The challenges of banking union

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The agreement on the need to strengthen Economic and Monetary Union in order to exit the current crisis, made at the June 2012 European Council meeting of Heads of State and Government, was the most decisive step towards European integration since the creation of the euro in 1999. On 12 September 2012, the European Commission presented two legislative proposals, one on the creation of a single supervisory mechanism (SSM) and the other on adapting the regulations setting up the European Banking Authority (EBA). The two proposals were accompanied by a communication providing a roadmap towards banking union. In addition to SSM, the Commission intends to continue working towards a single rulebook (European transposition of Basel Committee recommendations, known as CRD IV) while calling for a common deposit protection system and the integrated management of banking crises.

The ECB [1], the European Parliament and the European Council published their positions between late November and mid December 2012. On 13 December, European finance ministers unanimously agreed on single bank supervision in the eurozone.

Banking union is the link between monetary union and the coordination of budget policies as part of the European fiscal compact[2] that took effect on 1 January 2013. It aims to loosen the ties between banks and states that are a source of vulnerability, largely reinforced by externalities pertaining to the single currency. It is in part founded on the theory of optimal currency areas (part I). Banking union is governed by an overall logic, and its four parts (single supervisory body, single rule book, partially mutualised deposit guarantees and bank resolution) form an inseparable whole (part II). Lastly the scope of banking union lies somewhere between that of the eurozone and the European Union, which will require appropriate governance (part III).

Theoretical foundations

A group of countries forms an optimal currency area when the use of a single currency does not result in any loss of well being (Mundell, 1961). Two criteria for a successful currency area are the homogeneity of shocks experienced by its member countries and the mobility of production factors. The architects of the European Economic and Monetary Union undoubtedly hoped that the emergence of a single currency would create the conditions for an optimal currency area by encouraging labour mobility and by reducing the specialisation of national economies (Frankel and Rose, 1996). Yet the theory of the endogeneity of OCA criteria had already been called into question (Krugman, 1993)[3].

In the absence of perfect economic and financial integration between member countries, a monetary union creates externalities that require transfers between member countries during severe circumstances, such as asymmetric shocks, in order to offset the fact that they can no longer adjust exchange rates. Literature on optimal currency areas often point out the substitutability of fiscal transfers and risk sharing via more integrated financial markets.

In the absence of sufficient financial integration, fiscal transfers help reduce cyclical differentials. In this case, fiscal federalism is the best response, because it allows for the implementation of effective insurance mechanisms.

In the unfolding of the recent crisis, asymmetric shocks arose at times from the impact of banking crises on public finances, as in Ireland (see chart 1), and at other times from the impact of public finances on the banking system (i.e. Greece). As a result, the troubles of the banking and public spheres were mutually sustained, while responsibility for financial stability was still largely national.

Banks recapitalisation* with public funds in the countries of the European Union

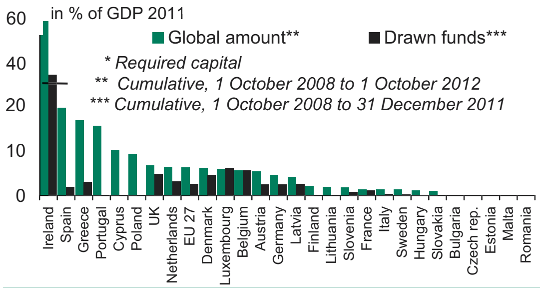


Chart 1 Source: European Commission

This point is illustrated by the national correlation between the cost of bank resources and the widening of government bond spreads relative to the Bund (see charts 2 a and 2 b).

The shocks of summer 2011 (the dollar-denominated financing shock that hit the big European banks and the sovereign debt crisis) led to the segmentation of banking systems within the eurozone. The repatriation of capital within national borders reduced the degree of integration of government bond markets, interbank markets and deposits, which had been increasing constantly since the start-up of the euro. To illustrate this point, the cross-borders lending between eurozone banks have culminated at nearly 7% in June 2008, but fell back to 4,1% of bank assets at the end of 2012, a level inferior to the one prevailing just after the euro's introduction (5,1% in March 1999, see chart 3).

Although the theory of optimal currency areas does not explicitly refer to banking union, some authors explored the question of the role of a single central bank as lender of last resort for member states (De Grauwe, 2011) and commercial banks (Goodhart, 2000), which was sometimes qualified as a banking union. The ECB finally agreed to play the role of lender of last resort for ailing states, but its emergency action must be seen as a temporary means of easing liquidity constraints and to help the eurozone set out on the path to greater fiscal integration.

European banking union is seen differently. First, it represents an intermediate response between financial integration and fiscal federalism. It aims to strengthen the integration of banking systems by harmonising the rules that govern them (single rulebook, single supervisory mechanism, resolution plans). It introduces a dose of fiscal federalism by mutualising some of the cost of banking crises, after taking into account national franchises to contain moral hazard. This form of banking union seems to be more ambitious and potentially less dangerous than an overly explicit role of lender of last resort bestowed on the central bank.

To avoid encouraging public debt and to ensure the ECB's independence, the central bank must be prevented from rescuing a state, except when the integrity of the single currency is at stake. Since its creation, European monetary union has suffered from the lack of genuine fiscal federalism. Monetary policy cannot be truly autonomous as long as public finances are direct tributaries of the troubles of the banking system. Of course, if the house is burning, the ECB can put out the fire, but its action risks interfering with its monetary policy objectives. Consequently, it seems immensely preferable to have a supra-national policeman with a preventative mission. Based on article 127 (6) of the Treaty on the Functioning of the European Union (TFEU), which authorises the Council, "acting by means of regulations (...)[4], to confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings", the European Commission adopted a proposal for a Council Regulation[5] on 12 September 2012. The European Council laid the first stone of banking union on 13 December 2012 when it approved the policy agreement[6] at the ECOFIN meeting[7].

