CEPS COMMENTARY

Thinking ahead for Europe

Banking Union in the Eurozone and the European Union

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The opportunities for institutional advancement in the EU created by the dismal management of the eurozone crisis may well include the establishment of a banking union, a theme that could be placed on the agenda of the forthcoming European Council at the end of June. The debate on this topic, however, seems mired in confusion, notably as regards the features and tasks of deposit insurance at the eurozone or EU level in combating contagion and restoring financial stability. It also seems at times to overlook the fact that many constituent elements of banking union are already present in the legislation in force or tabled for approval and, more importantly, that much of what is needed may be feasible with ordinary legislative procedures.

There is a need, to start with, to distinguish clearly what is needed to address a 'systemic' confidence crisis hitting the banking system – which is mainly or solely a eurozone problem – and 'fair weather' arrangements to prevent individual bank crises and, when they occur, to manage them in an orderly fashion so as to minimise systemic spillovers and the cost to taxpayers, which is of concern for the entire European Union. Much of the ongoing debate on deposit insurance and banking resolution funds mainly refers to the latter issue; deposit insurance or resolution arrangements can be instrumental in confidence-building over the medium term but couldn't ever have sufficient resources to meet a spreading run on deposits. More important, "using extended insurance coverage to stabilise financial systems in the absence of appropriate institutional, political and fiscal conditions to address existing problems" would entail moral hazard (IADI, 2012). Financial stabilisation in the short term is the proper task of lending of last resort by the central bank.

Taking up the 'fair weather' system first, we have always known that a stable and well-functioning internal market in banking requires EU-wide deposit insurance, crisis resolution procedures and supervision. While the desire to preserve national

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prerogatives in these domains has slowed down the progress in this direction, the crisis is now accelerating progress on all three fronts.

As to deposit insurance, Directive 94/19/EC, as amended by Directive 2009/14/EC, and a new directive under consideration by Council and Parliament, based on a Commission proposal of July 2010,[1] have already harmonized the level of depositor protection (€100,000) and will require all national systems to be funded ex-ante with a significant risk-based component of fees paid by participating banks. The European Commission has further proposed that each national scheme should target a level of funding of 1.5% of total insured deposits, to be reached within 10 years (which Parliament has lengthened to 15). The target level is supported by the European Parliament, but the member states in the Council would like to lower it to 0.5%. A recent survey prepared by the Financial Stability Board shows that most EU members are already compliant with the principles of the Commission proposal (with ex-post-funded deposit insurance still present in Italy, the Netherlands and the United Kingdom); however, the size of insurance funds is very small, well below even the lower target acceptable to the member states (see FSB, 2012, Table 7, p. 52).

There is also a provision whereby national guarantee funds may, under certain circumstances, lend funds to each other on a voluntary basis to meet unexpected shortages; the Commission wanted this to be a legal obligation but Parliament and Council did not accept it. This provision is insufficient to meet the funding needs that may arise from substantial losses at a large cross-border bank. An adequate solution may only come from an EU-wide deposit insurance scheme covering all cross-border banks, as proposed by Carmassi et al. (2010).

Regarding crisis prevention, management and resolution, the Commission proposal[2] published on June 6th represents significant progress towards an effective framework to reduce the risk of a systemic banking crisis and minimise taxpayers' exposure to losses from an insolvent bank. There would be a single administrative (i.e. out-of-court) procedure covering crisis prevention, crisis management (with early intervention) and resolution; all countries would have to confer similar resolution powers to a competent authority to be identified at national level, as originally suggested by BCBS (2010). In order to strengthen the incentives for management and shareholders to avoid excessive risk-taking, it is also envisaged that banks may be required to issue a sufficient proportion of their capital in the form of convertible debentures, which would be converted into equity by discretionary decision of the resolution authority (discipline effects would have been stronger with automatic conversion triggered by market indicators of capital strength much before arriving at the stage of resolution, as in Carmassi & Micossi, 2012).

