Global Economy and Development at BROOKINGS

# KEY ISSUES ON EUROPEAN BANKING UNION

## TRADE-OFFS AND SOME RECOMMENDATIONS

Douglas J. Elliott

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# KEY ISSUES ON EUROPEAN BANKING UNION
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## OVERVIEW

European leaders have committed to moving toward a banking union, in which bank regulation and supervision, deposit guarantees, and the handling of troubled banks will be integrated across at least the euro area[1] and possibly across the wider European Union. This is quite positive for two reasons. Most immediately, it will help solve the euro crisis by weakening the link between debt-burdened governments and troubled banks, where each side has added to the woes of the other. In the longer run, it will make the "single market" in European banking substantially more effective.

Unfortunately, it is much easier to endorse the concept of a banking union than it is to design and implement one. Banks are central to the European financial system, supplying about three quarters of all credit, and are therefore critical to the functioning of the wider economy in Europe. Their supervision is not just a technical issue; it requires many subjective judgments that have serious implications for credit provision, economic growth and jobs. Choices about how much credit banks provide, and to whom, strongly affect the relative performance of national economies and individual businesses and families. Not surprisingly, national governments have been extremely reluctant to give up control over more than €30 trillion of bank assets and are doing so now only because of the severity of the euro crisis. Designing integrated bank supervision will require fighting out how power will be divided among various European institutions and national authorities.

Nor is it the case that we know the right answers and have merely to summon the political will to push them through. Financial regulation is a balancing act, requiring judgments about the relative importance of many things, including:

- Dealing with the short-term euro crisis versus long-term improvement of the "single market" in financial services in the EU.
- The trade-off of economic growth and financial safety. It is well established that many safety margins in banking carry with them an economic cost[2].
- The efficiency of supervisory centralization versus the benefits of local knowledge.
- The efficiency of a single regulator versus the benefits of multiple specialized regulators, such as for

consumer protection or specialized financial institutions like savings banks.

- Supervisory independence from political interference versus accountability.

These choices are inherently subjective, since they require trading off one set of policy benefits for another. (In most cases, we do not even have sufficiently developed theory to know the magnitude of the tradeoffs.) Adding to the political difficulties, some aspects of a banking union directly involve the allocation of costs of significant magnitude and the risk of future costs that could be even higher. This is particularly true for the establishment of integrated deposit guarantee funds and the creation of new rules and funding sources for resolving banks on the edge of insolvency. Naturally, divvying up the pain and the risk will be very complicated, with all sides arguing cogently for minimizing their own share.

The body of this paper addresses a host of detailed questions about the design of the banking union, laying out the views of different analysts and the proposals from official bodies, as well as providing my own views and recommendations. The key policy choices include:

**Which countries should be in the banking union?** The logical choices are three: (1) just the euro area members; (2) the entire European Union; or (3) the euro area, plus volunteers from the remainder of the EU. The September 12th proposal of the European Commission (Commission) recommends the third alternative[3]. It would be better to include the whole EU, but that is politically impossible for now, particularly in light of the United Kingdom's opposition. Therefore, the "eurozone plus volunteers" option does appear best. It includes the entire eurozone, which is essential if banking union is to help solve the euro crisis, and it paves the way for a future expansion to include the whole EU. On the downside, there will be many complications from combining members who use the euro with ones who do not, including the need to coordinate among multiple central banks and to give appropriate weight to the views of non-euro members of the banking union.

**Who should be the main European-level supervisor?** The main choices are: (1) the European Central Bank (ECB); (2) the European Banking Authority (EBA); or (3) a new, independent authority. Here, too, politics and practical considerations will prevent the best long-term option, which would be a much-enhanced EBA as the supervisor, working closely with the ECB. In the long run, the EBA's role as guardian of the EU-wide single market and its pure focus on bank supervision makes it the right focal point for European supervision, the role for which it was designed. However, the ECB is central to the eurozone and is crucially important in the management of the euro crisis, which is more pressing for now. This has made it nearly inevitable that the ECB will play the main role.

The commission recommends that the ECB be the European-level supervisor, acting within an overall supervisory framework set by a "single supervisory handbook" created by the EBA. A central role for the ECB does bring a number of advantages. However, it would be better to have a new authority that is allied with the ECB, but not directly part of that organization. The commission's proposal provides for an internal division within the ECB but allocates the ultimate power to the ECB's governing council. This gives the ECB an uncomfortably large accumulation of power in a Europe with no effective counterweight and it raises the risk of tainting the ECB's monetary policy with too close an association with supervisory concerns and vice versa.

**How should responsibilities be divided between the ECB and national supervisors?** There is a spectrum of possibilities here, ranging from complete centralization and the abolition of national supervisors all the way to leaving the present system. In practice, the arguments lie within a narrower range. There is a strong consensus that the national supervisors should remain and should shoulder the day-to-day responsibilities, given their existing infrastructure, accumulated expertise and local knowledge. On the other hand, most everyone agrees that the European-level authority must have the ultimate power, including telling the national supervisors what to do, and will need to be quite directly involved with cross-border banks and probably the largest of the national banks. The commission proposal is for the ECB to be the ultimate supervisory authority within the banking union (as long as it follows the EBA's supervisory handbook.) The ECB would have the power to directly supervise any bank and to direct the national supervisors in their own activities. However, there is the explicit assumption that the ECB will choose to leave the bulk of normal supervisory activity to the national supervisors. This overall approach is the right one, although it will take some time to find the optimal balance in practice. In that sense, it is like prescriptions for being a good manager: provide clear direction but do not micromanage. This is much easier to say than to do.

**Which banks should be covered by the banking union?** The commission proposes the right answer, to include all banks in the member states of the banking union. German officials have urged that public, cooperative, and small banks, of which it has many, be left out of the banking union's supervision entirely. It is said that they have safer business models and that their small size means they are not of systemic importance. However, there are many dangers in excluding any set of institutions, particularly ones that have strong local political ties and therefore may be tempted to make noneconomic decisions in the future. The likely compromise is to include all the banks, but to create a strong presumption that the ECB will not take an active role in their supervision outside of exceptional circumstances. This is not ideal, as it could provide a quasi-immunity from European oversight, but it would probably not be fatal.

**Should any other financial institutions be covered by the banking union?** There has been relatively little discussion of the potential systemic risks represented by non-bank financial institutions in Europe. This does not appear to be a serious threat at the moment, and it therefore may not be worth the political difficulties to spotlight this issue. However, the new institutional structure should be designed bearing in mind the possibility that serious systemic risks could develop outside of the banks over time.

**What European-level body should handle the resolution of troubled banks?** There is a range of options for a resolution authority: (1) the ECB; (2) the European Stability Mechanism (ESM); (3) the EBA; (4) a new deposit guarantee fund; or (5) a new resolution authority. The best option seems to be a new authority, possibly with combined responsibility for resolution and deposit guarantees. Resolution activities can require committing taxpayer funds, especially in a severe crisis. They also entail allocating losses across various parties. Both attributes match very poorly with the political independence and technical nature of central banking activity, which is why the ECB would be a bad choice. On the other hand, the ESM does have fiscal and distributional responsibilities, but is probably too closely tied to the national governments and with too cumbersome a decision structure. The EBA both lacks the clout to enforce the necessary tough decisions and is too closely tied to its supervi-

sory role, which might taint its ability to take resolution actions that put previous supervision in a bad light. A new authority would not have any of these disadvantages. The deposit guarantee function is closely related to resolution, which might make a combination natural, although this would not be free of conflicts.

**Who should run the European deposit guarantee fund?** A new authority is almost certainly the best answer, for essentially the same reasons as just discussed for a resolution authority.

**How should the losses from insolvent or restructured banks be divided?** This breaks down into two questions. Who pays for losses that already exist, whether recognized or not, and how will the cost of future losses be divided? The right answer on past losses is fairly clear: they should be evaluated transparently and then explicitly divided up. In particular, the troubled countries of the eurozone should not expect to slip the losses from their banks onto the books of the new European deposit guarantee or resolution funds as a backdoor subsidy for their national governments. Explicit aid may be appropriate; implicit aid in this manner is not. Future losses are best dealt with through a system of prefunding, in which premiums are charged to the covered banks. Ideally, the premiums would be risk-adjusted so that banks that present more of a risk of a future rescue must pay more.

All of the preceding is focused on the losses that taxpayers end up bearing. However, one of the keys to an effective resolution regime is to maximize the extent to which any losses are borne by shareholders and debtholders. This excludes unsophisticated depositors, who should be protected both for their own sake and to avoid damaging bank runs.

**What will be the impact of the U.K. remaining outside of the banking union?** Leaving Europe's dominant financial center, the City of London, outside of the banking union raises serious concerns. There is a real risk that two supervisory regimes will develop in practice, one in London and the other on the continent. This could encourage regulatory arbitrage, where activities shift to whichever locale provides the lighter regulation for that activity. Moreover, there is also a risk that a single regime develops, but that it is the ECB's supervision that effectively annexes the rest of the EU. A single supervisory regime for Europe would be good, but only if it has the right governance structure, so that all concerned can defend their viewpoints and their interests. Having a eurozone entity effectively dictate overall EU policy is not appropriate and would ratchet up tensions with the U.K. sharply, especially given the often quite divergent views of finance and its regulation that are espoused by the U.K. as compared to the continent. In the worst case, tensions of this nature could help push the U.K. to exit the entire EU.

The commission's proposal attempts to ameliorate this issue by cementing the EBA's legal position as the overseer of the supervisory framework for banking in Europe (particularly by making it the author of a "single supervisory handbook" that would bind the ECB and all other supervisors in the EU) and by offering a new voting structure in the EBA to protect non-members of the banking union. The intentions are laudable, but it is not clear that either step will be very effective. Unfortunately, there is no obviously superior answer, given the U.K.'s unwillingness to join the banking union or the eurozone. There will simply be a major source of potential conflicts that will have to be managed carefully over time. Given goodwill from all concerned, it should be workable, but that premise may not always be fulfilled.

**Timing and transition issues.** Once the overall design choices are made, there will be a host of critical issues to be decided about the timing of changes and the transitional arrangements from now until the new structures are fully in place. This is very important, but lies outside of the scope of this paper. I do, however, strongly recommend that near-term considerations not be allowed to overwhelm the need to get this right. There is a danger that the focus on the immediate euro crisis will lead to answers that create further crises in the medium to long term.

## BACKGROUND

### What is a "banking union"?

In recent months, the leaders of the Euro Area have committed themselves to moving expeditiously toward a "banking union." The concept of a banking union is an analogy to the monetary union that already exists in the euro area and the political union toward which many members strive. It is a term of art, without precise meaning, but generally refers to a structure under which nations coordinate their banking systems in at least three ways:

- **Common regulation and supervision of the banking system.** This means applying the same rules to banks in different countries and supervising compliance with these rules in a common manner, overseen by a single ultimate authority. National supervisors may retain substantial powers, delegated from the ultimate authority and subject to its intervention. The common approach may be limited to the dominant banks, with smaller banks remaining subject solely to national authority, at least in the ordinary course of activity.

- **Common management of the "resolution" process for troubled banks.** When a bank is in danger of insolvency, the problem may be resolved through a restructuring process that includes liquidity assistance, capital injections, or other forms of aid. A restructuring into a "good bank" and a "bad bank" will often be part of the solution. In the event of actual insolvency, decisions need to be made about how any losses are divided between investors, creditors, trading counterparties, taxpayers, deposit guarantee funds and other parties. Authorities may also step in to manage the bankruptcy or similar insolvency proceedings, if necessary to preserve the functioning of the financial system. Resolution processes in Europe remain essentially at the national level, with some cross-border cooperation for international banks. In a banking union, there would need to be a common process, most likely managed by a single resolution authority.

- **A common deposit guarantee fund or a fund that backstops national guarantee funds.** Currently, deposit guarantee funds are purely national. In addition, the rules about how protection is provided, to whom, and at what levels differ considerably across countries. Virtually all observers believe that a banking union would be incomplete without either a common guarantee fund or at least a fund that would guarantee the guarantors, so that depositors would no longer need to be concerned about whether their national guarantee systems would remain solvent.

### Why is Europe considering it?

There are at least five main reasons why Europe is committing itself to a banking union. For the most part the implications of these various rationales are consistent, but there are also tensions between them. Key structural choices about the banking union will often hinge on the prioritization of these various objectives.

- Dealing with existing bank weaknesses that contribute to the euro crisis.
- Reducing the risk that banking will contribute to later stages of the euro crisis.
- Restoring the effectiveness of the monetary policy of the ECB.
- Reintegrating the European banking system.
- Fixing long-standing problems with the "single market" in banking in the EU.

**Dealing with existing banking problems that contribute to the euro crisis.** The crisis was partially caused by and very considerably exacerbated by national banking crises. In some countries, particularly Ireland

and Spain, failing banks added massive liabilities to the balance sheets of the sovereigns, weighing them down. In other countries, such as Greece, the problems of the sovereigns endangered the banks through various mechanisms, but particularly by raising questions about the value of the large bank holdings of government bonds. These two sets of mechanisms also combined to make each other worse, with sovereigns pulled down by increasingly troubled banks whose woes have been made much worse by the problems of their sovereigns. The interaction of troubled banks and troubled sovereigns makes it clear that the eurozone would be considerably more stable if banks were anchored in Europe and not tied so closely to the sovereigns of their home country.

One path of financial contagion has particularly sparked the current move toward a banking union – the risk, and in some cases reality, of national bank runs. Fears about default on national debts and/or withdrawal from the euro motivate many citizens of troubled countries to move their funds outside of the country. Unfortunately, this almost always means pulling money out of the banks in that country. This kind of bank run, even when it occurs in slow motion, gravely compromises the solvency of the local banks. At a minimum, it has forced many of them to rely on the ECB for liquidity life support, which does not reassure anyone about the long-term ability of these banks to survive.

A banking union, particularly the prospect of a mutualization across borders of the potential costs of backstopping deposits and resolving troubled banks, would reduce the risk of this kind of downward spiral in the weaker nations. For countries such as Ireland that have already invested large sums into resolving troubled banks, there is even the possibility that some of this burden will be shifted retroactively onto the broader shoulders of the eurozone nations as a whole, perhaps through the ESM.

**Reducing the risk that banking will contribute to later stages of the euro crisis.** In addition to dealing with banking problems that have already surfaced, there is the prospect that a banking union will avoid the worst of potential future problems. At a minimum, it should make it easier to handle the troubles as they arise. Thus, a banking union would reduce the fears of depositors, investors, and others that new countries would find themselves caught up in the downward spiral of failing banks leading to failing countries and vice versa.

**Restoring the effectiveness of the ECB's monetary policy.** The monetary policy of every central bank is primarily effectuated by nudging the key financial institutions and markets to change the price and availability of credit. The processes by which central bank moves are translated by the financial sector into changes in lending conditions are referred to as the "monetary transmission channels."