An inseparable whole

In the midst of a financial crisis, it is essential to restore confidence in the mechanisms for risk supervision, prevention and the handing of banking crises. It is for this purpose that the Commission adopted a set of proposals on 12 September aiming to implement a banking union. The communication outlining the Commission's vision of banking union covered the following points:

1) a single rulebook,
2) a single supervisory mechanism,
3) a common system for deposit protection,
4) the implementation of rules and national funds for bank resolution.

These four pillars were divided into two sections, the first preventative and the second remedial, highlighting the logic and unity of banking union:

- The preventative section covers the mechanisms designed to reduce the probability and

Dangerous liaisons: Banks and public finances (monthly data, 2010-2012)

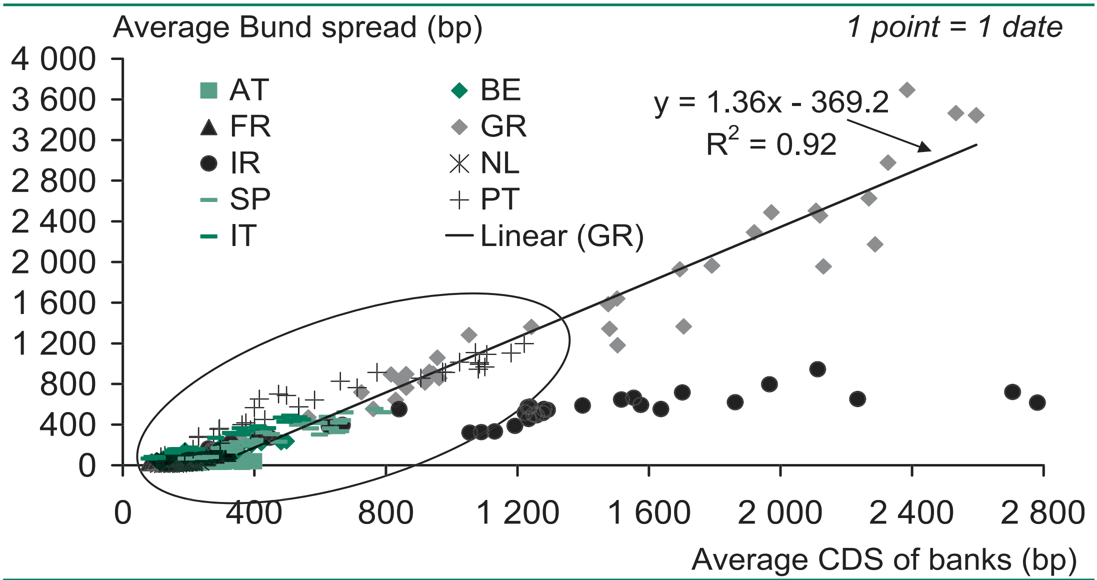


Chart 2-a Sources: Thomson Reuters, BNP Paribas calculations

Excluding Greece (montly data)

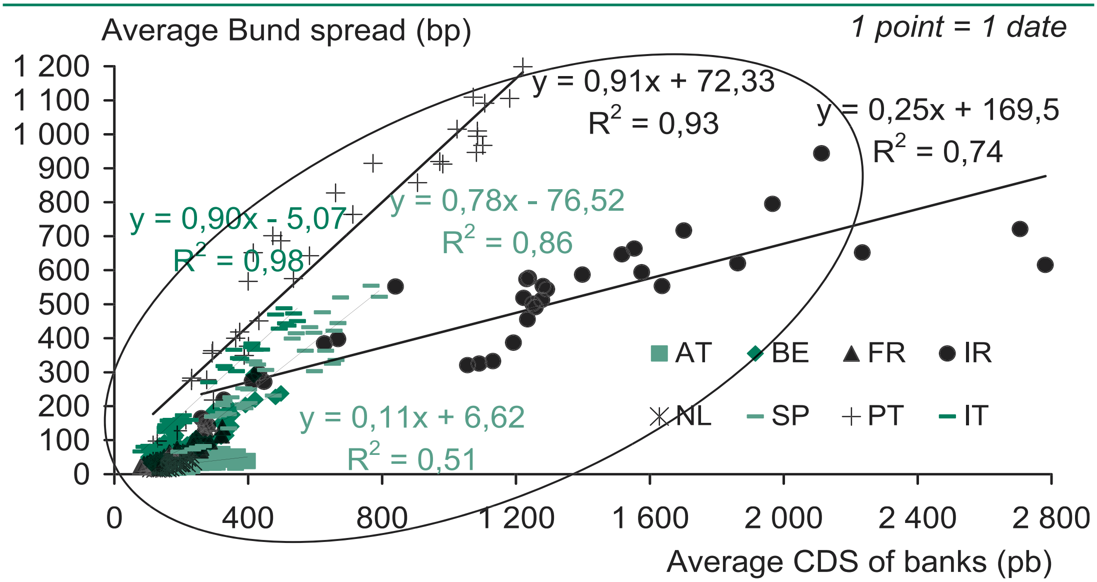


Chart 2-b Sources: Thomson Reuters, BNP Paribas calculations

Cross-border interbank lending in the eurozone

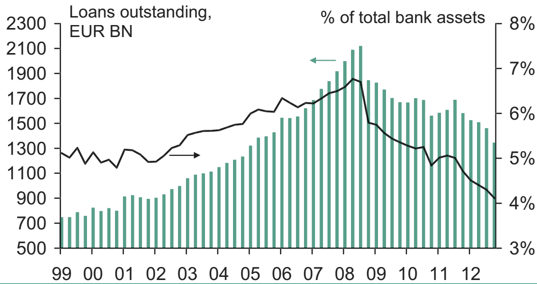


Chart 3 Source: ECB

severity of banking crises (a single rulebook, stronger capital requirements and a single supervisory mechanism).

- The remedial section encompasses the mechanisms designed to protect national public finances from the consequences of bank failure by creating a European firewall: pre-funded deposit guarantee schemes; the possibility for the European Stability Mechanism (ESM) to directly recapitalise struggling banks; a European bank resolution mechanism.