The proposal also requires each member state to set up a national resolution fund, again normally financed ex-ante with risk-based fees, in extraordinary circumstances

[1] Proposal for a Directive of the European Parliament and of the Council on Deposit Guarantee Schemes [recast], Brussels, 12.7.2010, COM(2010)368 final.

[2] Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010, COM(2012) 280/3.

also with ex-post contributions. The targeted funding level must reach, within 10 years, at least 1% of the amount of deposits of all banks authorised in the member state which are guaranteed under Directive 94/19/EC. In principle these funds should never be used to cover losses of banks undergoing resolution, but only to support the restructuring process and provide capital for the new bank possibly emerging from resolution. More broadly, the Commission text leaves too much discretion to national supervisors and resolution authorities in their decision to undertake corrective action. What is needed is a system of mandated corrective action at EU level that will force supervisors to intervene and apply measures of increasing intensity as bank capital weakens below pre-determined thresholds, in full public light (see Carmassi & Micossi, 2012).

A specific element of supranational solidarity is represented by the obligation for each fund to lend money to their counterparts in other member states – for an amount up to one-half of its resources – in case of need. This proposal, however, has been met by strong opposition by the member states, not surprisingly, since it entails a 'mutualisation' of risks that seems hardly acceptable without a centralisation of supervision. An additional difficulty is represented by the wide variation of capital requirements made possible by Basel capital rules, which Basel III and the new CRR/CRD IV will only aggravate. Moreover, as with deposit insurance, there are no specific provisions for the resolution at EU level of cross-border banks, with attendant resolution powers and resources.

Lack of centralised supervision and mandated supervisory action are main missing elements in the proposals that have been tabled so far. Here, a decision must be taken, first of all, on the competent authority at EU level: should these powers be centralised within the European Central Bank, or rather with the European Banking Authority (EBA)? Should the occasion be exploited to create an integrated supervisory system covering all financial activities and organised according to horizontal objectives, i.e. macro-stability, micro-stability and transparency cum market integrity (as outlined in Di Noia & Micossi, 2009)?

Whatever the decision, the good news is that the Council already has the legal power to implement the first solution (centralisation of supervision at the ECB) under Treaty Art. 127.6, while the second solution (EBA) could be realised with ordinary legislation by building upon the binding mediation powers already entrusted to EBA by its founding Regulation.[3] Whatever route one chooses, centralization could be limited to cross-border banking groups, while continuing to utilize existing national supervisory structures, under appropriate coordination arrangements.

Crisis management is an entirely different matter that specifically concerns only the eurozone. What is special to the eurozone in the present circumstances is a confidence crisis bred by intertwined sovereign and banking crises that are a consequence of faulty design of the currency union: eurozone member states share a common currency but cannot use it freely to roll over their sovereign debts or

[3] By modifying Arts 19 and 21 of Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC. This legal route was proposed by Carmassi et al. (2010).

provide liquidity to their banking system in case of a liquidity or confidence shock. Indeed, while the ECB can intervene to provide unlimited liquidity, it is reluctant to do so in the absence of solid 'fiscal' arrangements for sharing the risk of its interventions – as Mario Draghi once again reiterated, after the latest monthly meeting of the ECB Governing Council, while explaining the decision to hold interest rates constant despite sharply falling activity in the eurozone.

The appropriate instrument to build adequate fiscal backing for ECB interventions obviously is the European Stability Mechanism: while it is for the ECB to provide temporary relief of liquidity strains, only the member states can deploy the resources required to recapitalise troubled banks, of course under appropriate conditionality – but so far have failed to come up with satisfactory and lasting arrangements, able to restore confidence in financial markets. The principles to be followed and the specific measures required to stop the meltdown of the Greek banking system and halt contagion in Spanish banks are well identified by Gros & Schoenmaker (2012) and Véron (2012). What must be stressed, once again, are the disastrous consequences of continuing the game of brinkmanship between governments and the central bank, which has brought us closer and closer to the dissolution of the eurozone.

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