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Thinking ahead for Europe

The Roadmap to Banking Union: A call for consistency

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The proposal to move to a full banking union in the eurozone presents the EU with a radical shift in regime. Whereas until today the home country rule had prevailed, the European Central Bank (ECB) will now become the supervisor of the eurozone. Precisely how this is implemented will need to be closely monitored. Since it is such a radical change, there is a risk that the decision will not be taken to its fullest extent and that member states will continue to maintain some control.

The concept of a banking union entered the EU debate fairly unexpectedly. There is still some discussion as to who coined the term, which in itself is unclear and certainly confusing for European citizens. If the eurozone now wants to form a 'banking union', what were the single market programme, the financial services action programme and the G-20 agenda all about? Why does the EU still have so many backdoors to a real single market, 20 years after its accomplishment? What makes the eurozone so different from the rest of the Union that it needs a banking union? And how will this work alongside the single banking market?

The challenging tasks facing authorities in the EU, in particular in the eurozone, include i) properly defining the term 'banking union', ii) detailing the role of the ECB and allocating the respective powers and cooperation between federal and local banking authorities in a banking union and iii) adapt EU legislation accordingly. The test for a banking union will be whether it manages to stop the increasing the 'home bias' and financial market disintegration within the eurozone, which also hinders the efficient execution of monetary policy.

1. The what and how of a eurozone banking union

A banking union can be defined as a fully integrated bank regulatory and supervisory system within a federal structure. Supervision is de-nationalised, in that its form becomes exactly the same and is neutral with respect to the nationality of the bank. Banking unions exist today in other federations, such as in Canada, the US, Australia and even Germany and Switzerland. It is worth recalling that in these federations other elements of financial supervision, such as the supervision of securities markets and insurance companies, or the taxation of firms and financial products, are not necessarily unified. Full federal supervision of banks does not mean that lower-level authorities no longer exercise competences, as is exemplified in the US.

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In the EU federal model, a banking union, further to the Eurozone Council decision of June 28-29, will be formed on the basis of Art. 127(6) of the EU Treaty (TFEU). Hence, supervision will move to the European Central Bank only for banks licensed in the eurozone, as that article is only applicable to those countries that are part of EMU, not to the countries that have a derogation or a special status within the EU. However, the decision will need to be taken with the unanimous agreement of all 27 EU member countries' finance ministers.

Art. 127.6 (TFEU) 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 European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.

This article is repeated in Art. 25 of the European System of Central Banks (ESCB) Statute.

An EU banking union, in the form defined above, could also be constituted differently to apply to all countries of the EU, but it would undoubtedly have been more difficult to find a legal basis and hence an agreement. Art. 65 of the Lisbon Treaty (TFEU) indirectly states that, in discussing the freedom of capital movements, the prudential supervision of financial institutions is a prerogative of the member states. Another possibility, but only within the context of EMU, is Art. 136 allowing EMU member states to adopt specific measures for budgetary and economic policy coordination, although it is debatable whether this could be extended to prudential supervision. Finally, there is also the 'enhanced cooperation' route (Art. 326 and following). The European Commission itself, while claiming that it originated the idea at the informal European Council on 23 May 2012, was in favour of the full EU option, although it did not specify which institutional changes a banking union would imply. In its memos on the Banking Union, it did not refer to any specific treaty articles.[1]

In turning supervision over to the ECB, the eurozone will become the 'home country' of banks, with the ECB in charge of authorising the banks. This is a dramatic shift from the system of supervision that the EU has known so far. It means that, in the ESCB, the ECB will be the authority granting a banking licence and exercising day-to-day supervision. It will also allow eliminate the grey area in the respective tasks of the ECB and the eurozone National Central Banks (NCBs), especially with regard to financial stability, the Lender of Last Resort (LOLR) function and emergency liquidity assistance (ELA).