The remedial section implies greater European solidarity, something which will only be politically acceptable if the preventative section is considered credible. Banking union therefore has an overarching logic and forms an inseparable whole.

Single rulebook[2]

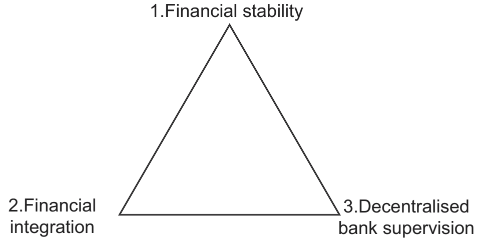
The first pillar of banking union is comprised of a "single rulebook" for the banking sector that will implement, through the Capital Requirement Directive CRD IV, the new bank liquidity and capital requirements established by the Basel Committee (Basel III). In practice, the introduction at the end of 2011 of CRD 3 (Basel 2.5), which increased the capital requirements for market risk, together with the publication of the Basel Committee's preliminary recommendations in 2009, have already pushed European banks towards a significant strengthening of their solvency ratios since 2010. CRD IV, the legislative package adopted by the European Commission on 20 July 2011, combines the proposed directive of the European Parliament and the Council[8], and the proposed regulation of the European Parliament and the European Council[9]. It is currently in the final phases of tri-party negotiations between the Commission and the co-legislators (the European Parliament and the Council), and an agreement is expected in 2013.

Single supervisory mechanism

Bank supervision traditionally aims to prevent systemic risk within the banking sector and to improve transparency and depositor protection.

The traditional argument for centralised supervision lies in the difficulty of reconciling a single financial market and financial stability with decentralised supervision conducted by national authorities through a triangle of incompatibilities (Schoenmaker (2005), Thygesen (2003))[10] (cf.diagram 1).

The second* triangle of incompatibility



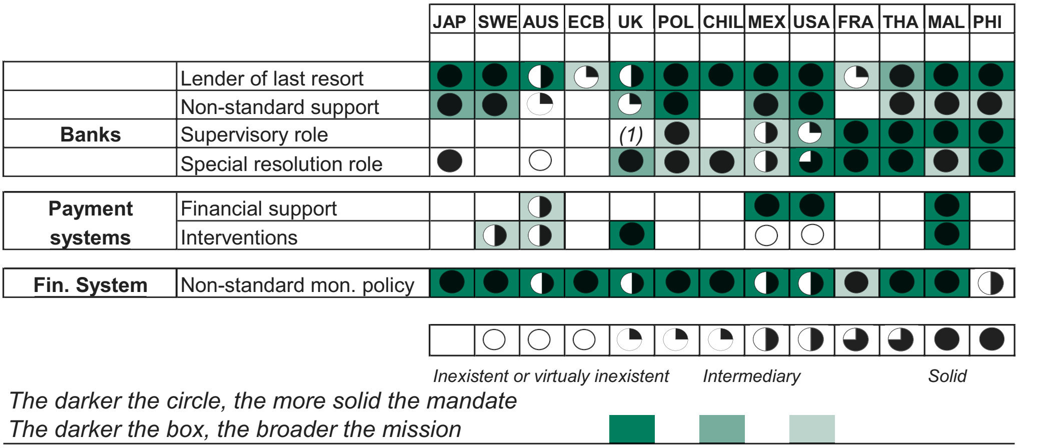
after the one of Mundell/Padoa-Schioppa

Diagram 1 Sources: Schoenmarker (2005), Thygesen (2003)

Another argument relates to "regulatory capture". Greater proximity between the supervised entity and their local supervisors makes the latter less vigilant (Rajan and Zingales, 2003). Moreover, eventual political pressures on banks could lead to a less efficient allocation of credit (Becker (1983)).

Between the birth of the euro and the outbreak of the financial crisis, the development of cross-border interbank operations has increased the integration of financial and banking markets (see chart 3). This growing integration has helped improve the transmission of the single monetary policy. But at the same time, the threats that banking troubles have created for the stability of the region as a whole justify the centralisation of supervisory functions with a single authority, rather than leaving them in the hands of national authorities. Since the ECB is the only European institution not directly subject to political power, it seems only natural that it would be attributed this mission.

FINANCIAL STABILITY MANDATES OF CENTRAL BANKS, 2009



(1) As of 1 April 2013, under the Financial Services Act (2012), the FSA's bank supervision mission will be transferred to The Prudential Regulation Authority (PRA), a part of the Bank of England

Japan.Sweden.Australia.Europ. Central Bank,United Kingdom,Poland,Chile,Mexico,USA,France,Thailand.Malaysia,Philippines