When the monetary transmission channels are working effectively, central bank moves translate fairly rapidly and effectively into changes in credit conditions for the ultimate customers. Sometimes, though, a central bank will find itself "pushing on a string" where the steps it takes to encourage cheaper and more readily available credit are ineffective, as reductions in policy interest rates fail to overcome other factors that keep banks from lending. This is true to a substantial extent today in many parts of the euro area. The opposite can also be true in boom times, when tighter monetary policy can fail to find traction in an overly optimistic market as lending is perceived to be highly profitable and low risk.

Banks dominate the financial system in Europe, providing about three quarters of all credit to the private sector. Unfortunately, banks today are facing very adverse conditions that often make it difficult to persuade them to lend even to creditworthy businesses, except at high rates. Most banks are still suffering from the after-effects of the 2007-09 global financial crisis. On top of this, they are adjusting to a wide range of regulatory changes, many of which are not yet fully defined. The uncertainty and higher regulatory burden increase banks' caution about lending[4]. Perhaps most importantly, Europe as a whole is in recession and parts of the continent are suffering very severely, adding still further risk to lending.

The ECB wants to encourage more lending in order to foster economic growth in this time of recession. However, the serious problems in the banking sector make it difficult to accomplish this, requiring the ECB to take emergency measures to overcome the problems in the monetary transmission channels. An effective banking union would help restore normal banking operations and make ECB actions easier.

**Reintegrating the European banking system.** One of the key problems with monetary transmission channels in Europe is that the integrated European money markets have temporarily disintegrated into a series of national markets. In particular, banks are often unwilling to lend to banks in other countries. This contrasts with the pre-crisis period when there was a very active cross-border market. The reemergence of national money markets presents a grave challenge for the ECB, since its traditional instruments only allow it to influence the price and availability of euros in the eurozone as a whole. Under current conditions, moving its policy interest rates for the euro area has quite different effects in different countries, which creates virtually insoluble problems for managing monetary policy.

This disintegration of the European banking market also destroys many of the advantages envisioned when the EU moved to create a unified financial market. It is nearly impossible to have an integrated market under conditions where interest rates and credit availability in different countries vary so much.

The institution of a banking union is intended to restore confidence in banks all across the eurozone, allowing funds to flow freely across borders again.

**Fixing longstanding problems with the "single market" in banking in the EU.** Observers have pointed out for years that a truly unified European banking market requires much stronger European-level institutions to supervise banks and to manage the resolution process when they become troubled. However, national authorities wanted to retain the ability to exert substantial control over their own banks and therefore resisted steps to truly unify the European banking market. Politicians and supervisors resisted cross-border banking mergers and equal application of rules in all EU countries, and often meddled in particular bank decisions. Even when they agreed to the establishment of an EU-level EBA, in response to the severe financial crisis, they ensured that it started with very little authority for direct action, forcing it to rely on persuasion of the national banking authorities.

The supremacy of national supervisory authorities and governments allowed the continuation of national banking markets with significant variations between them, despite the fact that many key rules are set at the European level. These distinctions have come back to haunt the eurozone, and the EU, as the financial markets now treat many of these national markets quite differently from each other, helping to

fuel the euro crisis. On the positive side, this crisis provides the impetus to overcome parochial interests and organize European banking more intelligently. Virtually all of the steps being considered toward a banking union would also assist in furthering the single market in financial services.

As noted, there are areas where a concern for meeting one of these five objectives would push in a different direction than concern for meeting another. For example, if dealing with the immediate problems of the euro crisis is the top priority, this would tend to argue for: relatively quicker action; a narrower focus on the eurozone; and a stronger role for the ECB. On the other hand, a concern to complete the integration of the single market in financial services and to restore a functioning European financial market would push toward: more carefully constructed and more deliberate action; insistence on EU-wide initiatives; and a consequent stronger role for the EBA and other EU institutions.

Although most analysts support pushing forward with a banking union in the hopes of tackling both the longer and shorter-term problems at the same time, there are dissents from this view. For example, the European Shadow Financial Regulatory Committee (2012) asserts that "the introduction of the Single Supervisory Mechanism in which the overall supervisory responsibility for the eurozone banking sector is transferred to the ECB already in 2013 requires agreement within the EU on controversial economic, legal and political issues." The committee argues that it is "unfortunate that European crisis management has become hostage to the negotiations to create a European Banking Union," since they see proper design and implementation of a banking union as being a considerably longer-term project than is consistent with the urgent need to deal with the euro crisis.

## How does a banking union intersect with moves to a fiscal union?

The eurozone is making major strides toward coordination of national fiscal policies and there is the real possibility of further steps toward fiscal union. These include eventual mutual debt guarantees, for at least a portion of national liabilities, and/or the creation of a central European Treasury deploying significant resources. These moves toward a greater degree of fiscal union to complement the existing monetary union intersect in significant ways with a banking union.

Most obviously, governments may need to provide fiscal support for deposit guarantee funds or to assist in the resolution process for banks. Effectively this would represent yet another aspect of fiscal union and one of real significance. Ireland and Spain, among others, have found bank resolution a very expensive process when done at a national level, contributing heavily to their sovereign debt burdens. Moving this to the European level provides a much larger and more stable base of support, but also effectively spreads the costs across all the governments involved. One implication is that a strong country such as Germany could find itself contributing significantly to bank rescues in more troubled countries through a relatively automatic mechanism in situations under which it would not have voluntarily provided that same level of support to the sovereigns had they remained responsible for their own banks. Of course, the flow could work in reverse as well. Germany has experienced major losses at some of its banks and there are persistent concerns of still more losses to come. Conceivably, a poorer nation with a relatively strong banking system might end up as a net contributor to a German bank rescue.

There are also moral hazard issues that arise if banking union is more complete than fiscal union. It is

already true that banks are major holders of the government bonds of their home countries, partly out of choice, partly out of explicit regulatory pressure to own highly liquid assets, and sometimes in response to behind the scenes pressure from their home governments. There is, however, some limit to how far this can be pushed, since loading up local banks with a country's debt can make the banks riskier, with attendant problems for the sovereign. If, though, much of the pain from those bank problems is shifted to a European guarantee fund, then it will be all the more tempting for national governments to push their debt onto the balance sheets of their banks, to the extent European authorities will let them.

Banking union also affects fiscal union in the other direction, making national fiscal conditions more stable and thereby easing the difficulties of creating more fiscal coordination. Removing the potential for major increases in national debt burdens as a result of the collapse of their national banking systems should help significantly.

## How would a banking union affect monetary and macroprudential policies?

Monetary policy could be quite significantly affected by a banking union, at least while the euro crisis remains an active problem. As noted, monetary policy achieves its principal effects by changing the availability and price of credit. Therefore, central banks rely on financial institutions to transmit moves on interest rate policy into the broader economy. Under normal conditions, the direct impact of central bank moves is very considerably amplified by reactions by banks. In the current crisis, it appears that a number of banks are hoarding any liquidity they can find, in order to have greater capacity to deal with potential runoffs of their deposits and bonds and to deter such runoff by showing that they can do so.

If European banks were perceived as safer due to the advent of a banking union, then they would be more prepared to redeploy the reserves they hold at the central bank by lending them out. Thus, the monetary transmission channels would be unclogged and monetary policy would work in more predictable and effective ways again.

In recent years, a consensus has developed that there has been a gap in regulation of the financial system, falling between monetary policy and other macroeconomic policies that operate at the level of the economy as a whole, and traditional prudential (or "safety and soundness") regulation of individual financial institutions. New "macroprudential" policies are being developed that operate at the level of the financial system as a whole, with the intent of reducing the frequency and level of damage to the wider economy from financial crises. (Traditional prudential regulation of individual institutions has been renamed "microprudential" policy to distinguish it.) Such policies would include systemwide increases or decreases in capital or liquidity requirements for banks or the tightening or relaxation of credit standards for mortgages or other debt, such as by altering the maximum loan to value ratio[5].

Creating a banking union would have pros and cons with regard to macroprudential policy. It would make it distinctly easier to deal with credit bubbles or crunches that were broader than in a single country, but might make it somewhat more difficult for national authorities to tackle homegrown problems, if too little flexibility is provided for national responses. In addition, choices about the structure of the banking union would also tend to strengthen or weaken the

### The Key Institutions of the European Union*

The European Union is governed principally by four institutions. The highest one, the European Council, is composed of the heads of state or government of the member states. It meets four times a year and defines the political priorities and general direction of the EU. The European Commission represents the "European interest" of the EU as a whole. In addition to being the closest thing to an executive branch that the EU has, it has exclusive power of initiating legislation in most policy fields under EU competence. It does so by drafting specific bills, to be voted on by the two other main institutions of the EU: the European Parliament and the Council of the European Union. The European Parliament represents the interests of European citizens and is directly elected with representation from each country. More populous nations have more members, but the numbers of members from each nation resulted from political bargaining during treaty negotiations and is not strictly proportional to population. The Council of the European Union is composed of the relevant ministers of each country, and thus represents the interests of the member states. Most decisions by the council are taken by a super-majority known as "qualified majority"; the most sensitive issues require unanimity.

Once the commission has submitted proposed legislation, parliament and council can make amendments before voting. Should they disagree after holding two readings each, a formal conciliation procedure is launched to attempt to find a common position. The commission is involved in the whole process, providing comments on the texts of both parliament and council. Once laws are passed, they are implemented at either the EU level or the national, depending on the type of law (regulations, directives, and decisions are all binding laws that take precedence over national law, but differ in the way they are implemented). The commission and various specialized bodies, such as the European Banking Authority, monitor and ensure the proper application of EU law. The commission has the power to bring legal cases against non-compliant member states and to impose sanctions against individuals and companies who are in breach of EU law.

The EU also has judicial bodies, which are not directly relevant to this paper.

* I would like to thank Justin Vaisse and Antonia Doncheva for substantially redrafting my first version of this text box.

role of various institutions in setting macroprudential policy, with the ECB potentially the biggest winner from this change, simply because its role in overseeing the banks will almost certainly expand greatly.

A full discussion of macroprudential policy in Europe is beyond the scope of this paper, but decisions in this area could be quite important, as they have the potential to lower the risk of damaging bubbles in housing or other areas in the future. Avoiding such bubbles, and their very painful bursting, would make it substantially easier to operate a monetary union going forward.

Millar (2012) expresses some concern that the role of macroprudential policy has not been given enough consideration in the design of the European supervisory mechanism, pointing out that there is no detailed discussion, for example, of the interaction of the existing European macroprudential authority, the European Systemic Risk Board, and the ECB in its new supervisory role[6].

## What has been agreed to date on steps toward a banking union?

The heads of state and government[7] of the nations in the euro area agreed on June 29, 2012 to move toward a banking union, with the initial emphasis of the leaders being on the establishment of a "single supervisory mechanism" involving the ECB on the basis of Article 127(6) of the Treaty on the Functioning of the European Union (TFEU), one of the two fundamental treaties governing the EU. This article allows the Eurosystem of central banks run by the ECB[8] to take on supervisory powers over banks[9].

The leaders noted that the establishment of such a mechanism would open up of the possibility of the ESM recapitalizing banks directly, rather than by funding national governments that would then fund their own banks at their own risk. The European Commission was mandated to present proposals for the single supervisory mechanism and the European Council was requested to "consider these proposals as a matter of urgency by the end of 2012."

The European Commission offered its proposal for a single supervisory mechanism on September 12, 2012[10] . The proposal, described in greater detail throughout this report, calls for a new body within the ECB to take on overall supervisory authority for all eurozone banks and those of other EU countries which reach agreement with the ECB about inclusion. National supervisory authorities would continue to be the main day-to-day supervisors, but the ECB would have ultimate responsibility and could take over day-to-day supervision to whatever extent it chose for those banks where it felt this to be necessary. The European Banking Authority is authorized to create a "single supervisory handbook" which would apply across the EU and which the ECB would be required to follow. The voting procedures within the EBA would also be altered under the proposal to make it more difficult for the countries in the banking union to dictate EU-wide policy, a point of particular importance to the U.K. with its very large financial sector and position outside of the eurozone.

In order for these proposals to take effect, the European Council must create regulations to embody the recommendations with whatever changes from those proposals it desires. It is very probable that there will be substantial revisions to the commission's proposals, although it is much less clear what those revisions will be. The commission has urged that regulations be passed by the end of 2012, but key representatives of the governments of Germany and several other nations have indicated that they expect the process to take longer than this. (This might, of course, change if there is a resurgence of the euro crisis of sufficient force.) On the other side, the French finance minister, among others, continues to push for resolution by the end of this year[11].

The use of Article 127(6) gives the European Parliament no formal say in establishing the role of the ECB in banking regulation. There is, however, a real possibility that whatever compromise is worked out will extend beyond what can be created under this article and therefore might require legislation involving the European Parliament. It might even require re-

visions to the fundamental treaties underlying the EU, in which case unanimity would be required and there might be the need for referenda in some countries.

The European Council Summit of October 18, 2012 reached a series of conclusions on banking union, listed as points 4 to 10 of the conclusions related to economic and monetary union:

"4. We need to move towards an integrated financial framework, open to the extent possible to all Member States wishing to participate. In this context, the European Council invites the legislators to proceed with work on the legislative proposals on the Single Supervisory Mechanism (SSM) as a matter of priority, with the objective of agreeing on the legislative framework by 1 January 2013. Work on the operational implementation will take place in the course of 2013. In this respect, fully respecting the integrity of the Single Market is crucial.

5. There is a need to ensure a clear separation between ECB monetary policy and supervision functions, and the equitable treatment and representation of both euro and non-euro area Member States participating in the SSM. Accountability takes place at the level at which decisions are taken and implemented. The SSM will be based on the highest standards for bank supervision and the ECB will be able, in a differentiated way, to carry out direct supervision. It will also be in a position to use the effective powers conferred on it by the legislation as soon as it comes into force. In addition, it is of paramount importance to establish a single rulebook underpinning the centralised supervision.

6. It is important to ensure a level playing field between those Member States which take part in the SSM and those which do not, in full respect of the integrity of the single market in financial services. An acceptable and balanced solution is needed regarding changes to voting modalities and decisions under the European Banking Authority (EBA) Regulation, taking account of possible evolutions in the participation in the SSM, that ensures non- discriminatory and effective decision-making within the Single Market. On this basis, the EBA should retain its existing powers and responsibilities.

7. The European Council calls for the rapid adoption of the provisions relating to the harmonisation of national resolution and deposit guarantee frameworks on the Commission's legislative proposals on bank recovery and resolution and on national deposit guarantee schemes. The European Council calls for the rapid conclusion of the single rule book, including agreement on the proposals on bank capital requirements (CRR/CRD IV) by the end of the year. 2

8. In all these matters, it is important to ensure a fair balance between home and host countries.

9. The European Council notes the Commission's intention to propose a single resolution mechanism for Member States participating in the SSM once the proposals for a Recovery and Resolution Directive and for a Deposit Guarantee Scheme Directive have been adopted.

