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The shape of the banking union confirms Berlin's privileged position in the eurozone

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On 18 December 2013, EU finance ministers reached agreement on the structure of a banking union. The body will be tasked with oversight of the largest banks across the EU. It will also devise recovery and resolution programmes for institutions at risk of bankruptcy, and it will handle wind-up arrangements and decide on the allocation of resulting costs. The proposals are expected to be approved by March of this year by the governments of the eurozone states, by other EU members interested in joining the banking union, and by the European Parliament. A compromise on the supervision of the largest banks in the eurozone was reached several months ago. The most recent negotiations focused on the second pillar of the banking union: a Single Resolution Mechanism. The parties successfully negotiated a set of procedures for rescuing banks capable of recovery and for the closure of institutions that cannot be rescued. A joint position was also agreed on the allocation of costs resulting from such actions.

The recent financial crisis has revealed the difficulties faced by many national governments trying to oversee the banks upon whose loans they remain dependent. As a result, the main objective of the banking union has been to transfer not only the supervisory responsibilities, but also the burden of rescue or closure costs from the national to the EU level. This would place the EU financial sector under greater scrutiny, and give national governments room for manoeuvre in crisis situations. However, these objectives have been only partially achieved. The banking union introduces a new institution with extensive supranational supervisory powers over major banks, namely the Single Resolution Board. Moreover, bank restructuring is to be financed mainly through a levy paid by financial sector actors in individual states. Initially, the money is to be collected in national pots for local use, and only later are the funds to be pooled at the European level.

This formula strengthens Germany's position. In the event of the financial failure of a large institution (and insufficient EU funds to address the problem), Germany – as the country with the largest financial reserves – would be able to loan the necessary funds from its national pot. Germany would also hold a key vote on loan applications to the European Stability Mechanism (ESM). That is because, together with France, Germany is a major capital contributor to the ESM, which gives it a veto over the agency's loan decisions. In addition, ESM interventions would have to be approved by the Bundestag. Since the German financial sector will be making the greatest contribution to the Single Resolution Mechanism, Berlin will also have a decisive say in any work on future restructuring plans. Importantly, thanks to its strong economy, Germany will be able to rescue its local banks without resorting to outside help. Germany has therefore managed to achieve its main objective, namely to gain control over the restructuring of European banks and to impose a series of safety mechanisms on the use of German money to this end. However, this has significantly complicated the new system, and has raised questions about the ability to work out a compromise should a large eurozone bank need rescuing in the future.

The structure of the banking union

The decision to form the banking union is a response to the diagnosis of one of the causes of the current economic crisis, namely the lack of adequate controls over banking institutions, which stems from the dependence of some national governments on the sale of bonds to these banks. Financial institutions which collect deposits from the public have in the past engaged in high-risk speculative transactions, exposing depositors to potential losses in the event of bankruptcy. In addition, the national supervisory bodies have not always been able to fully control the risks taken by banks operating in a number of EU countries.

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Under the existing proposal, the banking union is to consist of three pillars. The first pillar (the Single Supervisory Mechanism) will give the European Central Bank supervisory powers over the largest banking groups, and it will come into operation in November of this year. The second pillar (the Single Resolution Mechanism) envisages the creation of a European institution which from 2015 would have the powers to devise recovery plans for banks and to wind up failing institutions. The third pillar (the Single Resolution Fund) is a pool of money to be used for the restructuring of banks in countries which are unable to meet the cost of the process themselves. The ratification of an intergovernmental agreement on the establishment of the fund by countries representing at least 80% of capital contributions is a pre-condition for the implementation of the second pillar.

The creation of the banking union is based on a series of legal provisions. Article 114 of the Treaty on the Functioning of the EU serves as the legal basis for the first and second pillar, and the drafting of relevant EU directives is already in progress. The third pillar, meanwhile, is to be based on an intergovernmental agreement.

All eurozone members are obliged to participate in the banking union, while other EU countries are able to join the new regime voluntarily.

Procedures for restructuring banks

The second pillar – the Single Resolution Mechanism – envisages the creation of a resolution fund made up of bank contributions amounting to €55 billion over the next 10 years. At first, the funds will be collected in separate national pots, and will be used to rescue only those banks which are based in the country where the contributions originated. Over time, however, the contributions will be gradually pooled together by transferring some of the funds from the national pots to a 'common' fund enabling the restructuring of any eurozone bank. By 2026, all of the contributions are to be paid into the pooled eurozone fund.

The ministers have also drawn up a set of rules – coming into effect in 2016 – governing the order in which losses incurred in the restructuring process should be covered. The liabilities of rescued banks are to be met, first by the bank's creditors and shareholders, followed by the holders of bonds in excess of €100,000, and finally (in the absence of sufficient funds) by the Single Resolution Fund. During the transitional period, additional funds required to rescue a bank could be obtained through government loans from the reserves built up in national pots. Germany has reluctantly agreed that countries should also be allowed to apply for a European Stability Mechanism (ESM) loan, but it has refused to simplify the procedures set for banks seeking EMS loans.