Table Source: BIS survey of participating central banks, conducted in 2009

Bank supervision and the central bank

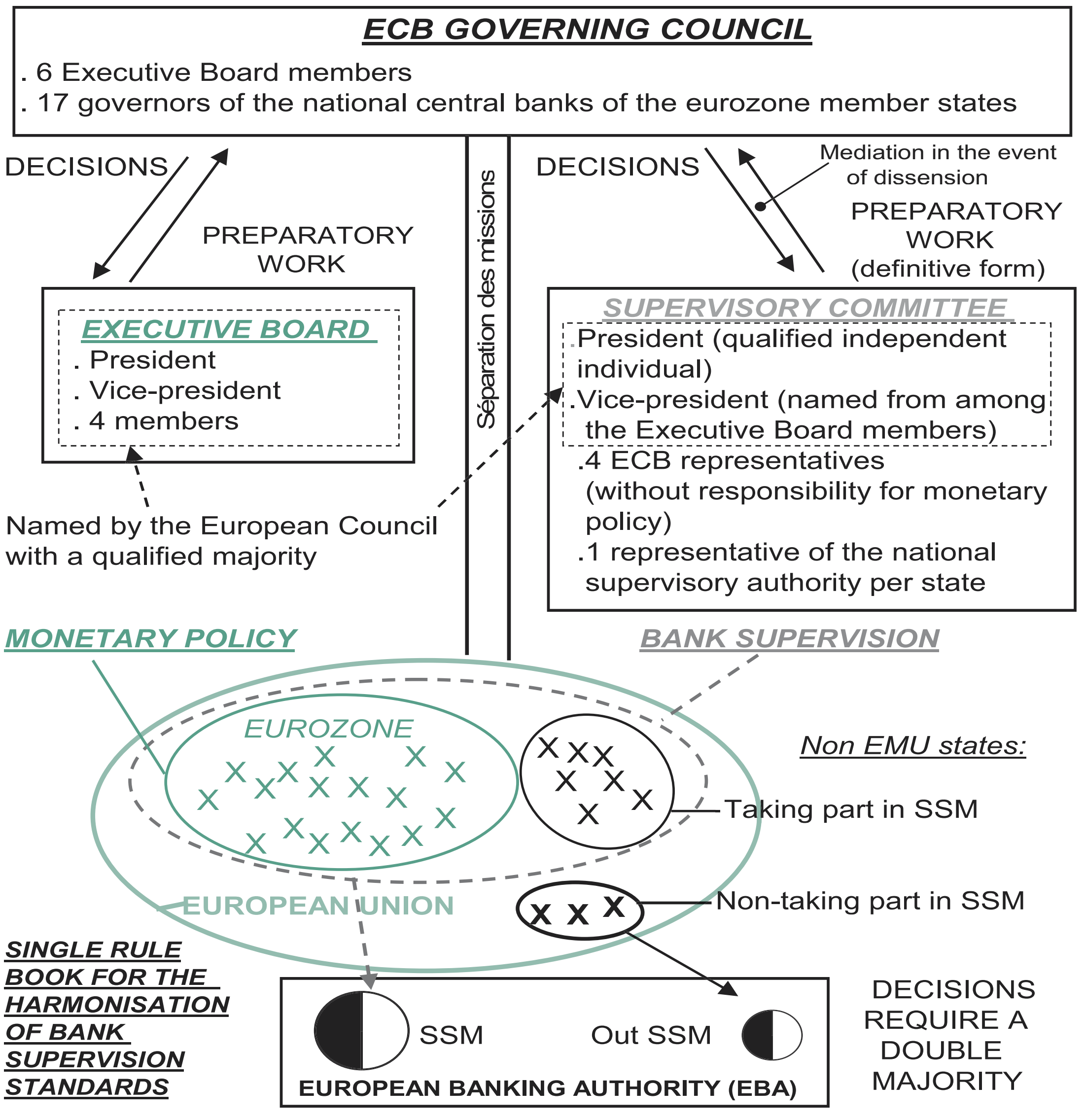
The argument for combining monetary policy and supervisory responsibility within the central bank stems from the natural role that it has in ensuring financial stability. Thus Article 127-6 of the Treaty on the Functioning of the European Union gives the Eurosystem responsibility for contributing to “the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.” In this respect, we would like to point out that central bank mandates concerning financial stability are not always specified so clearly (see table). Like the ECB, the Bank of England owes its competence in terms of financial stability to the Banking Act of 2009. In contrast, the mission conferred on the National Bank of Austria is derived from a simple ministerial statement. As to bank supervision, twelve of the 27 central banks in the eurozone have already been given this responsibility. The five other supervisory institutions are either autonomous or semi-autonomous (France, Germany, Luxembourg, Finland and Estonia)[11]. In the United Kingdom, it is worth noting that the Financial Services Authority (FSA), harshly criticised for its management of the failure of Northern Rock, was partially reintegrated in the Bank of England recently.

Bank failure presents a contagion risk that a central bank would be hard pressed to avoid in order to preserve the smoothing functioning of the money market and the transmission of its monetary policy. Moreover, under Bagehot’s dictum of 1866, 1873, the central bank must limit its actions as lender of last resort to liquidity crises. To distinguish these from cases of bank insolvency, it is necessary to maintain a level of expertise and analyse the quality of counterparties before lending to them, giving clear legitimacy to a supervisory role. Lastly, there is a close link between macro-prudential and micro-prudential supervision: the exploitation of individual information provides a better appreciation of micro-financial risk. The same can be said for information obtained from the management of payment systems (TARGET 2).

Possible conflicts of interest between ECB missions

Conversely, there may be conflicts of interest between the conduct of monetary policy and of supervisory roles. One example is an increase in interest rates that would help ensure price stability but which could result in the failure of one or more of the banks under supervision. That said, for most of the central banks given responsibility for supervision, the staff in charge of these functions is attached to a distinct structural entity that is physically separated from other services. Thus, the Commission’s proposal stipulates that preparatory and executive activities will be carried

Organisation principles of the single supervisory mechanism (SSM)



Sources: BNP Paribas based on the Protocol of the ESCBs and the ECB appended to the EU and TFEU and the texts adopted by the Council of the European Union on the proposed regulations (2012/0242 and 2012/0244, 14 December 2012)

Diagram 2

out by “administrative divisions and structures distinct from those responsible for the monetary policy function, within the framework of a supervision committee established expressly for this purpose within the ECB”.

Some voices have called for a change in the ECB’s organisation with the introduction of SSM to guarantee a strict separation between monetary policy and bank supervision, considering that under the current structure, the Council of Governors would have the last word on decisions pertaining to bank supervision [12]. This interpretation was not accepted unanimously [13]. President Van Rompuy[14] considers that in their current state, the treaties authorise a strengthening of the Economic and Monetary Union and, assuming any changes were necessary, they would have to wait until after the European elections planned in 2014.

A structure built on that of the ESCB

The ECB will have exclusive competence to carry out key supervision functions aimed at identifying risks and forcing banks to correct them. In particular the ECB will be responsible for approving lending establishments, ensuring that capital requirements are met and adapting these requirements, as necessary, to the risk profile of the institution (pillar 2). It will conduct supervision of financial conglomerates on a consolidated basis and may conduct its investigations within them. As with the ESCB in monetary policy, the single supervisory mechanism will consist at creation of the ECB and the central banks of the eurozone member countries, with the ECB maintaining final responsibility.

