Banking Union in the Making

Stefano Micossi*

Since last June's European Council and Eurosummit, banking union has become a principal building block of the reinforced Economic and Monetary Union outlined in the Four Presidents' Road Map (European Council 2012). The immediate reason for this momentous decision was the urgent need to tackle the mutually reinforcing sovereign debt and banking crises in Spain, which held the potential to wreck the entire eurozone financial system: centralization of supervision was decided as the precondition for intervention by the European Stability Mechanism (ESM) in the recapitalization of ailing Spanish banks, which would thus take place without further augmenting Spain's sovereign debt.[1] Ireland, overburdened by its decision to make good all of its banking losses with taxpayers' money – not least owing to German insistence – was seen as next in line.

An additional ill-effect of the national supervision of cross-border banks, by both home and host country supervisors, has been informal action to impede the transfer within banking groups of pools of liquidity held by branches and subsidiaries of banks based in other member states of the Union. This behaviour, which is clearly inconsistent with the Single Market rules, reflects the segmentations of financial markets engendered by the opening of wide spreads in banks' borrowing costs and the progressive drying-up of the cross-border interbank market. At least to an extent, these spreads are a reflection of sovereign risk pricing rather than banks' specific risk profiles. By eliminating this anomalous component, the banking union would help restore open financial markets within the eurozone and the Union, together with well-functioning monetary policy transmission mechanisms.

* ASSONIME, Rome, College of Europe and CEPS.

[1] See the Euro Area Summit Statement of 29 June 2012.

More broadly, the crisis fully highlighted the role of reckless lending by 'core' eurozone banks in accommodating not only excessive government spending, but also housing bubbles, divergent wages and price inflation in the 'periphery' in the build-up of unsustainable public and private debts (Figure 1).

In a highly integrated financial system like the European Union, taming moral hazard and excessive risk-taking requires the simultaneous centralization of supranational banking supervision, deposit insurance and crisis management (including resolution). The three functions are intimately interconnected and only their joint management can eradicate the expectation of national bail-outs.

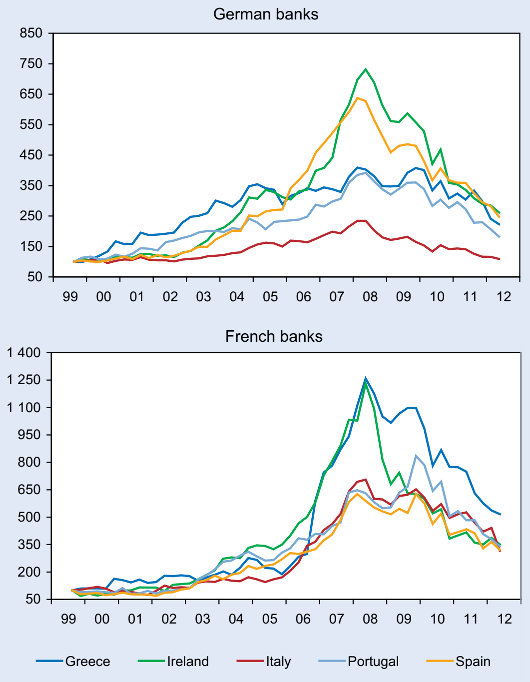
The Commission proposal published on 12 September 2012[2] covers bank supervision but not deposit insurance and resolution. On this subject, the Road Map speaks of '*single* European banking supervision and a *common* deposit insurance and resolution framework' (see p. 4), potentially paving the way towards a different legal regime for the two latter domains. However, in its Communication on the banking union, the Commission has announced its intention to seek 'a single resolution mechanism' in the banking union (see p. 9).

Since the June summits, enthusiasm for banking union has somewhat receded, following a barrage of objections that have called into question even the initial goal of severing the vicious link between sovereign and banking crises in Spain. And yet, at its forthcoming meeting in December, the European Council is committed to deciding on the legal framework for banking supervision by the ECB, as well as on appropriate modifications of the European Banking Authority (EBA) powers and voting rules so as to

[2] Proposal for a Council Regulation conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions, COM(2012) 511 final of 12.9.2012; Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking 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 of 12.9.2012; and Communication from the Commission to the European Parliament and the Council, A Roadmap towards a Banking Union, COM(2012) 510 final of 12.9.2012.

Figure 1

CLAIMS OF GERMAN AND FRENCH BANKS ON PIIGS
(June 1999 = 100)



Source: Bank for International Settlements (2012).

ensure that Union countries not participating in the Single Supervisory Mechanism (SSM) will not see their rights in the Single Market weakened.

