ISSN 1359-9151-213

Banking Union: What Will It Mean for Europe?

By

Thomas F. Huertas

SPECIAL PAPER 213

LSE FINANCIAL MARKETS GROUP PAPER SERIES

November 2012

Thomas Huertas is a Partner in the financial services risk practice at the accounting firm Ernst & Young. Previously, he was a member of the U.K. Financial Services Authority's Executive Committee and also alternate chairman of the London-based European Banking Authority. He has published and lectured extensively on financial regulation, including his recent book *Crisis: Cause, Containment and Cure*. He holds a PhD in Economics from the University of Chicago. Any opinion expressed here is the personal opinion of the author and not necessarily that of Ernst & Young LLP or the FMG. The research findings reported in this paper are the result of the independent research of the author and do not necessarily reflect the views of the LSE.

Banking Union: What Will It Mean for Europe?

Thomas F. Huertas♣

Banking union will change the face of Europe. It will significantly deepen integration in what is arguably the key sector of the economy. For the Member States that join the banking union, this will mean signing up for 'more Europe'. This will raise not only technical questions as to how banking union will actually work, but also political questions. These relate to how that deeper Europe should be governed and how the banking union will fit within the EU as a whole.

This paper outlines what has to be done in order to make banking union a change for the better, one that will in fact break the link between banks and sovereigns so that neither the euro nor the EU is at risk from banks and banks are not at risk from sovereigns.

Banking union consists of five elements:

- Regulation
- Supervision
- Deposit guarantees
- Resolution
- Liquidity provision from the central bank

All need to work together. Just as one needs a blueprint for the entire building before laying the foundation, so too would it be helpful to have a sense of banking union in its entirety before initiating the Single Supervisory Mechanism as the first instalment. Otherwise one runs the risk that banking union will remain partial, and that this will make things worse, not better (Wyplosz, 2012, p. 12).

However, the Commission proposal[1] does not give a full blueprint for banking union. It only introduces a Single Supervisory Mechanism. Under the Commission proposal, supervision should shift from the national level to the European level for all banks headquartered in the Member States that join the banking union. The European Central Bank will be the European entity responsible for exercising supervision, and

♣ The author is Partner in the risk advisory practice at Ernst & Young LLP. The opinions expressed here are his personal views and are based on a presentation given on 5 November 2012 in Amsterdam at the LSE Financial Markets Group – Duisenberg School of Finance conference "Banking Union: Pros and Cons?". I am indebted to participants at the conference for their remarks, in particular to Charles Goodhart for his comment on the role of deposit guarantee schemes in a banking union.

[1] See (EC 2012a) for a summary of the Commission proposal. The Commission proposes to create the Single Supervisory Mechanism under the provisions of Article 127(6) of the Treaty (EC 2012b). This requires unanimous approval of the Member States.

steps will be taken to separate supervision from monetary policy. The exact details are to be worked out before year end.

Under the Commission proposal regulation would continue to be set at the EU level and be applicable to all Member States, both those that join the banking union and those that do not. Legislation approved by the Council and Parliament would continue to set the overall framework. Binding technical standards set by the EBA would fill in the details. The Commission envisions that this will continue to be the case, but proposes to adjust the way in which the EBA makes decisions to reflect banking union (EC 2012c) – a subject to which I will return.

Ultimately, European supervision should be complemented by a European resolution authority, and the Commission will bring forward proposals to create one sometime next year. This makes sense. Resolution should be at European level, at least for the Member States that sign up to the banking union. Indeed, that was the very promise that prompted Member States to agree to pursue banking union. In June the Heads of State agreed that the European Stability Mechanism (ESM) could be used to recapitalise banks directly, once supervision had shifted to a European level.

