ASTRID

Towards the European Banking Union

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Passigli Editori

General editor: Marzia Gandiglio
Language editor and translator (Chapter I, Part three): Mark Walters

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Emilio Barucci, Franco Bassanini, and Marcello Messori

INTRODUCTION

1. The crisis of the European Economic and Monetary Union (EMU), which followed, at the end of 2009, the international financial crisis, is not over yet. From May 2011 to July 2012, it was fed by the vicious circle between the sovereign debt crisis in the peripheral Member States and the crisis of a major part of the European banking system. This vicious circle has highlighted the weaknesses of financial regulation/supervision as well as the economic governance of the euro area. The Banking Union (BU) is an important component of the attempt to resolve both these problems.

2. The formal proposal of a banking union was launched by the European Council in June 2012, when it was suggested that a European supervisory mechanism was to be defined by December 2012. The actual formulation of the BU process can be dated to September 2012, when the European Commission produced structured papers on the subject, developing suggestions elaborated the previous spring. In the September version, the BU was made up of three pillars: the Single Supervisory Mechanism (SSM), the Single Recovery and Resolution Mechanism (SRM), and the Single Deposit Guarantee Scheme (SDG). The institution of the SSM and the SRM aimed to create a level playing field in the banking regulation of EMU countries as well as in that of the other European Union (EU) countries voluntarily applying to the BU. The institution of the SDG was intended to create a protection mechanism at the European level in favour of bank depositors.

At the European Council of October 2012, it was agreed

that the SSM would be approved by the end of 2012 and that this new mechanism would be entrusted to the European Central Bank (ECB). This important decision raised a number of major issues. The first was the definition of a clear-cut division of responsibilities between the ECB and the national authorities of the Member States in charge of the current banking regulation. A second issue was related to the possible conflict of interest between the ECB's traditional responsibility of monetary policy and its new supervisory role. A third problem arose from the fact that, according to the European treaties, the ECB's decisions are binding for the EMU Member States but not for the non-EMU States member of the EU; and, as stated above, some of the latter can apply to the BU. A fourth problem was the overlap between the ECB's new functions and the role of the European Banking Authority (EBA).

These four issues hindered the progress of the BU during the autumn of 2012 and threatened its future implementation. Indeed, the launch of the SSM led to some EMU Member States blocking the construction of the SRM and the SDG. It was emphasized that there were two European directives, concerning – respectively – the harmonization of the national systems on deposits guarantee (2010) and the construction of national resolution mechanisms and their coordination (2012), which still waited to be approved. Hence, it appeared reasonable to postpone any discussion on the SRM and the SDG to the approval of these two older European directives; and the Commission had to commit itself to design a possible SRM only after this approval.

3. Despite these difficulties, the implementation of the BU process unexpectedly accelerated in mid-December 2012. The EU Council duly approved the SSM, thus taking a fundamental step in the construction of the first pillar of the BU. Moreover, the final design of the SSM was able to overcome, or at least to weaken, the above four problems raised by its initial definition.

First, as regards the division of the responsibilities between the ECB and the national authorities, although the SSM is based on a system composed by the ECB and by the national authorities, the former holds full responsibility for the new supervisory system. More specifically, the ECB directly oversees around 130 larger European banks whereas each national authority retains the supervision on the other banks based in its domestic market. However, since the ECB is also responsible for the supervision of the latter banks, it has to take the place of the national authorities in an emergency and can always do so on a discretionary basis. Second, as far as the conflict of interest is concerned, the governance of the SSM includes a Supervisory Board which is largely independent of the ECB Governing Council and – hence – is not involved in the monetary policy decisions. Third, in order to protect the participation of the EU's non-EMU Member States in the BU, any divergent position between this new Supervisory Board and the Governing Council calls for the intervention of an SSM Mediation Panel, and the irreversible exit of the non-euro participants is allowed. Fourth, in order to protect the EU Member States which remain outside the BU and to guarantee a role for the EBA, the latter retains the task of developing a single rulebook on banking supervision and needs a double majority (that of BU participants as well as BU non-participants) to take crucial decisions.

These four features of the SSM raise a number of new problems, which are carefully analyzed in several chapters of this book and are outlined below (see point 6 below). Here, it must be emphasized that the launch of the SSM changed the inertia of the BU process, and more generally of the banking regulation process. At the end of February 2013 the European Commission, the EU Council and the European Parliament agreed on the definition and the approval of new prudential rules (CRR/CRD IV) on banks' capital requirements. In

March 2013 the European Council certified the support of the European Parliament with respect to the new supervisory responsibilities of the ECB and the new role of the EBA. Moreover, it defined a very ambitious «time schedule» for the launch and implementation of the remaining parts of the BU process. This schedule required the approval of the two old European directives on bank recovery and resolution and on deposit guarantee schemes which aimed to coordinate national initiatives in their respective fields (see above) before the end of June 2013. This first step would allow the European Commission to make a proposal for the creation of an SRM based on a «bail-in» process and a Single Resolution Fund (SRF); and this proposal would have to be examined, redefined and approved by the European Parliament before the May 2014 European elections.

