Network of European Union EUCE Centers of Excellence

Europe's Progress Towards Banking Union

ECB	European Central Bank
OMT	Outright Monetary Transaction
ESM	European Stability Mechanism
CRD/R IV	Capital Requirements Directive/Regulation IV
MiFID/R	Markets in Financial Instruments Directive/Regulation
RRD	Recovery and Resolution Directive
BU	Banking Union
EMU	European Monetary Union
SSM	Single Supervisory Mechanism
SRM	Single Resolution Mechanism
RF	Resolution Fund
DGS	Deposit Guarantee Scheme
EBA	European Banking Authority
EFSF	European Financial Stability Facility
EFSM	European Financial Stability Mechanism

The European Union (EU) has developed a number of plans in response to the financial and eurozone crisis that is holding some member states in recession and limiting the euro-area's economic output. These plans range from short-term reactions to urgent flare-ups, to more long-term thinking about the financial policies of the European Union and the broader architecture of EU finance.

Examples of the more urgent crisis-measures would be the European Central Bank's (ECB) decision to start Outright Monetary Transactions (OMT) to ease the burden on certain peripheral European economies, and the subsequent development of the European Stability Mechanism (ESM) to put emergency bailout funding into a predictable framework. On the longer-term issues of financial policy, the European Commission has unveiled proposals, among others, to implement the global Basel III accords into EU law through the Capital Requirements Directive/Regulation IV (CRD/R IV), to regulate certain trading activities more closely through the Markets in Financial Instruments Directive/Regulation (MiFID/R), and to create a harmonized European solution for failing banks through the Bank Recovery and Resolution Directive (RRD) with the aim of stopping or at least limiting the need for the public sector to bail out the banking sector.

The European Union Center of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.

Closely linked to this legislative agenda is the Commission's most ambitious proposal, deriving from an agreement between member state governments in the summer of 2012: the Banking Union (BU). This brief will look at the idea behind the banking union proposal and examine the Commission's ambitions as unveiled in its Blueprint and Roadmap of September 2012, before reporting on the progress that been made so far on the various stages of the BU's construction and casting an eye to the future to see how likely it is that the BU will ever be built in anything like the form originally envisaged by the Commission.

The basic idea

The aim at the heart of the banking union proposal is simple: to break the negative feedback loop between banking crises and sovereign crises. The story of the economic crisis in Europe can be seen as a series of near banking failures stemming from the global financial crisis that originated in the USA. Losses on investments in the US market caused European banks that are "too-big-to-fail" in system terms to threaten collapse, necessitating emergency bail-outs from national governments both individually and, ultimately, through European institutions.

The European dimension of the bailout was unexpected. The large size of many of the banks under strain relative to the gross domestic product (GDP) of the countries in which they are headquartered this put a huge strain on member state government finances, causing the debt-to-GDP ratio to spiral out of control. The economic recession only made matters worse, by lowering prospects for future GDP growth and therefore also prospects for government revenues. With such fragile public finances, a number of EU governments found that their borrowing costs in the markets, as reflected in the effective yields they had to pay on sovereign debt, increased dramatically and became unsustainable. As a result, governments needed both external money to bail them out and domestic austerity measures to repair public finances. This happened in Greece, Portugal, Ireland, Spain and Cyprus, with Italy and even France teetering on the brink.

The banking and sovereign debt crises created a vicious cycle. When the banking system comes under strain, public finances are required to save it so as to avoid a complete meltdown of the financial system (which would have intolerable economic consequences), thus making a private-sector failure suddenly a public-sector concern. However the poor state of the global banking system has increased risk aversion within banks, making them unwilling to lend to weaker institutions such as European governments with their poor post-bank-bail-out public finances. These more fragile government finances now mean that they are less able to support national banking systems when they need it, and so on and so forth, hence the negative trend of this cycle.

In essence, at the heart of this problem is what Mervyn King, the recently departed Governor of the Bank of England, explained as the fact that "banks are global in life, but national in death." That is, thanks to the liberalization and globalization of the banking system, banks over the past decades have had the opportunity vastly to expand their balance sheets, to the extent that these can often dwarf the GDPs of their 'home' nations – which is to say, the countries in which they are headquartered.

The European Union Center of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.

To take one example, Dexia, a Belgian bank that failed in 2010, was estimated to have a balance sheet roughly twice the size of Belgium's GDP. Nevertheless, when these very large financial institutions failed, it was to their national (in the European context, member state) governments that they ultimately had to turn for bail-out and other assistance. Obviously, for example in the case of Dexia, there is no way a government can bail out an entity that is 'worth' more than twice as much as it.

