduced.

⁶ Federal Deposit Insurance Corporation; US Agency: <http://www.fdic.gov/>.

⁷ See <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/918> for the deposit insurance proposals. The common bank resolution framework proposals can be found at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/570>.

4. WHERE ARE WE STANDING NOW?

Having put forward a vision for how a euro area banking union could work, it is chastening to note how far away we are achieving such an outcome. While the 29 June 2012 statement was widely hailed as a first step on the road to banking union, the reality is that it represented a very small step towards risk sharing. All that was promised was that *“ESM could, following a regular decision, have the possibility to **recapitalise** banks directly.”* The statement that ESM *could* recapitalise banks is a **long way away from** ESM **will recapitalise** banks nor did the statement clarify the conditions under which *“could”* becomes *“will”*.

The joint statement on 25 September 2012 of the Finance Ministers of Germany, Netherlands and Finland⁸ has affirmed that the euro area's major creditor states are deciding to interpret this June summit statement in the most minimalist way possible.

This statement articulates some *“principles”* for how these countries believe ESM should operate in relation to bank recapitalisations.

- *“When an effective single supervisory mechanism is established”* is being interpreted by Germany, Netherlands and Finland as *“[...] once the single supervisory mechanism is established and its effectiveness has been determined.”* In other words, these three countries are signalling that original statement's reference to *“effective”* allows them to delay any decisions on recapitalisation until they are fully satisfied with the new arrangements.
- These countries now state that *“[...] the ESM can take direct responsibility of problems that occur under the new supervision, but legacy assets should be under the responsibility of national authorities.”* In other words *“if it happened under your watch, it's your problem”*. Given that, by definition, all of the banking problems that are afflicting Europe today occurred prior to the new supervision, this appears aimed at minimising the number of banks that could receive investment from ESM in the coming years.
- Finally, the three countries have asserted that *“[...] direct bank recapitalisation by the ESM should take place based on an approach that adheres to the basic order of first using private capital, then national public capital and only as a last resort the ESM.”* This approach suggests that ESM can only invest in banks as a last resort when national public capital cannot be used. In other words, countries need to be effectively bankrupt and locked out of financial markets before ESM can be used. This new *“principle”* appears to enshrine the vicious circle as official policy rather than get rid of it.

European Commission staff and Finance Ministers from other countries have been insistent that the statement by Germany, Netherlands and Finland does not undo the 29 June statement and that the statement stands as official policy. However, this is beside the point. Without concrete actions to enforce it, the affirmation that it is imperative to break the vicious circle between banks and sovereigns will stand alongside many other EU aspirations: Nice words that make people feel better but don't do much else. In the meantime, the vicious circle that has already trapped Spain and Ireland may widen its radius and continue to undermine the integrity of the euro as a common currency.

⁸ See Press Release 175/2012: http://www.vm.fi/vm/en/03_press_releases_and_speeches/01_press_releases/20120925JointS/name.jsp.

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Banking Union and a Single Banking Supervisory Mechanism

Sylvester C.W. EIJFFINGER

NOTE

Abstract

The European Commission has put forward a proposal that moves the euro area towards a banking union. While the nature of the proposal is good, several components are missing. First, the ECB can never supervise all 6000 banks in the euro area. Non-systemic banks should be supervised by national supervisors in a harmonised framework. Second, there are loopholes with respect to the relation between euro and non-euro area Member States. This mainly concerns the United Kingdom and Sweden, who have been put at a disadvantage as they do not have a direct say in the ECB Governing Council. Their Finance Ministers' discontent during the recent informal Ecofin meeting demonstrates this problem. In the current setup, there will have to be constant cooperation between the ECB and the BoE for liquidity purposes, and between the ESRB and the British Chancellor of the Exchequer for solvency issues and resolution of systemic banks; a coherent protocol for this cooperation is missing. Furthermore, there is no mention of a burden sharing in the proposal except for a paragraph referring to the ESM as a fund for restructuring purposes. This is an important political issue, as many member states (mainly Germany) will not accept the ECB as supervisor and resolution authority while resolution efforts are still funded at the national level.

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INTRODUCTION

The European Commission (EC) has put forth a proposal to establish a Single Supervisory Mechanism (SSM) for banks in the euro area¹. Primarily, this proposal tackles the supervision of large cross-border banks by delegating this task to the European Central Bank (ECB). The ECB will ultimately also be responsible for supervising smaller banks, but the day-to-day supervision of these banks will be left to national supervisors. The European Banking Authority (EBA) can coordinate this effort through the proposed Single Supervisory Mechanism. This proposal serves as a step to a fully integrated European banking and financial supervision in the future. Given the Commission proposal, this paper outlines the necessary structure for an effective and incentive-compatible supervisory mechanism. It considers various dimensions (these are not exhaustive): i) Which institution should be in charge? ii) Which banks should be covered by this European supervision? iii) How to ensure coherence of banking supervision between the euro area and the whole European Union and iv) Which supervisory tools and powers are necessary. Furthermore, I also briefly consider the interaction with the (already existing) proposals on bank recovery and resolution and deposit guarantee schemes.

However, this paper will focus mainly on the new task that the ECB will be appointed to, and the consequences this has for its functioning, reputation and credibility. As its governing authorities have noted, for the ECB to be involved three prerequisites have to be fulfilled:

- i) The primary mandate (price stability) must remain unaffected; this means that monetary policy has to be separated from bank supervision - organisationally and in the personnel.
- ii) The independence of monetary policy has to be granted. However, the ECB agrees with a stronger parliamentary and judicial control of the new bank supervision part.
- iii) All instruments necessary (including access to necessary information, intervention rights and right to close non-viable banks) to perform an effective banking supervision have to be provided.

In what follows, I will discuss these requirements and their implication for the organisation of the newly proposed supervisory regime. The existing liquidity instrument and the new solvency instrument will be discussed, and I will stress that it is imperative for the ECB to exercise ambiguity.

¹ European Commission (2012), *Banking union: Commission proposals for a single supervisory mechanism*, http://ec.europa.eu/internal_market/finances/committees/index_en.htm#maincontentSec1.