But the details of how resolution would work at a European level are still sparse. Under the Commission proposal for a Single Supervisory Mechanism the ECB would determine when a bank's authorisation should be withdrawn and therefore when the bank should be put into resolution. But the hand-off would not as yet be to a European resolution authority, but to national authorities who would then resolve the bank under the terms of the proposed Crisis Management Directive (EC 2012d). That is impractical. Failure to link resolution and supervision can lead to a choice among three unappealing outcomes:

- Disruption of financial markets and the economy at large (if the ECB were to put a bank into resolution);
- Forbearance (and possibly create an environment in which the failing bank could 'gamble for resurrection'); or
- Recapitalisation of the failing bank through the ESM (and a very large contingent liability for European taxpayers).

Ultimately, European supervision should also be complemented by a European deposit guarantee scheme. Indeed, for the man or woman in the street, a European deposit guarantee scheme would go a long way to underline that a euro in a bank deposit in one banking union Member State is just as good as a euro in a bank deposit in another banking union Member State. With such a guarantee there would be no reason to withdraw one's funds from a bank in a Member State whose sovereign was experiencing difficulties in raising debt. Runs on banks due to concern about currency redenomination would diminish dramatically or disappear entirely. However, it is not clear that such a guarantee against redenomination risk could credibly be given absent full political union, and this may be one of the reasons why the Commission will refrain from putting forth such a proposal.

The fifth element in banking union is the provision of liquidity to banks from the central bank. Although the ECB provides normal liquidity facilities, extraordinary liquidity assistance (ELA) is still provided by national central banks at their own risk (subject to no objection from the ECB, which may block large amounts of ELA on the grounds that it conflicts with monetary policy). Will banking union change this, so that the ECB takes direct responsibility for ELA? Logic would suggest that it should, but the Commission proposal is silent on this point.

What might a full blueprint for banking union look like? How should the five elements mesh together? How should banking union work ten years hence when all the elements are in place? Will it merely be the current national system writ large, or will it be substantially different and significantly better?

Under the current system national supervisors have allowed, perhaps even encouraged, banks to build up concentrations in domestic government securities. They have also been reluctant to force banks to take timely provisions against residential and commercial real estate loans as property values have declined and/or borrowers have fallen behind on their payments. Although the EBA stress test has led to a significant improvement in the capital position of European banks, there is arguably still a great deal of forbearance, as evidenced by the persistently high levels of ELA in many Member States. This has – with very few exceptions – meant that banks are spared resolution, that creditors are by and large protected and that taxpayers bear the cost of bank failure in that they are expected to recapitalise banks at which losses have become too big to ignore.

Is this any way to run a European banking union? Leave aside for the moment what to do about the banks that currently require resolution and/or recapitalisation. Leave aside for the moment what needs to be done to promote recovery in the European economy. What type of regime should a banking union bring to Europe? Should it be rigorous or lax?

From a supervisory perspective, I believe the answer is clear. One wants banking union to deliver a system which limits the risk that banks will fail and makes the banks that do fail 'safe to fail' so that banks can be resolved without undue disruption to the economy or cost to the taxpayer. From an economic perspective, one wants a system that will support economic growth.

Central to such a regime is the question of resolution. In the banking union will investors bear the cost of bank failures, or will they continue to fall on taxpayers? The proposed Crisis Management Directive takes a step in the right direction by introducing bail-in – a measure strongly endorsed by the Liikanen Group (2012). This would make investors, not taxpayers, primarily responsible for bearing the loss arising from a bank's failure.

Deposit guarantees are also central to the new regime. As outlined above, a European scheme would be ideal, but this is unlikely to be possible without full

political union. However, it is possible to limit the risk of deposits (and limit the risk to the deposit guarantee schemes) by giving deposits preference and requiring banks to issue a minimum amount of bail-in-able debt. In my view the Crisis Management Directive should be amended to provide for this.[2]

Regulation is the primary method to limit the possibility that banks will fail. At the moment the EU is considering implementing the Basel III agreement in a manner that the Basel Committee considers to be deficient (BCBS 2012). This will potentially increase the risk that banks may fail. In my view a rigorous regime would not make deviations from Basel III permanent. It would implement Basel III as agreed and allow a longer transition period to the standard Basel rule.