The legal basis for entrusting management of the SSM to the ECB is likely to rest[3] on Article 127 Paragraph 6 of the Treaty on the Functioning of the European Union (TFEU): accordingly, decisions will be taken 'with special legislative procedure' by the Council acting 'unanimously' and 'after consulting' the European Parliament and the ECB.

At the time of writing, the European Council is only few weeks away and it is naturally impossible to predict the outcome of its deliberations. However, the questions that can be raised at this stage and the solutions proposed here may offer a standard against which to evaluate the Council conclusions.

Who should participate in the SSM?

Under the Commission proposal, the centralization of supervisory powers at the ECB would legally bind eurozone members, while non-euro member states of the Union could join voluntarily by signing a 'close cooperation' arrangement entailing reduced membership rights (i.e. presence on the Supervisory Board as observers only and the possibility of unilateral termination of the cooperation arrangement by the ECB in case of any breach of the terms of the agreement).

This approach was justified by reference to the ECB Statute, which provides that the ECB rules and decisions have legal value only *vis-à-vis* the members of the eurozone (Article 42 Paragraph 1). Such an approach entails risks of segmentation of the Single Market for banking and financial services, to the extent that over time the ECB came to develop divergent supervisory standards not accepted by non-euro countries. Precisely for this reason, Britain and other non-euro Union members are pressing to strengthen the standard-setting powers of EBA in the domain of supervision (including the *rulebook* as well as the *handbook*, i.e. operational practices) and to require special majorities for EBA decisions so as to preserve the interest of countries not participating in the SSM.

In this regard, the remit of Article 127 Paragraph 6 is not restricted to the eurozone, but may apply to the entire Union.[4] There is little doubt, more generally, that under the Treaty the ECB is a Union institution, while the restriction of its monetary functions only to certain member states is a 'temporary' situation permitted under a derogation from Treaty obligations. It is also worth recalling that the Road Map had called for "an integrated financial framework […] cover[ing] all EU member states, whilst allowing for specific differentiations between euro and non-euro area member states" (see p. 4). As far as this point is concerned, it may be argued that, as a general principle, the Treaty should prevail over the ECB Statute, as the Council attributed new legal powers to the ECB based on Article 127; alternatively, one would have to revise the ECB Statute with the same (unanimous) Council decision setting up the SSM, and subsequent ratification by the member states.[5]

Should some countries decide not to participate and threaten to exercise their veto power to block the deci-

[3] Likely, but not certain: indeed, some may argue that Article 127 Paragraph 6 does not provide a sufficient legal basis for the centralization of the whole activity of supervision – since this paragraph speaks of "specific tasks […] concerning policies relating to prudential supervision of credit institutions […]". If this argument were to prevail, then the establishment of the SSM would require a Treaty change.

[4] This is made explicit by the transitional provisions of Article 139(2c), which do not mention Article 127 Paragraph 6 among those that do not apply to member states 'in derogation' (i.e. not using the euro). A similar provision is present in Protocol 15 regarding the application of Article 127(6) to Britain and Northern Ireland.

[5] In this manner, the European Council would proceed under the simplified procedure for Treaty revision under Article 48 Paragraph 6 TUE.

sion, then the others may well decide to go ahead by using Article 127 in conjunction with Article 20 of the Treaty on the European Union (TUE), providing for enhanced cooperation between some (at least nine) member states.

This issue is one of paramount importance for the future of the Union: the decision to move on with the narrow eurozone circle may have unpredictable consequences not only for the Single Market, but also in terms of the ability of the Union to survive as the overarching political body in the European construction; bearing in mind that many a decision already taken to preserve the euro already points in the direction of a narrow circle architecture of Economic and Monetary Union.

The institutional set-up

Three questions must be examined here: (a) the separation of monetary and micro-supervisory functions within the ECB, (b) the relationship between the ECB and EBA in the performance of supervisory tasks, and (c) the relationship to be established with existing national supervisory structures. As for the first issue, the ECB is currently responsible for carrying out the monetary policy functions, defined by Article 127(2) of TFEU, while the ECB President also chairs the European Systemic Risk Board[6], which is responsible for macro-prudential stability and for which the ECB also provides a secretariat.