National authorities will retain their prerogatives for tasks that do not relate to financial stability: consumer protection, combating money laundering and also the supervision of credit institutions from third countries which have branches or provide cross-border services within a member state. EU member states which have not adopted the euro could nevertheless take part in the single supervisory mechanism by cooperating with the ECB.

Lastly, the European Banking Authority will retain its current role but will exercise its powers and missions for the ECB. In particular it will continue to develop the single rulebook and will also become the standard bearer for supervision practices within the European Union, i.e. between the ECB, which acts under the SSM, and the Bank of England, for example, which will preserve its own powers in terms of supervision. It was with this in mind that on 12 September 2012 the European Commission adopted, at the same time as its proposal for a directive of the European Parliament and of the Council on the single supervisory mechanism, a directive of the European Parliament [15] seeking to harmonise regulation 1093/2010 relative to the EBA within the modified framework for bank supervision.

The scope of supervision

One argument put forward in favour of restricting the scope of supervision to establishments of systemic importance is that the central supervisor will only have a real information advantage over national supervisors in the case of institutions that are active across several member states. On the contrary, European experience tends to suggest that small and mid-sized banks are frequently sources of financial instability, particularly due to the strong correlation of risks between them (as with the Cajas).

The agreement between the Heads of State and Government on 13 and 14 December 2012 makes it probable that the final text on the single supervisory mechanism will be adopted in April 2013. The threshold at which banks will be directly subject to ECB supervision was set at €30 billion or 20% of national GDP. It would exclude banks with balance sheets of less than €5 billion. Independently of this size criterion, SSM will cover at least three banks per country. According to estimates, the system would cover between 150 and 160 banks in the eurozone, representing a total of about 90% of bank assets in different proportions according the countries (chart 4). Smaller banks will continue to be supervised by their national supervisory authorities, although they could be placed under direct ECB supervision if their situation were to deteriorate to the point of threatening financial stability.

Scope of Single Supervisory Mechanism (SSM) by country

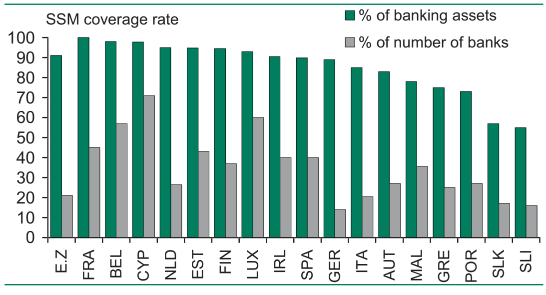


Chart 4 Sources: the Banker Database, Bruegel calculations

The single supervisory mechanism will not be operational before 1 March 2014, a technical delay required by the ECB. In the meantime, however, the ECB could take responsibility for the supervision of "any eurozone bank, notably a bank receiving public aid" in order to open the possibility for direct recapitalisation of the bank by the European Stability Mechanism.

Single oversight is a prerequisite for direct recapitalisation of banks by the European Stability Mechanism. ESM became effective on 8 October 2012 after its founding treaty was ratified on 27 September by member states representing at least 90% of its capital requirements. The fund, an international organisation with a maximum lending capacity of €500bn[16], provides five different types of financial support programmes. Members states in financial difficulty complying with a principle of conditionality can receive direct loans, primary market support, secondary market support, or precautionary financial assistance through back-up credit lines in case of troubles accessing the market. For requesting member states, the recapitalisation programmes aim to provide lower cost financing via ESM to recapitalise their banking systems. The advantage of direct recapitalisation (see above) is that it skirts the precondition that a member state request financial assistance, which it might be reticent to do, and allows for the necessary action to be taken to prevent the crisis from spreading within the banking sector.

Another direct consequence for European banks placed within the scope of the single supervisory mechanism is that oversight of pillar 2 requirements would no longer be the responsibility of national supervisors (ACP in France, BaFin in Germany) but solely of the ECB.

Deposit guarantee funds: national up to a certain level, European thereafter

Bank deposits have been covered by a harmonised guarantee across all EU member states of EUR100,000 per depositor since 1 December 2010.

National structures benefit from at least an implicit government guarantee. However, in the event of a severe crisis, fiscal room to manoeuvre could be considered too limited to create a credible guarantee for depositors, thus leading to bank runs and hence to a weakening of the banking system and governments. It therefore seems fairly undesirable to maintain public deposit guarantee schemes within a strictly national framework.

The European Commission proposed to go further by adopting on 12 July 2010 a Directive of the European Parliament and of the Council[17] that aims to harmonise and simplify the definition of deposit guarantees by reducing the time limit for paying out depositors. The amount repayable within one week would be raised from €5,000 to €100,000 per depositor as of 1 January 2017. By way of derogation, member states could nonetheless extend the limit for obtaining funds to 20 days for the part exceeding the threshold of €5,000.

The proposal adopted by the European Commission calls for the modification of deposit guarantee systems, notably be setting up ex-ante funding, via a contribution from banks set according to their risk profile according to a method established by the EBA, and a restrictive common borrowing facility for national deposit guarantee schemes. National funds that run out of resources would be authorised to borrow from other funds according to a kind of national franchise. After several amendments, the text was adopted by the European Parliament on 16 February 2012. It is now pending the Council's position on first reading, although there has been a drawn out debate over the amount of these funds and their means of financing. The legislative proposal adopted by the Commission on 6 June 2012 (see below) establishing a framework for bank resolution (see below) makes it possible to combine deposit guarantee and bank resolution mechanisms within the same fund. This text, which is currently pending first reading by Parliament, arrives just in time to restart talks on deposit reform, raising hopes that a definitive vote could take place during 2013, even though there is bound to be a bitter debate over the degree of fiscal equalisation. The Commission could use this mechanism to present the next step towards banking union: a single bank resolution mechanism structured around a single bank recovery and resolution authority.

