Banking Union: Proposals for Banking Regulation
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Introduction

On 12th September 2012 the European Commission published its proposals for the supervision of banking in the eurozone. These proposals were requested by the European Council in June 2012 and apply to banks in the eurozone although EU banks outside the eurozone will be affected because so many have cross-border operations. They are one leg of the four-legged stool which the European Council has chosen to call “banking union” but whose proposals amount to less than that implies.

The other legs of banking union are: a single rule book for financial institutions in the single market; a common framework for deposit protection for bank customers; and a single framework for the recovery and winding-up of banks in difficulty. Work to develop a single set of rules for financial services in the EU has been on-going for a number of years but those rules have hitherto not covered the regulation of banks or how failing banks were to be rescued or wound up. In addition, although the single market in financial services is largely complete, not all institutions were regulated before the global financial crisis (e.g. hedge funds) and some rules need revision in response to the crisis.

Detailed proposals for bank recovery and winding-up, the fourth of the four legs, were published by the Commission in June 2012 and are discussed in a separate paper. This paper looks at the proposals for banking supervision and for deposit protection. It also considers the reasons for the proposed banking union and assesses its likely impact.

Why Banking Union?

The global financial crisis exposed the fact that although the EU has a single market covering most of financial services and a single currency covering 17 of its members it still had 27 different national regulatory systems for its banks when the crisis began. These different regulatory systems failed to stop banks from getting into difficulty and EU taxpayers were called upon to provide no less than €4.5 trillion in bailout funds and guarantees to prop up the banking sector.

Subsequent inquiries found that national regulators had monitored the banks and other financial institutions ineffectively, that the capital requirements for banks were inadequate and that deposit protection schemes did not have the flexibility to cope with cross-border banks in an emergency.
These problems affected all Member States but the eurozone countries had additional problems. They had one currency and a central bank but no single rule book for their retail and commercial banks, differing deposit protection schemes and in some cases very serious sovereign debt problems once they had rescued their banks.

“Banking union” is the EU’s response to the difficulties in the eurozone banking sector but some of the measures (such as those relating to depositor protection and to bank recovery and resolution) apply to the whole of the EU. The intention is that economic and monetary union will now be matched with fiscal union (i.e. agreement on national spending plans and debt obligations) and banking union (to ensure a common regulatory structure for eurozone banks). There is a related debate about whether greater political integration is needed in the eurozone to ensure that the new fiscal rules and regulatory structures can be held to account in a democratic manner.

**Banking Supervision Proposals**

**Outline of Proposals**

The banking supervision proposals would create a single supervisory mechanism (SSM) for all 6,000 or so banks in the eurozone under the overall direction of the European Central Bank. Cross-border banks operating outside the eurozone will have the parts of their business inside the eurozone subject to this new system. National regulators would continue to have day-to-day supervision of banks in their Member State and they would be responsible for implementing decisions of the European Central Bank (ECB).

The key elements of the proposals are that:

- powers would be conferred on the ECB to supervise all banks in the eurozone, with a voluntary mechanism so that non-eurozone countries can join if they wish to do so;¹
- the ECB should, in the euro area, authorise credit institutions, ensure compliance with capital, leverage and liquidity rules and supervise cross-border banks;
- all tasks not specifically given to the ECB will remain with national regulators, including consumer protection, tackling money laundering and supervision of third country banks which have branches or offer services in a eurozone country;
- the ECB should have the powers necessary to enable it to intervene early to rescue or wind-up a bank in difficulty in the eurozone;
- the ECB should have a supervisory board on which each eurozone country would have one vote;
- the rules governing the operation of the European Banking Authority (EBA) should be aligned with the new rules on banking supervision with the EBA remaining responsible for oversight of those banking rules that apply to all Member States; this proposal involves a controversial change of voting procedures within the EBA (see below)²;

¹ For convenience, the terms “eurozone” and “euro area” are used in this paper as shorthand for all the EU countries, whether in the eurozone or not, who agree to participate in these arrangements

² The role of the EBA is explained in Senior European Experts, Financial Supervision in the EU, September 2011
• for cross-border banks operating both inside and outside the euro area (e.g. some of the banks in the City of London), the existing rules governing regulation, which provide for a home country where the bank is based to be the main regulator and host countries where there are branches, will continue to operate with the ECB acting as the home and host authority for banks operating in the euro area.

The Commission proposed an ambitious timetable under which the new arrangements would be in place for 1 January 2013 with a phasing in period. This would mean the ECB having the ability to take supervisory authority over any bank or credit institution in the euro area from 1 January 2013, particularly those that have received or have requested public funding. From 1 July 2013 all banks of, in the words of the Commission, “major systemic importance,” would be put under the supervision of the ECB with the remainder by 1 January 2014. The October 2012 European Council stuck to the 1 January 2013 date for agreement but stated that work on “operational implementation” would occur in 2013.

The eurozone countries have agreed amongst themselves that the European Stability Mechanism will have the power to bail out banks in the eurozone directly (rather than lending money to governments so that they can rescue a bank) provided a single supervisory mechanism is adopted. Reaching agreement on these proposals is therefore of the highest importance for several eurozone countries (notably Spain).

Reaction

The reaction to the Commission’s proposals has been generally positive but differences over detailed aspects of them have revealed considerable tensions. The German government did not think that the ECB needed to supervise all eurozone area banks, just the larger ones (a reflection of the fact that Germany has many small savings and co-operative banks which have considerable political influence). The Commission took the view that even small institutions can cause systemic difficulties - the recent problems of the cajas, or local savings banks, in Spain is often cited as an example by commentators – and that most supervision will stay with national supervisors day-to-day. Germany agreed in principle to all banks being covered at the October 2012 European Council.