In shaping banking union policymakers will also need to decide whether or not to incorporate the recommendations of the Liikanen Group with respect to macro-prudential supervision and banking structure.

The group strongly endorses the concept of macro-prudential supervision and proposes that the macro-prudential authority be given the right to set loan-to-value and loan-to-income ratios for mortgages. For the banking union the macro-prudential authority will presumably be the ECB. If so, should the ECB be able to set loan to value and loan to income ratios for individual Member States, if necessary over the objections of the Member State concerned? Although such a step might be economically logical, it would certainly be politically controversial, and Member States will need to consider very carefully ceding such authority to the ECB. The ECB will in turn need to weigh whether it needs to authority to set the ratios or merely a right to recommend the right ratios to Member States.

With respect to banking structure the Liikanen Group recommends ring fencing significant trading and market making activities from the rest of the banking group. Such separation is likely to force banks with significant trading activities to adopt a holding company structure akin to that employed by US banking groups. That would open the door to the same 'single point of entry' approach to bank resolution that is being advanced for US banking groups by the FDIC. This in my view will be far more significant than any alleged reduction in risk that the structural change is purported to achieve. The reduction in risk will come from the adoption of measures advanced in the Basel Committee's fundamental review of the trading book (and endorsed by the Liikanen Group).

What about supervision itself? How will the supervision conducted by the ECB differ from that exercised by national authorities? Will the ECB be rigorous or lax? I would suggest that a litmus test will be the attitude that the ECB will take toward

[2] The current Crisis Management Directive proposal puts deposits on a par with bonds that will be subject to bail-in and envisages bailing in both deposit guarantee schemes and uninsured depositors. This will raise the cost of deposit guarantee schemes and increase the risk of runs from uninsured depositors. See (Huertas & Nieto, 2012).

government debt in the banking book. A rigorous ECB would require banks to hold capital against such exposures, limit concentrations and/or force banks to value such debt at the lower of cost or market. A rigorous ECB would be more aggressive than national supervisors in forcing banks to take provisions against real estate lending. And, a rigorous ECB would be stricter than national supervisors in limiting the forbearance that banks provide to SMEs and other borrowers.

Finally, in a rigorous regime the ECB would take over direct responsibility for ELA. It would set stricter limits on terms and amounts for such facilities than national central banks. And, a rigorous ECB would be readier than national authorities to put into resolution banks that fail to meet threshold conditions. Under a rigorous regime, forbearance would cease

In sum, banking union is a very significant structural change. In deciding how to lay the foundations, it would in my view be wise to consider what the banking union should be in a position to accomplish when all of its components (supervision, regulation, resolution, deposit guarantees and central bank liquidity provision) are implemented in full. Will banking union be a more rigorous regime than what we currently have? If so, that will lead to a sounder banking system and lower demands on taxpayers. If not, banking union may not be anything more than a mechanism to facilitate access to European funds as a means to recapitalise banks in restructuring countries.

This brings me to the political issues surrounding banking union. Regardless of whether the new regime is rigorous or lax, it will involve very significant transfers of authority from Member States to European institutions, such as the ECB and prospectively a European resolution authority and possibly a European deposit guarantee scheme. To the extent that taxpayers remain responsible for losses relating to bank failures, banking union means that these would be at European level as well – and this implies a certain mutualisation of liabilities, something many Member States have been reluctant to support.

This transfer of authority is at the very core of banking union. Without such a transfer, banking union cannot take place. If banking union occurs, it will be mandatory for Member States in the euro-zone. They will be full members of the banking union with full rights to vote at the ECB on supervisory decisions. Other Member States will be given the option to join, but may not be able to do so on the same terms as Member States in the euro-zone. If they decide to join, they will be bound by the decisions of the ECB, but will not necessarily be entitled to a vote on those decisions.