The official reason for moving supervision to the ECB is to do away with the country-risk premium, and in so doing, "break the vicious circle between banks and sovereigns", as the June Euro Area Summit stated. During the sovereign debt crisis, banks' wholesale funding costs have increasingly become correlated with the funding costs of their home country, creating a very unlevel playing field. However, it may also have been a condition set by the ECB to enable it to continue its liquidity-providing operations. Since the start of monetary union, the ECB has complained of a lack of information about the national banking systems, a complaint that has grown louder as the crisis deepened. Until recently, however, member states managed to fend off this criticism with the argument that sensitive information regarding the competitiveness of the local banking system could be leaked to foreign competitors. The regulation forming the European Systemic Risk Board (ESRB) states, in Art. 15, that supervisory information is provided "as a rule in summary or aggregate form such that individual financial institutions cannot be identified". However, with the massive long-term refinancing operations of December 2011 and February 2012, the ECB provided

[1] See the European Commission press releases on the banking union, 6 and 22 June 2012.

troubled banks such as Bankia, €40 billion, or Dexia with €32.5 billion.[2] With supervision entirely in national hands, and limited or non-existent information-sharing, it is no wonder that the ECB would like to know more about the soundness of the financial institutions to whom it is making loans of such magnitude.

2. Operational implications for the ECB

Viewed in a global and European context, transferring more supervisory powers to the central bank is nothing new. Most central banks in the eurozone are also bank supervisors. In response to the crisis, central banks in several jurisdictions have been given more banking supervisory powers, in particular in the US and the UK. Overall, it was judged that central banks needed to have all the information necessary to respond rapidly to a crisis and that closer cooperation with macro-prudential supervisors should increase the quality of supervision. Specifically in an EU context, transferring supervision to the ECB raises a number of conceptual, legal and operational issues, which will need to be clarified in the Council decision.

Clarify the objective of prudential supervision by ECB

Unlike monetary policy, prudential supervision and its objective are not defined in the Treaty. It only says that the ESCB can contribute to financial stability, and that specific aspects of the prudential supervision of financial institutions can be transferred to the ECB, with the exception of insurance undertakings. As a result of the financial crisis, the ECB was already given the responsibility for macro-prudential oversight through the creation of the European Systemic Risk Board, an independent body that is staffed by the ECB and is largely controlled by the central banks of the EU. Its main tasks are to identify, monitor and act against systemic risk of markets and institutions,[3] although it cannot adopt binding decisions.

The ECB mandate will thus have to be clarified in the European Commission's proposals. It will be important to indicate that (micro)-prudential supervision focuses on *institutions*, with the aim of protecting their solvency and viability. It is distinct from other forms of financial supervision, which control the behaviour of financial institutions (conduct of business rules), financial products or anti-competitive practices (competition rules).

The nature of prudential supervision in the ECB

Transferring prudential supervision to the ECB means that it becomes part of an independent European institution. Until very recently, the Ecofin Council had insisted that financial supervision had to be executed where accountability lies and budgets are available, which meant at the level of the member states, in an organisation closely related to the ministries of finance.[4] The European Parliament also wants accountability, and strived hard to have this included in the regulations creating the European Supervisory Authorities (ESAs) (see e.g. Art. 3 in the ESAs' regulations). The Eurozone Council decision is a radical

[2] *Financial Times*, 2 March 2012.

[3] See ESRB regulation No 1092/2010 of 24 November 2010, recital 9 and Art. 3.

[4] In reaction to an obvious attempt by the ECB to obtain a greater role in prudential supervision, the Ecofin Council adopted a statement in May 2002 saying that the structure for financial regulation and supervision must be accountable to the Ecofin Council. The Ecofin Council recalled this position in the early days of the financial crisis in 2007 and 2008, stating that the structure of financial supervision should not unbalance the EU institutional structure (see Lannoo, 2008, pp. 18-19 and 22-23).

departure from this, which will need to be taken into account in the ECB's operational structure.

A central bank's need for independence in carrying out its monetary policy function is commonly accepted. The success of a central bank in executing its monetary policy can be objectively measured by the maintenance of price stability. This is also why the central bank should be immune to short-term political considerations in fulfilling its mandate. These considerations do not apply in the same way to financial supervision. While prudential supervision needs to be exercised independently, the measurement of success in the execution of this function is more difficult, and requires broader accountability. Prudential supervision is performed to maintain financial stability and to protect depositors. Taxpayers' money may be needed to achieve this stability, which requires accountability before a parliament.

