CEPS ESSAY
Thinking ahead for Europe

The Contents and Timing of a European Banking Union: Reflections on the differing views

H. Onno Ruding

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Introduction

The first step towards a European banking union (EBU) was taken in 2009, with the launch of the report by the High-Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière.[1] Until that time, supervision of banks in the EU had basically been a national task, although the member states had accepted several non-binding arrangements to coordinate their national policies in this area.

Swift political action ensued in 2009 and 2010, with the aim of putting most of the measures proposed in the de Larosière report into EU legislation. For the first time, policy responsibilities were entrusted to three new European authorities operating at a supranational, European level. One of them, the European Banking Authority (EBA), is now empowered, inter alia, to perform a mandatory, legally binding mediation role to solve disputes between national bank supervisors over the supervision of cross-border banks as well as to define binding common supervisory standards to be applied throughout the EU. More than this was not politically possible in 2009.

The serious financial crisis in the euro area, which came out into the open in 2010 and still prevails, exposed the dual weakness in several eurozone countries of unsustainable deficits and debts in government accounts and unsustainable weaknesses (both solvency and liquidity) in national banking systems. The contagion effects of these sick Siamese twins, sovereigns and banks, proved too strong to be solved solely on a national basis by the country involved and are now threatening the existence of EMU and the euro. This threat has made it possible to achieve political agreement in principle to significantly deepen European integration by moving towards intensified bank supervision at the European level, accompanied by a corresponding decline in national supervision and national sovereignty.

It needs to be emphasised that this political drive towards a European or euro-area 'banking union' is a necessary but not sufficient step to achieve a credible and satisfactorily

[1] Download report at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

H. Onno Ruding is Chairman of the CEPS Board of Directors and former Minister of Finance of the Netherlands. This essay is based on a speech he gave at a workshop on the Pros and Cons of Banking Union, organised by the Duisenberg School of Finance (DSF), Amsterdam, 5 November 2012.

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functioning EMU, which after all is much more than a monetary union in the technical sense of sharing a common currency, the euro. A "genuine Economic and Monetary Union", as Herman Van Rompuy, President of the European Council, calls it, requires not merely the EBU (an "integrated financial framework", according to Van Rompuy), but a high degree of *fiscal* union and serious steps toward an *economic* union as well.

At the European Council in late October 2012, President François Hollande of France expressed the opinion that political decisions on the EBU are crucial and urgent, whereas progress on a fiscal union can be addressed by the European Council at a later stage. In my view, this approach fundamentally as well as politically flawed. A credible EMU cannot stand on one leg of a banking union only.

Although views differ on the precise contents and timing of a genuine banking union, there is wide political agreement in principle on the need for three basic and vital elements:

1. European bank supervision,
2. a European deposit guarantee scheme (DGS) and
3. a European bank resolution mechanism.

This essay offers my personal views on the progress achieved to date, the outstanding issues that will prove the most difficult to resolve and recommendations on the way forward.

1. Difficult decisions on European bank supervision

Several crucial elements of the proposal to create a single supervisory mechanism (SSM) were addressed but were not decided upon at the European summits in June and October 2012. They will reappear on the agenda in December 2012. I select the three most important ones for discussion below.

What should be the scope of the supervision?

Should the central European authority in charge of banking supervision be responsible for micro-prudential supervision of all banks in the countries that participate in the EBU or should it supervise 'only' a rather limited number of large cross-border or 'systemic' banks? A serious disagreement has emerged on this question. Germany insists on the latter, more limited approach and wants to keep national control of its numerous local and regional banks (*Landesbanken, Sparkassen*). It argues that these local banks are too small to create a banking problem of a European dimension and that Germany is willing and able to finance any default of these domestic banks by itself but does not want to become involved in solving problems of domestic banks in other countries. It is true that Germany can handle financial problems of domestic banks by itself, unlike several other euro members such as Spain and Ireland. Although one may sympathise with the specific issue of the federal character of Germany which complicates the transfer of sovereignty of supervision of the many banks that are deeply-entrenched (politically) in the various states (*Länder*) of Germany, on balance I favour the proposal of the European Commission, supported by, among others, France, to apply European supervision to *all* banks, big or small.