Towards a single bank resolution mechanism

The final pillar of banking union proposed by the Commission is a single orderly liquidation mechanism that would set the rules for bank resolution and allow the coordinated application of resolution instruments to non-viable failing banks within the banking union. Bank supervision alone is not enough without a resolution mechanism. The supervising authority must have the power to order a bank to be shut down, a task that must be assigned to a distinct authority, possibly at the national level.

A bank resolution scheme seeks to split losses between shareholders and bondholders under a so-called 'bail in' whilst preserving the systemic functions of the bank and liquidating its non-viable activities. To date the Commission has used its powers in the area of competition to control bank restructuring and the use of state aid. Yet this instrument is not well suited to the task as cases are not considered on the basis of financial stability or the protection of taxpayers. Lastly, the experience of the Federal Deposit Insurance Corporation (FDIC) in the United States shows that the use of public funds within such a framework is limited, in accordance with one of the desired objectives. A comparison of banking crises in Ireland and Nevada illustrates the advantage of a more integrated banking system in which losses are absorbed at the federal level (Gross (2012)). The troubles of Nevada banks did not trigger severe disruptions in the banking system: losses were covered by FDIC funds, non-viable banks were liquidated and their operations were transferred to more solid banks. In 2008 and 2009, the FDIC proceeded with the liquidation of 11 banks with a total of $40bn in assets, the equivalent of 30% of Nevada's GDP. Crisis management required a federal transfer of about 10% of GDP, and in the end, losses and restructuring costs were limited to about 3% for the FDIC.

The Commission's 6 June 2012 proposal

On 6 June 2012, the European Commission published a 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"[18]. This legislative proposal fits within the extended commitments made by the G20 following the collapse of Lehman Brothers in order to set into place the orderly resolution of non-viable banks and to prevent a domino effect of failing institutions. The United Kingdom, which rapidly adapted its framework, was largely inspired by the proposed European directive, which has some similarities with the living wills system developed by the Financial Services Authority (FSA) and the UK Treasury since 2009. However, the European solution differs from its UK counterpart by offering a broader scope of application, identical to that of CRD IV, i.e. credit institutions and investment firms on both a consolidated and individual basis. Non-banking investment services are excluded from the UK scheme for entities with less than £15bn in assets. The date for transposing the directive into national law is currently set at 31 December 2014.

The European directive will equip member states with powerful legal tools that will take precedence over national regulations, by ensuring the harmonisation of bank resolution rules and procedures in order to avoid the insolvency of credit institutions, to minimise any negative repercussions and to preserve critical functions for the economy. The proposed directive also calls for sharing responsibilities. The EBA will ensure the coordination of the different resolution authorities and will write the regulations applicable to the system. The national supervisor receives the Recovery and Resolution Plan (RRP), makes amendments through discussions with the bank and transmits them to the EBA. The resolution authority will direct the recovery or liquidation procedures for the failing bank.

Bail-ins

The bail-in tools provided under articles 37 through 51 of the proposed directive aim to recapitalise a bank without injecting new capital, through the forced conversion of debt claims into equity so that it can pursue its business and/or the transfer of doubtful loans and capital to a defeasance structure.

Brussels confirmed its intention to place holders of bank debt in a position of renouncing all or part of their claims in case of bankruptcy or the restructuring of the debtor. If the proposal is accepted, "all existing or newly issued debt" by banks with a systemic risk would be eligible for a discount when requested by the resolution authorities (for unsecured debt). The proposal calls for the bail-in tool to apply to all eligible liabilities, which are defined as all liabilities with the exception of guaranteed deposits, secured debt, liabilities pertaining to customer operations, liabilities with an original maturity of less than one month, and liabilities to employees, the Treasury or social security funds that benefit from preferred status in case of liquidation[19].

In its current state, the system risks introducing distortions to competition that could be harmful for European banks by obliging bondholders to take losses before the liquidation of the bank. In a traditional liquidation procedure, bondholders must assume losses in excess of book equity. Under French common law, for example, the same applies to ailing companies. In the United States, the Orderly Liquidation Authority introduced by the Dodd Frank Act can intervene on the FDIC's request and require bondholders to take losses, but only as part of bankruptcy proceedings. This is a fundamental difference with the European bail-in tool, which calls for this action to occur prior to the liquidation procedure, which raises a number of legal questions[20].

The application horizon was set at 1 January 2018, which the Commission sees as a sufficient timeframe for banks to adapt the structure of their resources. In principle, virtually all existing securities should reach maturity before the bail-in takes effect. The bail-in also raises the risk of higher bank financing costs for senior debt, which the European Commission estimates within a range of 5 to 15 basis points for banks with systemic risk, the only ones concerned.

According to Brussels, a contingent capital share of 10% of liabilities (excluding capital solvency requirements) would be enough to handle most bank failures via a bail-in. But differentiation rather than the harmonisation of establishments would be the rule: on a discretionary basis, each national resolution authority would determine the most suitable threshold for each bank, based on its balance sheet structure and risk profile.

Resolution funds

Towards the same objective of isolating public finances from bank failures, under the proposed directive, each member state must make resolution financing arrangements (article 91). Article 99-5 allows the possibility of using the available financial resources of deposit guarantee schemes[21].

With the introduction of the bail-in, the European institution lowered its requirements. By 2023, these funds, which cover both deposit guarantees and resolution costs, must cover at least 1% of deposits in each of the 27 EU countries, or about €70bn for the eurozone and €100bn for the EU-27 according to the European Commission. Many European countries totally lack such funds. The funding effort is all the bigger since a minimum of 70% of these guarantees must be available in cash, and the remainder simply guaranteed through collateral.

The text, which has entered the legislative process in the European Parliament and the Council of Finance Ministers, also lays the foundations for the co-responsibility of national resolution authorities. They must agree on the conditions under which one resolution fund could finance another, for example, in the case of cross-border groups.