10. The Eurogroup will draw up the exact operational criteria that will guide direct bank recapitalisations by the European Stability Mechanism (ESM), in full respect of the 29 June 2012 euro area Summit statement. It is imperative to break the vicious circle between banks and sovereigns. 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 recapital-

ize banks directly."[12]

These summit conclusions generally support the Commission's proposals, but leave room for further modifications and compromises.

## Does starting with integration of bank supervision make sense?

The decision to move first on European integration of bank supervision, without equivalent progress on bank resolution and deposit guarantees, is primarily a political decision. For all its difficulties, it will still be easier to gain agreement on supervision as opposed to the other two pillars, which require a discussion of sharing financial pain. It is also potentially much easier procedurally, since it allows the use of an existing treaty provision as the legal basis for the reforms, (Article 127(6) of the Treaty for the Functioning of the European Union).

Virtually all policy analysts argue that there are serious problems and dangers in designing bank supervision before knowing how resolution and guarantees will work. Verhelst (2012) argues that by "postponing essential decisions on two out of the three pillars of banking union, the EU risks making the same mistake as when it decided to create an EMU [Economic and Monetary Union]. If the flaws in the design of the EMU teach us one thing, it is that ambitious integration projects should be put in place in a coordinated manner." He continues "common supervision risks failure if it is not backed by common responsibility for bank crises." He goes on to argue that the difficult issues must be addressed transparently rather than trying to design banking union "by stealth."

European Shadow Financial Regulatory Committee (2012) contends that "[i]n view of the critical role of resolution procedures for the supervisory authority to be effective and credible, the allocation of supervisory authority to the ECB without having resolution rules in force would create ambiguity with respect to the consequences of supervisors' findings and recommendations. Therefore the [bank recovery and resolution] directive should be implemented on the same timetable as the SSM.[13]"

Davies (2012b) asserts that the approach of starting with supervision, which is closely tied to the decision to use Article 127(6), is flawed. "For starters, the existing treaty cannot be used to create a single European resolution authority, leaving an awkward interface between the ECB and national authorities. Nor can it be used to establish a European deposit protection scheme, which is arguably the most urgent requirement, to stem the outflow of deposits from southern European banks."

Beck (2012) summarizes the views of several authors of chapters of the book he edited who "criticize the sequential introduction of supervision and bank resolution, which might lead to less, rather than more, stability, as conflicts between the ECB and that national resolution authorities are bound to arise. Schoenmaker argues for the joint establishment of a strong European supervisor (the ECB) and a credible European Deposit Insurance and Resolution Authority.[14] "

Sapir (2012) summarizes the views of a committee of academics that "existence of a workable resolution regime is a prerequisite for the effectiveness of a supervisory mechanism. By contrast, the creation of a European deposit insurance system could come later; on this point, the ASC report was clear to the effect that moral hazard effects of deposit insurance can only be avoided if effective resolution and supervisory

mechanisms are in place."[15]

However, the strong consensus that it would theoretically be better to proceed forward simultaneously on the key pillars of banking union, does not mean that analysts necessarily disapprove of the approach chosen by Europe's leaders, given the political, procedural and legal realities. In fact, Veron (2012) appears to speak for a majority of analysts in viewing the Single Supervisory Mechanism as "the first step on a long journey" and the fact that it "does not immediately lead to a fully consistent and complete banking policy framework" as "an unavoidable consequence of the ambition and complexity of the banking union project. "[16]

## What is the right geographic scope of the banking union?

Considerations of a banking union are seriously complicated by the fact that only 17 of the 27 EU nations are currently in the eurozone, although 7 of the remaining 10 outsiders have treaty commitments to eventually join the euro area[17]. The first major complication is that the ECB sets monetary policy for the 17 eurozone members, and is currently a very large liquidity supplier to the banks in most of those countries. On the other hand, there are separate national banks that perform those functions of monetary policy and back-up liquidity provision in the other 10 countries. Many of them also have some role in banking supervision within their national borders. Therefore, extending the banking union beyond the 17 brings in a host of complications and coordination issues.

Fortunately, the most important rules affecting banks in the EU are set at the EU level, based on legislation proposed by the European Commission and revised and ultimately passed by the European Parliament and the Council of the European Union. As with other major economic sectors, the deliberate intent is to foster a "single market" for the entire EU, with oversight from Brussels. Further, in the case of banking, the EBA is the central coordinator for all 27 nations.

All of this is complicated further by the fact that Europe's dominant financial center is the City of London, which is housed in a non-member of the euro area. This is discussed at length below.

There are three main logical possibilities for deciding which countries are included:

**The eurozone.** At a minimum, the entire eurozone must be part of the banking union in order to achieve the overall financial stability objectives that provide much of the impetus for establishing that union. If any euro area nation were left out, it could easily become either a weak link or a perceived "safe haven". If Greece, for example, were left out of the banking union, it would likely encounter high levels of capital flight as deposits were withdrawn and moved to countries that would be in the union. On the other hand, if Germany chose not to join the banking union it would be seen as a vote of no confidence in that union and would considerably reduce the fiscal resources available to deal with banking problems in the union. Germany could also be a recipient of capital flight from nations in the union. These issues are compelling enough that there are few, if any, serious proponents of a banking union that excludes any members of the euro area. (The exception might be views on Greece, but only in the case of observers who believe Greece will or should exit the eurozone.) The International Monetary Fund, for example, has stated that "while a banking union is desirable at the EU27 level, it is critical for the euro 17[18]."

**The European Union.** At the other end of the spectrum, including all 27 EU countries would be the most logical way to preserve the EU's single market in banking and financial services. Many observers support the establishment of the banking union for the full EU, but few believe that there is the political consensus necessary to make this happen in the near future. (In part this is a reflection the U.K.'s strong aversion to joining such a union.)

**The commission proposal:** The eurozone plus voluntary participants. The European Commission has recommended mandating that the eurozone countries join the banking union while allowing other EU members to join voluntarily, with the agreement of the ECB. This approach would be most clearly logical if the goal is to eventually include the entire EU in the banking union, while recognizing that political realities will not currently allow this. There are, however, drawbacks to allowing additional voluntary participants.

**Other views.** There is a range of views among analysts. Pisani-Ferry (2012a), for example, praises the idea of a banking union encompassing the whole EU, but states "our assessment is that creating a banking union that would include all EU member states is too high an ambition to be practical, at least for the foreseeable future." They further note that allowing additional voluntary participants "would create additional risks and uncertainties, for example the coordination of liquidity policies by different central banks in different currency areas during a funding crisis. It would also be incompatible with some policy choices, such as if the ECB is chosen as the single supervisor of the banking union.[19]" (emphasis added). Wyplosz (2012) opposes dragging non-eurozone countries into the banking union, saying the "commission is making a grave mistake when it proposed an EU solution for a [eurozone] problem."

Speyer (2012) states that the "objectives of maintaining financial stability in an interlinked financial market and of preserving the single financial market for financial services require that the geographic scope for an EU supervisory mechanism be the entire EU-27[20]." Carmassi (2012) also calls for the banking union to be built at the EU level and states that if some member states (read the U.K., in particular) threaten to veto such an approach, "then it would perhaps be preferable to offer them an opt-out rather than excluding all non-euro member states from a banking union from the outset."

## Recommendation

**The commission's approach appears to be the best of the options that are feasible in the near term.** It would be much better in the long run to have an EU-wide banking union to assist with the integration of the single market in financial services. The lack of strong EU-wide supervision has been a serious weakness of the single market for a long time and it would be desirable to use this crisis to overcome the obstacles to doing this the right way. Unfortunately, political constraints make it impossible to implement this ideal in the next few years. The role of a banking union in helping to solve the euro crisis is too important to wait until the ideal answer becomes feasible, if it ever does. In the meantime, opening the banking union up to non-eurozone members on a voluntary basis at least provides some impetus toward the better long run solution. It could bring complications, but many of the potential problems are inherent in the close interconnection of the economies and financial systems, regardless of whether a country joins the banking union.

## What are the potential legal bases on which to establish the banking union?

It is critical that the banking union be built on a solid legal foundation, to ensure that the new structures and rules fit within a known framework of law that provides for enforceability, accountability, democratic process and judicial oversight. Without such a foundation, there will be a lack of clarity as to whether decisions about supervision and resolution are being made in an appropriate and legally binding manner. This issue is usually relatively straightforward at a national level, since banking supervisory and resolution structures would almost certainly be set up through the normal, democratic legislative process. Within constitutional limits, national legislatures have broad scope to establish regulatory bodies and the procedures for them to follow.

As with so much else, the issue is more complicated in Europe, since there is the question of national versus European level authority. In a somewhat analogous manner to the approach of the U.S. constitution, the treaties forming the basis of the EU leave powers at the national level unless they fall into specific categories, admittedly often broad ones, that are allocated explicitly to the European level. There is also the basic principle of "subsidiarity", which states that authority should be left at the national level except where tasks need to be at a European level or would be more effectively performed at that level.

There are several potential legal bases for banking union. As noted earlier, the commission, as directed by the heads of state and government at the June summit, proposed the use of article 127(6) of the Treaty on the Functioning of the European Union which allows the council, in consultation with parliament, to "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 approach has two major appeals. First, it embeds the supervisory mechanism firmly in EU treaty law. Second, because this provision already exists in the TFEU, it is potentially substantially faster to proceed on this basis than on some of the other bases described below.

On the other hand, use of Article 127(6) brings some limitations and difficulties. Most obviously, it dictates the choice of the ECB as the core of the supervisory system. It also requires unanimous assent of the EU member states, including those that choose not to participate in the banking union, giving each state a veto. It also uses a procedure that gives the European Parliament little formal power; although this is likely to be worked out in practice by ensuring that there is strong support in parliament for the ultimate arrangements. (Some aspects will require action to modify existing legislation, such as changing the voting provisions within the EBA. This gives parliament leverage, since it has equal power to the council on those matters.) The question has also been raised as to whether "policies relating to the prudential supervision of credit institutions" is sufficient authority to give the ECB the power to directly supervise banks as opposed to helping set policy. Davies (2012b) refers to this article as "a thin legal basis for establishing a pan-European supervisor with direct responsibility for individual institutions, and it was clearly not intended for that purpose. Indeed, Germany agreed to the wording only on the understanding that the ECB could not be a direct supervisor." Millar (2012) also expresses the concern that "[w]hether TFEU 127 (6) provides sufficient basis for banking union may yet be challenged,[21]" focusing on the point about "policies".

Nonetheless, I suspect that this wording will prove not to be a problem in the end, given the oft-observed ability of European lawyers to expand interpretations of the European treaties, especially where the wording provides such a plausible case for action.

At the other end of the spectrum, virtually unlimited flexibility could be obtained by amending the EU treaties in order to establish the desired legal basis for the banking union. It may be that this option will eventually be used to clean up the legal structure of the banking union, but it is certainly not likely to be the choice anytime soon. The two crippling problems are that the treaty process takes years and would require not only unanimity among the member states, but parliamentary votes in many countries and even national referendums in some cases, including Ireland. Article 127(6), in contrast, would side-step the need for a longer and more involved approval process, since it uses an existing treaty provision. Having emphasized the daunting nature of treaty changes, it should be noted that the authority for the euro area member states to negotiate a treaty to establish the ESM was created via a two-sentence addition to the TFEU. So, treaty revision is certainly not impossible if there is a sufficiently compelling reason.

An alternative to 127(6) that also relies on existing treaty provisions would be to use Article 352, which states, in part, "[i]f action by the union should prove necessary, within the framework of the policies defined in the treaties, to attain one of the objectives set out in the treaties, and the treaties have not provided the necessary powers, the council, acting unanimously on a proposal from the commission and after obtaining the consent of the European Parliament, shall adopt the appropriate measures." This article would provide considerably greater flexibility, such as eliminating the need to center arrangements on the ECB. However, there is certainly a risk that the European Court of Justice, or an assertive national constitutional court, might ultimately rule that the treaties have already provided the necessary powers for some or all of the attributes of a banking union, particularly since Article 127(6) is generally interpreted to allow precisely that for banking supervision using the ECB. It appears more likely that Article 352 would be used as a back-up source of authority for actions taken under Article 127(6) in the event of a very narrow interpretation of that article.

The basic treaties underlying the EU provide still another option, which would be to establish an "enhanced cooperation agreement". If a sufficient number of member states (currently nine) want to embrace closer cooperation, but cannot persuade enough members to make the change for the EU as a whole, they can, within certain limitations, proceed forward on their own while still making use of the support of EU institutions. The commission, council and parliament would have to endorse the agreement and there are a number of safeguards, including the requirement that any member state must be able to join the agreement if it meets the qualifications. Importantly, the treaties indicate that the agreement must be a "last resort" because of the inability to create the desired cooperation within the EU in another manner in a reasonable period of time.

Finally, it would be possible to set up a banking union outside of the European Union structures through an intergovernmental agreement of the consenting member states. However, this would forfeit the ability to use EU entities and legal powers, including those associated with the ECB. It would also create a high potential for conflict with existing EU institutions, laws and regulations, including those of the EBA. This truly does seem the last resort option if all of the alternatives for basing a banking union in EU law were to fail.

Reviewing the options, it is easy to see why the June summit chose to go with Article 127(6) as the legal basis. This is almost certainly the right answer, at least for now, if one agrees that the ECB should be at the center of European bank supervision. As noted, it might be better to clean things up later with treaty revisions, if a convenient occasion arose or if necessity impels, but 127(6) seems to provide a strong legal basis for at least the coordination of banking supervision. On the other hand, if one believes that the ECB should not be central to bank supervision, then it would be necessary to go with one of the other legal bases which are not tied directly to the ECB.

It is not yet clear what the best options are for establishing a sound legal basis for bank resolution and deposit guarantees at the European level. This may well depend on what structure is chosen for those tasks and which powers are brought to the European level. Broadly speaking, however, the range of options would be similar to the list for bank supervision, with the exception that Article 127(6) is probably not applicable because of the focus on bank supervision.

# BANK REGULATION AND SUPERVISION

## How are banks regulated and supervised now?

Regulation, in this context, means the set of formal laws and rules that govern banks. Supervision refers to the application of those rules by an authority empowered to tell banks what they must, may or may not do. It intrinsically involves data gathering and monitoring in order to help the supervisor make choices and ensure compliance.

Currently, many of the most important regulations are already determined at the level of the European Union, as part of the "single market" in financial services. This creates a fair degree of commonality in the rules. However, national regulators can also add their own rules to reflect the unique characteristics of each country and financial system, as long as they do not contravene the European rules.