4. It is amazing that all these ambitious deadlines were met. At the end of June 2013, the EU Council reached a compromise to approve the European directive on the creation of national resolution mechanisms and to transpose the content of the national deposit guarantee schemes into the approved directive. Then, in July 2013, the prudential rules on banks' capital requirements were implemented and the draft of the SRM was completed by the European Commission. In mid-October 2013, the EU Council adopted the regulations to actually build the SSM and to redefine the EBA's operational rules, and in mid-December of the same year it set its regulation on the SRM and SRF and agreed with the European Parliament and the European Commission the legislation on the national resolution mechanisms and the national deposit guarantee schemes. Finally, following political agreement reached in March, May and July 2014, the EU Council adopted a directive and a regulation, respectively establishing a framework for the recovery and resolution of credit institutions and investment firms concerning both the SRM and the SRF. The European Commission also launched public consultation on the key elements related to determining contributions of institutions to resolution financing arrangements.

Summarizing the status of the building of the new architecture, we may say that the SSM is legally in place, the SRM is close to being finalized, whereas the construction of the SDG is far from being settled. In a nutshell, the role of the EBA and ECB on regulation and supervision appears to have been reinforced, which should eliminate regulatory arbitrage opportunities between different Member States adopting the euro or voluntarily choosing to adhere to the BU. The SRM and the Deposit Guarantee Scheme should break the vicious circle between bank balance sheets and public finance, and should then render a safer environment for the EMU and EU. In this perspective early intervention measures can play a crucial role to prevent disruptive defaults of credit institutions, and the creation of a fund financed by the banking sector itself can facilitate the handling of single banks in difficulties.

At this initial stage it is not possible to take stock of the BU working, since the evaluation of many important details requires that the new institutions start to operate and build up their track record. This specifically applies to the SSM and the SRM. However, it is already apparent that some features of the BU will raise a number of problems. In what follows we point out a part of these problems by first focusing on the general framework (point 5 of this Introduction), then on the SSM (point 6), and finally on the SRM (points 7 and 8).

5. The first part of the book introduced herein is devoted to the critical analysis of the main features of the BU. In particular, this part highlights the following critical points.

First of all, the decision to insert the BU into the regulatory and supervisory framework already in force calls not only for the construction of a limited number of new actors and the redesign of a few mechanisms, but it also requires reshuffling of

the competencies of all the different regulatory and supervisory authorities operating in the European banking sector. As a matter of fact, we are going to have a dual system: the European System of Financial Supervision (ESFS) for the financial intermediaries of all EU Member States, and the BU for the banks of the euro-zone.

As far as the banking sector is concerned the ESFS is centred on three regulators: the competent national authorities, the European Systemic Risk Board (ESRB), and the European Banking Authority (EBA). On the regulation side, there is a possible conflictual overlap between the EBA and ECB. In principle, the latter would have to comply with the technical standards of regulation adopted by the former; however, the ECB's dominant position in supervision could interfere with EBA's regulatory activity. A similar problem may arise in the relationships between the Single Resolution Board (SRB) and the EBA. However, in this case the conflict appears to be less significant. By contrast, a significant risk of overlap and conflict arises in the relationship between the ESRB and the ECB. When it comes to macro-prudential policies, the ESRB may issue warnings and recommendations to the national regulatory authorities. However, the ECB has the power to amend any decision taken by a specific country, even if this decision was based on a specific recommendation of the ESRB. The consequent possible conflict is difficult to manage. Moreover, macro-prudential tools (such as countercyclical buffers, systemic risk buffers and higher buffers for systemic important institutions) which are activated by the ESRB and the competent national authorities, may have a negative interaction with the transmission mechanisms of the monetary policy of the ECB. The outcome may be increasing segmentation of European as well as of national financial markets. Hence we conclude that the ESRB's attempts to coordinate macro-prudential policies within the SSM area might generate inefficiencies.

Finally, the role of macro-prudential supervision remains an

open debate: there are insufficient international benchmarks to fix an efficient use of the tools that are at the ESRB's disposal. On the other hand, the European division of labour between macro-prudential and micro-prudential regulators would require strong coordination between the two types of authority; and even if this coordination were implemented, it is hard to believe that the current architecture could be definitive. The ESRB concerns all EU countries and is not limited to banks; nevertheless, the ECB plays a predominant role in the governance of the ESRB. Hence either the status and organization of the ESRB are going to be reinforced (also in terms of independence), or many of the ESRB's competencies will be absorbed by the ECB.