The restructuring procedure also envisages establishing a Single Resolution Board, consisting of representatives appointed by financial supervisory authorities from individual countries. Its task will be to devise a resolution plan for any bank considered to be at risk of bankruptcy. Such a plan would need to be approved by two-thirds of the board's members, representing at least two-thirds of the capital paid into the resolution fund. The plan would then form the basis for the restructuring of the bank in question, unless within 24 hours, and at the request of the European Commission, the Council of the European Union decides to veto the plan (by a simple majority) or proposes changes to the plan. In order not to infringe on the budgetary powers of individual member states, the Single Resolution Board will not be able to force any state to rescue a financial institution using taxpayers' money.

Conclusions

• The proposed compromise on the banking union slightly simplifies and accelerates the process of bank restructuring, addressing the recent calls made by a number of politicians and economists, including ECB president Mario Draghi. However, the main unresolved problem is the fact that the pot of funds made available under the new regime is too small. It is estimated that the current crisis has consumed €1.6 trillion, and some estimates suggest that banks may have around €1 trillion of non-performing loans. In this context, the €500 billion available under the ESM, and the €55 billion reserve fund, represent an amount far too small to give the banking union the credibility it needs – €55 billion might only be enough to rescue two medium-sized banks. Consequently, the proposed compromise on the banking union should not be seen as a breakthrough. If the banking crisis were to worsen, finding a way to refinance failing institutions would require time-consuming negotiations. According to an analysis carried out by the *Financial Times*, in the event of disagreement, a decision on a resolution plan for a single bank could require 143 votes by nine committees. Meanwhile, the experience of the crisis in Cyprus shows that the entire process would need to take no longer than a few days.

• The compromised proposal maintains Germany's control over bank restructuring across the eurozone, as well as over the direction of reforms in member states experiencing economic problems. Any restructuring plan can be vetoed by members contributing a third of the capital. Germany, which holds between 18.8% and 25.7% of the capital (depending on the number of EU countries that choose to enter the banking union and on the amount of capital they contribute) will in effect be able to block any solutions it deems unfavourable. At the European Council level, however, where a simple majority of votes will be required, Germany's positioned will be notably weaker. Similarly, any restructuring loans made available through the ESM, or through German deposits, will allow Berlin to determine the direction of reforms in the countries requesting such assistance. Germany could also potentially exert influence on eurozone members on other matters that the German government is particularly interested in (one such example could be the pressure put on Ireland to vote against limits on CO_2 emissions in cars, which was widely reported in the European press in July 2013). Nonetheless, the final proposal for the banking union does include Germany's concession to gradually pool together the reserve funds, although specific provisions on how this will be achieved have yet to be agreed. Germany has also in principle approved the use of ESM funds, although it should be stressed that

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individual decisions in this regard will be hard to pass should Germany choose to block them.

• It is possible that following the introduction of the banking union, the position of banks from southern Europe could be weakened due to low confidence levels among investors. These banks have already been struggling to find sources of finance for their investment, and now they will also have to bear the costs associated with the accumulation of reserves for restructuring. Many countries do not currently have sufficient resources in their deposit guarantee schemes. Consequently, for the foreseeable future, these states may have no choice but to seek assistance from the European Central Bank. The probability of such course of events has increased the decision of the US Federal Reserve announced in December, to slowly taper off its quantitative easing policy – that is, the policy of purchasing large amounts of US Treasury notes by the US Central Bank, which has been the main source of substantial additional capital in financial markets and has increased interest in European bonds in recent years. In addition, the proposal leaves an element of uncertainty about the extent to which owners of large deposits will be liable for banks' debts. For this reason, such depositors are likely to spread their savings between several banks to avoid exceeding the €100,000 deposits guaranteed by the EU. The potential weakening of the financial condition of European banks could also have an impact on Poland. The Polish financial sector could experience a drop in a share of foreign capital as many Eurozone banks may have problems holding their assets in Polish financial institutes.

• The analysis also needs to stress the repositioning of the main political actors following the crisis across the eurozone over the past few years. The negotiations on the banking union have confirmed that Germany has emerged as an undisputed leader within the EU. France's contribution to the debate has been rather weak, and perceived as a voice of one of the countries from the 'weakened South'. The course of the negotiations has also exposed the relatively weak position enjoyed by the European Commission *vis-à-vis* that of the national governments, calling its role as a decision-maker into question. It remains to be seen whether the European Parliament will want to and will be able to shape the final draft of the agreement in any discernible way. The parliament will nonetheless find itself under considerable pressure to adopt the relevant directives as soon as possible, before its current terms ends in May and the balance of power changes after the elections, which are likely to result in a more eurosceptic chamber.
The structure of the banking union itself will also change the power relations between the different EU institutions. Its establishment will create a completely new and powerful actor in the form of the Single Resolution Board, and it will strengthen the position of the ECB thanks to the bank's new supervisory powers. The role of the European Commission within the banking union will be restricted to purely technocratic measures (such as requesting the Council of the EU to change its decisions on restructuring plans for banks). Meanwhile, the European Parliament is unlikely to have any powers to intervene on issues relating to bank restructuring.

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