If a non euro-zone Member State decides not to join the banking union, they retain their current rights, but face the very real prospect that the single market for financial services will in fact be shaped by the ECB from the perspective of the banking union rather than the EU as a whole. Under the Commission's proposal for the Single Supervisory Mechanism the ECB would be mandated to coordinate and express the

view of the member states of the banking union on regulatory and supervisory matters, including proposals made within the EBA for binding technical standards. As a practical matter this means that the EBA could not decide any such standard without the concurrence of the ECB. In other words, the ECB would certainly have a veto, and it would be very close to having a qualified majority.

Such voting arrangements create an inner core of euro-zone Member States, supported by a ring of Member States who have opted into banking union and a fringe of Member States who have refused to join banking union. This is unlikely to satisfy Member States in either the outer ring or the fringe. Some way will need to be found to accommodate these Member States, at least under the current proposal, as this requires unanimous approval.

A second political issue concerns how to handle current problem cases. Although the Heads of State agreed that the ESM should be able to recapitalise banks directly once a European system of supervision is in place, differences remain as to how the transition to the new regime should occur. Specifically, does setting up a Single Supervisory Mechanism open the door to the ESM's recapitalising banks immediately, or do 'old losses' remain the responsibility of national governments? Although recourse to the ESM may not be the solution, finding a way to deal with banks that currently require restructuring will certainly have to be part of the political bargain that will need to be struck, if banking union is to occur.

A third political issue relates to the role of the European Parliament. Technically, Parliament need not approve the proposal for banking union, as this is not required under the specific article of the Treaty that would permit Member States to grant supervisory powers to the ECB. All that is required is the unanimous approval of the Member States. However, leading figures in Parliament object to this, and have threatened to block approval of related legislation, such as the Capital Requirements Directive, unless Parliament is given a voice in deciding banking union. As a practical matter, some way will have to be found to satisfy the Parliament's wishes.

But the ultimate political issue relates to the future of Europe itself. Banking union represents not only a commitment to preserve the euro, but a commitment to deeper integration. Some Member States will subscribe fully to that vision. Others will not, and at least one appears to recoil from it. If banking union goes ahead, does this imply that the euro-zone will one day become synonymous with Europe? If it does, the influence of Member States outside the banking union will be much diminished. So will the ability of such member States to function as a financial centre for Europe as a whole. Even if Europe makes an a la carte menu available to non-participants in the banking union, the entrees may be few in number and cost a great deal.

References

BCBS 2012. Basel Committee on Banking Supervision. *Basel III regulatory consistency assessment (Level 2). Preliiminary report European Union.* Retrieved November 8, 2012, from http://www.bis.org/bcbs/implementation/l2_eu.pdf

EC 2012a. European Commission. *Banking union: Commission proposals for a single supervisory mechanism (2012).* Retrieved November 8, 2012, from http://ec.europa.eu/internal_market/finances/committees/index_en.htm#maincontentSec1

EC 2012b. European Commission. *Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions COM (2012) 511 final.* Retrieved November 8, 2012, from http://ec.europa.eu/internal_market/finances/docs/committees/reform/20120912-com-2012-511_en.pdf

EC 2012c. European Commission. *Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards its interaction with Council Regulation (EU) No…/… conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions COM(2012) 512 final.* Retrieved November 8, 2012, from http://ec.europa.eu/internal_market/finances/docs/committees/reform/20120912-com-2012-512_en.pdf

EC 2012d. European Commission. (2012, June 6). *Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms COM(2012) 280/3.* Retrieved July 4, 2012, from http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/COM_2012_280_en.pdf

Huertas, T. F., & Nieto, M. J. (2012). *Banking union and bank resolution: How should the two meet?* Retrieved November 8, 2012, from http://www.voxeu.org/article/banking-union-and-bank-resolution-how-should-two-meet

Liikanen Group. (2012). *High-level Expert Group on reforming the structure of the EU banking sector chaired by Erkki Liikanen: Final Report.* Retrieved November 8, 2012, from http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf

Wyplosz, C. (2012). Banking union as a crisis-management tool. In T. Beck (Ed.), *Banking Union for Europe: Risk and Challenges* (pp. 9-14). London: Centre for Economic Policy Research.