The emphasis laid on regulatory and supervisory problems relegates to the background the ECB's possible conflict of interests in performing both its functions, namely of supervision and monetary policy. A central thesis of this book is that, in actual fact, the governance of the SSM provides enough guarantees for a separation between these two functions: the SSM's Supervisory Board presents few overlaps with the Executive Board of the ECB. Moreover, the relatively short history of central banks shows that the latter traditionally performed both functions. In a sense, as the recent crises have shown, dealing with different duties is connatural to the function of a central bank. Indeed, in the EMU over the last eight years, the ECB has been the only institution able to provide emergency liquidity assistance to banks; in this perspective, the ECB will be facilitated by playing a leading role in supervising banks. On the other hand, the BU may have a positive effect on monetary policy since it can reduce the market segmentations that are due to different regulation/supervisory standards.

6. Several chapters of the book are devoted to the critical analysis of the SSM. Here we outline the main problems arising.

First of all, these chapters emphasise the limited operational efficiency of the Supervisory Board which is a body within the ECB. This board is too large since it is formed by at least 24 members (with a maximum of 34 members): President, vice-President, four ECB representatives, a representative for each of the national authorities belonging to the EMU's Member States, and a corresponding representative for each of the national authorities belonging to an EU non-EMU Member State which decided to participate in the BU. The Steering Committee of the SSM should help to organize the activities of the Supervisory Board, but its modus operandi is still to be defined.

A second problem concerns the complexity of the decision making process. The Supervisory Board proposes draft decisions to the Governing Council of the ECB. If the latter Council does not raise any objection or if its possible objections are immediately shared by the Supervisory Board, the draft decision (with its possible agreed changes) will be adopted. On the contrary, should at least one of the objections raised by the Governing Council not be shared by the Supervisory Board, a Mediation Panel has to come into play and solve the controversy by drawing up definitive decisions (that is, the changes to the draft decisions). In principle, this process may jeopardize the independence of the SSM and of the ECB itself. The Mediation Panel consists of a representative for each of the participating Member States. Hence, its intervention as a supposed independent arbiter tends in fact to create tensions between the ECB and national interests (in terms of its monetary policy role as well as its supervisory role). In practice, there is more likely to be *ex ante* coordination between the Governing Council and the Supervisory Board in order to avoid the intervention of the Mediation Panel.

All the architecture of the SSM is based on the twofold assumption of close cooperation between the regulatory institutions and between the latter and the different regulated actors. We showed above that the first assumption can lead to a lack of functionality; the second can instead transform the way-outs offered to non-euro Member States participating in the BU into veto powers that could create problems in the event of a banking crisis. The ECB plays a dominant role in the final decision-making body of the SSM; however, the European treaties state that an EU's non-EMU Member State has the right to disagree on the ECB's evaluations and to reject its decisions. This means that, unlike the EMU's members, a non-EMU State participating in the BU holds the right – under given conditions – to express dissent and not to respect a decision taken by the Supervisory Board; in this case, that State has to irreversibly abandon the BU. It follows that, due to this exit threat, each of the (non-euro) participating Member States is empowered with a mild veto power. Moreover, due to the double majority introduced into the EBA's governance (majority of both BU participating countries and BU non-participating countries), non-participating non-euro Member States have a strong veto power on the single rulebook and on the EBA's other key decisions.

Our conclusion is that the architecture of the SSM is exposed to veto powers, and that they can hinder the efficient functioning of European regulation since they create uncertainty about the perimeter of the banking rules. In this respect, it is sufficient to recall that the most significant financial site in Europe (London) belongs to a country outside the EMU and outside the BU process.

The various chapters of the book devoted to the SSM seem to overlook the problems pertaining to the relationship between the ECB and the national authorities. We are ready to acknowledge that this point raises delicate coordination problems. However, we think that, in practice, these problems can be easily addressed given that there is a tradition of strong cooperation between European institutions and national regulatory authorities in the banking sector, and especially since

many of the people working at the ECB come from these same national authorities. The asset quality review-stress test exercises represent the first opportunity to lubricate the cooperation between ECB and national authorities for large banks. With regard to small banks, a trial period is necessary to see how the delegation/takeover opportunity by the ECB actually works.

7. The final chapters of the book are devoted to critical analyses of the SRM and SRF. The SRM represents an important novelty in the European regulatory landscape. However, several points are still to be settled or raise serious problems. Let us try to identify a number of key issues.

