Library Briefing
Library of the European Parliament 12/11/2012

A first step towards banking union
The single supervisory mechanism

SUMMARY *Banking union is one of four building blocks for creating genuine economic and monetary union identified by European Council President, Herman van Rompuy. Such a union would aim to break the negative feedback loop between sovereign debt and the health of the banking system.*

As a first step, the European Commission proposed in September 2012 to confer supervisory authority for all eurozone banks on the European Central Bank. A second proposal includes a set of modifications to enable the European Banking Authority to continue its mission under the new supervision framework.

Political leaders and economists are now examining the proposals' feasibility and operational challenges. If a single supervisory mechanism is to be established, questions need to be answered on which banks will be covered, its geographical reach, sharing of responsibilities amongst different supervisors and the lack of common deposit guarantee and resolution mechanisms. Discussions are also ongoing on possible recapitalisations of troubled banks through the European Stability Mechanism and the exact timeline to be followed for all these measures.

Banking crisis

Sovereign-banking loop

A feedback loop links sovereign (government) debt and the health of the banking system in eurozone countries. Public rescues of unhealthy banks contributed to a rise in sovereign debt, which can in turn jeopardise the wellbeing of banks. The loop is reinforced by the cross-border nature of capital markets: credit institutions looking for security in the crisis direct their capital towards the "safest sovereign option". The German government in August 2012 was able to borrow money for five years at 0.31% whilst Spanish two-year bonds yielded above 7%. Additionally, banks are increasingly focusing activities on their home markets, leading to cuts in lending in the countries from which they withdraw. This deepens recession, and calls for further sovereign funding in EU periphery countries.

Establishing a banking union

In an attempt to break this negative feedback loop by addressing the health of the banking system, the European Commission (EC) called for a banking union in May 2012. It was one of the building blocks mentioned to reinforce Economic and Monetary Union alongside improving competitiveness and forming a fiscal and political union. The European Council subsequently endorsed more integrated supervision for the banking sector. Likewise,

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the International Monetary Fund (IMF) believes the immediate priority for the EU is the establishment of a banking union. A banking union would help reinforce prudential rules and place Member States (MS) on a more equal footing in terms of crisis prevention and management.

The EC identified three pillars of banking union:

- Strengthening deposit guarantee schemes, to protect EU citizens' savings at the same level throughout the EU.
- Establishing national resolution funds and legislation to avoid future bank bail-outs.
- Establishing a single rulebook for financial institutions.

In the single rulebook, the European Central Bank (ECB) would play a fundamental role. Some economists agree with the European Council on this new ECB role of supervisor and its potential collaboration with the European Stability Mechanism through recapitalisations. According to them, the ECB today lacks sufficient tools to control credit institutions (such as banks) in the EU that depend heavily on the Central Bank's liquidity.

Capital Requirements Directive (CRD) IV

The CRD IV, implementing Basel III in the EU, is currently under discussion by the EP and the Council. The Directive would cover prudential supervision of banks, establishing a range of supervisory powers to gather information and impose sanctions. Under the SSM proposal, the ECB would act directly as the "competent authority", or, until the CRD IV comes into effect, through instructing national regulators.

Commission proposals

The EC published its package proposing to set up a single supervisory mechanism (SSM) on 12 September 2012. Its “Roadmap towards a Banking Union”, confirms that the SSM is a crucial first step towards a banking union. The communication is accompanied by two legislative proposals, to set up the SSM in collaboration with the ECB, and to adapt the European Banking Authority (EBA) to the new prudential rules.

The single supervisory mechanism

Given the interdependence between banking policy and monetary policy, the ECB will play a central role in the architecture of the SSM. The use of Article 127(6) TFEU implies a direct link of the SSM to the Economic and Monetary Union and authorises, if approved unanimously by Council, the ECB to have supervisory tasks for financial institutions in the eurozone.

Scope

The regulation proposes that the ECB be able immediately to take over the supervision of any eurozone credit institution for which it deems this necessary, in particular if the institution has received state aid. For supervision of other banks, a phase-in could take place from 1 July 2013 for systemically important credit institutions in the eurozone, followed on 1 January 2014 for the remainder. The proposal reserves SSM membership to eurozone MS but keeps open the option of "close supervisory cooperation" with other MS. Non-eurozone MS could be allowed to "opt in" to the SSM provided they comply with ECB instructions. Independently of SSM membership, the ECB is also allowed to participate in supervisory colleges for banks that offer services to MS.

