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The European Council and Banking Union

The first permanent European Council President, Herman Van Rompuy, considered the June 2012 meeting to be 'the most important European Council' of his five-year term. At that meeting, euro-area leaders committed themselves to launching what is the most ambitious EU project since the introduction of the single currency – the Banking Union. The European Council not only provided the impetus to establish a Banking Union but EU leaders have also regularly monitored the progress being made. In the coming years, a number of challenges remain for the fine-tuning and completion of the Banking Union, and these could potentially require the European Council's further involvement.

1. What did the European Council/euro-area leaders initially commit to at the height of the crisis in mid-2012? What priorities were highlighted by the European Council?

At the initiative of President Herman Van Rompuy, the members of the European Council held an 'open and frank' exchange of views on the future design of Economic and Monetary Union (EMU) at an informal dinner on 23 May 2012. Here, euro-area leaders agreed to mandate the European Council (and Euro Summit) President to draft a report setting out a long-term vision for EMU in order to safeguard stability and ensure prosperity.

The European Council President – in close cooperation with the European Commission, Eurogroup and ECB Presidents – presented a preliminary version of the report on the main building-blocks to achieve a strengthened EMU at the June 2012 European Council meeting. Most notably, it included efforts towards an integrated financial framework, an integrated budgetary framework, an integrated economic policy framework, and strengthened democratic legitimacy and accountability.

At the Euro Summit that immediately followed the 29 June 2012 European Council meeting, Heads of State or Government of the euro area committed to severing the negative feedback loop between banks and sovereigns, in order to safeguard the financial stability of the euro area and protect taxpayers from bank failures. To that end, the establishment of a Single Supervisory Mechanism (SSM) for euro area banks was agreed as a first step towards a fully fledged Banking Union. Equally, it was decided that the European Stability Mechanism (ESM) could directly recapitalise banks once the SSM is effective. The report also mentioned that common mechanisms to wind down banks and guarantee deposits should be established subsequently as part of an integrated financial framework.

The final version of the Four Presidents' report, 'Towards a Genuine EMU', submitted in early December 2012, confirmed a specific time-bound roadmap for the achievement of a genuine EMU. During the first stage (to be completed in 2013), the four Presidents called for the rapid establishment of the SSM, the ESM Direct Recapitalisation Instrument (DRI) and a single rulebook. In the second stage (2013-2014), a common resolution mechanism would complete the integrated financial framework.

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Author: Stanislas de Finance
European Council Oversight Unit
PE 573.282

2. Why did the European Council launch Banking Union?

After nearly two and a half years of sovereign debt crisis, and amid heightened uncertainty about the integrity of the euro area, it became evident to the European Council that a 'qualitative breakthrough' was necessary to address flaws in the initial design of EMU. Although new rescue and crisis management mechanisms (for example, the adoption of the ESM Treaty in spring 2012) and macroeconomic surveillance tools and rules (for example, the six- and two-packs and the Treaty on Stability, Coordination and Governance) had been established, this proved to be insufficient to help restore confidence to the markets.

The 2008 financial crisis revealed a vicious circle between banks, corporates and sovereigns, which has been acting as a significant drag on euro-area growth. Prior to the bursting of the financial and real estate bubbles, banks had grown to the extent that many had significant weight in the financial system. Several banks were deemed to be 'too big to fail' and, as a result, were rescued by sovereigns, with the aim of stabilising and restoring confidence in the financial system. Such a large amount of money being injected into the financial system led to a sharp deterioration of public finances and an increase in market-funding costs for stressed euro-area sovereigns. As a result, public debt increased to record highs and financial assistance had to be granted to a few peripheral sovereigns, that had ended up cut off from markets, in exchange for their implementation of economic adjustment programmes.

The euro-area financial system, which had become (relatively) integrated since the introduction of the single currency, also began to fragment, as interest rates saw significant divergence. This fragmentation occurred despite all of the unconventional monetary policy measures carried out by the ECB. New loans to corporates dropped as banks' credit conditions tightened significantly. At the same time, weak businesses had a negative impact on banks, as non-performing loans went up significantly in stressed economies. In turn, the quality of assets on banks' balance sheets deteriorated. Due to increasing risks, banks were forced to raise margins on new loans to companies, especially SMEs. Ultimately, this nexus between banks, corporates and sovereigns had sizeable negative effects on the real economy of the euro area.

Against this background, the European Council decided to address, as a matter of priority, the identified weaknesses in the euro area financial framework. In particular, it decided to tackle the negative feedback loop between banks, corporates and sovereigns. It was agreed that short-term actions would include the gradual establishment of a Banking Union while work continued on the longer-term vision for EMU.

3. What is Banking Union project in practice?

The European Banking Union aims to restore financial stability and confidence in the banking system, so as to foster economic growth. It has two core provisions: firstly, to ensure that there is sounder and unbiased supervision of financial institutions; and secondly, to ensure that failing banks are wound down swiftly and orderly so as to safeguard financial stability and protect taxpayers' money.