The lack of global financial governance system to complement the global nature of putatively 'national' financial institutions has meant that a relatively small number of individual governments have been left to foot the bill banking losses that spanned the globe. This is unsustainable. One way that some policy-makers have decided to react to this situation is to try to 'mutualize' (or share) the governance of the financial system across countries.

The 'banking union' is the set of common or shared institutions for banking supervision, resolution decisions, resolution funding and deposit guarantees. These institutions would be shared across those countries that have adopted the euro as a common currency – the Eurozone – but they would be open to participation from other EU member states as well. Within those institutions, would be taken by a centralized entity which would be able to marshal resources on a larger scale than any individual government. The creation of this banking union would also resolve the problem of cross-border (but still intra-eurozone) banks, which currently fall under multiple banking jurisdictions, making it complex an unnecessarily political to decide how to monitor a bank, resolve it should it fail, and especially how to fund this eventuality. In this way, the European banking union would stop what one Member of the European Parliament (MEP) described as "a *bank in* crisis from turning into a *banking* crisis."

The plan

The heads of state and government of the EU member states agreed at the June 2012 Summit that the EU should pursue a Banking Union as a matter of urgency in response to the financial and economic crisis in the EU.[1] In response, the European Commission came out with its *Blueprint for a deep and genuine Economic and Monetary union (EMU)*.[2] This blueprint details not only the Commission's opinion of what Banking Union should look like, but places it into the broader context of further European integration.

The implications are worth considering before going into the details of the proposal. First, the Commission's blueprint sees the Banking Union (which is itself split into numerous stages, as will be outlined below) forming the first step on the road towards eventual political union through fiscal and then full economic union. By 'fiscal union' the Commission means the harmonization of tax and budgetary policy by member state governments and some fiscal capacity for the Union itself, and by 'full economic union' the close alignment of the various economies within the European Union, central fiscal

The European Union Center of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.

capacity and the issuance of common debt (so called 'euro-bonds') which itself ought to help government funding and the stability of the single currency.

Alongside this economic integration, the Commission document foresees the need to increase political integration so as to ensure that there is proper responsiveness to citizens' needs and reinforced democratic legitimacy and accountability. This, naturally, in practice would lead to the further pooling of not only economic sovereignty but also political sovereignty.

Finally, the Commission proposes that this internally-strengthened and increasingly-centralized European Union would have to then have further authority to represent itself externally as well. Such external representation would be important both in global efforts to elaborate banking regulation and accounting, and in the broader framework for the global economy provided by the International Monetary Fund and the World Bank.

Of course, not all of these implications will come to pass. Many view the full entailments of the Commission proposal as a roadmap to full economic and political union – which they describe as the Commission's Federalist utopia. The political support for such a sweeping project does not exist at the moment.

That is not to say, however, that Europe is unable to integrate further. Tellingly, the Commission parceled the steps in its blueprint into short-, medium-, and long-terms of 6-18 months, 18 months-5 years, and beyond five years respectively. The short term includes many of the immediate steps towards Banking Union as well as agreement for the next Multiannual Financial Framework (essentially the EU budget), the medium term includes tax and employment harmonization, while the long term would include full fiscal autonomy for the EU, as well as total monetary and economic union and steps towards further political union. The emphasis is clearly on the short term. There is an institutional logic here. The College of Commissioners' term in office itself only lasts five years, and the rate of change of the political and economic developments in Europe and across the world is extremely high. Hence putting off a legislative proposal for five years is as good as saying that it will never happen. The Commission, with these more ambitious and longer-term aspects of the proposal, is essentially just laying down a marker for the direction of travel it would like for the EU: they are more symbolic than concrete.

The more concrete measures are set out in the Commission's September 2012 *Roadmap towards Banking Union.*[3] These span the short- and medium-terms as set out above, and are themselves divided into a number of smaller steps. The Commission claims these steps should be possible under secondary Union law, hence not requiring treaty change from the member state governments (which is highly contentious and can take many years to agree).

The first stage of Banking Union requires the harmonizing of banking regulation and the equal monitoring and resolution of banks within the BU's remit. In EU terms this means the Single Rulebook, Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM). The Single Rulebook itself consists of many pieces of financial

The European Union Center of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.

regulation as set out under the last Commission and Parliamentary terms that are ending in 2014.[4]

The aim of this first stage of Banking Union is, in the blueprint's own words, "to effectively break the vicious circle linking Member States' public finances and the health of their banks, and to limit negative cross-border spillover effects." Beyond the SSM and SRM, the Commission Roadmap details the need for two or three next steps for a full BU (different people count them differently) which would need to be delivered within the next five years:

1. a dedicated, ex-ante Resolution Fund (RF) to fund any bail-outs required by European banks;
2. a Common Deposit Guarantee Scheme (DGS) to prevent potential bank runs anywhere in the Union; and (possibly)
3. Eurobonds to allow for equal access to the markets of all participating member state governments within the BU, removing discrepancies for different banking markets. However, though these bonds will be helpful for EU financial stability, as more of a fiscal matter and one relating to the balance of sovereignty and autonomy between member states and the European Institutions, it is not clear that they should really be considered an integral part of the BU itself.