1. ORGANISATIONAL STRUCTURE: ECB INVOLVEMENT, COORDINATION AND COOPERATION

According to the proposal by the European Commission, the ECB should ultimately be responsible for financial supervision and stability in the euro area. This process would enter into force on 1 January 2013 with a phasing-in period until 1 January 2014 at the latest. The ECB will begin with banks which has received or requested public financial assistance; then expand to the most significant credit institutions of European systemic importance and in a last step, would take over supervision of all euro area banks.

This has several advantages, as recently outlined by ECB Vice-president Vitor Constâncio² and already mentioned in my Briefing Paper³ of March 2009. To begin with, the ECB has an interest in a stable financial system for the transmission of monetary policy. It can ensure this with macro-prudential oversight (via the ESRB), but micro-prudential supervision is tightly related. Assessing systemic risks is facilitated by having specific information on individual institutions. Furthermore, the ECB is responsible for the oversight of payment systems, which can also be combined with banking supervision because of informational synergies. Another benefit of having the ECB as a banking supervisor is its expertise on the financial sector, obtained through its experience with monetary and financial stability. Finally, the ECB is an independent body that is not subject to political interference, and thus will be less prone to regulatory forbearance than national regulators.

Of course, there are also downsides to having the ECB as a micro-prudential supervisor. As Executive Board Member Jörg Asmussen has stated, the ECB demands several prerequisites to be fulfilled before it takes up the role of banking supervisor⁴. First, the primary mandate (which is price stability) must remain unaffected. This means that monetary policy has to be separated from bank supervision, organisationally as well as in terms of personnel. This may prove to be a hard nut to crack, as I have already outlined last year⁵; Mr Draghi may have a difficult time separating the two functions. Especially the fact that the ECB has only one instrument (liquidity, or the interest rate) complicates these decisions greatly. This is why the ECB also demands all instruments necessary to provide adequate banking supervision, including access to necessary information, intervention rights and right to close non-viable banks. Finally it demands, naturally, that the independence of monetary policy from political involvement has to be granted. Here, the ECB is mainly concerned about reputation risk: a bad performance in its role as a supervisor may reflect badly on its reputation as an inflation fighter. On the other hand, the ECB does agree with stronger parliamentary and judicial control of its new banking supervision efforts.

The main questions that arise from these observations are the following:

- What will be the main objective of the ECB, and how to unite two different objectives in one institution?
- Which banks will the ECB supervise, and which will be left to national supervisors?

² Constâncio, Vito (2012), *Towards a European Banking Union*, speech delivered at the Duisenberg School of Finance, Amsterdam, 7 September 2012, <http://www.ecb.int/press/key/date/2012/html/sp120907.en.html>.

³ Eijffinger, Sylvester C.W. (2009), *What role for the ECB on financial market supervision?*, Briefing Paper for the Monetary Dialogue of March 2009.

⁴ Asmussen, Jörg (2012), *Die Finanzmarktunion als Element einer stabilen Währungsunion?*, speech delivered at Handelsblatt, Frankfurt am Main, 4 September 2012, <http://www.ecb.int/press/key/date/2012/html/sp120904.de.html>

⁵ Eijffinger, Sylvester C.W. (2011), *Changing of the Guard*, Briefing Paper for the Monetary Dialogue of October 2011.

- Which new instruments will be given to the ECB, and how effective are these?
- Will the ECB remain able to conduct its tasks independently, without succumbing to the dangers that other regulators have faced (forbearance, regulatory capture, lack of power)?

Let us attend to these questions below, starting with the simplest one: which banks will the ECB supervise? According to the Commission proposal, the ECB should start supervising the most systemically relevant banks from 1 July 2013 onwards. After 1 January 2014 the ECB should be responsible for supervising all banks in the Euro area. This is a daunting task, for which the ECB would have to set up large, completely new supervisory division. As Mr Asmussen and Ms Merkel have already stated, this is not a feasible solution as there are too many banks to supervise.

Instead, as also outlined in the proposal, day-to-day tasks could be exercised by the national supervisors which form an integral part of the single supervisory mechanism. However, unlike envisaged in the proposed solution, they should remain responsible for the supervision of smaller, non-systemic banks. This setup could be facilitated by the ESRB and the EBA who are in charge of, respectively, the monitoring of systemic risk and the coordination between national supervisors and the ECB. As proposed, the EBA will *'further develop the single rulebook'* to ensure harmonisation within the euro area and the EU as a whole. Furthermore, the *'EBA should develop a single supervisory handbook to complete the rulebook.'*⁶ To eliminate regulatory competition and other inconsistencies, it is especially important to have a harmonised accountability process across the EU: If all supervisors are required to operate under the same rules, there is less scope for banks to *"game the system"* by choosing residence in the country with the most favourable regulation. Furthermore, Masciandaro et al. (2011) advocate that political independence should be enhanced, while at the same time improving the accountability rules for national supervisors⁷. These supervisors should not only be accountable to National Parliaments, but also to the European Parliament. In general, the authors recommend an upward harmonisation of the supervisory framework along the lines of the Commission proposal; this harmonisation even goes further as it aims for pan-European accountability to align incentives, promote information sharing and build mutual trust and cooperation.

According to Article 4(1)(a) of the Proposal for a Council regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (COM(2012) 511 final) the ECB will be responsible *'to authorise credit institutions and to withdraw authorisation of credit institutions'*. Article 13 specifies the authorisation process in more detail and states that the national authority *'shall take a decision to propose to the ECB the authorisation.'*

In the proposal, national supervisors will also remain responsible for other tasks such as the day-to-day supervision of banks and the assessment of internal risk models. Moreover, the national supervisors will still continue to coordinate with supervisors in non-euro area Member States as regards existing home/host supervisory procedures and colleges of supervisors. As the Commission proposal suggests this will have to be organized along the lines of the home/host supervisory mechanism that has been used up until now. They will, however, also have to adhere to the single rulebook and the single supervisory handbook that is set up by EBA.

⁶ See Commission Communication, COM(2012) 510 final, 12 September 2012, Brussels; http://ec.europa.eu/internal_market/finances/docs/committees/reform/20120912-com-2012-510_en.pdf.

