



# FUTURE OF EUROPE OBSERVER

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## Editorial

Whithout a doubt, the global economic crisis had a negative influence on the EU's economy. While in the media and in political debates it has been claimed that the economic crisis has been a crisis of the EU itself, a closer look shows that the integration process is continuing and increasing. Establishing a banking union will be a crucial step towards resolving the economic crisis. This new edition of the „Future of Europe Observer“ gives a brief description of the facts and arguments put forward in this debate about the pros and cons of a banking union in the EU.

Thorsten Kim Schreiweis, Editor

## The Future of Europe Observer

The Future of Europe Observer accompanies the debate in the European Union on governance and regulation.

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## One for All? The Banking Union and the Answer to the Financial and Economic Crisis

by Matti Meyer\*

Immediately after the global outbreak of the financial and economic crisis in September 2008 – which led to the sovereign debt crisis within the Euro Zone in 2010 – the European Union began to install short term stabilization measures aiming to reduce possible damage. In order to prevent the economy from deflation declining into deflation, several programs to reflate the market and to grant loans to the governments and the European Union were needed, along with unconventional measures of monetary policy taken by the European Central Bank. Five years after the beginning of the crisis

the decision by the heads of states and governments of the European Union member states to install a banking union in Europe has led to a heated debate in political and economic discussion.

The banking union includes several different mechanisms of regulating the financial services industry: Central elements of the banking union are firstly the foundation of one central European banking supervision (Single Supervisory Mechanism „SSM“), secondly the creation of a coherent process to liquidate or refloat banks (Single Resolution Mechanism „SRM“) and thirdly enabling the direct recapitalization of banks by the

*“With this proposal, all the elements are on the table for a banking union to put the sector on a sounder footing, restore confidence and overcome fragmentation in financial markets. We have already agreed common European supervision for banks in the euro area and other Member States who wish to take part. Today’s proposal complements that with a strong and integrated single system for dealing with failing banks. We cannot eliminate the risk of future bank failures, but with the Single Resolution Mechanism and the Resolution Fund it should be banks themselves – and not European taxpayers – who should shoulder the burden of losses in the future.”*

EU Commission President Barroso, 10 July 2013.

European Stability Mechanism (“ESM”). These elements are supposed to establish long-term stability. The most controversial part of this concept is the central banking supervision. Already in 2008, the previous system showed signs of failure when attempts were made to master the crisis. The European Economic and Monetary Union (“EMU”) established strong economic and financial integration of EU member states, but but did not include a central supervision mechanism guaranteeing compliance with the regulations of the stability and growth pact. The Member States objected to the establishment of central banking supervision. In fact they agreed in 2011 to the foundation of a European System of Financial Supervision (EFSF) with three controlling institutions – “EBA”, “EIO-PA” and “ESMA”. However, these controlling institutions were only tasked with developing coherent standards of supervision, while the supervision itself was still left to the member states. Finally it was the crisis in Cyprus which led to the understanding that national authorities were not up to the task.

After extended proceedings, the Council of the European Union and the European Parliament agreed on a central banking supervision (single supervisory mechanism, SSM) under the direction of the European Central Bank in March 2013. The ECB will monitor European banks who either show an amount of more than 30 billion € on their balance, or who show an amount of more than 5 billion € and at the same time constitute 20% of the economic performance of the Member state. Furthermore, those banks that applied for, or made use of, the help of either ESM or EFSF are now also under the authority of the ECB. This directly affects about 150 to 200 of about 6000 banks within the EMU. For all remaining banks, supervision is carried out by national authorities. The tasks of the ECB are controlling the appropriateness of the capital of a credit institution, in relation

to its risk profile, as well as early intervention in cases of violation of the regulated requirements of equity capital by a credit institute in consultation with the executing authorities. Moreover the ECB will participate more actively in the admission process of new banks in the future.

On the 10th of July 2013 the European Commission presented the “Proposal for a Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund” (COM 2013/0253), which lays down substantial rules about the SRM.

### European Stability Mechanism (ESM)

The European Stability Mechanism („ESM“) assumes the tasks formerly fulfilled by the European Financial Stability Facility („EFSF“) and the European Financial Stabilization Mechanism („EFSM“) in providing, where needed, financial assistance to euro area Member States.