With these four or five pillars (SSM, SRM, RF, DGS – Eurobonds), the Commission would consider there to be a full Banking Union within the European Union, which would be able to break the link between failing banks and economically failing governments and ensure the smooth functioning of financial markets within the BU. This is with the ultimate aim, of course, of promoting economic growth as a response to the crisis, and to ensure stability to prevent a similar crisis from taking place in the future, thus guaranteeing the future of the euro.

The progress

The initial proposal in June 2012 was greeted with tremendous enthusiasm. The European Commission's papers (cited above) added momentum. However, efforts by the European Central Bank (ECB) to stem the crisis inadvertently sapped some of the pressure for political reform. ECB President Mario Draghi's promise to do whatever it takes to safeguard the euro created space for Europe's politicians to reconsider their bold plans to establish a banking union and to worry about the costs of sharing institutions for banking supervision. Progress slowed in response. Therefore, we are left with a mixed record of achievement.

1. ***Banking Supervision:*** The Commission announced its proposal on the single supervisory mechanism in September 2012, dividing its aims into two parts: a Council Regulation on conferring SSM powers to the ECB,[5] and a Regulation[6] altering the voting modalities in the European Banking Authority (EBA) to take into account the single supervisor. The Council Regulation required unanimity

The European Union Center of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.

within the Council for approval, with no formal role for the European Parliament, while the EBA Regulation followed the usual co-decision procedure between Council and Parliament. Early on in discussions, however, both Council and Parliament decided to treat the two as a package, giving Parliament an effective veto also over the Council Regulation.

This 'veto' was significant in that it allowed the Parliament to insist on 'democratic oversight' (ie, parliamentary say) over the nomination of the chair and vice-chair of the ECB's Supervisory Board which will take decisions on supervisory matters for the central bank. The two proposals were finally agreed and ratified in March 2013, with an initial start date for the ECB to take over supervision of European banks set for March 2014, though this date has now been pushed back, and is currently expected towards the end of the year 2014.

Another major significance of the ECB becoming SSM lies in the fact that this will trigger the start of the ability to directly recapitalize distressed European banks through the European Stability Mechanism (ESM), which is designed to provide certainty as to the capacity, impartiality and conditionality of future bank bail-outs. The ESM is a separate European institution, set up in 2012 as part of the EU's crisis response to take over permanently from the short term European Financial Stability Facility (EFSF) and European Financial Stabilization Mechanism (EFSM). Though this is not conceptually a part of the Banking Union, it is designed to work alongside it to prevent another generalized European banking crisis.

2. **Banking Resolution**: In July 2013 the Commission proposed its Regulation for the Single Resolution Mechanism.[7] This is designed to complement the SSM, and will of necessity have the same membership as it: as one senior Commission official put it "if you're in one, you're in the other." Analogously to the SSM's role of implementing the Single Rulebook for supervision, the SRM will implement EU rules for the recovery and resolution of failing banks. These rules are currently being decided through the co-decision of the Council and Parliament, following the Commission's proposal for a bank Recovery and Resolution Directive of June 2012.[8] This proposed Directive has not yet been finalized, and will likely only be agreed by the end of 2013 at the earliest.

   The Commission has asked for the SRM to be set up within the European Commission itself, giving the Commission authority to close down failing banks. This is a contentious proposal, to say the least, as it is seen by many member states (especially Germany) as conferring sovereignty to the Commission, which

The European Union Center of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.

would require a treaty change. The German Finance Minister, Wolfgang Schaeuble called this a "competence hijack" by the Commission. The major worry is that this would allow the Commission to decide the fate of a bank, but have member states pay for this through plans for mutualized resolution funding (below), without any say over the decision itself. Instead there are proposals inside the Council to set up a Resolution Authority within the EU made up of a network of national authorities, which could make these political decisions with greater accountability to member states. Despite there being no agreement yet in Council or Parliament, the plan is for the SRM to be implemented in 2015, with the new common rules (as to be decided through the RRD) being implemented progressively by 2018.