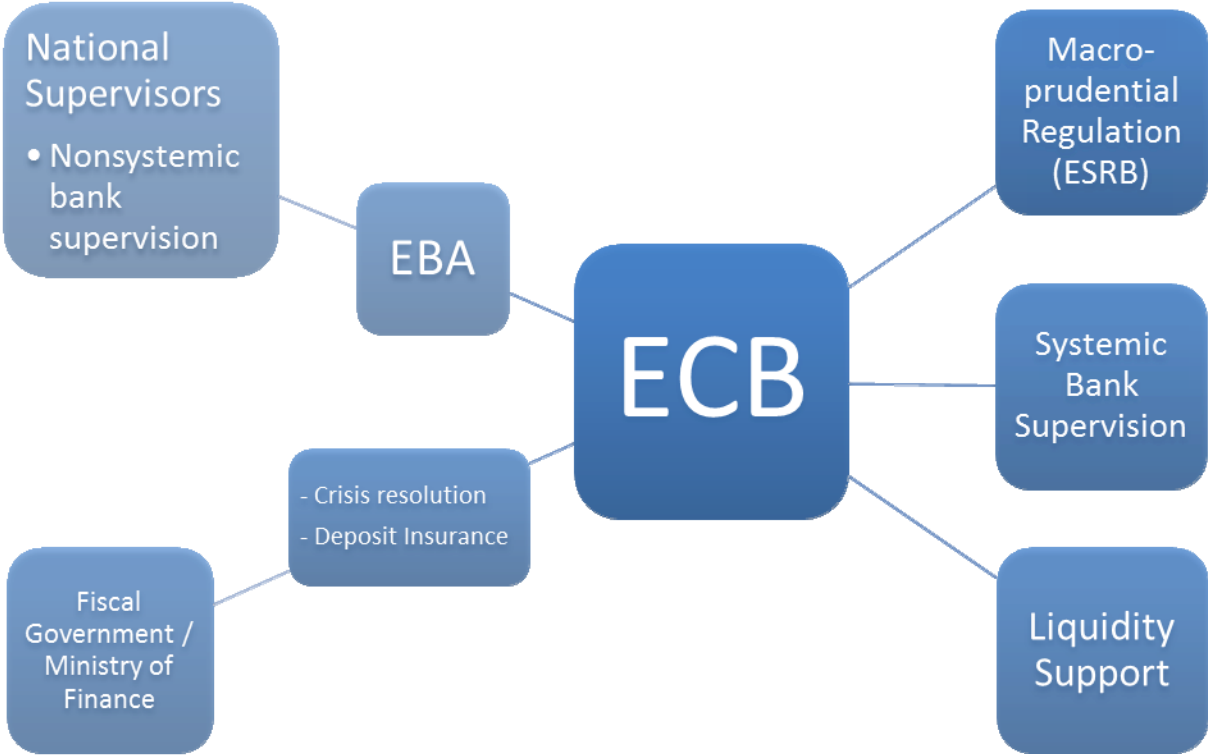
⁷ Masciandaro, Donato, Maria J. Nieto and Marc Quintyn (2011), Will they Sing the Same Tune? Measuring Convergence in the new European System of Financial Supervisors, in Eijffinger, S. & Masciandaro, D. (Eds.) Handbook of Central Banking, Financial Regulation and Supervision, pp. 485-530, Edward Elgar Publishing.

Reforming the system in this manner also simplifies the interaction between supervisors from euro area and non-euro area countries. The countries outside of the euro area (mainly the United Kingdom) are at a disadvantage since they have no voting rights in the ECB Governing Council. However, they do have a say in the European Systemic Risk Board (ESRB), of which the governor of the Bank of England is the vice chair, and the EBA. These two authorities, being independent, can coordinate the supervisory efforts of the ECB and national supervisors inside and outside the Euro area without political interference.

On the other hand, as has become apparent during the meeting of Finance Ministers on the 14 September there are quite some facets of the plan that mainly the United Kingdom and Sweden do not agree with. Especially the cooperation in the SSM between ECB, EBA and the National Central Banks will have to be revised. A careful compromise between the ECB's and Member states' voting weights will have to be struck.

To conclude this section, the figure below schematically explains the supervisory structure that will arise from the Commission's proposal and the recommendations above. The lower part of the figure, concerning liquidity and solvency matters, will be addressed in the next section.

Figure 1: Schematic overview of the new Supervisory Structure in the euro area



Source: Author's elaboration

2. LIQUIDITY INSTRUMENT

Another question that arises is which objectives the ECB will pursue, and which instruments it will employ to do this. The ECB currently disposes over a liquidity instrument in the form of the interest rate. As we have seen recently, the operational framework of this instrument ranges from easing reserve requirements to straight-out provision of liquidity. Although this instrument was originally intended to conduct monetary policy, it has also worked very well in maintaining financial stability: the ECB has successfully acted as a Lender of Last Resort to keep the European financial system afloat.

The Commission proposal also aims to officially invest the ECB with the task to protect the stability of the financial system through its new supervisory powers. While, undoubtedly, the ECB is very well suited to this task this new responsibility may be accompanied by conflicts of interest. As the instrument of liquidity is also used to conduct monetary policy one can imagine situations in which the objectives of financial and monetary stability will clash. As mentioned above, this is the main challenge that ECB president Draghi will face during his term in office. As Alex Cukierman has noted recently, these problems will not arise in the short-term; in the medium- to long-term, however, there will be a trade-off between price stability and financial stability⁸. The reason for this problem is that the central bank has only one instrument: monetary policy, i.d. the interest rate. As long as the objectives can be achieved with one instrument (e.g. they both require lower interest rates) everything is fine. However, as soon as inflationary pressures rise when financial stability is still unsatisfactory the two objectives conflict. This requires a separate instrument to ensure financial stability; this is also part of the Commission proposal and will be dealt with in the next section.

Yet, there are not only downsides to such new responsibilities of the ECB. Of course, the new supervisory role of the ECB would give it also more control over the very banks it has assisted (and will assist) with liquidity. It would be possible to explicitly impose conditionality on these banks, and also credibly enforce this⁹. The new Outright Monetary Transactions (OMT) introduced on 6 September is a step in this direction. However, these still rely on the European Stability Mechanism (ESM) for conditionality; this does not have much democratic support. The ECB, being an established, independent and credible institution, will have more legitimacy when invested with the power to impose conditions on banks that it assists. Nevertheless, this will not be established without political opposition; an obstacle that will have to be dealt with fast. This obstacle is also the major impediment to the resolution of solvency problems, which is the subject of the next section.