Perhaps more importantly, how supervisors choose to interpret and implement the rules has a great effect on the safety and performance of their banking systems. Bank supervision involves a large number of judgment calls and there can be systematic patterns of differences in how national supervisors make those calls. For example, supervisors generally have an overarching authority to discourage, or sometimes forbid, activities which appear dangerous to them. National supervisors differ considerably in how frequently they exercise this authority, how insistently they do so, and how they decide such pressure is warranted.

The formal authority of supervisors is illustrated well by a listing of the key powers that the European Commission proposal recommends are given to the ECB within the banking union[22]:

- Authorizing credit institutions to operate.
- Ensuring compliance with minimum capital requirements.
- Ensuring the adequacy of capital relative to risk according to Pillar 2 procedures.
- Supervising the consolidated activities of the banking group.
- Ensuring compliance with leverage and liquidity rules.
- Applying capital buffers.
- Carrying out, in coordination with resolution authorities, early intervention measures when a bank becomes troubled.

The ECB will be given investigatory powers and the authority to order and enforce remedial measures, including levying fines or even closing banks.

A fair amount of supervision occurs by nudging banks in one direction or another, without formally exercising supervisory powers. Supervisors' formal powers are compelling enough that banks will generally try to stay in the good graces of the authorities and are therefore prone to accept advice without forcing supervisors to invoke formal enforcement mechanisms. The use of this influence may extend outside the areas that supervisors are formally empowered to act; for example, by nudging banks to make more loans to certain types of businesses even when there is no legislation or regulation authorizing them to push that goal. This can make supervisors quite powerful in economies such as Europe's that depend heavily on bank lending, with the resulting risk of mixing technical regulation and more political roles.

## Role of Political Authorities

Politicians at the national and local levels have a substantial stake in how their banks are supervised, since the banking system is a large participant in the economy and discretionary actions by banks can make a real difference in multiple ways. Most basically, the economy almost always grows faster in the short to medium term when credit is cheap and easily available, and it grows slower in credit crunches. A politician looking toward the next election will usually want local banks to make loans aggressively, which can be difficult to do if supervision is conservative. (One clear example of this in the U.S. was the way in which politicians pushed back strongly when the Federal Reserve proposed guidance on commercial real estate loans intended to counter a growing bubble in the run-up to the financial crisis.) The volume of bank lending is particularly important in Europe, where bank assets are approximately three times GDP, compared to a bit over three-quarters of GDP in the U.S.

Politicians in many European countries also take an active role at times in influencing the allocation of lending by banks. This can be a form of industrial policy, favoring certain sectors of the economy, and may at times be useful for the economy as a whole. However, it can easily expose banks to excessive risks to one sector or to one overall bet on how the economy will develop and therefore could be forbidden or discouraged by careful supervisors. Political influence can also be a more straightforward attempt to aid certain companies. This is particularly prevalent in economies where the state itself owns substantial stakes in industry, but similar activity occurs even when the favored recipients are in the private sector. The "cajas[23]" in Spain and the "landesbanks[24]" in Germany offer many examples of clientelism of this nature, with resulting large losses on bank loans and the requirement for dramatic restructurings of the financial institutions. Again, conservative supervision could have prevented the worst effects and limited the exposure to the favored firms.

The political importance of decisions made by banks and their supervisors makes it particularly important that supervisors be independent of political influence. This objective is likely to be furthered by the movement of supervision to a European level, further from direct political control. At the same time, there is a need for democratic accountability of supervisors, which is difficult to separate from the influence of politicians who act as the voices of the voters. This will always be a difficult balancing act and one that tends to be aided by appropriate levels of transparency and other safeguards, including sufficient levels of compensation to ensure high-quality staff of integrity will work at the supervisors.

## Current Supervisory Arrangements

Supervisory arrangement differ substantially across Europe, with different degrees of centralization in one or a group of regulatory bodies, different divisions of authority between supervisory discretion and formal legal procedures, and different choices about the particular institution or institutions that act as supervisors. There are many reasons for these divergent approaches:

- Differing economic and financial systems.
- Varying legal, bureaucratic and political cultures.
- Accidents of history.
- Lack of an intellectual consensus on optimal supervisory structures.

There remain very considerable differences in economic and financial systems across Europe, even with

the increasingly greater commonality and integration. Supervisory choices that are right for Germany might be wrong for Greece, and vice versa. National leaders, particularly in smaller countries, naturally worry that centralized supervision might impose an excessively rigid approach that does not take account of these differences.

National supervisory regimes also reflect disparate legal, bureaucratic and political cultures, as well as certain accidents of history. Some countries have strong bureaucratic traditions and cultures that give regulators more independence from influence by politicians and voters. Other nations have a greater emphasis on political accountability and are therefore more leery of vesting power in unelected bodies. History has also pushed some countries in certain directions. For example, the German central bank, the Bundesbank, is revered by many Germans and viewed as an important safeguard against inflation and political influence, reflecting the unfortunate history of the Weimar Republic and the strong protective role played by the Bundesbank since the 1950s. This makes it easier for the Bundesbank to have a more influential role in financial areas, such as bank supervision, although concerns about political accountability recently blocked efforts to shift bank supervision more completely to the Bundesbank.

There is also the key point that no one has found the absolutely optimal way to organize bank supervision. Most basically, we do not know whether a single supervisor is better than multiple bodies. There are clear arguments for one central supervisory body, in terms of clarity of approach, information sharing, efficiency and overall effectiveness. However, there are also arguments for dividing bank supervision by type of financial institution, for example, if there are big differences between how savings banks and other banks work. Alternatively, different aspects of bank supervision may merit different authorities supervising them. For instance, the deposit guarantee or bank resolution funds may need some supervisory powers to protect them from potential losses, especially if there are weaknesses in other supervisory bodies. Consumer protection may need its own supervisory agency, as is the case in some countries. Further, the central bank is often given some direct supervisory powers because they are sometimes considered best suited to ensure financial stability, even in cases where they are not the sole supervisor.

One illustration of the lack of an intellectual consensus is that most countries that suffered in the financial crisis have substantially changed the degree of centralization of their banking supervision. Tellingly, those nations that were more centralized have tended to move toward decentralization and those that were more decentralized tended toward greater integration. Thus, it is pretty clear that scrutiny of the financial crisis has not shown a compelling, single answer for this critical structural issue. Instead, there has been a natural reaction to move away from whatever approach had just failed.

### Role of Central Banks

It is particularly interesting, in light of the ECB's likely dominant role in European bank supervision, to examine whether and how central banks are involved in national level bank supervision. A survey paper by the ECB in 2010[25] found that 16 of the 27 EU members had substantial direct involvement by their central bank in bank supervision and two additional members were planning to give their central banks supervisory responsibility, including the U.K. In 4 of the 16 countries, there were plans to add to the existing supervisory responsibilities of the central bank.

However, this still leaves more than a quarter of the EU members (7 out of 27) where central banks have no supervisory responsibility and there were no plans to change this. Even in the nations with central banks acting as supervisors, other bodies often played important supervisory roles, including in Germany.

This mix of systems is consistent with academic theory, which finds that there are both pros and cons to central banks acting as supervisors. The primary positives of central bank participation relate to information efficiencies, particularly the close link between understanding the state of the financial system and monitoring the individual financial institutions, especially those that dominate the system. Blinder (2010), for example, concludes that it is essential for the U.S. Federal Reserve to be the main supervisor of systemically important banks[26]. Peek (1997) shows empirical evidence that supervisory knowledge can increase the ability to forecast variables important to a central bank's monetary policy. To the extent that giving the central bank supervisory powers creates a stronger and more unified bank supervisor, there is also the potential advantage of a greater ability to force politically difficult actions on banks that are operating unsafely.

On the other side, there are numerous ways in which having responsibility for both bank supervision and monetary policy can adversely impact one duty or the other and ways in which reputational risks from bank supervision could threaten central bank reputation and potentially independence. These are discussed below in regard to the ECB's situation, as they are directly relevant there. In addition, at least one academic study, Boyer (2010), found that the danger of regulatory capture of a central bank could be increased by enhancing its supervisory role.

There are other advantages and disadvantages of central bank involvement in bank supervision. A particularly clear and well-reasoned exposition of the arguments can be found in Goodhart (2000).

## Who should supervise banks under a banking union? Why?

There are three main possibilities for the European-level entity to supervise banks:

**An arm of the European Central Bank.** If the banking union is confined to eurozone countries, and possibly nations that intend to join the euro, then the ECB could reasonably be the ultimate supervisor. This has several major advantages. First, it would make it easier to respond effectively to problems in the banking system that make it difficult for the ECB's monetary policy to work as intended. The ECB is already making ad hoc adjustments to how it deals with banks, such as the types of collateral that it accepts when it lends to them. Being directly responsible for their safety and soundness and having more levers of influence over them would be helpful.

Second, the ECB is almost certain to become a de facto "lender of last resort" for euro area banks, even though this is not an official ECB role under the treaties that govern it. It has become clear that every country or monetary union needs such a lender of last resort and the ECB has effectively been doing this through massive liquidity provision, even to relatively troubled eurozone banks. Making it the European level supervisor for banks would make this role more legitimate and provide better tools to make the necessary decisions. (Most critically, a lender of last resort should generally only lend to solvent banks that have run into liquidity problems. Since solvency and cash

flow problems blend together it would be helpful for the ECB to have a closer knowledge of the banks needing assistance.)

Third, as noted, the treaty establishing the monetary union specifically envisions that the ECB could be given powers in regard to bank supervision. Using Article 127(6) may ease some of the legal challenges that would exist in implementing any new banking union.

There are also a number of concerns about a larger ECB role, which are discussed in the next section.

**The European Banking Authority.** The EBA already exists as the EU-level bank supervisor. The problem is that it has been given very few direct powers, relying instead on moral suasion over national bank supervisors. It is a frequent pattern in the progress of the European project that new entities have been given very little power, but accrue much more authority over time as they prove their value and as crises show that it is indeed desirable to have a stronger European-level authority. Many have believed that crises such as the present would lead to a much stronger EBA; it could well be that this would happen, if the entire EU were to participate in the banking union. It might even happen if virtually all EU members join the banking union. However, as discussed below, the U.K. has very strong reservations about the EU-level banking supervisor also becoming the ultimate supervisor for the new banking union, which the U.K. does not intend to join. This is especially important in light of the need for unanimity if treaty changes are required to implement the banking union.

**A new authority.** There would also be advantages to creating a totally new banking supervisor for the new banking union. First, it would avoid the problems of meshing the geographical choices with the remits of the ECB and EBA. Second, it creates a chance to start over with a blank slate, without inheriting historical choices that might hamper either the ECB or EBA from operating effectively. This may be particularly important in the case of the EBA, which already suffers from previous compromises limiting its ability to supervise banks. Third, there are concerns with giving the ECB too large a role in bank supervision, which are discussed in the next section.

**The commission proposal.** The ECB with some additional authority for the EBA. The commission recommends, as it was essentially directed to do by the June summit, that the ECB be the principal supervisor in the banking union. However, it tries to maintain and strengthen the role of the EBA to the extent that it can do so consistent with the ECB's new role. It confirms that the EBA is to remain the ultimate banking authority in the EU and tries to strengthen this by empowering the EBA to create a "single supervisory handbook" that would bind the operations of all EU supervisors, including the ECB.

It is unclear how this will play out in practice, since it could mean a great many things. If the supervisory handbook essentially just repeated the regulations and gave some simple suggestions about how to enforce them, then it would mean very little. If the handbook instead tries to be immensely detailed so as to seriously curtail the discretion of supervisors, then it could be very important and could also create a number of conflicts with the ECB and other supervisors. This would lead to a key question: what would happen, both in theory and in practice, if the ECB claimed to be following the handbook, but the EBA disagreed?

One strong concern of EU nations that are not in the eurozone is that the EBA could essentially be taken

over or neutered by the ECB, as a result of the ECB's potential ability to carry a majority of EBA board members with it on any issue. This follows from: the ECB's automatic supervisory authority in 17 of the 27 EU member states; probable accretion of some additional voluntary participants; and automatic acquisition of a supervisory role as further EU states enter the eurozone. When combined with the ECB's prestige, technical resources, and bargaining power from its powerful role as monetary authority, it is easy to understand concerns that the EBA would always dance to the tune of the ECB.

In an attempt to counteract this, the proposal states that "[v]oting arrangements within the EBA will be adapted to ensure EBA decision-making structures continue to be balanced and effective reflecting the positions of the competent authorities of member states participating in the [banking union] and those which do not.[27]" This, of course, is much easier said than done and there is considerable disagreement about the potential effectiveness of this part of the proposals.

**Other views.** Speyer (2012) calls for the EBA to play a central role, in line with a preference for a pan-EU banking union, but with the ECB also being involved in "financial supervision in some shape or form.[28]" Pisani-Ferry (2012) endorses the idea of a new authority as the ultimate supervisor, or as a second supervisor alongside the ECB[29]. However, they do not take a strong stand on this point, noting that "a longstanding body of comparative literature generally concludes that no single pattern of division of supervisory responsibilities between central banks and other authorities is unquestionably superior to the alternatives.[30]" Sinn (2012) opposes a banking union altogether and therefore would keep supervision, deposit guarantees, and resolution functions at the national level. Wyplosz (2012) applauds the choice of the ECB as the key supervisor, although departing from many analyses by emphasizing the centrality of the lender of last resort function, which is clearly a central bank role.

### Recommendation

**Ideally, the European level supervisory body would be more removed from the ECB than the commission proposes, although the ECB should have significant influence with that supervisor and coordination between them needs to be strong.** As explained in the next section, with Europe's unbalanced growth of federal governance structures, there is a danger of too much power accruing to the ECB, with several potential deleterious effects. In contrast, national governments have strong counterweights to a central bank's power and can ultimately change the laws governing the central bank if they need to do so. European level institutions are considerably less developed and therefore less of a counterweight if too much power should accrue to the ECB. In addition, changing the treaties governing the ECB would require a consensus of national governments that could be very difficult to achieve.

Assuming that it is effectively a "done deal" to empower the ECB as the main supervisor, it would be good to provide considerably more separation of the supervisory unit from the rest of the ECB. This would achieve some of the benefits of setting up a separate new authority, without losing too many of the advantages of the ECB association. That said, it would still leave considerable concerns about the ECB's disproportionate role in Europe.

**The commission's goal of strengthening the EBA is laudable, although it may be very difficult to**

do. These attempts can serve the dual purposes of creating some counterweight to the ECB while also strengthening an organization that will be focused on the EU's single market in financial services. However, the institutional clout of the EBA is far below that of the ECB and is unlikely to remotely approach its overall influence anytime soon. Further, the risks of capture or subordination of the EBA by the ECB are real and there is a limit to what can be done through actions such as the commission's proposals to strengthen the voice in the EBA of members of the EU that are not in the eurozone. The latter issue will be even tougher as the eurozone grows over time, as it is legally mandated to do as newer EU members move towards adoption of the euro.