By straining profitability, however, this objective risks conflicting with efforts to strengthen equity capital undertaken by banks as they work towards full application of Basel III in 2019. Some analysts esteem that the measure could amputate average banking income by between 5% and 10%. The contributions required from UK banks was set at 0.044% of their long-term liabilities (time deposits for the most part), and at 0.088% of short-term liabilities. These contributions were negotiated with the commercial banks with an eye on striking a fair balance between moral hazard and preserving the financial sector's competitiveness. They seem to be much lower than those that would have been required, using solely this resource, to create a fund amounting to 1% of all guaranteed deposits outstanding from a 10-year horizon (about 0.1% of all guaranteed deposits).

Under a mechanism similar to the one used for guaranteed deposits, article 97 of the proposed directive of 6 June 2012 provides that the resolution funds of each country would be obliged to lend to any other country whose resolution funds proved to be insufficient. This obligation would not apply, however, in cases when the lending country would then have insufficient resources as well. The member states could interpret this as an incentive not to be too generous in allocating resources to the funds, in order to reduce the risk of "forced mutualisation". The directive proposal of 6 June also provides the possibility for funds "to contract borrowings or other forms of support from financial institutions, the central bank, or other third parties, in the event that the amounts raised (...) are not sufficient to cover the losses, costs or other expenses incurred by the use of the financing arrangements". In its opinion of 29 November, however, the ECB stresses that "in line with the prohibition on monetary financing, central banks may not finance these financing arrangements either"[22].

For international groups, the resolution plan must be established by the supervising authority of the home country. Article 98 of the proposed directive specifies that the resolution plan must be negotiated in consultation with the supervising authorities of the countries in which the group is located, but it is the responsibility of the group level resolution authority to determine the respective contributions of the national resolution funds.

The proposed directive outlines a subset of banking union under which the European resolution authority would have the power to use the resolution planning tools available to national supervising authorities. The United Kingdom, however, saw this as paving the way for the financing of bank bailouts in the eurozone, which is why it opted out of this measure.

Member states must transpose this directive into national law by 1 January 2015 at the latest, with the exception of measures pertaining to bail-in tools (see above), which must be transposed into law by 1 January 2018 at the latest.

The bank resolution section is much harder to implement than bank supervision, from both a legal and political perspective. The treaty is completely silent on this point. Moreover, the approach of German elections in fall 2013 is unlikely to encourage the start-up of negotiations.

This kind of framework would help member states avoid banking crises and, should they arise, to contain them in a more orderly and effective fashion. Member states would have to constitute a pre-funded liquidation fund, financed by contributions from banks. Tightly circumscribed mutual lending facilities between national systems, within precisely defined limits, are also planned.

As responsiveness and credibility are essential features, this mechanism would offer greater effectiveness than a network of national resolution bodies, particularly in the case of cross-border failure. Decisions would be taken in accordance with the principles of resolution set out in the single rulebook (first pillar). In time, this mechanism could become responsible for coordination of crisis management and resolution instruments in the banking sector.

Challenges: governance and a transition period

Different responses are needed in terms of governance to accommodate differences in the scope of action between the European Union, the Economic and Monetary Union and banking union. A transition period is planned to make sure that implementing banking union does not become synonymous with the immediate mutualisation of losses and to buy time to win over reticent contributing countries.

European Union and banking union

The variable geometry of the European Union, EMU and banking union raises some governance issues.

Although the project was confirmed in the June 2012 conclusions of the European Council, European banking union is essentially an initiative by the members of the eurozone. This slant is strengthened by the use of article 127-6 of the Treaty on the Functioning of the European Union (TFEU), which by attributing the role of supervisor to the ECB, creates a scope of supervision restricted de facto to the eurozone. In virtue of the treaty, the ECB cannot exercise coercive powers outside of the eurozone. Consequently, EU members states who are not members of EMU cannot participate fully in this mechanism. The Council's regulation does call for a cooperation procedure in which these states declare to the ECB that they intend to join the SSM. Towards this end, they must take the necessary measures to place their national supervising authority under the ECB and to implement its decisions. Once these conditions have been met, the ECB would not be able to refuse cooperation and would have to open deliberations of the Supervisory Board to non-eurozone states. However, if these conditions were no longer being met, the ECB could unilaterally terminate cooperation.

Maintaining a single market for financial services would ideally require a scope of application that covers all members of the European Union. The UK financial sector alone accounts for nearly 24% of European banking assets. Yet the UK has already let it be known that it will not participate in single bank supervision.

Under these circumstances, two key factors seem to preserve the unity of the European financial market beyond the eurozone. The first is prudential regulation of banks. The capital requirement directive CRD IV is in the final phase of negotiation. Its adoption calendar overlaps with that of the single supervisory mechanism, which must be unanimously approved by the 27 member states. It is important to make sure that stronger prudential regulation is adopted, applicable to the entire European Union, while respecting the initial equilibriums that guided its preparation, and to be careful not to compromise the capacity of banking institutions to finance companies and local governments.

In the end, the directive illustrates the philosophical opposition between the appropriate degree of cooperation between member states situated within EMU and those outside of the eurozone. The directive is designed to apply to both eurozone member states and non-member states. For the British Prime Minister, the proposed directive would follow "the remorseless logic of a single currency"[23]. The choice of the ECB, which is justified economically, obliges special rights to be granted to eurozone non-member states. Fearing the ECB could issue rules with the sole purpose of protecting the single currency, these states have demanded a double majority requirement – one for the group of countries participating in banking union and one for those not participating in the banking union – for the adoption of regulatory reform by the EBA, the regulatory body of the 27 EU member states, and the ECB (schema 2).

So far, very few countries have declared that they intend to remain outside of SSM (the UK, Sweden and the Czech Republic), which mathematically gives them a *de facto* veto right. There is a major risk that the advancement of European prudential rules could be blocked by 2 countries against 25, by two countries outside of the eurozone not participating in SSM.

Transition period

European architecture and the banking union must be designed to handle losses arising from operations prior to banking union, the management of which requires both imagination and the acceptance of a certain degree of solidarity in loss sharing.

It is important to ensure that the banking systems of peripheral countries do not collapse, in which case there would hardly be any European identity left to preserve. In time, the European deposit guarantee fund, as approved by the Council in June 2012, should be in a position to respond to a banking crisis like the one that Spain is experiencing today.