3. **Resolution Funding**: The track record on this part of the banking union agenda extends back before the June 2012 commitment. Already in 2010 the Commission proposed setting up ex-ante Resolution Funds nationally to pay for bank bailouts. In an ex-ante system, banks would have to finance a levy up to a certain amount which would then be held separately and used in the case of need. This is opposed to ex-post funding, whereby a bank is bailed out, and then when it has recovered it is expected to pay back the capital that was injected into it; naturally ex-post funding is more risky from a public finances perspective (as it is the public sector that would have to float the resolution funding), but preferred by the banks themselves.

   What the banking union proposal adds is the idea that this collection of member state resolution funds would be pooled into one resolution fund which could be used to cover the costs of resolving bailed banks across participating countries. This is not intended so much for a general collapse of the whole banking system (for which any putative fund would be insufficient), but more for individual banks at any one time which may be in distress. The parameters of how much a fund would have to hold are being discussed in the context of the debates in Council and Parliament, but the amount proposed is 1 per cent of all covered deposits within the baking union. The timing of the shared resolution fund is uncertain, and it will anyway take many years to build up the level of funding envisaged, but the ECB is calling for the start of the central facility by summer 2014.

4. **Deposit Guarantees:** Although accepted by all as a necessary corollary to a banking union so as to ensure that all bank deposits are protected equally (up to a certain level), the Commission's plan to include a mutualized deposit guarantee scheme in its Roadmap was pulled at the last minute after objections from member states. Germany, again, was the prime mover on this since it, not

The European Union Center of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.

unreasonably, assumed that essentially its (less risky and greater number of) deposits would be used most often to protect the deposits of other euro countries in distress. This would lead, quite directly, to German deposit holders (ie all citizens with a bank account) giving money to citizens of other countries, without any say in the matter and some risk of not having it returned.

Having German depositors bail out depositors across the rest of Europe would be, at the very least, politically unfeasible. As with resolution funding, there is a history here that goes back before the June 2012 commitment. In this case, the idea was to set common standards for nationally funded deposit guarantee systems. This is politically less contentious than having pooled funding. It is controversial nonetheless. There is a national deposit guarantee proposal currently inside the co-decision procedure between Council and Parliament, which has been blocked since it was proposed in 2010. Moreover, there is no end in sight since parliamentarians and member state diplomats have more or less given up trying to find an agreement in the current Parliamentary term which ends in May 2014. This means that the prospects for a common deposit guarantee scheme are hazy, with nothing likely to be proposed for at least a year until the new College of Commissioners comes into power in September 2014.

The way forward

There is widespread agreement from all sides that a Banking Union is necessary for the smooth functioning of financial markets in the EU - most especially within the Eurozone. Nevertheless, when pressed by the Commission to pool sovereignty and to open up access to their own finances in order to support the common BU, member states have shied away. This shows the tension between economically sensible decisions and politically feasible decisions. This is not a critique of populism, as it seems inherently just that national politicians should protect their fellow citizens' money from being 'expropriated' by a body over which they have no say. Nevertheless, if the aim really is "genuine and deep economic and monetary union", then, as the Commission Blueprint says, the pooling of political sovereignty is a necessity.

The only way such sharing of resources can be done legitimately is if European citizens are given a choice to voice their opinion on this: either through explicit platforms in the 2014 European elections, or through referendums. Currently this does not seem likely to happen. As a result, despite initial haste, the construction of a European banking union is grinding to a halt. Of the four stages set out by the Commission:

- one has been completed legislatively, but with delays to its implementation (SSM);
- one has been proposed and is under discussion, though not yet agreed by EU politicians (SRM); and

The European Union Center of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.

- two are not yet proposed in a form that could be accepted by the member states, and so we are still waiting for further action from the Commission (RF, DGS).

In the terms of European politics, the one year from the Council's decision to mandate the Commission to come up with banking union proposals to the current situation represents quite quick work, especially on the single supervisory mechanism for banks within the eurozone. For this it deserves praise. However, it is the very speed of this which is, in the long run, slowing down progress towards banking union as it is alarming member states, which have to take into account factors other than European financial stability, such as citizens' acceptance of further integration.

Written: 30 July 2013

[1] http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/131388.pdf
[2] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0777:FIN:EN:PDF
[3] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52012DC0510:EN:NOT
[4] The collection includes the six-pack and two-pack legislations, CRD/R IV, MiFID/R. Market Abuse Regulation / Directive (MAD/R), the UCITS proposals and critically the RRD.
[5] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52012PC0511:EN:NOT
[6] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52012PC0512:EN:NOT
[7] http://europa.eu/rapid/press-release_IP-13-674_en.htm
[8] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52012PC0280:EN:NOT

The European Union Center of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.