## What should the ECB's role be? Why?

The ECB clearly needs to have a close relationship with European banking supervisors and regulators, whether it takes some of the authority directly or simply coordinates with others. As noted, monetary transmission channels run heavily through the banks in Europe and the ECB also will have, de facto, some level of lender of last resort responsibility, since it is unlikely that any other authority will be in a position to fulfill that role. Therefore, it needs good information about the banking system as a whole and about key individual banks and it has a vested interest in encouraging sound regulation to prevent financial crises.

It is not surprising that the commission's proposal, and many other proposals, call for the ECB to directly take on supervisory responsibilities, given the importance of this coordination, and the strong institutional capabilities and credibility that the ECB has developed. Perhaps of equal importance, national and European level politics encourage this outcome. Germany remains the key nation in terms of determining how far Europe will go to tackle the euro crisis. Its politicians and public place much more faith in the ECB than they do in other European institutions and therefore it may well be necessary to vest powers in the ECB in order to gain German approval. At the same time, the ECB plays a very important role in tackling the immediate problems of the euro crisis, such as by its newly reinforced willingness to intervene in national bond markets. It appears that gaining supervisory powers for itself is one of the quid pro quos that the ECB wants for taking the risks that are being thrust upon it by the national leaders.

On the other hand, there are a series of concerns about too strong an involvement of the ECB in banking supervision. Some simply believe that the ECB, a body with somewhat limited democratic control, should not garner still more power. Banks in Europe play a powerful economic role and the authority to supervise them, which involves a fair amount of discretionary decisions, is correspondingly powerful. The ECB has been deliberately given a great deal of political independence, enhanced still further by the relative weakness of European-level government institutions and the difficulty of 17 euro area national governments in acting together to push back against ECB policies which may concern them. Political independence is desirable for monetary policy and, to a great extent, for bank supervision, but it still may be that the ECB is simply too far removed from oversight to take on such important functions.

Others believe that monetary policy decisions could become tainted by concerns over the weakness of banks. Sapir (2012) summarizes the views of a committee of academics that "ASC members have raised the concern that ECB responsibility for banking supervision might ultimately divert monetary policy from

the objective of monetary stability and price stability; some ASC members would therefore prefer that the ECB should not be entrusted with supervisory tasks at all. Other ASC members have pointed to the need for monetary policy to be informed about the state of the financial system.[31]"

Supervisors have a stake in the health of their charges, for a variety of reasons, starting with their responsibility to preserve financial stability. Any problems may also point back toward supervisory mistakes, harming the careers of the supervisors. There is also a nearly universal tendency toward some degree of "regulatory capture" even if it is only in the form of "intellectual capture," where regulators come to think in similar terms to those they regulate. For all of these reasons, there is the possibility that the ECB as bank supervisor may want the ECB as monetary policy setter to loosen monetary conditions in order to shore up the banks, or to fail to tighten them when more discipline is required.

There is also a potential risk in the opposite direction. The ECB as monetary policy setter might decide it wishes the banks to take more risks than they should, in order to get the economy moving again, in a period such as the present when restoring economic growth is so difficult. It might then use its power as bank supervisor to encourage a laxness in lending standards, although it would not itself perceive this as laxness. Related to this Beck (2012) raises the concern that "the ECB might not necessarily be a tougher supervisor than national authorities. It might actually be more lenient, as it is concerned about contagion across the eurozone and because it has more resources available.[32]"

Some of these risks can be lessened by having sufficient internal separation between the organizations within the ECB that control the two roles of monetary policy setting and bank supervision. For this reason, the commission proposal calls for a separate governing body within the ECB to oversee the supervisory activities. However, importantly, the top-level ECB governing council would retain the ultimate authority. This may in part be due to legal issues relating to the governing council having been established by treaty as the ECB's highest authority, making it difficult to give a different part of the organization co-equal or higher power in banking supervision.

Setting up an internal separation is a difficult balancing act, like so many others involving regulation. The key is to maximize the flow of information and to minimize organizational conflicts, while ensuring that one set of considerations, such as monetary policy, does not come to dominate decisions at the expense of a proper analysis of other factors. Separating the organizations helps avoid excessive dominance of one set of priorities, but may come at the expense of proper communication and internal discussion.

The ECB itself faces a substantial reputational risk by taking on bank supervision in addition to monetary policy. In reputational terms, there is considerably more downside than upside in being a bank supervisor. If banking markets are kept unusually calm for a lengthy period, supervisors tend to get only a fraction of the credit. On the other hand, the inevitable bank failures and near-failures are usually perceived by politicians and the public as being a very black mark for the supervisors, especially in Europe. The ECB is currently viewed as a highly competent organization, but this could shift to a much more skeptical view if the organization is perceived as failing to prevent bank failures, no matter how strong the internal firewalls are between the supervisory and monetary policy sides of the ECB.

## How should national and European supervision be coordinated?

Unless national supervisors are completely disbanded and replaced by a European level supervisor, which is extremely unlikely, there will be a need to coordinate between the European and national level supervisors. There are multiple points along the spectrum of centralization that could be chosen, with no clear theoretical answer on where to land. Centralization brings clarity and efficiency while reducing the scope for cronyism, clientelism, and lax standards more generally. On the other hand, decentralized approaches take advantage of local knowledge and avoid the problems created by overly rigid decisions that ignore the many differences that still exist across Europe in the underlying business, economic, legal, and political circumstances and traditions. (This is similar to the spectrum of government involvement in the economy, with a broad consensus today that the two extremes of "laissez faire" free market policies and full state control do not work well, but considerable disagreement on where in between is optimal.) There are three main models that could be chosen corresponding to different points on this spectrum:

**Maximize the centralization at the European level.** In theory, the national supervisors could be abolished and replaced by a single European supervisor. This is extremely unlikely in practice, due to vehement opposition at the national level and the inefficiency of abolishing supervisory systems that were built up painstakingly over many years. (Even this theoretical extreme would likely end up with the existing employees of the supervisory agencies being hired into the new European body and continuing largely to fulfill their old roles.)

The maximum feasible level of European integration would probably be to give the central body ultimate authority over all bank supervision, including the ability to hire, fire, and direct the national supervisory personnel. In practice, the central body would create clear common standards, directly supervise the major pan-European banks and the largest banks at the national level, and monitor and direct the supervision at national level of all other banks. Pisani-Ferry (2012a) and others support the inclusion of all banks if a political consensus can be achieved for it[33].

**Maintain strong national supervisors with European-level oversight.** At the other end of the spectrum, it would be theoretically possible to move to banking union in other areas, such as common deposit guarantees, with minimal modification of the existing supervisory structures. However, this would be a flawed approach and one that would face strong political opposition from countries such as Germany that fear they would foot the bill for supervisory errors throughout the banking union. In practice, national supervisors will be subordinated in both theory and reality to a central body. However, it would be possible to leave the national supervisors largely intact, as direct supervisors of all but the pan-European banks, operating under the loose overall direction of the central body. There is even the possibility that the European-level authority would only have the power to order changes in the supervision of smaller banks in extreme cases. (Germany would appear to prefer to leave small to medium-sized banks completely out of the remit of the central body, but it is almost certain that the European-level authority will have ultimate control of their supervision, even if this is made difficult for them to exercise under normal circumstances.)

**The usual European compromise.** There is a fairly high chance that the final result will be a compromise between these two points on the spectrum of centralization. Pan-European banks and the largest of the national banks would come under direct central supervision. Small banks would be supervised at national level with very loose overall direction from the central body. Banks between these two size ranges would be supervised at the national level, but with overall direction and significant input from the central body. Overall supervisory approaches would be more standardized, with less discretion for national supervisors even in situations where they retain their authority.

**The commission proposal.** The commission calls for all banks in the banking union countries to have the ECB as their ultimate supervisor. National supervisors would continue to play a substantial de facto and somewhat less substantial de jure role, especially with the smaller banks. In practice, national supervisors would be the first line of contact and decision-making, and most decisions would not rise any higher. However, the ECB would have the power to exercise the full extent of its supervisory powers on any and all banks within the banking union, with no requirement to defer to national supervisors, except for a few areas such as consumer protection, anti-money laundering efforts, etc., which remain solely the province of national supervisors.

**Analytical views.** Speyer (2012) argued for an approach similar to what the commission later proposed, saying the supervisory system should be "federal in nature … such a federal structure would comprise the existing national supervisory authorities and a new EU-level institution. Small and domestically oriented institutions would continue to be supervised by national authorities, acting on the basis of common rules … and subject to the final say of the EU-level authority, which in turn would supervise systemically relevant financial institutions that operate on a pan-European basis and would be the final authority on interpretation and implementation of EU financial market rules.[34] "

Pisani-Ferry (2012a) generally agrees with the commission as well, advocating "broad coverage extending significantly beyond E-SIFIs, and ideally a "complete" banking union covering the entire sector if a political consensus can be achieved.[35]" It further notes, "centralization of authority should not be confused with operational centralization. Even in a complete banking union, the subsidiarity principle should apply and there would be a delegation of many supervisory operations to national or sub-national entities under the authority of the European supervisor. In no scenario should and would the thousands of banks that exist in the EU be all supervised centrally.[36]"

Hesse (2012) notes opposition from Germany, including its finance minister, to the oversight by the ECB of regional and smaller banks.

Millar (2012) refers to the commission's proposal as creating a "hybrid of a bifurcated/two-tier system – one that features an extra layer of protection provided by the ECB's right to take over active supervision at any time, but without the cover of national supervisors being held responsible for their role in prudential supervision. This could introduce moral hazard issues."

Sapir (2012) generally endorses the commission proposal in regard to the division of roles between the ECB and national supervisors but goes on to specify the desire that when the ECB needs to direct work by national supervisors "it should be possible for

such assistance to take the form of secondments of national supervisors' staff working on tasks directly coordinated by the ECB … rather than national authorities simply executing such tasks 'wholesale' under instructions from the ECB.[37]"

**Recommendation**

**The commission's proposal appears to be about right in regard to the balance between European and national supervisors.** There is value in maintaining the existing infrastructure and tapping into the local knowledge of the national supervisors. However, the European level supervisor must be able to respond to systemic risks directly and to oversee the work of the national supervisors without obstacles beyond the usual management challenges of any multinational organization. How well this works in practice remains to be seen, but at least the proposal offers the legal framework for the European level supervisor to adapt its practices as necessary without hindrance from local interests.

## BANK RESOLUTION

### How are troubled banks handled now?

There is a great variety of approaches at the national level to dealing with troubled banks and many of them still rely on ad hoc solutions, as was very largely true during the financial crisis. In July 2012, the European Commission proposed legislation to harmonize the national resolution approaches, but this is likely to be superseded by, or incorporated into, a new proposal to create a European-level resolution authority. There is no such mechanism today, although the Competition Directorate of the European Commission does play a role by monitoring the way in which state aid is used when banks fall into trouble. That has meant, in some cases, the requirement that the banks receiving aid be restructured and shrunk as part of the resolution process. The commission's banking union proposal of September 2012 refers to the need for common resolution and deposit guarantee schemes, but does not address this area any further.

Overall, there are a couple of strong trends across Europe in how bank resolution is handled in practice. First, there is a strong predisposition not to allow any bank to be liquidated, no matter how small or troubled. A bank failure is generally viewed as a very bad thing, rather than the inevitable consequence of operating in a capitalist system, as it is viewed in America. Banks have sometimes been forced or coaxed into mergers and they have been restructured, but they have seldom failed in a manner analogous to a Federal Deposit Insurance Corporation (FDIC) takeover of a U.S. bank. Second, it is nearly always the case that all liabilities have been guaranteed, so that no depositor or lender to a bank loses any money. There is now a strong push to change this approach going forward, and to ensure that bank creditors know that they are at risk, but this will clearly represent a major break from the past, assuming it is carried out in practice.

### How should the resolution of troubled banks work under a banking union? Why?

The European Commission's July 2012 proposal on harmonization of national resolution regimes includes a good summary of the basic rationale for resolution mechanisms:

> "Banks … provide vital services to citizens, businesses, and the economy at large (such as deposit-taking, lending, and the operation of payment systems). They operate largely based on trust, and can quickly become unviable if their customers and counterparties lose confidence in their ability to meet their obligations. In case of failures, banks should be wound down in accordance to the normal insolvency procedures. However, the extent of interdependencies between institutions creates the risk of a systemic crisis when problems in one bank can cascade across the system as a whole. Because of this systemic risk and the important economic function played by institutions, the normal insolvency procedure may not be appropriate in some cases and the absence of effective tools to manage institutions in crisis has too often required the use of public funds to restore trust in even relatively small institutions so as to prevent a domino effect of failing institutions from seriously damaging the real economy.
>
> Accordingly, an effective policy framework is needed to manage bank failures in an orderly way and to avoid contagion to other institutions. The aim of such a policy framework

> would be to equip the relevant authorities with common and effective tools and powers to address banking crises pre-emptively, safeguarding financial stability and minimising taxpayers' exposure to losses.[38]"

The primary reason for moving the resolution authority up to the level of the banking union is to substantially reduce the importance of the dangerous link between the solvency of national governments and of their banks. It has additional advantages in terms of harmonizing resolution approaches and reducing the risks presented by excessively close links between local and national governments and their banks. Such flaws can allow banking problems to linger and grow, as governments put off the serious political consequences of corrective action, or encourage too generous a use of taxpayer funds to protect local interests.

### Goals of a bank resolution framework

The most important goal of any approach to bank resolution must remain to contribute to the avoidance or minimization of severe financial crises, such as we just experienced. Banks are crucial to the European economy and the damage that a financial crisis can cause is quite evident in light of the pain from the most recent one. There is a limit to what a good resolution framework can do in this regard, since the more important factors will relate to private sector decisions and the quality of bank regulation and supervision. However, the right framework gives all of the key players in the financial sector, including regulators, the incentives to avoid financial crises. In addition, a good approach to resolution will ensure that critical financial services remain available, even in crises, and will minimize financial contagion as losses from the failure of one institution, or fear of such losses, make others suspect. All of this must, of course, be done in a way that does not foster an excessive conservatism that chokes off lending or makes it too expensive.

A second critical goal is to minimize the cost to taxpayers if a bank does encounter trouble. In part, this can be accomplished by encouraging early intervention, before too much economic value has been destroyed. Perhaps more importantly, the right regime will place the economic burden on those who have voluntarily funded the banks by buying their equity or debt, rather than the taxpayer or ordinary depositors. That said, taxpayers will ultimately need to backstop any resolution mechanism, since a widespread financial crisis may exhaust the funds available to ensure the effective working of the financial system. In such a case, there needs to be a mechanism to recoup over time any such losses for the taxpayer through levies on the banks and perhaps other participants in the financial system.

A third key goal is fairness, which is particularly important in terms of the distribution of any losses across the member states of the banking union. It does not arise to the same extent at the national level, since there is usually an acceptance by the public that losses in one part of a country may need to be borne by the entirety of the nation.