The ESM guidelines specify under which conditions, subject to State aid rules, Member States which are unable to provide public support to banks can get loans, or if necessary how banks can be directly recapitalized by the ESM. Entered into force at Sept., 27th 2012.

Whereby, necessary measures should not only be taken more systematically and more efficiently, based on „bank resolution expertise and experience“ within a “centralized pool”, but also more efficient protection of tax payers should be achieved by decoupling the banks from the credit status of their Member State. Furthermore, an increasing fragmentation within the European financial markets should be called to a halt and the

sustainable supply of loans for the real economy should be guaranteed.

The decision making structures of a uniform liquidation mechanism comprise of the Single Resolution Board, the national liquidation authorities of participating Member States and the European Commission. The duties of the SRM include the initiation of bank liquidation and corresponding competences as well as the development and control of liquidation plans which are divided between the Single Resolution Board and the national liquidation authorities. Competences of the European Commission according to state aid law (Art. 107 TFEU) remain unaffected. The coherent liquidation fund should mainly guarantee financial stability and is not seen as a rescue fund.

## ZEI Class of 2014 have begun their studies

24 participants from 17 nations started their studies at ZEI on October 02, 2013.

Over the next twelve months, the fellows of the “Master of European Studies – Governance and Regulation” (MES) are going to deepen their knowledge of the European integration process with special emphasis on European governance and regulatory aspects.

ZEI Managing Director Prof. Dr. Ludger Kühnhardt welcomed the new ZEI fellows and wished them an interesting and enriching year at ZEI.



The banking union is legally based on Art. 114(1) TFEU concerning the SRM and Art. 127(4) TFEU concerning the SSM. Art. 114(1) TFEU is generally seen as a substantial legal basis for the SRM, whereas there is significant disagreement about the legal basis for the establishment of the SSM especially concerning legal supervision competences of the ECB. Concern was partly raised due to the fact that the ECB was given more competences in the area of banking supervision than permitted by the TFEU, as Art. 127(6) TFEU only allows the Council to confer “specific tasks” to the ECB. However within the SSM the ECB is not only supposed to take over specific exceptional tasks, but main parts, if not core areas, of banking supervision.

Therefore only non-explicitly mentioned areas devolved to the ECB remain as competences of the member states. Given the fact though that not all tasks are completely conferred to the ECB there is still a remaining – however small - range of duties for the member states. Furthermore centralized supervision by the ECB is needed to comply with the requirements set by the “effet utile” of Art. 127(6) TFEU, which aims at ensuring financial stability and growth within the Euro monetary union and within the entire internal market.

Further aspects which are discussed critically, mainly refer to the devolution of other important competences to the ECB. An insufficient separation of monetary policy and banking supervision is especially criticized even though there is a detachment of these task areas within the institution. Therefore it has been suggested by some to establish a separate European institution. Despite this criticism the banking union has proven to be a necessary improvement of former conditions and removes serious shortcomings. Nevertheless, the banking union is also part of a European integration, to an unpredictable extent, which is not endorsed by all member states.

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# European Banking Union – Disaster or Saviour?

\*by Bernd Hayo

Since mid-2007, Europe's economies have been hit by three different types of crises, all of which are highly connected: a financial crisis, an economic crisis, and a debt crisis. These crises dispelled any benign notions about the stability of the European banking system. National governments stepped in and bailed out their ailing banks in the hope of keeping them alive and preventing a credit market collapse. At the same time, banks that were already on the brink of collapse started buying billions of government bonds, which could be handed in as first-rate collateral to the European Central Bank (ECB) and would ensure their supply at low costs. This entanglement between governments and banks became a toxic cocktail after international investors perceived the danger that government debt may not be risk free.

As a consequence of this development, in a number of euro area countries, especially Cyprus, Greece, Ireland, Portugal and Spain, threats to government solvency directly endangered the survival of the financial system.