Apart from the important principle of the level playing field, it is important to note the fact that a default of single medium-sized domestic bank may create much turmoil in the financial markets and angst among savers, even internationally. Consider, for example, the case of Northern Rock in the UK. Even more serious problems can arise if a multitude of medium-sized or smaller banks in a single country manoeuvre themselves towards illiquidity and insolvency resulting from similarly inadequate risk management as well as insufficiently strict national bank supervision (as illustrated e.g. in the excessive lending to property companies and projects as well as mortgages in both Spain and Ireland). In Spain,

none of the *cajas*, the regional savings banks, would be considered a large bank, but in the aggregate their size is close to half of the domestic banking sector. All together they have been able to bring Spain financially to its knees and endangered the stability of the euro. There is really a need for an independent bank supervisor from outside the home country, which would not be susceptible to efforts to influence by regional politicians and other interested parties. Daniel Gros rightly comments: "The Spanish case is symptomatic of a larger problem. National supervisors always tend to minimise problems at home. Their instinct (and their bureaucratic interest) is to defend their countries' 'national champion' bank(s) abroad."[2] I would add that in Spain, with the *cajas*, and elsewhere (like Germany with the *Landesbanken*!), this applies not only to supervisors but to politicians (national and regional) as well. Gros concludes from this behaviour: "Given national supervisors' predictable tendency not to recognise problems at home, it seemed natural that the cost of cleaning up *insolvent* banks should also be borne at the national level".

Another objection raised against a central European supervisor for all banks is that it is practically impossible to thoroughly supervise all banks in the euro area from one central institution in Frankfurt. This authority must first build up a large staff with local expertise in the various countries. I agree that this issue creates practical complications, certainly in the early years. In fact, however, a lot of supervisory work on individual smaller banks should and can be delegated by the central supervisor to the national bank supervisor in the country in question. The important point is that final decisions on whether or not the supervisor wants to declare the condition of a particular bank unsatisfactory and take corrective action should be made at the European level, and no longer nationally.

Who should perform the role of supervisor?

On this second difficult decision, the report of the de Larosière Committee of 2009 took a firm position. It noted (para 167): "A number of people, including representatives of the ECB, have suggested that the ECB could play a major role in a new European supervisory system in two respects: a role in macro-prudential supervision and a role in micro-prudential supervision." The report (para 171) concluded: "While the Group supports an extended role for the ECB in *macro*-prudential oversight, it does not support any role for the ECB for *micro*-prudential supervision."[3]

The report gave several reasons for its opinion (para 171): "Adding micro-supervisory duties could impinge on its fundamental mandate about monetary stability. In case of a crisis, the supervisor will be heavily involved with the providers of financial support (typically Ministries of Finance) given the likelihood that taxpayers' money may be called upon. This could result in political pressure and interference, thereby jeopardizing the ECB's independence."

It was therefore surprising that the European Council, in June and October 2012, so easily decided on the ECB as the new Single Supervisory Mechanism (SSM). After all, the same European Council two years earlier had supported the creation of three European authorities, one of which was for banking: the EBA. It would have made more sense to enlarge the mandate of the EBA to include European micro-prudential bank supervision.[4]

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[2] Daniel Gros, "A Banking Union Baby Step", Project Syndicate, 2 July 2012.

[3] Author's emphasis in italics. It should also be noted that the macro-prudential oversight function has become the responsibility of the European Systemic Risk Council (ESRC) of the EU, where the ECB plays a major role.

[4] In their earlier publications, Daniel Gros (CEPS) and Dirk Schoenmaker (Duisenberg School of Finance: DSF) advocated the EBA for this function rather than the ECB. However, after the European Council

The likely reason for choosing the ECB over the EBA is the high reputation of the ECB in its current area of responsibility: monetary policy, compared with the difficulties the EBA has encountered in conducting its stress-testing of many (large) banks in Europe.

That still leaves on the table, however, the issue of the risks of the dual task of the ECB. The concerns about this combination of monetary policy, macro-prudential bank supervision and micro-prudential bank supervision now focus not only on the above-mentioned dangers of political interference and attacks on the independence of the ECB but also on the danger of conflicts of interests *within* the ECB in carrying out its dual mandate. In crisis situations, will the ECB give priority to its monetary policy goals over its (new) supervision of individual banks, or (less likely) the other way round? The current thinking, including at the European Commission, is to avoid these conflicts of interest by creating two *separate* bodies or divisions or 'Boards' within the ECB to carry out these two mandates.

I seriously doubt whether this device can satisfactorily address these concerns. It is possible, indeed, to create two divisions, with completely separate staffs, each entrusted with only one of the mandates of the ECB and protected by hopefully credible Chinese walls. But the ultimate decisions on important matters of both monetary policy and bank supervision are made by the same, single Executive Board of the ECB where possible conflicts of interest may still arise. In addition to legal concerns whether all this can be reconciled with the provisions in the EU Treaty (Article 127), this fundamental issue is not yet resolved. It is frustrating to note that the more the structure of the ECB is going to be adapted to create separate bodies or units under the 'umbrella' of the ECB, the more the conflict anticipated in the de Larosière report is being validated.

Will bank supervision extend to the EU-27 or be confined to the euro area of 17?