⁸ Cukierman, Alex (2011), *Reflections on the Crisis and on its Lessons for Regulatory Reforms and for Central Bank Policies*, in Eijffinger, S. and Masciandaro, D. (Eds.), *Handbook of Central Banking, Financial Regulation and Supervision*, pp. 66–103, Edward Elgar Publishing.

⁹ J.P.Morgan (2012), *The State of the Union*, Europe Credit Research, September 10, 2012.

3. SOLVENCY INSTRUMENT

According to the Commission proposal, the ECB should also become responsible for micro-prudential early intervention in banks¹⁰ (see Article 4(1)(k) *'including recovery plans and intra group financial support'*); it has these powers already at the macro-prudential level. However, in practice it might be difficult to always clearly distinguish where early intervention finishes and resolution begins, so any reform in this domain will lead to quarrels over national sovereignty, as the German discontent with the current proposal has shown. There will be legal difficulties in transferring solvency resolution powers and conflicts with ministries of finance of the respective countries, especially those with a large financial sector relative to GDP. On the other hand, these quarrels have to be resolved quickly: the cases of Fortis (the Netherlands and Belgium) and Dexia (Belgium and France) demonstrate the problems arising from incomplete resolution regimes. These cases show that it is necessary to set up a new structure of resolution that is stronger than only Memoranda of Understanding: a truly European resolution mechanism.

Macro-prudential regulation and supervision has already been transferred to the European field through the arrangement of the European Systemic Risk Board (ESRB). The ESRB can issue warnings and impose macro-prudential sanctions, such as extra capital requirements or other precautions, on systemic banks. The Commission proposal also centralises micro-prudential regulation and supervision of these systemic banks at the ECB, which means that the ECB can carry out early interventions if necessary. As mentioned above, this can lead to political difficulties. However, as long as there are systemic banks that operate across borders, they need to be uniformly supervised across these same borders. It is thus imperative that politicians reach a consensus on this matter.

A closely related question is: who is going to pay in a crisis? The Commission has not incorporated a section on burden sharing and deposit insurance in its proposal; this will prove to be a tough matter to solve. These two issues have been subject of economic debate for several years, already before the crisis hit.^{11;12} As crisis management and deposit insurance concern (largely) taxpayer money, they are politically sensitive topics.

Economists have put forward several proposals to harmonise both burden sharing in a crisis and deposit insurance. Nieto and Garcia (2012) have proposed national Bank Recovery and Resolution Funds (BRRFs), harmonised across Europe, as a first step to a European-wide resolution fund¹³. The BRRF would be responsible for bank resolution in cooperation with deposit insurance institutions, and banks should contribute *ex-ante* to the BRRF according to their systemic relevance. At a European level, the setup of BRRFs would be harmonised in governance, funding and resolution authorities to maintain a level playing field. In the context of the actual Banking Union proposal, Schoenmaker and Gros (2012) suggest the setup of a European Deposit Insurance and Resolution Authority as a separate institution

¹⁰ Explanatory Memorandum 4.2.1. to proposal COM(2012) 511 final: *'Furthermore, the ECB will also ensure compliance with provisions on leverage and liquidity, apply capital buffers and carry out, in coordination with resolution authorities, early intervention measures when a bank is in breach of, or is about to breach, regulatory capital requirements.'*

¹¹ Freixas, Xavier (2003), *Crisis Management in Europe*, Chapter 4 in J. Kremers, D. Schoenmaker and P. Wierst (Eds.), *Financial Supervision in Europe*, Edward Elgar, Cheltenham.

¹² Garcia, Gillian G. H. & Maria J. Nieto (2007), *Preserving Financial Stability: A Dilemma For The European Union*, *Contemporary Economic Policy*, Western Economic Association International, vol. 25(3), pp. 444-458, 07.

¹³ Nieto, Maria J. and Gillian G. Garcia (2012), *The Insufficiency of Traditional Safety Nets: What Bank Resolution Fund for Europe?*, *Journal of Financial Regulation and Compliance*, Vol. 20 Iss: 2, pp. 116 - 146.

responsible for crisis resolution and depositor protection¹⁴. This should serve as the final step of the banking union. It would be funded by the current deposit insurance funding arrangements, with a risk-based premium based on banks' current (and not past) contributions to systemic risk. If necessary, the ESM can function as a back-stop. The authors also provide a route map for the transition process to this European-wide resolution mechanism. Huertas and Nieto (2012) also propose to do this: they argue that a single supervisor in a banking union needs to be complemented with a single resolution authority and a single resolution fund¹⁵. Additionally, by making depositors senior claimants it is possible to make banks "safe to fail" as the costs will be borne by the resolution fund and not by taxpayers.

These are all economically feasible solutions for collective burden sharing of banking losses. It is up to politicians to implement these. Many politicians and economists have argued that there cannot be proper burden sharing without European supervision; now we have the latter, it is time to go forward and set up the former. Simultaneously, however, it is important to delineate the operating procedures in the new institutional setup. The next section will elaborate on this.

¹⁴ Schoenmaker, Dirk and Daniel Gros (2012), *A European Deposit Insurance and Resolution Fund - An Update*, Duisenberg School of Finance Policy paper no. 26.

¹⁵ Huertas, Thomas and Mario J. Nieto (2012), *Banking union and bank resolution: How should the two meet?*, VoxEU column, <http://www.voxeu.org/article/banking-union-and-bank-resolution-how-should-two-meet>, retrieved 18 September 2012.

4. CONSTRUCTIVE AMBIGUITY

To establish a sound supervisory system with incentive-compatible crisis resolution, it is important that the responsible institution (ECB) is sufficiently credible. This credibility facilitates building confidence in regulation from the side of banks and financial markets, and thus helps the ECB in carrying out its new supervisory task. As mentioned above, it may be difficult to maintain this credibility if due to problems with its supervisory task its monetary policy reputation is impaired and vice versa.