## What European-level entity should handle bank resolution?

There are several possible candidates to be the resolution authority for Europe:

**The ECB or a related entity.** If the ECB becomes the main European bank supervisor, then there is some argument for it to also handle the resolution of troubled banks. It will already be in the position of lender of last resort and will have a great deal of information about

each bank and a good understanding of the systemic implications of any resolution. However, there are more compelling arguments against it taking this role. First, resolution involves the tidying up of problems that may have been abetted by bad supervision. This creates the temptation for any supervisor to hold off on initiating a bank resolution and perhaps to alter the form of the resolution to minimize the apparent flaws in its previous decisions. Second, resolution may well involve drawing on taxpayer funds, at least in the first instance, which could further blur the line between the ECB and the fiscal authorities and possibly compromise the ECB's overall independence, which is of crucial importance for monetary policy and is also important for any bank regulator, given the potential for political interference.

**The European Stability Mechanism or a related entity.** The ESM is designed to deal with troubled sovereigns and has the authority to participate in bank recapitalizations and other forms of rescue when this is instrumental to preserving the credit of the sovereign, as it often is. This overlap of purpose makes it a good candidate to manage bank resolutions more generally. It also focuses on the Euro Area, which is likely to make for the best fit with the scope of the banking union. However, it does bring with it a decision-making structure which can be cumbersome and that is intended to be responsive to national governments, which means it is not as shielded as one would like from political considerations. It also is very focused on systemic issues, which may incline it to place too high a priority on the avoidance of bank failures or events that would cause a large loss to creditors, given the potential for contagion, even at the expense of sacrificing other goals.

**The EBA or a related entity.** In theory, the overall supervisor for the EU banking system might be a logical place to run the resolution authority. However, there would be a number of drawbacks. It is an EU-level institution that would be operating within a banking union that will almost certainly not include the whole EU. It does not have a long history and has not accumulated much clout, which might make it difficult to defend and enforce the tough decisions that a resolution authority may have to take. It also shares with the ECB the problem that its supervisory role may taint its choices about how to clean up when supervision fails.

**The new deposit guarantee fund.** There is a fairly good case for the resolution authority to be combined with the manager of the deposit guarantee fund, as is done in the U.S., where the FDIC has the main resolution powers. Protecting the guarantee fund is a role quite similar to taking over troubled banks and managing them to minimize their further losses and their damage to the system. The nonexistent or limited supervisory role it would have would minimize the issue of temptations to cover up for supervisory errors. There would, though, be some concern that it might choose solutions that would minimize deposit losses, even if that might lead to larger total losses or to a premature intervention that would not have been necessary if sufficient patience were exercised.

**A separate, new resolution authority.** Alternatively, a completely new resolution authority could be set up. This has the advantages of a clear organizational focus and the ability to design it from scratch for the exact purpose, without inheriting previous biases or structural characteristics that are not appropriate to the new task. It also eliminates many of the potential sources of conflicts of interest. On the other hand, there are inefficiencies and risks in creating in new, unproven authority. Furthermore, many of the decision-making conflicts are inherent to the overall policy problem, whether the conflict ends up being

between institutions or inside a single institution. For example, consideration of actions that seem fair and appropriate when viewing the situation of a given institution on its own may conflict with consideration of the impacts on the overall system, such as the risk of financial contagion. Placing the conflict within one institution does not necessarily make the problem any harder and might even avoid some institutional conflicts that would otherwise arise.

**Analytical views.** The commission has not made any proposals on this point. Pisani-Ferry (2012a) endorses the ultimate creation of a new European resolution authority, which "might have strong links with the ESM – as is typically the case in national contexts beween bank resolution authorities and treasuries.[39]" They go on to suggest that the new entity have "some degree of direct supervisory authority over those banks that are covered by the banking union" and that it could make sense to combine the deposit guarantee function into the same new authority.

Speyer (2012) strongly opposes having the ECB as the resolution authority, saying that the fact that the task is "eminently political" it "should definitively not be given to the ECB." Instead, Speyer favors the ESM for having the "right mixture of technocratic and political character" as well as directly controlling a key funding source that might need to be tapped during the resolution process[40].

Carmassi (2012) takes a quite different approach, calling for the ECB, as the key supervisor[41], to have all of the intervention functions of a resolution authority, but to stop short of handling the liquidation of a "bad bank." Carmassi states that resolution "would become a residual function that, under common rules preventing national authorities from making good the losses of shareholders and creditors, may well be performed by national authorities of the parent company according to the national rules. This approach does not eliminate the need for a European banking resolution fund. Rather than covering losses emerging from liquidation, its task should be to provide capital, in case of need, to the 'good banks' carved out by (European) supervisors."

Schoenmaker (2012) calls for a new "European Deposit Insurance and Resolution Authority," tailor-made for the tasks of insurance and resolution for the new banking union. This is consistent with Huertas (2012) which states "[f]or member states in the banking union there should be a single resolution authority, which would be better able to internalize more fully potential externalities in the decision to resolve a bank."

European Shadow Financial Regulatory Committee (2012) puts forward an intriguing suggestion for an intermediate step to ensure that acceptable resolution mechanisms are in place in tandem with the ECB's acquisition of supervisory powers. "Adapting the approach suggested for the fiscal compact, we advocate the empowering of the ECB to enter individualized 'resolution contracts' with each member state. The supervision by the ECB of any member state's banks can be made contingent on the signing of such a contract. The incentives of member states to enter such contracts would be strong because they would, in particular, facilitate bank recapitalization. Moreover, given the flexibility of the approach, there should be fewer objections to harmonized resolution on the EU level.[42]" However, it is unclear how this would work, whether it is feasible in a reasonable period of time, and what the full implications would be.

**Recommendation**

**The best option seems to be a new European resolution authority, perhaps with a combined role as the manager of the deposit guarantee fund.** The difficulties of setting up a new organization do not appear to be substantially greater than for building the same capabilities within an existing organization. On the positive side, there are real advantages to creating a purpose-built organization without the burden of past mistakes or current conflicts of interest.

## Which banks or other financial institutions should the resolution authority cover?

The most logical division may be to have the resolution authority cover those banks that are subject to direct supervision at the European level, assuming this includes those large banks that operate principally in a single country. (The resolution authority needs to be involved whenever there are potential systemic implications, which could easily arise with large banks, even purely national ones.) Beyond that, it may be more efficient, and fairer, to have the resolution authority cover all European banks. However, this is not critical to the systemic functioning of the banking union.

One issue that has hardly been addressed in the context of banking union is the extent to which it may be necessary to step in when a major non-bank financial institution runs into problems. This is primarily because non-bank financial institutions, with the exception of insurers, play a much lesser role in Europe than in many other countries, especially the United States. For their part, insurers are already closely regulated and insurance supervisors, with the strong support of their industry, jealously guard their prerogatives. The smaller role in Europe of non-bank financials, other than insurers, means it may not be necessary to take any major steps now in this regard, but European institutions should be constructed with an eye towards the possibility that this may change. In the long run, it will be important that European level authorities have the appropriate powers to deal with systemic financial risk, whether it resides at a bank, an insurer, or another type of financial institution. In the U.S., this is now covered by the creation of the Financial Stability Oversight Council, a council of the key regulators. The FSOC and the Federal Reserve have been awarded a great deal of power in regard to their oversight of systemically important financial institutions of all types. This largely reflects the fact that the U.S. has a quite different financial system from Europe in this respect, with non-bank financial institutions that are considerably larger and more prevalent.

## What powers should the resolution authority have and when should it intervene?

The resolution authority needs quite a number of powers, including:

- Replacing the board and management and giving direct instructions where necessary.
- Restructuring the bank as a "bad bank" and a "good bank".
- Selling off pieces of the bank or the whole bank.
- Providing or arranging funding for the bank from official bodies and the private sector.
- Forcing creditors to do a debt to equity conversion, within certain rules.
- Determining the division of losses among stakeholders, within certain rules.

Overall, it requires the authority necessary to intervene to assist, or potentially force, a restructuring plan if there is a viable approach available. It also needs the ability to manage an insolvency process when saving the bank is not feasible. This includes the powers normally given to the authorities overseeing bankruptcies, but with an enhanced ability to force a quick resolution in order to avoid the many disadvantages of having a bank remain in limbo. For example, the FDIC is empowered to make many choices quickly, with the best information available to it and without the need to develop a consensus among the stakeholders. There is judicial review available for its decisions, but a very high standard to overturn its choices. Again, this overall approach is in line with the European Commission's proposal on harmonizing national resolution mechanisms.

The authority should have the power to intervene while an institution is still solvent, if its capital has fallen below the minimal acceptable levels or if it is obviously heading for collapse according to some other clear criteria. This maximizes the authority's ability to craft a solution that minimizes losses for the various stakeholders and reduces the damage to the overall financial system. The resolution authority or the primary supervisors should similarly have the power to force corrective steps as a bank runs into trouble, with the power to intervene in management of the bank and even to take it over, in extreme cases. This is in line with the FDIC's powers in the U.S., often referred to as "prompt corrective action". It would be theoretically possible to take the alternative approach of waiting until bank insolvency, but this would considerably reduce the benefits the resolution authority could bring. The offsetting advantage, which does not seem sufficient, is that banks and their stakeholders would be less concerned about the potential for the resolution authority to intervene arbitrarily or in a harmful manner. The European Commission proposal on harmonizing national bank resolution mechanisms strongly supports giving authorities such powers.

## Who should pay? Why?

If the resolution authority takes over a bank, there may well be a need for temporary liquidity provision while it is restructured and there is likely to be a more permanent loss as well. Some or all of the liquidity provision may be arranged through the ECB, but this should only be done on the basis of lending against sound assets, in order to protect the central bank from loss. After all, it is the duty of the resolution authority and any associated funds to absorb and distribute any public loss. The ultimate loss, if any, should be spread across private sector participants, with taxpayers only retaining losses under truly extreme cases where it is impossible to restore a viable financial system without such an action.

Based on these principles, the question of burden sharing boils down to the distribution of the ultimate losses among: a bank's owners (its shareholders), its creditors, its depositors, its other customers, and the banking industry and possibly other participants in the financial system. Virtually everyone agrees that shareholders should bear the first loss, often losing the entirety of their investment. This would include holders of preferred shares, once holders of common shares (also known as "ordinary shares") are wiped out. Similarly, subordinated debtholders should take losses, up to the full amount of their bonds, since they knowingly purchased bonds with a lower claim in insolvency, in exchange for a higher rate of interest.

The remaining loss to be absorbed by senior debtholders would often be less than the amount of their claims, leading to a haircut, but not a complete loss.

This is because other parties would already absorb a portion of the losses and there is usually a large pool of unsecured debt sharing the remaining losses. There are many proposals for "bail-in" debt, to ensure that debt-equity swaps occur automatically when banks hit trouble, in order to avoid the economic losses of an actual insolvency and the risk that taxpayers might take a hit. Some of the proposals would put all unsecured debt on the same footing, systematizing the process described earlier. Others would encourage, or force, some of the debt instruments to be issued with a bail-in regime built in. In the latter case, the remaining unsecured debt without such a feature might be spared losses in insolvency or would have them reduced by the portion absorbed by the bail-in debt. The holders of bail-in debt would end up with equity stakes in exchange for whatever haircut they took on their debt, which might or might not recoup the loss on the debt itself, depending on the future performance of the restructured bank. Secured debt should be protected to the extent of the value of its valid collateral, but treated as unsecured debt for the portion that exceeds the collateral's value, if there is any excess.

The resolution fund could take a direct loss if it provides funding to facilitate a restructuring and the ultimate loss on the restructured bank(s) is higher than can be absorbed by the private sector participants listed above. This would be an unusual phenomenon, given the ability to wipe out the shareholders and many of the creditors, but could occur in a severe financial crisis. It would, of course, be more likely if there are limits placed on the ability to allocate losses to these other parties. If the resolution fund should take a loss, the intent is that premiums charged to the industry would ultimately allow the fund to recoup that loss, if it was not already sufficiently prefunded from such premiums.

It is important to note that a truly severe and widespread financial crisis would produce strong pressures not to follow the original plan for bank resolution. For example, subordinated European bank debt almost never took a hit in the recent crisis, even though it was acknowledged that subordinated debt was purchased with the knowledge of its lower claim in insolvency. The fear was that triggering a loss to the subordinated debtholders of one troubled bank would cause a massive drying up of liquidity for other banks that needed to roll over or expand their subordinated borrowings. This was too important a funding source for banks for regulators to be willing to take that chance. Similarly, it is not clear that there is any instance in Europe where senior bank debt took a loss, since these arguments held even more force for senior debt, whose purchasers had generally viewed the potential of loss as remote at the time they bought the debt. This has been true in many past crises as well. For example, the Swedish response to its debt crisis in the early 1990s, which has been much lauded, included a complete guarantee of all liabilities.

The tricky thing is to balance two objectives. The first is to structure a bank resolution mechanism that makes it very likely that creditors will actually suffer losses even in a severe future crisis and convinces them of this fact so that they do not lend to banks that are taking undue risks, reinforcing market discipline. At the same time, there must be the recognition that a crisis could be so severe, or flaws could be discovered in the resolution mechanism, such that creditors cannot be made to bear the full losses that are anticipated to fall on them. In those circumstances, it would almost certainly be the taxpayers that absorbed at least the initial loss, hopefully with ultimate recovery through levies of various kinds.

## How should the resolution authority be funded?

Any losses incurred by a resolution fund can either be obtained in advance (ex ante) by building up a precautionary fund or afterwards (ex post). There are arguments in favor of both approaches, but I believe that the ex ante method is clearly superior. This is also the conclusion of the European Commission in its resolution proposal. For that matter, it is difficult to find analysts who argue against ex ante funding for the new banking union's resolution authority. Key reasons for this choice are:

**Building up a fund in advance is the best way to ensure that taxpayers do not bear the cost.** Ex post funding requires the political will to charge levies on banks that may well already have been battered by a financial crisis.

**Ex post funding is pro-cyclical.** Charging high insurance premiums to banks in the wake of a financial crisis could easily exacerbate a credit crunch, especially as they will almost certainly attempt to pass the cost on to borrowers and other customers. Funding in advance evens out the burden over time.

**Ex ante funding does a better job of encouraging loan pricing that reflects the true risks.** Funding in advance effectively means that the price of loans and other bank services will generally reflect the insurance premium. Ex post funding is likely to mean that pricing in advance of a crisis is too low, as the banks themselves are unlikely to build up internal reserves for their share of the costs of an eventual, but infrequent and unpredictable, crisis. Loan pricing then would become too high after the crisis, as new borrowers would be hit with costs related to past business.