The intention is to create the bank supervision structure for the 17 euro countries, with the option for each of the 10 non-euro EU members to decide whether or not to participate. There is the risk that one or more countries that decide to opt-out may go one step further by voting against the proposal of the EBU as such, thereby killing the project. The UK has already declared its intention to opt-out but its first signal was that it would not block the proposal as such. It must be clear that if country A decides not to participate in the EBU, banks in country A are not affected by the European supervision, or by any common European bank resolution fund or European DGS (see below). This issue of the EU versus the euro area and membership of the EBU is creating many legal and political complications, including voting power and the influence of non-euro countries (see Article 127 of the Treaty). It also contributes to the undesirable development of a multi-speed Europe.

2. Remaining challenges to a European deposit guarantee scheme and bank resolution

In addition to a single supervisory mechanism, the other two vital elements for an EBU are a European deposit guarantee scheme (DGS) and a European bank resolution mechanism. All three components are interrelated and are necessary to create a genuine and effective European banking union. If Europe would implement a European bank supervisor without agreements on DGS and bank resolution, the structure would be ineffective because any decision by the SSM that a particular bank is unlikely to survive without further action would ring hollow if such further action cannot be taken at the European level. This implies a two-stage approach. Europe must first, with priority, agree on and implement European

decision of June 2012 to add this task to the ECB's existing mandates, these two experts – apparently without reservation –endorsed this course of action.

bank supervision and on that basis, enter into the second stage of binding agreements on deposit guarantees and bank resolution. This two-stage approach is advocated by Germany and the Netherlands, inter alia.

The real problem, however, is that even with speedy implementation of European supervision, it is politically unlikely that the next two steps will be agreed upon any time soon.

The main reason is that a large financial burden would be put on the shoulders of the taxpayers in euro countries other than those where the dangers of substantial bank defaults or bank recapitalisations emerge. What is not sufficiently understood is the cost of accepting cross-border commitments related to European bank resolution and DGS. The reason is the high likelihood of incurring significant losses on such exposures. After all, this concerns financial support to banks that are *insolvent* and (therefore) illiquid, or are about to enter that terminal phase. The liquidity support may come from the ECB, but the solvency support, and/or the bailing-out of guaranteed savings, weighs on the European bank resolution and DGS. For that reason, this burden-sharing issue is so much more delicate in a financial and political sense than the other type of burden-sharing among euro countries, namely participation in any financial support the new European support mechanism (ESM) may provide to either governments or banks. The fundamental difference is that the ESM's engagement is – or should be – related to *solvent* banks.[5] Their problem is primarily the need to increase their capital base. Then the risk of incurring losses is of a lesser degree, although still not trifling.

The most difficult political and financial issue is the *burden sharing* among the countries (and their taxpayers!) participating in the EBU. The de Larosière Committee was not able to reach recommendations on burden-sharing except for proposals (para. 139-143) for *general* guidelines or criteria to be accepted *ex ante* by all participating countries and to be applied later in each case of financial support needed after a European decision on an insolvent bank by paying certain creditors amounts of guaranteed savings and/or injecting extra capital to enable it to survive.

Even if the participating countries agree on common rules for burden-sharing in the cost of failed, insolvent banks, that still leaves open the awkward question of whether the burden-sharing agreements apply merely to *future* cases or also to bank disasters of the *past*, the so-called 'legacy cases'. It is obvious that burden-sharing rules should apply to all new cases of bank insolvency when their financial problems arise *after* the implementation of the SSM. However, some commentators rightly have doubts about European support for existing problems. "A precondition for establishing any European deposit insurance scheme is thus that the banking system in the countries under financial distress is *first* put on a sound footing by a combination of balance sheet cleansing and recapitalisation." [6] I agree, but disputes may arise about *who* will finance the work of establishing a "sound footing" and absorb losses in existing cases.

Graham Bishop[7] also questions whether "Europe" should become financially responsible for the "national" mistakes of the past. He says: "It is easy to see that if Europe has collective control in the future – of banks and finance – then it should pay collectively for any future mistakes of its own judgment. Understandably, taking responsibility for legacy mistakes is a

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[5] In several newspaper interviews, Klaas Knot, President of The Netherlands Central Bank, has stressed the condition that direct loans from the ESM are made only to solvent banks.

[6] Dirk Schoenmaker and Daniel Gros, "A European Deposit Insurance and Resolution Fund". CEPS Working Document No. 364, CEPS, Brussels, May 2012.

[7] "Graham Bishop comments on the FT story on illegality of Banking Union proposals" of October 18, 2012.

different matter and this has become an acute problem for any Spanish application for a support Programme." In other words, he endorses the same point when speaking of using the ESM: "So, the principle of the ESM recapitalising a clean, good bank … should be straightforward. Why Europe should fund the past supervisory mistakes that are the assets of the bad bank is a different matter."

Contentious conditionalities

It is highly unlikely that political and financial forces in Germany will accept to promise a blank check for European support for banks under the ESM and later under a bank resolution fund. They want to shift the responsibility and financial burden for losses more to the government, taxpayers and creditors in the country of the problem bank.