Micro-supervision, the subject of the Commission's proposal, is an entirely different matter since concern for individual banks' safety and soundness may at times come into conflict with monetary policy goals (Goodhart and Schoenmaker 1995; Ioannidou 2012). The argument is fairly simple: by construction, monetary policy is counter-cyclical (must lean against the economic cycle) while supervision is pro-cyclical (banks' balance sheets look better during expansions leading to less stringent supervisory constraints). The real danger of mingling the two activities is not monetary policy laxity, since ECB procedures leave little leeway; it is rather the possibility for the monetary authority to become entangled in political controversies with the member states over the application of supervisory practices, which could detract from its perceived impartiality.

In this regard, the Commission proposal does not go far enough, in that the new function is set up as an internal function of the ECB, exercised with delegated powers from the Governing Council of the ECB and under its 'oversight and responsibility' (Article 19.3 of the Commission proposal). Under such a set-up, separation seems hardly guaranteed and there is a high risk of contamination between the two functions. The desirable alternative is for the ECB to entrust the new Supervisory Board with full organizational autonomy, using its organizational autonomy under its Statute to this end.

The structure of the Supervisory Board should mimic that of the ECB Governing Council, and therefore also comprise of an Executive Board. The Executive Board should be charged with running day-to-day supervision and deciding individual cases, in full independence from member states' supervisors. As envisaged by the Commission Communication – but perhaps not fully reflected in legislative texts as yet – the EBA would remain in charge of ensuring not only a single rule book, but also uniform supervisory practices (the *'hand book'*). An extra guaranty of full and effective coordination with the EBA would be provided by the presence of its chairman as a full voting member on the Executive Board of the SSM.

The ECB and national supervisors

A further aspect that must be modified in the Commission proposal concerns the relationship between the Union and national supervisory structures. Under the Commission proposal, the ECB would acquire 'exclusive competences' in carrying out the tasks listed in Article 4 Paragraph 1, and build up a new administrative structure for its fully centralized exercise. Quite differently, the Road Map had envisaged the creation of "a single supervision system with a European and a national level. The European level would have ultimate responsibility […] and would be given supervisory authority and pre-emptive intervention powers applicable to all banks. Its direct involvement would vary depending on the size and nature of banks".

An alternative institutional set-up to the Commission proposal, more in tune with the Road Map, is offered by the network model for the enforcement of EU antitrust law (Articles 101 and 102 TFEU) contained in Council Regulation 1/2003. Under that model, the centralized enforcer (the Commission) and national

[6] Significantly, the ESRB also has a vice-chair from a non-eurozone country.

authorities are both obliged to apply EU rules in individual cases; the allocation of cases is governed by guidelines set out at the EU level; information on individual proceedings flows systematically within the network of competition authorities; and the European authority may advocate any case in order to ensure the consistent operation of the system. The beauty of this system is that cases are almost automatically handled at the right level, thereby avoiding any unnecessary centralization of powers or duplication of structures, in full accordance with the principle of subsidiarity. Under this 'network' model for supervision, national supervisory structures would be fully incorporated into the new supranational system, thus allowing full exploitation of their expertise and knowledge of national banking structures; and the need for fresh human and financial resources to manage the new supervisory tasks would be minimized.

Supervisory approach

The financial crisis highlighted, among many regulatory failures, a widespread tendency by national regulators and supervisors to side with their troubled banks in hiding information from the public, delaying loss recognition and postponing corrective action, thus magnifying eventual losses (Calomiris and Herring 2011; Carmassi and Micossi 2012). Transferring supervisory powers to the Union level can go most of the way in removing supervisory forbearance from the system; however, the system would be strengthened further by the adoption of Prompt Corrective Action as under the US Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, which entails stronger constraints for supervisors to act in the general interest of depositors and investors. The key feature in this approach is that supervisors are obliged to intervene, or at least under a strong presumption to act, once certain publicly available capital thresholds are crossed.[7]

As for *crisis management powers*, they must be attributed to the EU level in order to establish a credible threat that bank shareholders and managers will be fully liable for the consequences of imprudent behaviour. An important matter to be decided here is where to place the borderline between supervisory corrective action and resolution proper. On this point, the Commission proposal (Article 4.1k) includes, amongst supervisory powers to be transferred to the ECB, early intervention 'including recovery plans and intra-group financial support arrangements', with the proviso that these powers will be exercised 'in cooperation with the relevant resolution authorities'. A better solution would be to bring all crisis-management measures that do not involve winding up the banks explicitly under the supervisory umbrella of the ECB: therefore including the power to order the suspension of dividends, recapitalization, management changes, asset disposal and bank restructuring, up to the creation of a 'bad' bank (Carmassi *et al.* 2010). With these powers in the hand of the ECB – as they are under the US FDIC system and in some EU member states – deterrence would be sufficiently strong and supervisory forbearance at a national level would be precluded.