Exercising supervision may thus reduce the independence of the central bank, and its accountability will have to increase. Deciding on a monetary policy stance may be done rapidly based on a limited set of variables, whereas reviewing the situation in the banking markets and of individual banks is much more complex. The pressure upon the ECB will grow to explain its position, as will the criticism of its decisions. The ECB could find itself in a conflict of interest between its roles as guardian of price stability and guardian of financial stability. The debate about its stance vis-à-vis the Spanish banking sector is already an indication of just how difficult the performance of the supervisory responsibility will be for the ECB as an independent institution.

Structural implications for the ECB

The above considerations regarding the objective and nature of financial supervision should be clarified in the operational structure. Today, the ECB's Governing Council, which meets every fortnight, takes the monetary policy decisions, with the six-person Executive Board in charge of day-to-day operations. Adding prudential supervision to the ECB's tasks will require changes in the management structure, such as the creation of a special standing committee within the ECB for supervisory matters, reporting to the Executive Board.

Much of the day-to-day work on prudential supervision will be carried out by the participating central banks, in tune with the decentralised mode in which the ECB was created: *"the ECB shall have recourse to the NCBs, to the extent deemed possible and appropriate, to carry out operations which form part of the tasks of the Eurosystem"* (Art. 12.1 of the Statute of the ESCB). The implementation of this plan will be the most far-reaching for the four eurozone countries where supervision does not reside with the central bank: Finland, Luxembourg, Malta and Cyprus; and for Germany, where financial supervision is split between the Bundesbank (execution) and Bafin (formal responsibility).

In view of the importance of maintaining a strict separation between monetary policy and financial supervisory functions, it is strongly suggested that responsibility for communication about these matters be split, with the ECB vice-president placed in charge.

One issue requiring harmonisation is the contribution to the costs of supervision, where different systems are in operation in the EU and eurozone. The ECB will also need to possess the power to impose sanctions in the case of violations.

Scope of supervision by the ECB

The ECB's responsibility will apply to prudential matters of all banks operating in the eurozone, big or small. After the decision by the Eurozone Council, some commentators have argued that the ECB would only cater for the larger, systemically important banks,

whereas the member states' authorities would remain responsible for smaller banks. Such a system is in operation in the US, where the Federal Reserve can charter banks, mostly the larger internationally active banks, as well as the states, resulting in a very complex financial system, with overlapping and often competing controlling entities, despite various attempts by the rule-makers to streamline the system. The 2010 Dodd-Frank bill stated that the Fed should supervise all banks with balance sheets above $50 billion, but did not reduce the role of the states.[5]

How the eurozone decision will be worked out remains to be seen, but it is important that the same system will apply to all banks in the eurozone, large or small, with of course differences in supervisory intensity. Larger banks will be under much closer examination and inspection than smaller banks, but the system of supervision should be the same. To ensure objectivity, supervisory panels should be multinational in composition, even for large or mid-sized local banks. But a system of dual supervision as operates in the US should be avoided.

The assignment of micro-prudential supervision will render the task of the ESRB easier and give it broader powers. Since the ESRB has no formal power to issue binding directions, it was seen as a lame duck. The addition of micro-prudential responsibilities to the ECB radically changes the ESRB's task.

3. Regulatory changes

The most important short-term regulatory change will be the amendment of all EU legislative acts to make the eurosystem the competent authority for eurozone-based banks. In the long term, however, the most important questions relate to the impact on the form of regulation in the EU and the relationship between the members and non-members of the eurozone (the Ins and the Outs). Related to this is the question of the future role of the European Banking Authority (EBA).

As with the coming into force of the ESA regulations, the EU will have to enact an omnibus regulation changing all previous acts, stating that the ECB is the licensing authority for all banks in the eurozone. Licensing and reporting rules should thus be exactly the same across the eurozone, but this will have implications for the broader EU. As for the day-to-day supervision, it will be a huge task for the ECB to harmonise the supervisory methods, although the work done by EBA (in COREP and FINREP) so far will certainly be of help.