The European Parliament’s rapporteur for this proposal, Marianne Thyssen MEP (EPP), has, while welcoming the proposals, criticised the legal basis for this regulation as it only requires approval by the Council of Ministers and not co-decision with the Parliament. She would prefer an approach that enables co-decision but this runs the risk of delaying the legislation. The ALDE group (which includes the Liberal Democrats) also welcomed the proposals but objected to the choice of legal base. Similar views were expressed by the Socialists & Democrats group.

The UK government is supportive of the tightening of banking supervision within the eurozone but is concerned that it should not undermine the single market.

3 European Commission, Commission proposes new ECB powers for banking supervision as part of a banking union, IP/12/953, 12 September 2012
4 Article 127 (6) of the Treaty on the Functioning of the European Union, which provides for the conferring of specific tasks on the ECB concerning prudential supervision which requires unanimity in the Council
European Banking Authority Changes

One element of the new supervisory regime that needs careful consideration is the relationship between the role of the ECB and the role of the European Banking Authority. Although the ECB forms part of what the EU calls the European System of Financial Stability (ESFS) with the central banks and regulators of all Member States, its primary role lies within the eurozone.

The EBA, based in London, is the EU banking authority for all Member States. There is therefore the possibility of a conflict between what the ECB wishes to do in respect of the eurozone and what the EBA may think right for the EU banking sector across the whole of the Single Market.

The Commission argues in its proposals to reform the EBA that if the voting procedures are not changed there is a risk that decisions might not be taken in the interests of the EU as a whole. There is also a risk that when it comes to the Board of Supervisors of the EBA agreeing to enforcement action, the eurozone countries could block action against one of their number because of the current requirement for a simple majority.

The Commission proposes several changes to meet these potential problems:

- where there are disputes that require mediation by EBA, these should be handled by a panel of three members of the EBA Board of Supervisors which would have to act independently and objectively and at least one of whose members came from a non-eurozone country;
- the decision of the independent panel would then be considered to have been adopted by the Board of Supervisors unless it was rejected by a simple majority that included three eurozone countries and three non-eurozone countries;
- the management board of the EBA would have to have at least two members who are from outside the euro area;
- by the end of 2015 the Commission will have to publish a report on how these arrangements are working within the EBA.5

Impact on the UK

As the Member State with the largest financial services sector, the UK has particular concerns about the impact of EU regulation. The British Government has encouraged greater integration within the eurozone over the last two years in the belief that such an approach would reduce the risk to the UK of the crisis in the eurozone. The Government has, in that spirit, welcomed the banking supervision proposals but made it clear that the UK will not be a voluntary member of the single supervisory mechanism. But if the UK is outside the supervisory mechanism, major international banks with substantial business in the eurozone could relocate their headquarters from London to the continent or try to persuade the UK Government to accept voluntary supervision (the latter would probably require a referendum under the European Union Act 2011).

A key concern for the UK however is the impact on the Single Market of greater co-operation within the eurozone and the fear that a voting bloc of eurozone countries could seek to change the rules of the Single Market against the interests of the “outs”. The Commission has responded to this concern by emphasising the role of the EBA as the single market regulator for all banks and by its proposals to strengthen the position of the “outs” in the voting rules of the EBA and on its management board. The UK Government is seeking changes to the EBA voting proposals because it is not convinced that the Commission’s proposals are sufficient protection for the Single Market.

Deposit Protection

Since 1994 the EU has had legislation providing for a minimum deposit protection scheme for banks in all Member States. But the global financial crisis exposed the limitations of that scheme. As a response, the EU adopted a new regulation which raised the minimum guarantee to €100,000 from 1 January 2011 but that was an interim measure.

The Commission published proposals in 2010 for a new deposit protection scheme based around a €100,000 limit with a requirement to pay depositors back in seven days, a requirement that a host country would pay out to customers of the branches of banks based elsewhere in the EU (and then reclaim the money from the authorities in the home country) and new arrangements to ensure that refunds can be financed effectively. This scheme would also cover banks in Iceland, Lichtenstein and Norway.

This legislation has not been adopted more than two years after it was first proposed as negotiations continue between the Council and the Parliament.

Assessment

Banking Union

Banking union is a neat phrase that encapsulates a more integrated approach to regulation but it is not EU banking union but eurozone banking union. There will be a spill over into non-eurozone Member States but the greatest impact will be felt within the eurozone. There will be particular tensions over countries such as Poland and Sweden which are outside the eurozone but intend to join voluntarily the single supervisory mechanism as they have significant banking sectors.

The success or failure of banking union will be judged by whether, over time, it ends the dependence of the banking sector on public sector bailouts when things go wrong, whether it restores credibility to the financial sector and whether a remodelled and better regulated banking sector effectively underpins the real economy. Such a big change requires a change in culture in the banking sector in many countries as well as changes in regulation. No regulatory system is ever entirely proof against irresponsible or criminal behaviour.

Banking Supervision

The proposals on banking supervision have received a broad if muted welcome across the EU. But many points of detail are controversial, such as the voting arrangements on the EBA and the question of whether the ECB should supervise all banks within the euro area. These
controversies are significant and it will take considerable leadership to reach agreement on the Commission's proposals if the timetable it has proposed is to be achieved.

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Senior European Experts

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