To help stabilize the situation and to prevent its future occurrence, the European Union (EU) aims to implement an integrated financial framework, also called a 'Banking Union'. According to the 'van Rompuy plan', this banking union consists of three parts: banking supervision, resolution mechanism, and deposit guarantee. So far, no concrete decisions have been made on the latter two parts, so this discussion focuses on the first one. It is hoped that the single supervisory mechanism will help ensure the safety and soundness of the European banking system and foster financial integration and stability in Europe. At the end of May 2012, the European Commission called for the creation of an integrated financial supervision to restore confidence in the European financial sector. Following this announcement, and involving a negotiation process between most EU actors, such

as the European Commission, European Council, European Parliament, and euro area Heads of State, a Council Regulation was adopted by the European Parliament on the 12th of September 2013. This Regulation confers the specific task of prudential supervision of credit institutions to the ECB and is reflected in Article 127(6) of the Treaty on the Functioning of the European Union. It is planned that the ECB will assume its new banking supervision tasks one year later, i.e. in autumn 2014.

The new single supervisory mechanism will consist of, the ECB on the one hand, and the national financial supervision authorities of participating EU countries on the other hand. It is important to emphasize that the expected group of participating countries encompasses both euro

area member countries and non-euro area countries. However, the responsibility for the proper functioning of the single supervisory mechanism lies with the ECB, which also has to ensure effective co-operation with national supervisory authorities.

Thus, it is envisaged that banking supervision will take place both at the national as

well as at the European level, under the overall oversight of the ECB. The ECB will directly supervise particularly significant credit institutions and, if deemed necessary, will also regulate credit institutions of lesser significance. Whether a financial institution is considered as 'significant' depends on various aspects: the total value of its assets, the importance for the economy of the country in which they are located or the EU as a whole, the significance of their cross-border activities, and whether they have requested or received public financial assistance from the European Stability Mechanism (ESM) or the European Financial Stability Facility (EFSF). Currently, about 130 credit institutions can be considered as significant according to this definition, representing almost 85% of total banking

## Banking union (1) – Single Supervisory Mechanism (SSM)

**The Single Supervisory Mechanism confers powers on the ECB to supervise Euro Area banks and to enforce prudential rules in a strict and impartial manner with the objective to promote the safety and soundness of credit institutions and the stability of the financial system. Entered into force in October 2013 and will be implemented in the second half of 2014.**

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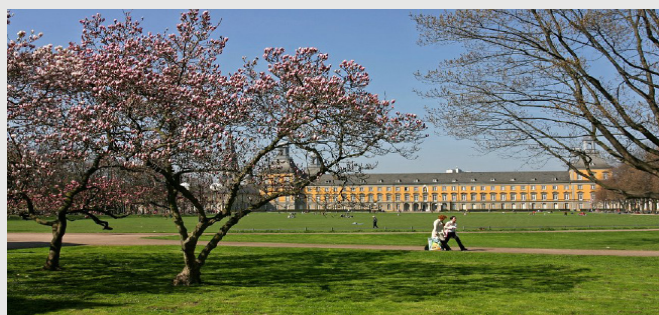
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assets in the euro area. This leaves about 6,000 banks for the national supervision authorities. What are the economic consequences of the decision to establish a European banking union? In Germany, at least, there has been an intensive debate about its pros and cons. Severe criticism is put forward in a letter drafted by Hans-Werner Sinn and signed by 172 German-speaking economics professors in early July 2012. They fear that by pushing the door open for the creation of a banking union, tax payers in fiscally-sound countries, such as Germany, may finally become liable for bailing-out indebted banks in other European countries. By creating a framework for EU-wide redistribution, as they perceive it, European integration is seen to be in jeopardy. Martin Hellwig and a group of supporters emphasize the importance of re-financing private banks while simultaneously removing sovereign debt from their balance sheets. Although they agree that there should be no collectivisation of banks losses, it is maintained that a banking

union would better administer insolvent banks, avoid contagion to other financial institutions, and help disentangle private banks and public debt.

**M**y reading is that Sinn's perspective is overly pessimistic, whereas Hellwig's perspective is overly optimistic. Note that, at this point in time, no concrete decisions have been taken with respect to resolution mechanism and deposit guarantee, so to some extent the following discussion is speculative. Sinn's conjecture is based on the assumption of the worst possible outcome, namely a shameless and ruthless exploitation of Germany and other countries by their Southern neighbours. While I agree that it would be naïve to suppose that politicians in the crisis countries would not attempt to mitigate the costs of this disaster for their electorate by obtaining financial support from other countries, I think they would not risk tearing the European house down. And although it seems prudent to closely monitor reform steps taken in these countries, this is already taken care of in the

context of ESM and EFSF. I also do not see how the situation can be improved using only national policies. Moreover, given the long recession these countries have been experiencing, it is not realistic to expect that all problems can be addressed in a short period of time. It took many years to get into this mess, and it will take many years to get out of it. At the same time, I believe it is likely that a share of the costs will be borne by those countries less affected by the crisis, especially Germany. However, if one views the EU as a long-term partnership, this may still be irritating to the current German tax payer but not necessarily life-threatening. In a few decades, it is perhaps Germany, burdened by demographic change, which will need help from other European countries.