In a longer-term perspective, banking union consolidates the move towards maximum harmonisation, for the EU as a whole. Within the eurozone banking union, it is evident that exactly the same rules should apply, but as the situation of the other member states is that of a derogation of monetary union (with the exception of the UK and Denmark), there is no reason to adopt a different approach for the Ins and the Outs. The recent call by Mark Hoban, the UK Finance Minister, for minimum standards and proportionate regulation, while supporting banking union, is thus puzzling.[6]

Banking union could thus make the eurozone more attractive as a financial centre. The complex interaction between home- and host-country authorities in the eurozone will no longer exist, as will continue to be the case, for example, for the remaining host-country supervisory powers for liquidity requirements. Supervisory colleges in the eurozone will be

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[5] See "The Federal Reserve System", US Federal Reserve, Chapter 5 (http://www.federalreserve.gov/pf/pdf/pf_5.pdf).

[6] "Banking Union in the Eurozone", speech by Mark Hoban, Brussels, 9 July 2012 (http://www.hm-treasury.gov.uk/fst_speech_090712.htm).

a thing of the past, and supervisors of cross-border banks in the eurozone will sit around the table as members of the ESCB, and no longer as sovereign supervisors. The formal responsibility of supervisory decisions will be with one institution, the ECB.

Within the banking union, capital could be located anywhere, but consolidation raises tricky corporate tax and accounting issues, which remain largely non-harmonised. Company law and shareholder rights also remain non-harmonised and could pose barriers to consolidation. Will banking through branches and subsidiaries in the eurozone become an issue of the past for eurozone-licensed banks? And how will this apply to non-eurozone but EU licensed banks?

Maximum harmonisation will also affect depositor protection and crisis-resolution systems. So far, both are the subject of draft directives, which leave much in the hands of the member states. The draft depositor guarantee schemes Directive (DGS) sets the level of protection at a maximum of €100,000, but does not harmonize the governance structure of the fund (public or private), nor does it create a Europe-wide fund, or a network of funds. The draft crisis management Directive for the first time harmonises bank resolution triggers and procedures and requires member states to appoint a resolution authority and create a resolution fund, but it does not put in place a unified resolution structure. With the agreement of the June Eurozone Council that the European Stability Mechanism (ESM) can (in the last instance) be used to recapitalize banks, it follows that resolution procedures should be fully aligned within the eurozone, and that the ESM will become the ultimate resolution authority.

Whither the EBA?

The EBA could continue to play a role in technical and regulatory standard-setting for the EU (and the EEA) for the level-2 rules, but this function is expected to diminish over time. EBA supervisory functions on the other hand will have limited or no significance under Banking Union, as they were designed for an EU-27, not for a Union with an emerging mega-supervisor. The problem towards effective change will be the European Parliament, which worked hard on the ESA's regulations to ensure a clear obligation on the part of the authorities to report to the EP. Such accountability will never obtain to the same degree from the ECB.

A future role for the EBA could be to re-orient it as a conduct of business and product regulator for the EU banking sector. The control of financial activities and products is one of the tasks of the EBA (Art. 9) that is not yet very developed, but urgently needed. Product regulation does not fall within the ambit of the ECB's future tasks, and will continue to reside under host country rules in the EU, because of consumer protection rules. In this sense, the eurozone, and the EU, will be moving more towards a 'twin peaks' or objective-based model of supervision, based on the subsidiarity principle. Only those tasks that can be better performed at the ECB level would be centralised. Conduct of business control would largely remain at national level, coordinated by the EBA and ESMA.

The ESA regulations will need to be modified to let the ECB be formally part of the steering committee of the European Supervisory Authorities. This will allow the ECB to obtain information about securities markets and insurance supervision, but it will raise the problem of the balance within the ESA Steering Committee. Will the chairs of the ESA's sit alongside the President or Vice-President of the ECB?