A solution to this problem is provided by Eijffinger and Nijskens (2012), who suggest that the ECB should adhere to a policy of “*constructive ambiguity*” ex-ante¹⁶. This can serve as a solution to forbearance. In a liquidity provision context (but this can also be applied to early intervention measures), constructive ambiguity means that the ECB can commit to a mixed strategy: never bailing out is too costly and therefore not credible, while always bailing out leads to obvious moral hazard problems. This strategy leads banks to behave more safely on their own by holding more liquid reserves and having a higher capital ratio. Adhering to ambiguity gives the ECB the possibility to retain discretion until the moment that assistance is necessary, thereby providing banks with the incentive to behave prudently.

An important prerequisite for ambiguity to be possible is that the ECB has a sound reputation and is credible. As the ECB is still an independent, reputable institution it is reasonable to assume that it is also credible; this means it is in principle able to pursue a “*constructive ambiguity*” policy. However, some caution has to be exerted when following this path. As Cukierman (2012) notes, too much uncertainty about assistance can lead to risk averse behaviour (such as a flight to safety) and can intensify panics¹⁷. Therefore, careful expectations management is inevitable, leading to a **trade-off between ambiguity and transparency**. Furthermore, to make this ambiguity strategy democratically sound a good *ex- post* accountability mechanism is necessary. Preferably, the ECB should be accountable to the European Parliament to justify its policy.

¹⁶ Eijffinger, Sylvester C. W. and Rob Nijskens (2012), *A Dynamic Analysis of Bank Bailouts and Constructive Ambiguity*, CEPR Discussion Paper No. DP8953, April.

¹⁷ Cukierman, Alex (2012), *Monetary Policy and Institutions Before, During, and after the Global Financial Crisis*, Paolo Baffi Centre Research Paper No. 2012-115, July.

5. CONCLUSION

The European Commission has put forward proposals that move the euro area towards a banking union. The proposal assigns to the ECB the task of systemic bank supervision, and ultimately responsibility for bank supervision in the whole euro area. It also suggests new micro-prudential powers for the ECB, through which it can intervene in problem banks at an early stage. Furthermore, the EBA is envisaged to set up a Single Supervisory Mechanism to which all national supervisors will have to adhere. This will foster cooperation, eliminate regulatory competition and create a level playing field for all banks in the euro area.

While the nature of the proposals is good, several components are missing. First, the ECB can never supervise all 6000 banks in the euro area. Non-systemic banks should be supervised by national supervisors in a harmonised framework. Second, there are loopholes with respect to the relation between euro and non-euro area Member States. This mainly concerns the United Kingdom and Sweden, who have been put at a disadvantage as they do not have a direct say in the ECB Governing Council. Their finance ministers' discontent during the recent informal Ecofin meeting demonstrates this problem. In the current setup, there will have to be constant cooperation between the ECB and the BoE for liquidity purposes, and between the ESRB and the British Chancellor of the Exchequer for solvency issues and resolution of systemic banks; a coherent protocol for this cooperation is missing. Furthermore, there is no mention of a burden sharing in the proposal. In recital 8 of the proposal, however, there is a reference to the euro area summit statement of 29 June 2012 which points out that *'when an effective single supervisory mechanism is established involving the ECB for banks in the euro area, the ESM could, following a regular decision, have the possibility to recapitalise banks directly which would rely on appropriate conditionality, including compliance with state aid rules.'* This is an important political issue, as many Member States (mainly Germany) will not accept the ECB as supervisory and intervening authority while intervention and crisis management efforts are still funded at the national level.

Finally and perhaps most importantly: how will the ECB assume its supervisory task? Will ambiguity be applied? Until now, Mr Draghi does the utmost to be as clear and transparent as possible, and no sign of ambiguity is to be seen in the liquidity domain. Perhaps this will change when the ECB is also responsible for supervision and intervention and is able to impose more conditionality on banks receiving assistance.

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Banking Union and a Single Banking Supervisory Mechanism

Guillermo DE LA DEHESA

NOTE

Abstract

A banking union needs to initiate a profound change in the current banking institutional framework of the euro area. A real banking union must consist of three main building blocks: a single euro area banking supervisor, a euro area wide resolution authority and a single European Deposit Guarantee Scheme. The ESM should build a bridge to a common European Bank Resolution Fund. However, the support for a real banking union starts to wane and the banking union project to slow down or even to fail.

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EXECUTIVE SUMMARY

The June 2012 European Council and the euro area summit took important decisions to proceed ahead towards a future banking union. The euro area summit asked the Council to consider the Commission proposal for a European Single Banking Supervisory Mechanism as a matter of urgency. This **single supervisory mechanism** will be together with the **ECB decision** one of the major steps in the euro area to do whatever is necessary to allow the monetary policy transmission mechanism to work more efficiently and to have access to EFSF/ESM recapitalisation funds after signing a Memorandum of Understanding (MoU) with strict conditionality.

Both decisions will help achieving a more transparent and efficient euro area and European banking market and a more efficient transmission of the ECB monetary policy. Furthermore, these decisions will help today's increasingly fragmented and disintegrated European banking market, that affects some Member States financial and banking markets very negatively. Nevertheless, and if the euro area shall survive, it is absolutely necessary, in the medium to long-term, to advance step by step towards a full euro area banking union.

As a first step, it is necessary to create a **single banking supervision**, in order to assess the real situation of euro area banks, resolving the problem of lack of systemic confidence, and to create a level playing field in supervision, which is absent today.

Second, it is necessary that a **single banking resolution mechanism** breaks up the diabolic loop between banking crisis and sovereign crisis, present in several Member States. Therein, the European Stability Mechanism (ESM) needs to play a major role as a transitory mechanism.

Third, it is also necessary to create a **single deposit guarantee scheme**, to avoid deposit runs and capital flight, as it is happening today and thereby provoking an increasing fragmentation of the euro area banking market.

INTRODUCTION

Since the EU intended to achieve a "*single market for goods and services*", any type of banking union would have been useful. However, this single market has not been truly reached yet, given that it should also include a "*single financial and banking market*". Since the eruption of a banking crisis in 2007, a banking union has become even more necessary. Now, after five years of banking crisis in several EU Member States, EU leaders seem to be ready to start a process for achieving it. This is very good news, but we do not yet know how many years it will take to achieve such a full banking union.