Responsibilities

The proposed SSM would transfer the responsibility for prudential supervision from national supervisors to the ECB. The Bank would, inter alia, be able to approve and withdraw the authorisation of credit institutions, assess their merger and acquisitions activity, ensure compliance with EU prudential requirements, carry out stress tests, and impose capital buffers. National authorities would assist the ECB in these tasks on a day-to-day basis, but the

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ECB would be authorised to request information directly from the supervised institutions and to impose sanctions directly or require national supervisors to do so. However, all tasks, such as consumer protection and anti-money-laundering practices, which are not explicitly mentioned in the ECB's new mandate, would remain the responsibility of MS. The supervision of third-country institutions – banks from countries outside the EU that offer services in the MS – and payment services would also remain under national regulators.

To guarantee independence, the ECB would have to separate the new supervisory activities from its monetary policy functions. A new supervisory board would be created by the ECB and national supervisors. The ECB would be accountable to the European Parliament (EP) and the Council. To fund the new mechanism, the ECB would levy a supervisory fee on supervised credit institutions, proportionate to their risk profiles, and call on seconded staff from national regulators.

European Banking Authority

In 2011, the EBA and the European System of Financial Supervision were established to improve coordination, and possibly to solve disputes, between EU banking supervisors. As one of the three European Supervisory Authorities, the EBA has the power to rule against national authorities in case of regulatory failure. Amongst other things it is responsible for stress tests that determine the possible effects of negative market developments on European credit institutions.

The European Banking Authority

The responsibilities of the European Banking Authority would remain largely unchanged, as it is proposed to lead the development of a "single supervisory rulebook" which would apply to all MS.

Responsibilities

To ensure that the EBA can continue its mission, the EC proposes to amend voting modalities. Input of MS involved in the SSM would be coordinated by the ECB which would "express a common position" in the Board of Supervisors and the Management Board of the EBA. In addition, the latter would always include representatives of two MS not participating in the SSM. Its governance arrangements would be adapted accordingly but voting rules in emergency situations (simple majority) and on regulatory and budgetary matters (qualified majority) would remain unchanged. The regulation would not alter the balance of competences between the EBA and national authorities.

Challenges

Scope

Selection of credit institutions

Whilst the EC proposal includes all eurozone banks, opinions differ on their respective importance. Citing the Spanish crisis, some economists argue for the inclusion of small banks. Yet, German Finance Minister Wolfgang Schäuble proposes that the ECB only look into "systemically relevant" credit institutions. An argument, some say, meant to keep the politically sensitive *Landes-banken* and *Sparkassen* – networks of smaller German public banks often claimed to be used as instruments of regional politics rather than being profit-making banks – out of supervisory sight. Keeping these banks out of scope could prompt other MS to demand similar exceptions. From a different perspective, exceptions for smaller banks could strengthen fears in smaller eurozone MS that their banking system is "less systemic" and will thus receive less scrutiny.

Recapitalisations

Disagreement also prevails on the use of the rescue scheme. It is unclear whether the ESM will be allowed to take over “legacy assets” (debt created prior to the recapitalisation taking place) in the course of future recapitalisations. Doing so could benefit Ireland and Spain who have spent large amounts of sovereign funding bailing out banks. However, Germany, The Netherlands and Finland insist that the assets remain under national responsibility. Moreover, whilst suspected by certain sceptics to be a negotiating tactic, the MS in question feel recapitalisation would only be possible once the supervisor is fully established.

Geographical limits
Whilst the banking union is most directly linked to the eurozone, in which MS have no access to customary monetary tools, the integration of the banking sector reaches beyond the eurozone. The proposal was endorsed by the EU-27 European Council, and most analysts claim the interests of all MS should be taken into account. Some non-eurozone and smaller eurozone MS feel they risk being "sidelined" on important economic decisions. Sweden, the UK and the Czech Republic worry about possible effects of a banking union on their banking sectors. Czech Prime Minister Petr Nečas fears ultimately having to pay for failing credit institutions in other MS. The UK, accounting for the major part of European banking assets, is afraid eurozone MS would impose their views on EU-wide bank rules. According to commentators, such fears may stoke further debate on "EU exit" in the UK.