**Ex ante premium charges are likely to be easier to agree upon.** Distributing resolution costs will always create difficult political arguments, especially across borders. However, it is likely to be less painful to agree on the level of a relatively modest annual charge and how it is spread across banks than to agree in the face of large, known losses. Reacting after the fact will require some national leaders to admit to their constituents that their banks are being charged to pay for losses in other countries. If these are large numbers, it may be very difficult to stick to whatever previously agreed formula is in place. This would not be nearly the same problem if the fund already has the resources, or most of them, to pay for the loss.

On the other hand, there are at least a couple of reasons to consider ex post funding:

**Building up a precautionary fund may encourage its use**. If the resolution fund already has substantial resources, it may be easier to make decisions that cost money. This would not matter if the resolution authority's actions would always be straightforward, transparent, and with no distributional consequences. However, that is not a description of how things will stand in the middle of a financial crisis or potential crisis.

**Contrary to the earlier assertion, it might be easier to agree in advance on the division of ex post losses.** It may be less difficult to agree on the division of theoretical future losses than to agree now on the division of annual insurance premiums. However, such an advance agreement may not be adhered to, in which case the problems described before would arise[43].

### Issues related to ex ante funding

If ex ante funding is indeed chosen, there are numerous questions about how premiums should be determined. Unfortunately, there is often no clear answer, but instead the need to make a judgment call that takes into account the entirety of the choices about the banking union.

**What is the right total premium level?** This requires an estimate of the ultimate amount likely to be needed and a decision about how many years to take to build up to that level. The commission, in its proposal on harmonizing national resolutions schemes, suggested a prefunding target of 1 percent of the value of deposits.

**Who should pay?** The banks covered by the fund should clearly pay premiums, but there is also an argument for having other market participants pay some lesser premium level, based on the value they would receive from the increased stability.

**Should premiums be risk-sensitive?** The theoretical answer is clearly "yes", since charging everyone the same premium effectively subsidizes higher risk activities, although not as much as in the present system for those countries where nothing is charged. However, it will be very tricky to design a premium structure that is appropriately risk-sensitive and also politically acceptable, given the distributional consequences among individual banks, sectors of banking, and national banking systems.

### Issues related to ex post funding

If funding for the resolution authority is to come after losses are incurred, then there are two sets of funding issues. Where does the up-front funding come from and where do the repayments come from?

The up-front funding, beyond what can be safely lent by the ECB against appropriate collateral, is a fiscal outlay. It could come from the ESM, which is backed by the eurozone national governments, or directly from the national governments themselves. In either case, it might be necessary to have the ECB provide the additional funding in the first instance, with the clear understanding that it would be reimbursed very quickly. It may not be possible for the ESM or national governments to provide the cash quickly enough otherwise, whereas the ECB can always create whatever volume of euros is necessary. The choice of a source for the up-front funding, or of the guarantees to the ECB in the first instance, will be relatively unimportant if it is very clear that repayment will occur ex post in the full amount, with appropriate interest payments, and if the time period for this is relatively short. The less clarity or the longer the period, then the greater the economic risk transferred to the national governments, directly or indirectly, and the greater the political cost.

The potential sources for ex post funding are essentially the same as those listed above for ex ante funding, with the exception that it is theoretically possible to add national governments to the list, despite the lack of political support for that choice. As noted, in an extreme enough case, it may be necessary for taxpayers to absorb a long-term loss, in order to avoid creating or exacerbating a long-term credit crunch.

## How should existing bank losses be handled?

A clear bone of contention with the resolution and deposit guarantee schemes is how to apportion losses that already exist. It seems clear that one of the attractions for the troubled countries within the eurozone is the possibility of shifting losses that already

exist from the national governments to the rest of the incipient banking union. This is crystal clear in the case of Ireland, where there are very large losses that have already been taken by the sovereign on their bank rescue and where some politicians hope to recover a portion retrospectively from others in Europe. Their particular argument is that they believe they were essentially forced by the ECB and their eurozone partners to absorb a high level of losses from their banks in order to protect the larger European banking system.

Beyond this special case, there are countries like Spain that clearly hope to have European funding of capital gaps in their banks. Here, there remains an argument that the funders may get their money back, although this does not appear to be a bet that many people would take voluntarily without a larger policy objective such as stabilizing the euro area.

The German finance minister and a number of others[44] have called for external examinations of the banks in the eurozone, so that only ones that appear to be truly solvent will be allowed to participate in the European deposit guarantees. Where there are existing capital needs that have not yet been acknowledged, the national sovereigns would remain responsible, although they could call on help from the ESM if these losses plunged their overall economic condition too low, so that the sovereign needed an adjustment program and related funding.

The right principle here is to know what level of losses exist at the onset of the banking union, as best as can be determined anyway, and to make a transparent decision about whether and how much to mutualize these previous losses. It would be inappropriate to use new deposit guarantees and resolution funds to provide a back-door subsidy of such magnitude.

## What control should national governments have on resolution decisions? Why?

National governments should generally have little control over the resolution process in the banking union, unless they provide significant resources beyond their own share of a European effort. They may have useful information and analysis to supply to the resolution authority, which should be considered carefully, but this should be the limit of their influence, barring additional funding from them.

Allowing national governments significantly greater say over resolutions of banks headquartered in their countries would open the doors to excessive political influence and the pleadings of various special interests. Even within national resolution schemes around the world, the processes usually work much better when held at a considerable distance from such political considerations. The exception is when the fiscal authorities place such importance on the outcome that they pay for the privilege of influencing the outcome, thereby improving the result for other stakeholders. This lesson is likely to be even more clearly salient when Europe is paying the bill, while national and local interests are being served by the politicians who attempt to influence the resolution.

## DEPOSIT GUARANTEE FUND

### How are bank deposits guaranteed now?

Each of the 27 member states of the EU has its own approach to deposit guarantees at present, within the confines of relatively broad EU requirements. Each nation is responsible for the guarantee of bank deposits within their borders, as well as carrying an ambiguous degree of moral and legal responsibility for deposits in foreign outposts of banks headquartered within its borders. The EU requires that all member states provide bank deposit guarantees with a cap of no less than €100,000 or equivalent. Currently all member states have met this requirement and insure 100 percent of eligible bank deposits up to the coverage limits. Several countries have additional deposit guarantee schemes beyond their primary one, with more generous coverage. Germany has a total of six schemes, some of which cover cooperative banks and publicly owned banks.

As of the end of 2007, there were about €17 trillion of bank deposits in the EU, of which €9 trillion were in categories eligible for guarantees and under €6 trillion were actually covered[45]. Almost half of deposits were ineligible because they were held by financial institutions, large businesses, or other depositor types that were excluded from protection in the particular country. (Nations vary significantly in which types of deposits are eligible.) Of the eligible deposits, over a third were not covered because they exceeded the maximum guarantee level in that country. The European Commission calculated that the move to a uniform minimum guarantee cap of €100,000, since completed, would move the coverage of eligible deposits from 61 percent in 2007 to 72 percent and would mean that the number of fully insured eligible deposits would rise from 89 percent to 95 percent[46].

Most EU countries charge premiums each year in order to have money available to pay depositors if necessary (ex ante funding) while others fund after the fact by assessing their banks (ex post funding). The minority of nations that used ex post funding as of 2007 included the major banking markets in the U.K., Italy and the Netherlands. Of course, ex ante funding methods effectively become ex post funding approaches if the level of pre-funding is insufficient to handle losses. This could certainly become the case in a major financial crisis, since the average level of funding across the EU was less than 1 percent of eligible deposits in 2007[47].

### How should this change under a banking union?

Many of the options and issues for deposit guarantees are virtually identical to those just discussed with regard to bank resolution, since the same basic functions are being served. The major distinctions are the centrality of bank deposits to a functioning financial system and the fact that consumers and small businesses are major deposit holders. The latter point implies that deposit guarantee schemes must act to protect parties who are not really in a position to do their own analysis of the creditworthiness of the banks. Therefore, supervisors and the deposit guarantee fund have the responsibility to protect them and ensure that confidence in the safety of deposits is maintained in order to avoid debilitating bank runs.

Otherwise, virtually all of the issues about the design of bank resolution regimes translate directly into the realm of deposit guarantee funds. One area that is worth discussing, though, is the question of what deposits should be guaranteed and up to what limits. At a minimum, deposits from unsophisticated consumers and small businesses need to be protected

so that they can have sufficient confidence to keep their money in banks, despite their inability to make an independent judgment of the banks' creditworthiness. However, bank deposits of large size are usually associated with more sophisticated parties who are in a better position to access and evaluate independent assessment of a bank's solvency. It is useful to maintain this market discipline by limiting the deposit insurance for large corporations and rich individuals, which is usually done by capping the total amount that is insured and sometimes by excluding corporate deposits. In this regard, the current minimum cap of €100,000 is probably a good balance between the need to avoid bank runs and the desire to retain some elements of market discipline. It does, though, mean that a significant chunk of bank deposits would continue to exceed the coverage limits and would be likely to flee troubled banks and troubled countries.

**Analytical views.** One way in which deposit guarantee schemes differ from resolution funds, is that there already exist such schemes in all of the EU nations, often with existing fund balances. Therefore, Pisani-Ferry (2012a) suggests that it might be best to maintain the national deposit guarantee schemes, but to back them with a supranational reinsurance fund to protect against the possibility that a national scheme might become insolvent[48]. They further suggest that the reinsurance fund be prefunded and that premiums should have an experience-rating element, so that deposit guarantee funds in nations that have drawn down on the reinsurance in the past would pay more. Speyer (2012) advocates a similar approach, with perhaps more emphasis on retaining the national deposit guarantee schemes and less emphasis on the mutualization of risk through the reinsurance mechanism[49].

Schoenmaker (2012) calls for a new authority that combines deposit guarantee and resolution functions. It would, at a minimum, cover the large banks, such as those subject to the EBA stress tests, but could have wider coverage. It would be funded ex ante, with risk-based premiums.

### Recommendation

Although there are clearly trade-offs, it seems better to move to a single deposit guarantee scheme within the banking union, funded on an ex ante basis. This would reduce the potential for regulatory arbitrage and depositor confusion across the banking union and seems fairer to the participants, particularly the individual depositors who expect their deposits to be safe regardless of where they reside in the eurozone (or EU, for that matter). There would need to be transitional arrangements, since it would take some years to reach acceptable funding levels and the existing funds at the national schemes should be transferred, on some fair basis, to the new banking union-wide fund. The existence of pure private sector deposit schemes will add some tricky questions, since it may be argued that governments do not have the right to dispose of these funds.

## What would happen if a country were to exit the euro?

Although theoretically possible, it is infeasible from a practical perspective to guarantee depositors against a potential loss of value if their home country withdraws from the euro system. Thus, there is a limit to the ability of guarantees of bank deposits to stop a run on the banks of a troubled nation that is perceived as likely to exit the currency zone. This fear must be dealt with through other political and economic policies that persuade depositors that the risk is low or nonexistent.

Why is it impossible in practice to guarantee against the loss? First, because the potential cost could be extremely high. Bank deposits are often considerably larger than the GDP of a eurozone country and a potential depreciation could be as much as 50 percent of that value. (Nations that choose to take the drastic stop of withdrawing from the eurozone are virtually certain to devalue and, having gone that far, there is little incentive to devalue by only a small amount.) Second, there would be no political support in Germany or other key countries for a system that subjected their own citizens to the cost of another country withdrawing. The only conceivable way would be through some extremely opaque technique that would defeat the very purpose of increasing confidence among bank depositors, since the opacity would keep them from understanding or relying upon the guarantee. Third, the guarantee would effectively be a very large economic subsidy that would encourage a withdrawal, the very thing that so much policy effort is being expended to avoid.

## INTERACTIONS BETWEEN SUPERVISION, RESOLUTION AND DEPOSIT GUARANTEE STRUCTURES

### How do decisions about these three areas affect each other?

Supervision, resolution, and deposit guarantee approaches each affect the other. Supervision can have a major effect on the conservatism with which a bank operates, increasing or decreasing the risk that a resolution will be necessary and deposit guarantees be called upon. For this reason, some national regulatory systems, including in the U.S., give the deposit guarantor at least some supervisory powers in order to protect its own interests. Coming from the other direction, resolution and deposit guarantee approaches provide incentives and disincentives that affect the direct willingness of bank managements to take risks and of their owners and funders to accept the taking of risk. For instance, complete deposit guarantees can make depositors entirely indifferent to the level of risk being taken at the various banks, since all of them effectively are guaranteed by the state as far as their deposits are concerned. This makes supervision more important and more difficult, since it receives less assistance from market discipline.

Similarly, resolution mechanisms are affected by deposit guarantees and vice versa. If deposits are not guaranteed beyond a certain limit, or certain types of deposits are not guaranteed, then the risk aversion of depositors, and their actions in a crisis, will be affected by how well protected they will be in a resolution process. On the other hand, the degree of protection depositors enjoy will have a major impact on the distribution of losses among nonguaranteed parties and therefore their behavior in anticipation of such losses.

Each of these pillars of the banking union must be designed in a coordinated manner, so that there are not major unanticipated effects of one pillar upon another. The devil, however, lies in the details, which are outside the scope of this paper.

## THE POLITICS OF A BANKING UNION

### How does the banking union look in political terms?

The politics are fairly straightforward when viewed from a high level. Citizens of those countries in the euro area that are troubled are strongly in favor of a banking union, since it would be of great economic value to them to stabilize their financial systems with help from their European partners. They are therefore willing to pass a great deal of supervisory authority to the European level, despite the pain to some vested interests.

Those in nations that are stronger, particularly if they trust their banking systems, are less enamored of a banking union, although many accept that a banking union is necessary to help deal with the euro crisis. Countries in the EU, but not the euro area, differ in their reactions. As described below, most people in the U.K. appear to favor the banking union as a measure to help solve the euro crisis, as long as the U.K. stays out of it. There are signs of similar reactions in some other countries such as Sweden.

When one gets into the details, a key differentiation is between Germany and countries with similar types of banking systems and the other members of the eurozone. In Germany, a large portion of the banking system consists of local institutions, many of which are either owned by local governments or closely allied to them. These countries would generally much prefer to keep such banks outside of the banking union altogether or to ensure that the European-level authorities exercise a very light touch on them. This is partly due to a belief in the economic and social value of these local banks, which might be endangered if they were to be forced to operate under the same supervisory scheme as the larger banks in other countries. In addition, European supervision could hamper the cozy arrangements that often exist with local vested interests, including that of key politicians. Many Germans feel these points even more strongly because they also do not see how banks of this size and business model could produce systemic risk. The commission, and many others, disagree, pointing out that the trigger for a financial crisis can come from problems endemic to a group of smaller institutions, rather than only coming from the troubles of larger individual institutions.

### How are the various political conflicts likely to affect the shape and timing of the banking union?

There are likely to be two main effects from the political arguments among and within countries. First, the end of year 2012 deadline for decisions will probably slip, perhaps significantly, unless the severity of financial market concerns about the euro crisis ratchet up considerably. The political differences on banking union are significant, but the eurozone members have a very strong common interest in avoiding a total disaster for the monetary union. Having identified banking union as a key part of the solution to the crisis, eurozone leaders are likely to push hard to complete that union if they find themselves staring over the cliff's edge.