A single market for banks has never existed in the euro area, even if cross border banking services and transactions have increased notably since the introduction of the euro. A single market means free access and competition in the whole EU banking market. With a few minor exceptions, mainly due to bank bankruptcies, it has been difficult for a bank from one euro area member to buy a bank in another euro area member. The most open EU member accepting foreign buyers has been the UK which itself is not a euro area member, but the banking crisis in 2007-2008 made it possible for a few intra euro area purchases of failing banks.

Since the beginning of the first banking crisis, the euro area banking system has become increasingly fragmented. Today it is almost disintegrated, forcing the ECB to then introduce Long-Term Refinancing Operations (LTRO) and more recently the Outright Monetary Transactions (OMT) in order to restore the functioning of the monetary transmission mechanism of its monetary policy.

This can, for example, be seen in different interest rates for **retail loans** in the euro area. Having the ECB reduced its main refinancing rate to 0.75%, German and French retail loans to households and small and medium size companies are given at rates two percentage points higher than the ECB main refinancing rate, while in Italy and Spain they are given at rates between four and four and a half percentage points above it. The retail rates in Italy and Spain are much more correlated to the spreads of their sovereign debt than to the ECB main refinancing rate. The major causes for this have been the increasing interaction between banks and sovereigns, as well as the increasing banking market disintegration.

The **interbank market** is not working for many of the euro area banks and an increasing number of deposits, mainly institutional, have been flowing from Spain and Italy towards Germany and France. Now, German and French supervisors do not let those banks, which have received those deposits, lend them back into Italy and Spain because they want to fully "*ring-fence*" their banking markets. It is unbelievable that this could happen in a monetary union which is supposed to have a single financial and banking market. This worrying fact should be a major reason for advancing towards a banking union in the euro area.

1. STEPS NEEDED FOR A BANKING UNION

A banking union needs to start from scratch initiating a profound change in the present banking institutional framework of the euro area. The changes should be implemented in **three successive steps**.

The first step would be to create a **single euro area banking supervisor**. This should be easier than the next two steps, since it could build on banking supervision provided at the national level. Most of the euro area central banks are already in charge of this function in each national Member State. The implementation mainly needs that those Member States, which are alternatively using their government as banking supervisor, instead of its central bank, agree to move that task to their National Central Bank (NCB) and to the ECB (the Eurosystem). This step would make a lot of sense because experience has shown that banks prefer to have different national supervisors for trying to do regulatory and supervisory arbitrage. The European Commission presented proposals for a Single Supervisory Mechanism (SSM) on 12 September 2012.

In a second step a **euro area wide banking resolution authority and regime** should be created. This task should also be performed by the ECB and the NCBs. However, the resolution tasks have to be conferred to a structure separated from that of their monetary policy duties, in order to not mix both Eurosystem competences. The banking crisis has shown that due to the increasing cross-border transactions, contagion among members of the euro area tends to make the present system of national resolution systems unviable. It is also very important because some national resolution authorities have been bailing out their own banks without letting senior, unsecured creditors and some junior creditors take losses, so that taxpayers have been paying the bill. This should never happen again.

A single banking resolution mechanism will assure a common resolution treatment to all euro area banks, which will be more efficient than a network of national resolution authorities, even more in case of cross-border failures. The **ESM** becoming a bank recapitalisation fund should build the **bridge for a future resolution fund**. Finally, this new resolution mechanism should make sure that shareholders and creditors bear the costs of a bank resolution before any external funding is granted.

The third step should be to create a **single European Deposit Guarantee Scheme** (EDGS). A first step was taken at the beginning of the first banking crisis by harmonising the coverage of national Deposit Guarantee Schemes (DGS) per depositor to EUR 100,000, per institution, effective as of 31 December 2010. A second step was taken in July 2010 with the harmonisation and simplification of protected deposits, faster pay-outs and improved financing, notably through the ex-ante funding of DGS paid by contributions from banks and a mandatory borrowing facility between national schemes within certain fixed limits.

This third step is going to be the most difficult to undertake, given that it may involve some degree of mutualisation of national banking risks. Nevertheless, this deposit insurance scheme, absolutely necessary to avoid deposit flight among Member States, could also be partly guaranteed by the euro area banking industry, at least temporarily, to facilitate its implementation.

In any case, the starting point for these three steps should be to try to convince the 17 Member States of the euro area and, if possible, the EU 27 Member States, to adopt the same procedures for supervision, bank resolution and deposit guarantees with arrangements for cross-border cooperation, in order to create a European banking plain level field and eventually, in the long run, ending merging the 17 euro area Member States schemes.

It will also be necessary to reconcile these steps towards a banking union made by the 17 euro area Member States together with the other 10 Member States of the EU who aren't members of the euro area, but which are also members of the single European financial and banking market. The case in point will be the UK, which represents the largest financial market of the EU. Nevertheless, the main problem in this final step will be the difficulty for the ECB to supervise banks across different currencies, so that it may be a better solution to find a way for the ECB to cooperate with the central banks or supervisors of the other 10 Member States of the EU.

Finally, the idea of launching a process to advance towards a European banking union is a major step in the completion of a true European Economic and Monetary Union and it will facilitate, later, the building up of a "*fiscal union*". The fiscal costs of a whole banking union with a single resolution and a single deposit guaranty scheme are going to be large and may need to advance, at the same time, towards a Fiscal Union. The banking union approach is based on a very clear idea: greater mutualisation of risk in exchange for more central control. This should be the same trade-off for a future fiscal union, whereas the potential issuance of Eurobonds should only be allowed to be done after establishing a greater and direct control, by a new euro area Treasury, over national budgets and over national economic policies.

2. FIRST STEPS

During the European Council in June 2012 and the euro area summit of 29 June 2012, the Heads of State or Government took several important decisions *“to break the vicious circle between banks and sovereigns”* as well as to avoid contagion among euro area banks:

First, by establishing a single supervisory mechanism run by the ECB, and once it has been created, to provide the ESM with the possibility to inject funds to capitalise banks directly, so that these capital injections will not count as debt for the Member State where the banks are located. The EFSF will provide these funds until the ESM becomes available and it will then be transferred to the ESM *“without gaining seniority status”* over other debts.