This implies that two conditions should be met before the ESM can be called upon to strengthen banks' weak capital positions: first, only solvent banks can qualify for assistance under the ESM and second, problems from the past will not be handled by the ESM. Those conditions are likely to limit significantly the use of the ESM for direct bank support. The judgment whether a bank is still solvent has to be made by the new SSM rather than by the national banking supervisor or the government of the country concerned.

This issue of conditionality is contentious. Countries like Spain and France probably want to ignore this issue, whereas countries like Germany and the Netherlands may insist on strict conditionality of which 'no legacy' is likely to be an important element.

The recent Communications from the European Council testify to the difficulty of making real progress on these matters, which require substantial solidarity and transfer of national sovereignty. This is difficult to achieve if it is not accompanied by tough and credible discipline on the part of the countries in need of support. The Van Rompuy report of 12 October 2012[8] merely speaks of "(H)armonising national DGS is an important step...". But what happens after this first step? The report is silent and non-committal. About the resolution authority, it vaguely says that after the move to an SSM, "a common authority with an appropriate backstop would come to be required …" when "… the ESM will have the possibility to recapitalise banks *directly*, relying on appropriate conditionality …". After the 18-19 October 2012 summit, the communiqué merely states: "The European Council notes the Commission's intention to propose a single resolution mechanism for member states participating in the SSM once the proposals for a Recovery and Resolution and for a Deposit Guarantee Scheme Directive have been adopted." So, nothing about burden-sharing, nothing about how to handle the legacy issue, nothing about the criteria that applying banks must fulfil (being solvent?).

Fortunately, there is wide agreement that under the proposed European arrangements, the financial burden of supporting banks should *in the first place* be borne by the private sector rather than the taxpayers. In other words, priority will be given to 'bailing-in' the financial participants in the problem bank: shareholders and creditors [9] as well as a DGS to be funded by *ex ante* annual contributions from all banks.

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[8] "Towards a Genuine Economic and Monetary Union", Interim Report, 12 October 2012 (http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/132809.pdf).

[9] Apart from those retail savers who benefit from the guarantees provided by DGS, it is still a hotly debated subject how to treat the other creditors, particularly holders of bonds issued by banks. It is clear to me that, first, subordinated (junior) bonds must absorb losses and thereafter unsecured (senior) bonds. Secured senior bonds can rely on their collateral. However, in many cases of bank bail-outs in recent years, unsecured senior bonds received a too favorable treatment.

3. The way forward on a DGS and bank resolution?

A final question to be addressed is the issue of the best sequence in which to create these new institutions. In my view, these two later steps of creating a deposit guarantee scheme and bank resolution probably should be implemented simultaneously. They are separate arrangements, but in practice they must go hand-in-hand. Their institutional and financial governance may, to a certain extent, be integrated or coordinated.

I agree with Daniel Gros and Dirk Schoenmaker[10] that these two functions can be combined into a European equivalent of the Federal Deposit and Insurance Corporation (FDIC) in the United States. In the US, an effective banking union exists in which the FDIC plays a crucial role at the federal level in seizing insolvent banks and then either closing them down or transferring them to other, healthier banks. The FDIC absorbs the losses and pays the insured retail savings of the banks' clients (see DGS). The FDIC has built a reputation for swift decisions and actions. The burden-sharing of banking losses (between the 50 states) takes place in fact automatically at the federal level. The FDIC is now in charge of small banks, but the Dodd-Frank Act will enable the FDIC to take on large banks as well.

Several southern eurozone countries, including France, are urging implementation of steps 2 and 3 immediately after step 1. I expect, however, that political agreement on steps 2 and 3 will take quite some time, partly due to the burden-sharing issue and partly by the other awkward (financially as well as politically) issue of 'legacy assets': the problems of the past.

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[10] See Daniel Gros, "Banking Union: Ireland vs. Nevada, An illustration of an integrated banking system", CEPS Commentary, CEPS, 18 October 2012; Dirk Schoenmaker, "Banking Supervision and Resolution: The European dimension", DSF Policy Paper Series No. 19, Duisenberg School of Finance, Amsterdam, January 2012; and Dirk Schoenmaker and Daniel Gros, "A European Deposit Insurance and Resolution Fund", CEPS Working Document No. 364, CEPS, May 2012. See also Karel Lannoo and M. Gerhardt, "Options for Reforming Deposit Protection in the EU", ECRI Policy Brief No. 4, European Credit Research Institute, Brussels.

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CENTRE FOR EUROPEAN POLICY STUDIES, Place du Congrès 1, B-1000 Brussels, Belgium
Tel: 32 (0)2 229 39 11 • Fax: 32 (0)2 219 41 51 • www.ceps.eu • VAT: BE 0424.123.986