**H**ellwig assumes that the banking union will actually manage to separate private and public debt. I am not so optimistic about that. How is the ECB going to do that in practice and are the governments of the crisis-ridden member countries really going to hand over control of their most important banks? The situation of many banks was aggravated by politicians influencing their lending and borrowing behaviour.

**I**n Germany, the case of Hypo Real Estate is a good example of how the combination of political influence and wrong management incentives can cause a huge waste of tax payers' money. In addition, there is the issue of a possible conflict of interest within the ECB. Its primary objective is to maintain price stability. But what would happen if a policy in line with this goal endangered the financial stability of significant banks in the euro area? In the end, it is the Governing Council of the ECB that has to decide on both monetary policy and regulatory measure. What are the appropriate weights that should be applied in the trade-off between stable prices and stable financi-

al institutions? In a recent paper, Guillaume-Pierre Méon and I provided some empirical evidence that national considerations appear to affect Governing Council interest rate decisions (*Behind Closed Doors: Revealing the ECB's Decision Rule*, *Journal of International Money and Finance* 37, 135–160, 2013). This suggests that after putting prudential supervision on the ECB's menu, decision-making in the Council may become even more difficult and subject to national conflicts of interest.

**S**till, it seems unlikely that any other authority could have been created in a comparable period of time to take over banking supervision. It is also important to note that the ECB is the only institution that can act as a lender of last resort, and, in that respect, it is even more powerful than ESM/

EFSF. Thus, although I believe this solution to be second-best, I argue that it is the only viable alternative. Nevertheless, I would recommend preparing for the separation of monetary policy and prudential policy in the longer run through the creation of a new European supervisory authority.

**D**rawing an analogy to a 'monitored' insurance system could help our understanding of the pros and cons of a banking union. It is possible to insure individuals against rare negative events because everybody contributes to paying the costs in times of need. Thus, resolution mechanisms and deposit guarantees are important aspects in the creation of a banking union. In their absence, we have to rely on ESM/EFSF to bail out a country. Moreover, it seems likely that, given the amount of money at risk, the ECB is also needed in the background as a lender of last resort to ensure the credibility of the system. However, any insurance system is plagued by 'moral hazard', a change towards more risky behaviour of the insured brought about by the existence of the insurance.

### Banking union (2) – Single Resolution Mechanism (SRM)

**The Single Resolution Mechanism with a central decision-making body and a Single Bank Resolution Fund is a framework that allows for the in-depth restructuring of banks by authorities whilst avoiding the very significant risks to economic stability and costs derived from their disorderly liquidation under national insolvency laws, as well as putting an end to the need to finance the process with public resources. The SRM is now in the final phase of negotiations and could be enacted at the end of 2014.**



## EU Commission President Barroso: State of the Union Address 2013\*

[...] So we have mapped out, in the Commission Blueprint for a deep and genuine Economic and Monetary Union, not only the economic and monetary features, but also the necessities, possibilities and limits of deepening our institutional set-up in the medium and long term. The Commission will continue to work for the implementation of its Blueprint, step by step, one phase after the other. And I confirm, as announced last year, the intention to present, before the European elections, further ideas on the future of our Union and how best to consolidate and deepen the community method and community approach in the longer term. That way, they can be subject to a real European debate. They will set out the principles and orientations that are necessary for a true political union.[...]