Second, by allowing EFSF/ESM funds to be used flexibly to buy bonds from Member States that respect their specific recommendations, targets and other commitments included under the European Semester, the Stability and Growth Pact (SGP) Excessive Deficit Procedure (EDP) as well as the Macroeconomic Imbalances Procedure (MIP).

The next step was taken by the Eurogroup meeting of 9 July 2012 stating that the ECB would be the agent for the EFSF and ESM for buying government bonds. The ECB and EFSF have signed a technical agency agreement creating the possibility of an efficient conduct of market operations by the EFSF and, as soon as the ESM is in place, another similar agreement is planned to be signed.

It was also approved that the EFSF would be recapitalising Spanish banks, after a MoU among both parties was agreed, until the ESM would be available, and only then being transferred to the ESM without gaining seniority status. Finally, under article 127 (6) of TFEU, the Eurogroup welcomed the intention of the Commission to present proposals in early September for a single supervisory mechanism involving the ECB. These proposals are expected to be approved by the Council by the end of 2012.

Third, the informal Eurogroup meeting in Cyprus on 14 September 2012 welcomed the favourable decision German Constitutional Court on the ESM and expected that would be up and running by the end of October. The ESM Board of Governors will have its inaugural meeting on the 8 October 2012 in Luxembourg. Finally, it considered the ECB independent decision to launch an Outright Monetary Transactions (OMT) programme, an important element in the euro area overall crisis response.

2.1. The need for a single Euro Area Banking Supervisor

A single supervisory authority run by the ECB and the 17 National Central Banks (NCBs) is essential given that they are already doing the supervision in most of the 17 Member States¹ of the euro area and because they are perfectly suited to supervise their national banks for the simple reason that they are the institutions which know them best, since they deal with them daily and, in most cases, are already supervising them.

Central Banks have proved to be better banking supervisors than other alternative institutions during the banking crises of 2007-2008 and **the ensemble of the ECB and the National Central Banks is, for two reasons, suited even better** to do so: **First**, national supervisors have not being able to deal properly with their own banking crises given that they could not avoid contagion from other banks from other Member States.

¹ See also Lecture held by Vitor Constâncio, Vice-President of the ECB at the start of the academic year of the Duisenberg School of Finance, Amsterdam, 7 September 2012: *‘In practice, the allocation of supervisory responsibilities is handled very differently across countries, even within the euro area. At present, a majority of euro area central banks, that is, 12 out of 17 National Central Banks have full supervisory powers while 2 others are also involved in supervisory tasks.’*

Second, national supervisors alone were not able to stop the **increasing contagion** between sovereign and banking crises. Therefore, supervision should be carried out jointly by the ECB and National Central Banks.

First, past experience shows that, **during the subprime crisis**, the worst banking problems and failures took place in those European countries where the supervisor was somehow linked to the government (e.g. Germany, Belgium² or Switzerland). This had to do with two reasons: On the one side, governments cannot pay their civil servants high enough salaries to be able to compete with the highly paid financial specialists of private banks, who have much deeper knowledge about how to construct highly sophisticated mathematical models to measure risk and which are extremely difficult to understand by non specialists. On the other side, governments are run by politicians, who, often, tend to pursue the main objective of winning elections and therefore tend to be less tough on credit risk and more lenient on credit growth.

Second, the next worst banking problems and failures were felt in countries where the supervisor was an independent agency, such as the FSA in the UK.

Third, banking failures and/or problems were much fewer in those European countries where the central banks were the sole supervisors as it is the case of France and Italy (and even Spain, except in the case of real estate). The same can be said of the central bank of Canada, in comparison to the US, where there are several supervisors and banks that tend to have an incentive to undertake supervisory arbitrage among them.

The only exceptions to this rule were the Netherlands and Ireland, where the central bank is the single supervisor. The main reason may have been that in both Member States there were several very large banks in relation to the size of the country, which normally is dangerous for supervisors, since very large banks tend to be more successful at *"capturing"* their supervisors for being *"too big to fail"* and even more *"too big to be rescued"*.

2.2. A single supervisor for all euro area banks

For the following reasons it does not make sense to keep present national supervisors for most banks whilst leaving the ECB only supervising the *"too big to fail"* euro area banks, which are about 25:

First, because in the previous banking crises, most banks which went bankrupt were not *"too big to fail"*. This was the case of IKB, Hypo Real Estate and West LB in Germany, Fortis and Dexia in Belgium and Northern Rock in the UK. Now Bankia in Spain falls in the same category of not too big to fail.

Second, because Basel II rules (and eventually Basel III rules) have been applied with broad different levels of rigor by different euro area supervisors, helping some national banks in some Member States to become more competitive at the expense of others from other Member States. This uneven treatment should have been banned by the EU Commission because it goes against the single market rules. Therefore, only a single supervisor would avoid it happening again.

Third, because 75% of the monetary transmission mechanism of the monetary policy of the ECB is done through banks and only 25% through financial markets, exactly the inverse proportion than the FED monetary policy in the US, so that the supervision of banks becomes a key factor for monetary policy as well.

² Since 1 April 2011 the National Bank of Belgium is in charge of prudential supervision: http://www.bnb.be/pub/01_00_00_00/01_01_00_00/01_01_05_00_00.htm?l=en.

The total number of credit institutions in the euro area is very large. According to the ECB annual statistics, the number of credit institutions in the euro area at the end of July 2012, was 6,119.

Of them, 1,885 were located in Germany (that is 30,8% of the total, when its relative GDP in the euro area total GDP is 27,06%); 759 in Austria, (12.4% of the total when its GDP is 2.77%); 732 in Italy (11.96% of the total when its GDP is 17.85%); 652 in France (10.61% of the total, when its GDP is 20.32%); 478 in Ireland (7,76% of the total, when its GDP is 1.58%); 326 in Spain (5.32% of the total, when its GDP is 11.87%); 315 in Finland (5.18% of the total, when its GDP is 1.79%); 281 in the Netherlands (4.59% of the total, when its GDP is 5.69%); 154 in Portugal (2.5% of the total, when its GDP is 2.5%); 140 in Luxembourg (2.29% of the total, when its GDP is 0.25%); 139 in Cyprus (2.27% of the total, when its GDP is 0.19%); 107 in Belgium (1.74% of the total, when its GDP is 3.46%); 53 in Greece (0.87% of the total, when its GDP is 2.80%); 30 in Slovakia (0.49% of the total, when its GDP is 0.99%); 26 in Malta (0.42% of the total, when its GDP is 0.09%); 25 in Slovenia (0.4% of the total, when its GDP is 0.47%) and finally, 16 in Estonia (0.26% of the total when its GDP is 0.25%).