Deposit insurance and bank resolution

As for deposit insurance, it must be understood that it is not an optional feature since there would otherwise be strong incentives for national supervisors to free ride on protection offered by others.[8] The paramount requirement, in designing the Union's deposit insurance, is that it should only protect depositors and never be used to cover bank losses or shield bank managers, shareholders and creditors. It must also provide equal incentives throughout the Single Market to bank shareholders and managers with *ex-ante* funding and risk-based fees. Finally, it must entail some risk and funds pooling at an EU level so as to be able to cushion large shocks affecting a large cross-border bank. The accumulation and pooling of funds would only start within the new system, and thus not affect accumulated insurance funds, in line with transitional arrangements proposed by Gros and Schoenmaker (2012). The management of insurance funds could be entrusted to the ESM, under instructions from the ECB supervisory function.

Under the supervisory approach that has been described, resolution would become a residual function that, under common rules preventing national authorities from making good on the losses incurred

[7] See Benston and Kaufman (1997). More precisely, some actions are mandatory and others are left to the discretion of supervisors; see Table 10 in Eisenbeis and Kaufman (2007). As for the capital indicators, the FDIC has referred to a combination of risk-weighted and unweighted capital ratios. However, overwhelming new evidence has shown that risk-weighted capital ratios are not reliable indicators of the weakening capital and risk positions of banks requiring enhanced supervisory action. Straight (unweighted) leverage ratios, on the other hand, seem to provide consistent forecasts of emerging trouble sufficiently in advance for supervisors to intervene in a timely fashion (Haldane 2012).

[8] The German Council of Economic Experts (Bofinger *et al.* 2012) warned against the creation of a Europe-wide deposit insurance without prior establishment of a European resolution authority. Véron (2012) and Schoenmaker (2012) share our view that a banking union without a resolution authority and a federal deposit insurance would be incomplete and not credible.

by shareholders and creditors, may well be left to the national jurisdiction of residence of the parent company. This approach would also offer the additional advantage of removing questions of the harmonization, let alone the centralization, of bankruptcy rules from the discussion.[9]

This, however, does not eliminate the need for a European banking resolution fund. Rather than covering losses emerging from liquidation, its task would be limited to providing capital, should it be needed, to the 'good bank' carved out by (European) supervisors to preserve deposits, sound commercial loans and other assets, and worthy systemic functions relating to the payment infrastructure (Carmassi *et al.* 2010). This approach was notably shared by a 2010 Commission Communication on resolution funds[10] and therefore should be readily acceptable to the Commission. In view of its limited scope, such a fund would not have to be very large; its resources could be raised by means of a small surcharge over the deposit insurance fee and be managed by the ESM together with the deposit insurance fund.[11]

Two things should be clearly established in this regard. Firstly, the ESM should not be tapped to cover losses stemming from individual bank insolvency, but only to provide time to ailing banks to restructure and return to good health. On this point, the ongoing discussion on 'legacy assets' appears misleading: the reference model for ESM intervention should be the US TARP recapitalization scheme of October 2008, with its cheap and plentiful equity injections that were later fully recovered by the US Treasury, and with hefty profits.[12]

Secondly, in case of a systemic crisis affecting large segments of the banking system, a much larger fiscal back-up may well be needed. However, instead of setting aside large resources *ex-ante*, the issue may be tackled by agreeing on a key for fiscal burden-sharing among Union member states (either all of them, independently of bank location, or those directly implicated in the banking crisis), as was envisaged by Goodhart and Schoenmaker (2009).

[9] It must be stressed that, were the resolution authority to be supranational, the creation of this new authority could not be covered by Article 127 and would have to rely on a different legal basis.

[10] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank, Bank Resolution Funds, COM (2010) 254 final, 26.5.2010, Brussels.

[11] In order for the ESM to play the role we have envisaged on deposit insurance and resolution, its treaty should be amended so as to allow it to perform these functions for the banks of non-euro countries too.

[12] The US Treasury has recovered 267 billion US dollars from TARP's bank programs to date, 22 billion dollars more than the 245 billion US dollars invested (US Treasury 2012).

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