In order to achieve the above-mentioned objectives, it was agreed that a fully fledged Banking Union should have a common supervisor for financial institutions, namely the Single Supervisory Mechanism (SSM), consisting of the ECB as the overarching authority, alongside the national banking supervisors of participating EU Member States.[1] In addition, there should be a common resolution mechanism for dealing with bank failures, namely the Single Resolution Mechanism (SRM). In practice, the central authority of the SRM, the Single Resolution Board, prepares and oversees the resolution of the most significant financial

[1] Note that participation in the banking union is mandatory for euro-area Member States.

institutions. At the same time, it is responsible for a common safety net, namely the Single Resolution Fund (SRF), whose resources are based on contributions from the banking sector and will be drawn upon for the resolution of failing banks. A credible fiscal backstop – for example, a European Stability Mechanism (ESM) credit line – should also be established in order to ensure that potential shortfalls – stemming from widespread bank failures or a systemic crisis – can be covered.[2] A fully fledged Banking Union should also contain a common deposit insurance mechanism – with an attached fund and fiscal backstop – aimed at preventing capital flight and deposit outflows, since these could have sizeable destabilising impacts on a local bank or the entire banking sector and, ultimately, on the real economy. As a complementary element, a common rescue mechanism – namely the ESM – has the possibility to directly recapitalise banks, through a Direct Recapitalisation Instrument (DRI).

Crucially, the structure of Banking Union is underpinned by a single rulebook applying to all EU Member States. This set of common rules is made up of the Capital Requirements Directive/Regulation (CRD/CRR), whose aim is to make banks more resilient and able to withstand shocks so that, ultimately, the financing of the real economy is safeguarded. An EU framework for bank resolution (the Bank Recovery and Resolution Directive, or BRRD) was also adopted and provides national authorities with adequate instruments to manage bank failures in an orderly manner, including cases with a cross-border element. Finally, the 2014 Deposit Guarantee Scheme Directive (DGSD) aims mainly to protect EU depositors, up to a ceiling of €100 000, in the event of a bank failure.

4. What role did the European Council play during the establishment of Banking Union?

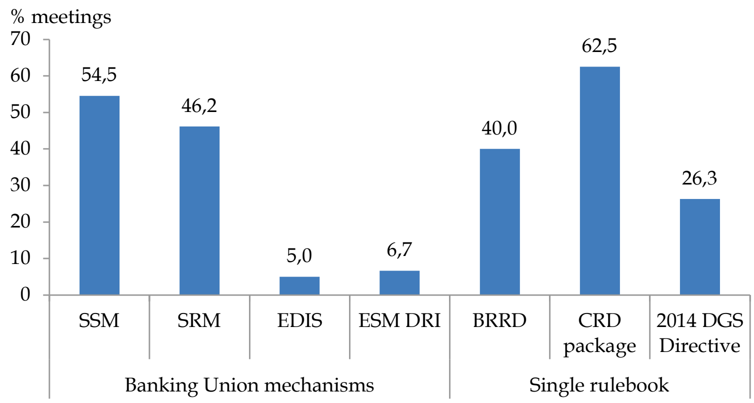
Since June 2012, EU leaders have regularly monitored the gradual establishment of the Banking Union's core mechanisms. The conclusions and statements show that the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) were addressed at half of all regular European Council/Euro Summit meetings (Figure 1) in that period. This suggests that setting up those two mechanisms was a top priority. During the mandate of Herman Van Rompuy, the European Council frequently called on stakeholders to find a deal. However, this was not an easy task, given the tough negotiations between the co-legislators to agree on the SRM before the end of the last parliamentary term. In addition, the European Council regularly monitored the progress being made on the adoption of the ESM Direct Recapitalisation Instrument (DRI). Two main factors may account for the low percentage of references to this in the conclusions or statements (Figure 1). On the one hand, it proved difficult for euro-area finance ministers to reach an agreement on this new tool, due to the issue of legacy assets.[3] On the other hand, euro-area leaders had committed to establishing the ESM DRI only once the SSM was fully operational. As a result, it gave more time to euro-area finance ministers to reach an agreement. Lastly, the European Deposit Insurance Scheme (EDIS) was barely discussed at European Council level, because building a consensus on its set-up amongst euro-area leaders has proved a real challenge for years, including at Eurogroup and Council levels. On top of that, this pillar has been widely considered to be less crucial or urgent than the other two mechanisms; hence there is a marked loss of momentum, displayed through repeated postponements.

The European Council also consistently followed up on the various pieces of legislation comprising the single rulebook applicable to all EU Member States. The capital requirements rules and the bail-in rules were referred to respectively in 62.5% and 40% of the EU leaders' meetings, due to their importance to the

[2] This common backstop has to be fiscally neutral in the medium term, meaning that any funds injected into the SRF must be recovered subsequently by additional contributions levied on the banking sector, i.e. *ex post* contributions.
[3] In other words, agreeing on the treatment of all assets held by euro-area financial institutions prior to the adoption of the ESM Direct Recapitalisation Instrument (DRI) was a challenge.

functionality of both the SSM and the Single Resolution Mechanism (SRM). As regards the revision of the Deposit Guarantee Scheme Directive (DGSD), the adoption process took much longer, as there was nearly four years between the introduction of the proposal by the Commission and the agreement reached in the Council. This mainly accounts for the relatively low percentage of mentions by the European Council, though it averaged once a year.