It should be taken into account that these figures are computed in gross terms and not in net terms, because they include affiliates and subsidiaries from other non-euro area countries credit institutions and from other euro area members in the different euro area Member States. The consolidated data should be lower, but is not compounded by the ECB yet. Moreover, the figures do not show the relative size of every single credit institution, so that it can be used only as an apparent, but not really as a proxy.

Nevertheless, in some Member States, the relative weight, in terms of total assets, of their largest banks as a percentage of total GDP is very high. For instance, in Cyprus the two largest banks total assets, Marfin Popular and Cyprus amount to 488% of Cyprus GDP; ING, Rabobank and ABN Amro in The Netherlands amount to 327% of GDP; Dexia and KBC, in Belgium, amount to 233% of GDP; BNP, Credit Agricole and Soci t  Generale, in France, amount to 235% of GDP; Santander, BVA and Bankia, in Spain, amount to 198% of GDP; Bank of Ireland and Allied Irish Banks, in Ireland, amount to 184% of GDP; Caixa Geral, BCP and Esp rito Santo, in Portugal, amount to 177% of GDP; Erste and Raiffeisen, in Austria, amount to 118% of GDP; Deutsche and Commerzbank in Germany, amount to 108% of GDP; Valetta in Malta amounts to 104% of GDP; Unicredit and Intesa Sanpaolo, in Italy, amount to 97% of GDP; BCEE, in Luxembourg, amounts to 94% of GDP; NBG and EFG Eurobank, in Greece amount to 90% of GDP. In any case, these figures tend to clearly show **four different situations** in the euro area:

First, there are a number of euro area Member States with a much larger relative number of banks in relation to their relative GDP in the euro area, such as Austria, Ireland, Finland, Luxembourg, Cyprus and Malta. **Second**, there is Germany, with 30.8% of the total banks, a percentage that is slightly higher than its relative GDP in the euro area total (27.06%). **Third**, there are some Member States, which have a relative number of banks in respect to the total similar to their relative GDP in the euro area (Netherlands, Slovenia and Estonia). **Fourth**, some of the Member States have a lower relative number of banks as the total percentage of banks in the euro area than their relative GDP in the euro area (Italy, France, Spain, Belgium and Greece).

The large figure of 6,119 credit institutions in the euro area is not "*too large*" for a proper supervision by the ECB and the 17 National Central Banks, of which most of them have already been doing that at the national level for many decades. The ECB should rely on its 17 National Central Banks for its daily supervisory work under its proper rules and guidance. But in any case those euro area Member States where the supervisor is not the central bank will need time not only to move their supervisors to their central banks, but

also for their central banks to start using them effectively. Therefore, they should have more time to adjust to the new system than the others.

This is the reason why those euro area Member States which have the largest number of credit institutions as well as those where the supervisory role is not carried out by its central bank are the ones which, naturally, tend to be more reluctant to transfer its supervisory role to the ECB and the National Central Bank.

Germany is a case in point, given that supervision is undertaken by BaFin, a Federal Government financial supervision authority, and, at the same time, having 30,6% of the total credit institutions in the euro area. In any case, the Eurosystem is by far the best alternative in terms of efficiency and reliability to take the supervisory role for all banks in the euro area.

Therefore, the euro area banking supervision of these 6,000 banks could be done more effectively by the ECB and the 17 National Central Bank (NCBs) rather than by any other alternative. Nevertheless, if this important objective is not able to be achieved, because Member States cannot reach an unanimous or sufficient majority agreement, there is another second best alternative: the number of credit institutions to be supervised by the ECB-NCBs could be lower provided it covers most of the euro area banking market.

Thus, the ECB-NCBs could focus their direct supervision on the 200 largest banks in the euro area which today represent close to 90% of the total euro area banking market, delegating the rest of the banking supervision, under the ECB rules, to national supervisors, having to report directly to the ECB.

In any case, as the ECB-NCBs should approve any new banking licence or any withdrawal of a banking licence in the euro area, it would still have indirect control of any bank being supervised by the delegated national supervisors.

Summing it up, a single euro area banking supervision would help to break the link between banks and individual sovereigns to avoid intra euro area banking contagion, to remove the national barriers, which deter debt market investors and to further develop pan euro area financial markets, which would eventually be the seed of a true banking and financial markets union.

Finally, a single supervisor for the euro area wouldn't be enough to solve the present and increasing problems of the euro area banking market, if it is not followed by a common pan euro area effective resolution mechanism, to avoid contagion among euro area banks and furthermore followed by a single European Deposit Guarantee Scheme to avoid deposit runs and capital flight among euro area Member States.

3. A BAD START

While the euro area summit statement of 29 June 2012 said that the Council should consider the single banking supervisory mechanism with urgency by the end of 2012, the German Chancellor said that there is no hurry to create a single banking supervisor and that everything should be thought through more carefully. She also stated that this issue should be dealt with at the Council in June 2013.

At the same time, the finance ministers of Germany, Netherlands and Finland are proposing a strict separation in regard of the direct bank recapitalisation via the ESM between *'problems that occur under the new supervision'* for which the ESM can take responsibility and *'legacy assets'*, which should be dealt by national authorities.³

Therefore, the basic principle of the banking union, which should be "to break the diabolic loop between banks and sovereigns, starts to wane and the banking union project to slow down or even to fail.

³ See: Press release 175/2012, Joint Statement of the Ministers of Finance of Germany, the Netherlands and Finland, 25 September 2012;
http://www.vm.fi/vm/en/03_press_releases_and_speeches/01_press_releases/20120925JointS/name.jsp.

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