Responsibilities
Conflicting mandates
Whilst one of the purposes of banking union is to relieve political capture of national regulators, some fear an adverse effect for the ECB. One of the main concerns is the combination of supervisory authority with monetary policy. Supervision includes political decisions potentially at odds with the neutral conduct of monetary policy. Whilst lowering interest rates can counter inflation and benefit price stability, it may also jeopardise bank solvency and financial stability.

Ultimate responsibility
Voting modalities in the EBA may change, but critics question the combination of an increased role for the EBA with greater influence of the ECB in the Authority. So far, it is unclear who would prevail in situations of conflict and what the EBA can do if it feels the ECB is not following the new handbook. This question of "ultimate responsibility" for financial stability, and of accountability, would become even more pressing if the ECB disagrees with national authorities from inside, or outside, the SSM.

Time pressure
Investors claim that the ECB has effectively taken the "tail-risk" out of the market with its "outright monetary transactions" (OMT) facility announced on 6 September. Moreover, some say that the rapid uptake of the initial idea of banking union creates confidence in its execution. But markets are impatient to understand when the proposed measures will be implemented, and to see the details. Rating agency Moody's cautioned its clients about the effects on sovereign ratings of disagreement among EU leaders over banking union. On the eve of the October European Council, Commission President José Manuel Barroso and Van Rompuy warned that establishing a banking union remained a pressing task.

Sufficiency
The proposals of the EC so far cover only the supervisory aspects of a banking union, leaving other points open. An incompleteness some fear is no better than not having a banking union at all. These economists believe having supervision at European level whilst deposit guarantee and resolution mechanisms remain at national level, is not "incentive compatible". Hoping to receive more ECB funding for their credit institutions to survive, national authorities would keep resolution as a very last option and under-report actual problems in the banks concerned.

EU Institutions

European Council
On 18-19 October, the European Council discussed progress made on banking union. Compromising between a French request

for a solid timeline and a German preference for "proper sequence", leaders decided the framework would be put in place by 1 January 2013, and be operational by the end of the same year. Confirming their June statement, the conclusions state that only once the SSM is "effectively" established, can direct recapitalisation of banks by the ESM take place.

As for scope, supervision would include all 6 000 credit institutions in the eurozone by the end of 2014, after a phase-in starting with "systemically important" banks and those which have received state aid. National authorities are likely to retain at least day-to-day oversight and might keep responsibility for certain banks. This would lead to a two-tier supervisory system, in which the ECB depends in some cases on information "pro-actively" provided by MS. As such, the relationship between national supervisors and the ECB, some critics say, turns into a more formal contract in which a "single" supervisor is only "partly" responsible.

Questions which remain to be answered in Council discussions include, inter alia, the accommodation of non-eurozone banks, voting at the EBA, "legacy assets" and the exact responsibility of the ECB.

European Parliament

EP President Martin Schulz declared the EP would do everything within its powers to establish an effective pan-European supervisory system, which he recalled corresponds to 2010 proposal of the EP for a European banking supervisory authority.

On 8 October 2012, the EP's ECON committee published its draft report (by Marianne Thyssen, EPP, Belgium) on the EC's proposal for establishing the SSM. The draft proposes to narrow the scope of banks supervised to those that are systemically important or have received state aid, and points to the need for a realistic timeline. In parallel, a second draft report (Sven Giegold, Greens-EFA, Germany) covers the role of the EBA in the new supervisory structure. The draft proposes that the Authority coordinates the EU supervisory structure, and gives it more "on the ground" powers to carry out stress tests effectively and to obtain easily information it needs from MS.

The EP has only a consultative role in establishing the SSM (as too does the ECB), whereas the EBA amendments are subject to the codecision procedure. To enhance democratic accountability, the EP has however announced that it will consider the two proposals as a single legislative package. The package will likely be voted upon by the ECON committee in November, with a plenary vote in December.

Further reading

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