Figure 1: References to Banking Union in the European Council conclusions and Euro Summit statements (as a percentage of meetings)



Source: EPRS based on European Council conclusions and Euro Summit statements

5. How far did the European Council meet its commitments on Banking Union? How has work progressed so far?

Most of the European Council's commitments and requests made since mid-2012 concerning the establishment of a Banking Union have been met.

The first pillar of Banking Union – the Single Supervisory Mechanism (SSM) – has been up and running since November 2014, in line with the European Council's commitment made in June 2012, albeit the initial deadline of 1 January 2014 set in the Four Presidents' report was missed.

The second pillar – the Single Resolution Mechanism (SRM) – also became fully operational, on 1 January 2016, following a one-year transition period. Again, this European Council commitment to establishing an SRM, once the SSM was in place, was achieved. Similarly, the Single Resolution Fund (SRF) has been operational since 1 January 2016, following the successful ratification of its intergovernmental agreement by a sufficient number of euro-area Member States.[4] However, the SRF is expected to be fully built up only in 2024, after an eight-year transitional period, during which contributions from the banking sector are levied and gradually mutualised.

Additionally, for the time being, a common fiscal backstop to the SRF is still absent, despite hints at its necessity in European Council conclusions and the Four and Five Presidents' reports. On top of that, a commitment was made at Eurogroup and Council levels in 2013.

The establishment of the ESM DRI for euro-area financial institutions – an initial commitment from the European Council back in June 2012, alongside the establishment of the SSM – was achieved in December

[4] Note that Luxembourg remains the only euro-area Member State not yet to have ratified the agreement.

2014, following a long process of negotiation at Eurogroup level. This was also in line with the European Council's conclusions, which specifically requested the possibility to directly recapitalise banks once the SSM was officially launched.

As far as the single rule book is concerned, the European Council repeatedly called for the adoption of the Bank Recovery and Resolution Directive (BRRD), the Capital Requirements Directive (CRD) package, and the revision of the Deposit Guarantee Scheme Directive (DGSD). That proved to be successful as all those pieces of legislation were passed before the end of the last legislature. However, many EU Member States must still transpose the BRRD and the DGSD into national law. The initial deadlines for the transposition of the BRRD and the DGSD were 31 December 2014 and 3 July 2015 respectively. As a result, infringement procedures have been launched by the Commission against those Member States who failed to incorporate these directives into their national legislation.

At their December 2015 meeting, Heads of State or Government reiterated their commitment to completing Banking Union. More specifically, the co-legislators were invited to make progress on the proposal on the establishment of the missing pillar of Banking Union, namely the European Deposit Insurance Scheme (EDIS).

6. What future European Council action can be expected in Banking Union?

The European Council is not expected to return to the subject of completing Banking Union before the end of 2017. Before then, the Council is invited to report on progress made in June 2016, while the Commission plans to submit a White Paper in spring 2017 setting out the next measures to be taken with a view to completing EMU, including Banking Union ('Stage 2' of the Five Presidents' report).

However, there is no room for complacency, despite past achievements on Banking Union. The European Parliament has called on stakeholders to complete Banking Union step by step, in order to further strengthen the resilience of the euro-area economy.

Should the process towards establishment of the EDIS stall – following significant opposition being displayed by a few euro-area Member States, Germany in particular – the European Council might again have to renew its commitment to provide the necessary impetus towards the conclusion of the negotiations on European Deposit Insurance Scheme (EDIS), in line with its role under the Lisbon Treaty (Article 15(1) TEU). In the same vein, the European Council and its President might play a greater role in rebuilding some momentum towards the establishment of EDIS in the event of a substantial bank run jeopardising depositors in one or several euro-area Member States, similarly to that which Greece experienced in the first half of 2015.[5]

Additionally, the establishment of a common fiscal backstop to the Single Resolution Fund (SRF) – through a European Stability Mechanism (ESM) credit line, for example – could require impetus from the European Council, especially should the SRF be under pressure in the early years of the Fund's implementation. Despite Eurogroup President Jeroen Dijsselbloem's position in favour of setting up a common backstop, there has been no broad support among euro-area finance ministers. It is possible to envisage that the President of the European Council could then try to unlock the situation at Eurogroup level, by seeking to foster consensus between euro-area leaders on the setting up of such a new ESM instrument.

[5] Between December 2014 and July 2015, Greece's bank deposits from the non-financial sector dropped by 33%.

List of abbreviations

BRRD	Bank Recovery and Resolution Directive
CRD (IV)	Capital Requirements Directive (IV)
CRR	Capital Requirements Regulation
DGSD	Deposit Guarantee Scheme Directive
DRI	Direct Recapitalisation Instrument
ECB	European Central Bank
EDIS	European Deposit Insurance Scheme
EMU	Economic and Monetary Union
ESM	European Stability Mechanism
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism

To contact the European Council Oversight Unit, please e-mail: EPRS-EuropeanCouncilOversight@ep.europa.eu

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