Second, it is quite probable that a compromise will shift somewhat more power back to the national supervisors than exists in the commission proposal. That proposal is probably the high water mark for the shift of power to the European level. National governments of various stripes will be more inclined to retain additional control at their own national levels, if they can do so without appearing to gut the new banking

union. Again, this calculation could be countered by a serious new stage of the euro crisis, depending on market views of what is necessary to make banking union work. Most investors are likely to be more concerned about the flow of European funds to troubled countries and their banks than on the details of how supervision is divvied up going forward.

## THE U.K. AND THE BANKING UNION

### How would a banking union affect the workings of the European Union Institutions: council, commission and parliament?

There does not appear to be any theoretical reason why the various European Union institutions could not continue to function as they have, even if a banking union were confined to the 17 members of the currency union. However, there is a real question as to whether this would work out quite that way in practice. For example, if the ECB takes on the role of dominant banking supervisor for 17 or more of the EU nations, it could become very difficult for the EU level institutions to make different choices than the ECB. At one extreme, the EBA would very likely lose a great deal of moral and practical authority as the EU-level bank supervisor, given the much greater institutional clout and credibility of the ECB. Even the European Commission, with considerably more authority and longer history than the EBA, would find it hard to argue for an approach to supervision that contradicted the ECB's choice. Even if the commission did, it might easily find itself outruled by a coalition of the countries in the eurozone, either in parliament or in the Council of Ministers.

Putting aside power plays of various kinds, there would also be a strong incentive to coordinate their decisions so as to avoid regulatory arbitrage within the EU and the appearance of disharmony to the outside world. Thus, the Brussels-based institutions would find themselves considerably constrained by the need to consider the views of the ECB.

As a result, there is likely to be a substantial shift of power from EU and national level institutions to Eurozone institutions, in regard to banking. With the exception of its effects on the U.K., described at length in the next sections, this would not necessarily carry over in a major way to the functioning of the EU and Eurozone on non-banking matters.

### Can the banking union be effective without the principal European financial center?

It is possible for the banking union to succeed even without the U.K.'s participation, as long as there is sufficient coordination between the British institutions and those of the banking union. Part of this would already occur automatically, since the single market in banking requires that many rules be determined at the EU level and therefore apply to those in the banking union. If the EBA is indeed given the power to issue and update a single supervisory handbook, this commonality would be strengthened further.

However, much of the practical impact of the overall rules is determined by supervisory decisions on how to apply them, which can involve a great deal of discretion. Thus, there is the risk of regulatory arbitrage, where certain activities move to London or into the banking union, depending on which place has a less conservative, and therefore more profitable, supervisory regime. It should be noted, though, that this risk already exists to an even greater extent now, since each of the 27 national authorities is in a position to exercise this level of discretion.

As long as the U.K. remains within the EU, the degree of potential regulatory arbitrage should remain within acceptable tolerances. Therefore, the greater risk, discussed later, is that the structure of banking union might feed forces that seek to pull the U.K. out of the EU.

## Can London remain the principal European financial center without being in the banking union?

In theory, the City of London could certainly remain the heart of Europe's financial system, even if it were outside the banking union. New York and London are the dominant global financial centers for a great variety of reasons and it would be a difficult and long-term process for another center to shove either of those aside[50]. They have the specialized infrastructure, including human talent, to most effectively and efficiently perform a wide range of services needed by the financial industry and it customers. They also benefit from economies of scale and scope that would be hard to duplicate.

That said, there is real fear in the City about the long-term effects of a banking union in which the UK does not participate. The biggest danger is probably that barriers are created to the functioning of the single market in financial services by differentiating between activities that take place in euros, or in the eurozone, from other activities. For example, if certain services were required to be provided in the monetary union itself or by legal entities headquartered and regulated in the zone, this could make U.K. financial institutions uncompetitive for those activities and perhaps related activities. This is not an idle concern. A policy paper issued by the ECB in the summer of 2011 called for a requirement that derivatives clearinghouses that handled more than 5 percent of the volume in a euro-denominated financial instrument be located in the euro area[51].

Similarly, regulation or supervision in the euro area could develop in a way different from that for the EU as a whole, despite safeguards intended to preserve uniformity on key issues. For example, Millar (2012) expresses the concern that the ECB might use "its powers to adopt regulation where union acts (based on drafts developed by the EBA) leave gaps in respect of the ECB's new responsibilities. [T]his could introduce a rule book for member states participating in the SSM that departs from that applying to member states outside the SSM.[52]"

This could either make it difficult for U.K. banks to compete or might force them to choose between retaining their current approaches or moving to a less profitable model in order to retain their share of European business. There could ensue a slow-moving disengagement of City institutions from financial activities in the eurozone and a greater focus on emerging markets or other growth areas.

Thus, the question of the role of London in a banking union that does not include the U.K. is likely to turn on regulatory and political issues more than on purely economic ones. This is perhaps the core of the City's fear, since the British model of finance is not popular with many of its European partners.

## Would a banking union push the U.K. toward withdrawal from the EU?

Based on these tensions and risks, there is a possibility that formation of a banking union in Europe could be the precipitating cause of an eventual withdrawal of the U.K. from the EU. This would be inconceivable were it not for the existing skepticism about the EU among many in the U.K., especially within the Conservative Party, combined with the euro crisis, which has dented the reputation of the European Project still further in British eyes.

In practice, even a banking union centered around the eurozone could effectively end up determining a great deal about overall bank regulation and supervision for

the EU as a whole, including the U.K. and therefore the City of London. The disparate national interests and political and economic views of the U.K. and many of the continental European nations mean that a eurozone-centric banking policy for the U.K. could be seen as putting the City at a very considerable disadvantage. There are already many conflicts between the U.K. and many of the other EU members about the extent and form of banking regulation, such as what it views as excessive regulations being proposed on hedge fund managers, compensation levels at banks, etc. If the EU-level institutions become weaker in practical terms because of a need to accommodate the views of the ECB and those within the banking union, then it would be harder for the U.K. to protect its interests. Since finance represents roughly a fifth of the U.K. economy, it would create powerful forces pushing the U.K. out of Europe, despite the many economic interests in that country that are served by the U.K.'s continued participation.

As Howard Davies put it in June 2012, "I suspect that a banking union of some kind will be implemented, and soon. Otherwise, the eurozone banking system will collapse. But the consequences of such a step for Europe's great free trade experiment could be serious, and, if not managed correctly, could lead to Britain's withdrawal.[53]"

## TIMELINE

| | |
|---|---|
| 1951 | Treaty of Paris creates the European Coal and Steel Community (ECSC) with six members. |
| 1957 | Treaty of Rome transforms ECSC into European Economic Community (EEC) |
| 1967 | Merger of EEC and Euratom into European Communities (EC) |
| 1973 | Denmark, Ireland and the United Kingdom join the EC |
| 1981 | Greece joins the EC |
| 1986 | Portugal and Spain join the EC |
| 1992 | Maastricht Treaty broadens the EC into the European Union (EU), with a commitment to Economic and Monetary Union (EMU), including the creation of the Euro |
| 1995 | Austria, Finland and Sweden join the EU |
| 1998 | Creation of the European Central Bank (ECB) |
| 1999 | Introduction of the euro as a unit of account |
| 2002 | Euro banknotes and coins enter circulation |
| 2004 | Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia join the EU |
| 2004 | A European Convention presents a draft Constitutional Treaty that is later rejected in referenda in France and the Netherlands |
| 2007 | Bulgaria and Romania join the EU |
| 2008 | Global financial crisis begins to hit European banks and markets in a serious way |
| 2009 | Lisbon Treaty reforms EU institutions and gives greater voice to the European Parliament |
| 2009 | De Larosiere report calls for reform of European banking regulatory system |
| 2010 | April - Greek government requests an initial loan from European partners |
| 2010 | May – EU leaders announce €70 billion plan to protect the euro |
| 2010 | May – EU ministers agree €500 billion fund to save the euro from disaster |
| 2010 | November – Irish government seeks assistance from the EU and IMF |
| 2011 | January – The European Banking Authority, European Insurance and Occupational Pensions Authority, and European Securities and Markets Authority begin operations |
| 2011 | April - Portugal requests a rescue package |
| 2011 | September - Europe's debt crisis prompts central banks to provide dollar liquidity |
| 2011 | October – Final country to approve the expansion of the eurozone's rescue fund |
| 2011 | October - Banks agree 50 percent reduction on Greece's debt: private investors take 'haircut' on Greek bonds in €100 billion package of measures that also strengthens European rescue fund |
| 2011 | December - Confidential paper from Council President Herman Van Rompuy proposes empowering the commission to impose austerity |
| 2011 | December - ECB institutes LTRO program to provide three-year liquidity for banks |
| 2011 | December – EU agrees "Fiscal Compact", coordinating economic policies and debt ceiling |
| 2012 | February - Second batch of three-year LTRO loans takes total lent to more than €1 trillion |
| 2012 | March - Eurozone ministers agree €500 billion in new bailout funds |

| | |
|---|---|
| 2012 | May - G8 leaders end summit with pledge to keep Greece in eurozone |
| 2012 | May – Germany rules out common Eurobonds |
| 2012 | June - Spain seeks a European rescue package for its banks |
| 2012 | June - G7 finance ministers back greater fiscal and financial union in eurozone |
| 2012 | June – Cyprus seeks eurozone bailout |
| 2012 | June – Euro Summit calls for quick movement to European Banking Union |
| 2012 | July - ECB will do 'whatever it takes' to preserve the currency declares Mario Draghi |
| 2012 | September – European Commission proposes plan for European banking supervision |
| 2012 | September – Draghi secures agreement for 'outright monetary transactions' scheme |
| 2012 | October – European Stability Mechanism becomes legally effective |
| 2012 | October – European Summit agree on a broad outline of European Banking Union |
| 2012 | November – Catalan referendum on independence |
| 2013 | January – European leaders to reach full political agreement on supervision |
| 2013 | January – ECB to begin taking on overall supervisory role for Eurozone banks |
| 2014 | January – ECB to be fully effective as bank supervisor |

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## ENDNOTES

1. In order to provide some verbal variety, this paper interleaves the more formal "euro area" with the more colloquial "eurozone", with the same meaning.
2. See Elliott (2012a) for a detailed analysis of the cost of higher safety margins in finance.
3. European Commission (2012).
4. This is not to say that the financial reforms are misguided, but simply to recognize that transitional effects add to the current difficulties.
5. See Elliott (2011a) for a deeper explanation of macroprudential policy.
6. Millar (2012), p. 3.
7. The unwieldy term "heads of state and government" simply means the group composed of the most powerful political figure from each country. The term is necessary because the strongest figure in some of the countries is the head of state, usually holding the office of president. Other nations have heads of state, often kings and queens, who are figureheads, while the head of government, usually the prime minister, is the true top decision-maker. Each country decides who to send as their top representative to these European meetings.
8. Monetary union, and the creation of the ECB, did not eliminate the national central banks. Instead, the ECB is placed at the peak, as the ultimate authority and supervisor of the "Eurosystem" of central banks, (known more formally as the "European System of Central Banks"). This can lead to situations where different national central banks operate differently, to the extent permitted by the ECB, such as with certain bank lending programs, where national central banks, at their own risk, are allowed to set collateral requirements somewhat more loosely than the overall ECB rules.
9. The Treaty on the Functioning of the European Union states in Article 127(6) in its entirety: "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."
10. European Commission (2012).
11. Hesse (2012).
12. European Council (2012).
13. European Shadow Financial Regulatory Committee (2012), p.2.
14. Beck (2012), pp. 15-16.
15. Sapir (2012), p. 2.
16. Veron (2012), p. 3.
17. The UK and Denmark have permanent opt-outs and Sweden has an implicit agreement with the other EU countries that no one will enforce their technical commitment to join the Euro Area. The other seven nations are committed as part of the broad EU treaties which consider joining the Euro to be one of the requirements of all EU members, except as described above.
18. IMF's 2012 Article IV Consultation with the Euro Area Concluding Statement of IMF Mission, June 21, 2012, as quoted in Pisani-Ferry (2012a).
19. Pisani-Ferry (2012a), p. 7.
20. Speyer (2012), p. 5.
21. Millar (2012), p. 16.
22. This is taken, with some paraphrasing, from page 7 of the English version of the proposal of September 12, 2012.
23. The cajas are regional savings banks in Spain that ran into severe problems, in part due to a strong

tendency to serve the local political and business elites.

24. Landesbanks are banks that were historically controlled by the governments of various states (Lander) in Germany. They, too, often suffered massive losses, abetted by aggressive lending and investment actions that were made easier by their strong political positions.
25. ECB (2010).
26. Federal Reserve officials, including Chairman Bernanke, have strenuously argued the importance of the Fed having supervisory powers for just this reason, extending the argument to the smaller institutions that they currently supervise in addition to the large bank holding companies. However, I am somewhat skeptical of this argument, given that the Fed clearly did not understand the fragility of the financial system prior to the bursting of the bubble, suggesting either a failure of supervision or a failure of communication within the Fed.
27. European Commission (2012).
28. Speyer (2012), pp. 4-5.
29. Pisani-Ferry (2012a), p. 12.
30. Op. cit., p. 11
31. Sapir (2012), p. 3.
32. Beck (2012), p. 15. This is the Beck's paraphrase of parts of a chapter by Goodhart, Allen, Carletti, and Gimber.
33. Pisani-Ferry (2012a), p. 11.
34. Speyer (2012), p. 6.
35. Pisani-Ferry (2012), p. 11
36. Op. cit.
37. Sapir (2012), p. 4.
38. European Commission legislative proposal of July 2012 on resolution mechanisms, p. 4.
39. Pisani-Ferry (2012a), p. 13
40. Speyer (2012), p. 8.
41. Carmassi does state that the ECB might choose to delegate some of this to national supervisors.
42. European Shadow Financial Regulatory Committee (2012), p. 3
43. Pisani-Ferry (2012a) expresses skepticism about the ability of what they call "burden-sharing agreements" to survive the stresses of an actual crisis, and therefore they support pre-funding or a binding commitment to a tax regime automatically triggered as necessary. (p. 14).
44. See Hesse (2012) and Pisani-Ferry (2012a), p. 15, for example.
45. European Commission (2010a), p. 17.
46. European Commission (2010b), p. 3.
47. Op. cit., pp. 29-38.
48. Pisani-Ferry (2012a), p. 13.
49. Speyer (2012), p. 9.
50. See Elliott (2011b) for an analysis in the context of Shanghai of the various global financial centers and the characteristics necessary to achieve that status.
51. Financial Times, "Britain to sue ECB over threat to City," September 14, 2011.
52. Millar (2012), p. 8.

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