EU rules will also need to be changed to add the ECB alongside the EBA, or to replace EBA with the ECB. Notifications or coordination on the supervisory level will require the clear involvement of the ECB.

4. Broader implications

The ECB's position internationally

A single supervisor for the eurozone should greatly facilitate the supervision of large cross-border banks and the communication amongst supervisors. This will remove one rung from the ladder in the EU, the home country. It will also oblige large eurozone-based banks to communicate in a more distant and formal manner with their supervisors.

The representation of eurozone countries in international supervisory fora such as the Basel Committee and the Financial Stability Board should fall to the ECB rather than the individual member countries. This issue has also been debated for a long time in the context of the eurozone's representation in the IMF, without success so far, but requires an immediate change for supervisory matters. This would also send an important signal to the international community that banking union will be implemented to its fullest extent.

The relationship with state aid and competition policy authorities

As stated in the June Eurozone Council decision, EU state aid rules will be applied in full to the recapitalisation of the Spanish banking sector by the ESM. Some of the conditions for recapitalisation were already highlighted in the Memorandum of Understanding, which are in line with the Commission's communications on the subject.[7] These include: i) aid must be limited to the minimum necessary, ii) it must be proportional to the contribution made by private share- and bondholders, iii) the aid must be appropriate and well-targeted and iv) the aid must be remunerated. These criteria will be applied by the Commission when vetting the support for the Spanish savings banks. If large cases in the past can serve as a reference, the conditions imposed by the EU authorities can be very drastic, as was the case for Commerzbank and ING. Hence it means that i) the business plans of recapitalised banks will be analysed in detail, and eventually further restructuring will be imposed, and ii) the aid will have to be remunerated, which in the case of aid by the ESM will be paid to the ESM. It can be expected that in its decision concerning capital support the ESM will be less generous than the member states were in 2008, as the decision has to be taken with the unanimity of its members (Art. 5.6 ESM Treaty), all of whom will be anxious to see their money returned.

State aid to the banking sector, however, raises the question of borders between Lender of Last Resort (LOLR) support by the ECB, Emergency Liquidity Assistance (ELA) by the NCBs and ESM support or outright state aid. Over the last year, the ECB has clearly been acting as LOLR for important parts of the eurozone banking system and replaced the interbank market. LOLR support is, in the Commission's understanding, not state aid as it is central bank money that is provided on a non-discriminatory basis to the banking sector and based on adequate collateral. The same cannot be said of Emergency Liquidity Assistance, which can be provided in extreme circumstances by NCBs in the EMU, but would be considered as state aid as it is provided in special cases, not necessarily against collateral, and from the reserves of the NCBs – not real central bank money. The agreement of the ECB's Governing Council and the Commission is required for ELA. The transfer of supervision to the ECB should clarify the role of the ECB as LOLR and do away with the ELA in the eurozone.

5. Conclusions

The move towards banking union is an opportunity for eurozone leaders to show the world that they are drawing lessons from the crisis and can streamline their supervisory structures. It is also an opportunity for eurozone-based banks to facilitate their communication and

[7] See CEPS Task Force Report, *Bank State Aid in the Financial Crisis*, CEPS, Brussels, October 2010.

reporting to supervisory authorities. For this to be the case, the implications of the decision of 27 June will have to be taken to their full significance. This applies both to the regulatory changes it necessitates, and to changes to the current supervisory structure and the role of EBA.

By moving prudential supervision to the ECB, a more optimal system of financial supervision will emerge in the eurozone towards a 'three-peaks' model, with centralised control over prudential and competition policy and decentralised conduct of business and product regulation. It also allows for the removal of some inconsistencies in the current eurozone financial supervisory framework with regard to the responsibility for lender-of-last-resort support, emergency liquidity assistance and crisis management.

Difficulties can be expected with the role of the ECB as an independent central bank with its new task in the domain of prudential supervision and its accountability before the European Parliament. The same form of accountability as at present for monetary policy is not adapted for financial supervision, and will require flexibility from both sides – the policy-makers and the ECB – to come up with a credible solution.

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