Yet since the ECB's supervisory role conditions any intervention by the European Stability Mechanism, this leaves open the question of doubtful assets inherited from the period when supervision was exclusively national. The solution currently under consideration is for national facilities to bear the brunt of these losses, with the possibility of borrowing from the European Stability Mechanism if necessary. The Spanish Fund for Orderly Bank Restructuring (FROB) could use a fraction of the available €100bn to break the vicious circle between banking troubles and public finances. At the end of this transition period, it seems indispensable to mutualise the deposit guarantee and bank resolution funds.

Through a special legislative procedure introduced by the Lisbon Treaty, the path taken to implement the supervision segment of banking union responds to the need for a rapid solution. It breaks with the principle of subsidiarity in an area in which the European Union shares competence with the member states.

The single supervision mechanism is already a major step forward, but the legislative path towards the completion of banking union will be long. In any case, it will take an enormous effort to end the segmentation of European financial markets. It will surely take years before all its components are fully operational, given the time required to build up deposit guarantee funds and/or bank resolution funds. Yet the creation of a single, credible and effective supervisor will make direct recapitalisation of struggling banks by the European Stability Mechanism more politically acceptable. This is particularly vital in the short term to protect Spanish public finances from further troubles with its banking sector.

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NOTES

[1] Opinion of the European Central Bank of 27 November 2012. [2] The Treaty on Stability, Coordination and Governance (TSCG) signed on 2 March 2012 by 25 of the 27 European member states introduces the balanced budget rule (article 3) for EMU member states. The rules on governance took effect on 1 January 2013. The balanced budget rule must be transposed into national law, preferably at the constitutional level, by 1 January 2014 at the latest. Obtaining ESM financing is subordinated to the signing of the budget pact.

[3] "A closer integration has as result a greater specialization and implicitly an increase of the asymmetrical shocks". See reference in the bibliography.

[4] "...acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank..." The Lisbon Treaty, which took effect on 1 December 2009, eliminated the condition "after receiving the assent of the European Parliament" in former article 105 (6) of the Treaty establishing the European Community.

[5] 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.

[6] PRES/12/528. http://europa.eu/rapid/press-release_PRES-12-528_fr.htm

[7] The Economic and Financial Affairs Council or ECOFIN is one of the oldest configurations of the European Council. It is comprised of the Economics and Finance ministers of the member states as well as Budget ministers when budgetary matters are discussed. ECOFIN meets once a month.

[8] Proposal for a directive of the European Parliament and of the Council on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate. COM (2011) 453 final.

[9] Proposal for a regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms. COM (2011) 452.

[10] This triangle of incompatibility is underscored in the Turner report: " Sounder arrangements require either increased national powers, implying a less open single market, or a greater degree of European integration", "A regulatory response to the global banking crisis", Financial Services Authority, March 2009, page 101.

[11] See " Proposal for a European resolution presented on behalf of the European Affairs Commission", in application of article 73 quater of the Regulation on Banking Union (E 5512, E 7417, E 7684 and E 7685), by M. Richard Yung, Senate, 24 October 2012, reasons presented on p. 12.

[12] An argument defended by Sabine Lautensschlaeger, vice-president of the Bundesbank, in a speech at the Symposium organised by the Institute for Monetary and Financial Stability (IMFS) and the "House of Finance" , 7 February 2013, in Frankfurt. See " European Monetary and Financial Union – what is needed in terms of banking supervision?". http://www.bis.org/review/r130208g.pdf

[13] According to Benoît Coeuré, ECB Executive Committee member, the treaty setting the ECB's bylaws offers a suitable framework for managing any conflicts of interest that may arise.

[14] Press conference by Herman Van Rompuy, President of the European Council, in Dublin on 9 January 2013.

[15] 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 2012/0242 of the Council conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions. COM (2012) 512 final.

[16] The fund has authorised capital of €700bn contributed by the member states, including €80bn of paid in capital and €620bn in callable capital. It has a financing capacity of €500bn and a safely invested capital reserve of €200bn in liquidities to ensure ESM always has a top quality credit rating.

[17]Proposal for a directive of the European Parliament and of the Council on Deposit Guarantee Schemes [recast]. COM (2010) 368 final.

[18] 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" adopted by the European Commission on 6 June 2012 (COM (2012) 280 final).

[19] The draft bill on financial and banking reform presented to the Council of Ministers on 19 December 2012 and currently being debated in Parliament, introduces a bail-in system into French law. Unlike the proposal for a European directive, which extends to senior debt, the French text is limited solely to subordinated debt. This is a reasonable precaution in so far as it must enter into effect ahead of the European text.

[20] The forced cancelation of equity and debt securities before the opening of the liquidation procedure could be judged by the European Union's Court of Justice as an infringement of property rights, a fundamental principle of the European Convention on Human Rights (Article 1 of Protocol 1), unless it is demonstrated that the bondholders and shareholders would have experienced at least equal losses in the absence of a bail in.

[21] This is the option adopted in France. Article 6 of the "draft bill on banking and financial reform" presented to the Council of Ministers on 19 December 2012 and currently being debated in Parliament, calls for strengthening the mission of deposit guarantee funds in order to make them "guarantee and resolution funds".

[22] Opinion of the European Central Bank of 29 November 2012, Official Journal of the European Union of 12 February 2012, paragraph 3.4.

[23] "Only the EU could have four presidents, but they are of the Council, the Commission, the eurozone and the presidency itself. I am glad I remembered that." Oral Evidence from the Prime Minister, Tuesday 3 July 2012. Oral and Written evidence, Tuesday 3 July 2012. House of Commons. Liaison Committee. The Prime Minister was reacting to the report "Towards a veritable Economic and Monetary Union" presented by the President of the European Council in collaboration with the President of the European Commission, the President of the Eurogroup and the President of the European Central Bank (ECB) at the European Council of 28 and 29 June 2012.

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