\* [http://europa.eu/rapid/press-release\\_SPEECH-13-684\\_en.htm](http://europa.eu/rapid/press-release_SPEECH-13-684_en.htm)

To some extent, it is the danger posed by moral hazard that is emphasized by many critical German economists. This argument is not necessarily compelling, since we know that private insurance companies exist in spite of moral hazard. In our context, moral hazard can come from two sides: governments and banks. Regarding the former, it is necessary to defend the conditionality as, e.g., implemented in ESM/EFSF financing. Regarding the latter, an important role falls to the financial supervision authority monitoring the behaviour of the banks. Such monitoring, however, can only be effective if it takes into account the high degree of integration of European financial markets. Given the failure of national supervision in the past, can we expect the ECB as regulator and co-ordinator to do a better job? I believe yes, as long as it is able to solve the potential conflict between regulation and monetary policy and remains independent from political influence, which is not necessarily ensured in the case of national authorities.

To summarize, creating a European banking union makes economic sense. So I do not

think it is appropriate to call it an impending disaster. At the same time, moral hazard and clashes of interest in the decision-making mechanism will always remain an issue. Both aspects have to be seriously considered when designing the European resolution mechanism and deposit guarantee. Thus, viewing banking union as a saviour appears naïve.

### Banking union (3) – Bank recapitalisation

The objective of an ESM direct recapitalisation shall be to preserve the financial stability of the euro area as a whole and of its Member States in line with Article 3 of the ESM Treaty, and to help remove the risk of contagion from the financial sector to the sovereign by allowing the recapitalisation of institutions directly. The European Stability Mechanism (ESM) will have a lending capacity of €500 billion. Recapitalisations can also be conducted under a loan accompanied by a fully-fledged macroeconomic adjustment programme. The ESM Treaty does not currently foresee direct lending by the ESM to a financial institution.

In practice, an economic institution, such as an integrated prudential framework, will rarely if ever become ‘optimal’ but could nevertheless help stabilize the European financial system. Thus, the planned banking union holds potential for improvement, but, of course, whether it will actually succeed remains to be seen and depends on future decisions regarding institutional design and policy.

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## Still much room to improve the European semester, say MEPs\*

European Semester economic policy coordination needs many fixes, not least to take proper account of growth, employment, investment and social concerns, warned the Economic and Monetary Affairs Committee in a resolution voted on Monday, on September 30th. Members of Parliament (MEP) also called for more rules to ensure economic convergence and again underlined that democratic accountability and ownership must be improved.

The warnings and requests are set out in the committee's annual resolution on the latest developments in the European Semester, the process whereby EU member states coordinate their budgetary and economic policies. Drafted by Elisa Ferreira (S&D, PT) and approved by 30 votes to 2, the resolution welcomes the fact that some concerns previously raised by Parliament have been addressed but notes that there is still ample room for improvement.

### More on economic convergence

More legislative proposals are urgently needed to achieve genuine convergence, inter alia by creating a Competitiveness and Convergence Instrument and strengthening economic policy coordination, says the text. To this end, more effort is also needed from „surplus“ countries, not just those in fiscal difficulties, it adds. Finally, MEPs encourage the Commission to take a more lenient view of non-recurrent, public investment programmes with a proven track record of ultimately improving a country's budgetary situation.

### More on employment and an EMU with a social dimension

The resolution urges the Commission to do much more to build social concerns into the Semester and, more broadly, into the Economic and Monetary Union. It calls for legislative proposals to give EMU a social pillar and set up a „social pact for Europe“, given that some countries' social welfare mechanisms have been greatly eroded by budget cuts. Finally, the Commission is urged to assess the social impact of its reform recommendations. Unemployment must also be tackled more directly and urgently, by better integrating measures to reduce it into other economic policies, prioritising investments in education, and ensuring better financing of the real economy and small firms, particularly in the EU's periphery.

### More for accountability, ownership and transparency

The Commission should also develop ways to increase the visibility of the Semester process, says the text. With its help, member states should step up the involvement of national parliaments, social partners and civil society, particularly in developing, discussing, monitoring and evaluating national reform programmes, it adds.

Finally the resolution calls for more transparency about the work of the European Stability Mechanism and the Eurogroup, as well as financial assistance programmes. It also urges the Troika (Commission, ECB, IMF) to revise its communication strategy, which has „repeatedly proved to be a disaster“.

### Next steps

The resolution will be put to a vote by the whole house towards the end of October. It will provide Parliament's input for 2014 coordination process, which the Commission is to launch in November.

\*<http://www.europarl.europa.eu/news/en/news-room/content/20131001IPR21225/html/Still-much-room-to-improve-the-European-semester-say-MEPs>

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