First of all, the introduction of the SRM and the related bail-in process are going to radically change the European markets for bank liabilities. Indeed, when the SRM is operative, the bonds issued by banks are not going to be «plain vanilla», since they will contain an optionality component with undefined triggers (arbitrarily fixed by the ECB and the SRB): during possible resolution processes these bonds will be subject to write-off or equity swap features that are difficult to model and to «price» *ex ante*. This may alienate retail and – perhaps – institutional investors from purchasing bonds issued by banks, since the high risk of these assets often exchanged in tiny segments of the financial market becomes apparent. Due to the peculiar «banco-centrism» which characterises the financial market of a number of European countries, the consequent decrease in the demand for bank bonds may have an important impact on the deleveraging processes of the European banks and on the financing of the related productive systems. The issue is crucial for the Italian banking system because the latter is characterised by a «funding gap» which is larger than the already significant «funding gap» of the rest of the European banking system and because it has traditionally compensated this huge gap by allocating bonds on the domestic retail market at low interest rates. As a consequence, large part of the amount of bonds issued by the Italian banking system is held by small investors and not by institutional investors.

These observations show that there is the risk of exacerbating the deleveraging process of the European banking system which was ignited by the international crisis, and strengthened by the EMU crisis and by the Basel III Regulation as implemented by CRD IV. This is a crucial point since the different forms of European «banco-centrism» cannot be immediately replaced with non-banking financial intermediaries or with market transactions. The transition from the dominant bank lending to tradable financial assets can be carried out just in the medium term. During this transition period bank deleveraging would have to be gradual in order to limit the credit crunch and to eliminate the difficulties characterising the transmission mechanisms of the ECB monetary policy.

In this respect, two features of the bail-in process deserve particular attention. First, the minimum level of 8% of total liabilities that has to be absorbed by the claimants of the bank in difficulty, before using the SRF, is too high and may exacerbate the credit market problem related to the optionality component implicit in bank bonds. The minimum threshold of 8% is particularly high also in comparison with the maximum level of 5% of total liabilities bound to the use of the SRF. The second problematic feature of the bail-in process concerns the degree of discretion in the hands of the SRB in defining the set of liabilities that are eligible for write-offs or equity swaps. The degree of discretion is too ample and leads to the exclusion of a variety of assets. The motivation for these exclusions is the public interest argument which is difficult to define and for financial markets to accept since it adds uncertainty to the resolution process and opens the way to non-technical arguments and hence to political/national interference. We should also point out that the exclusion of covered and secured

bonds from the bail-in process tends to cause a segmentation in terms of financial products with regulatory arbitrages. *De facto*, the SRM institutionalises the Cyprus model which jeopardized the functioning of the debt market.

8. To summarise the analysis of the last part of the book, the SRM introduces new constraints in the management of single banks in terms of asset-liability management. It would be worth carefully evaluating the advantages and disadvantages of these additional constraints. Our first conclusion is that much of the European banking system is thus subordinated to another authority (SRB) and to its resolution rules. Hence the question becomes: is this additional supervision an efficient tool to reduce the probability of systemic financial crises?

To give a positive answer, we would have to prove that the new authority fills a regulatory lacuna and interacts efficiently with the pre-existing authorities such that its introduction contributes to improve the European regulatory framework of the financial market. Unfortunately, this is not exactly the case. There is quite significant interference of the European Council in SRM activity. The Council – on the basis of a proposal by the European Commission – may challenge SRB decisions on the existence of a public interest and on the amount of the SRF to be used. On the one hand, this gives room for political intrusion in the regulation; on the other, it may lead to delays in the resolution process. In particular, the role of the European Council in assuring the presence of a public interest may create a significant *vulnus* in SRM functioning, as the definition of public interest is rather obscure and hence is vulnerable to political distortion. Moreover, the decision-making process becomes so much more complex that it is too difficult to meet the timing constraint (the resolution intervention has to be decided and specified through the weekend) and to act efficiently.

The drawbacks of the SRM call for an effective back-stop.

However, at least at this stage, there is no such mechanism. The SRF plays a complementary role with respect to the bail-in process. Its (limited) size and its governance render the fund useful to cope with idiosyncratic shocks but not with systemic ones. In this last respect, it is sufficient to recall that SRF's governance precludes a significant transfer of liquidity to a single credit institution. Our conclusion is that the SRF is – at most – useful to build a temporary bridge between a critical situation of a bank and its structural solution. This role is positive since the ECB could be in trouble in offering an «emergency liquidity assistance» due to the possible conflict with its monetary policy goals. However, the SRF cannot be interpreted as a private back-stop.

The lack of a private back-stop is not compensated by the presence of a public one. However, the possibility that public funds are needed is not ruled out in the actual working of the European financial market. This problem is exacerbated by the fact that the BU process has lost the third of its original three pillars in time: an effective deposit guarantee (to cover deposits up to 100,000 euro) is not in place. This means that the guarantee on covered deposits is just based on national deposit guarantee schemes which are not directly under the control of the SRB.