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Banking Union Moves to the Top of the Regulatory Agenda

For two years – until this summer – European bank regulators had been working their way through a well-recognised agenda of issues, driven largely by the international response to the global financial crisis of 2007-2009 and, to a smaller extent, by a need to respond to issues that resonate particularly loudly in Europe, such as short-selling and bankers' pay.

But in late May, the priorities changed: "banking union" jumped to the front of the queue.

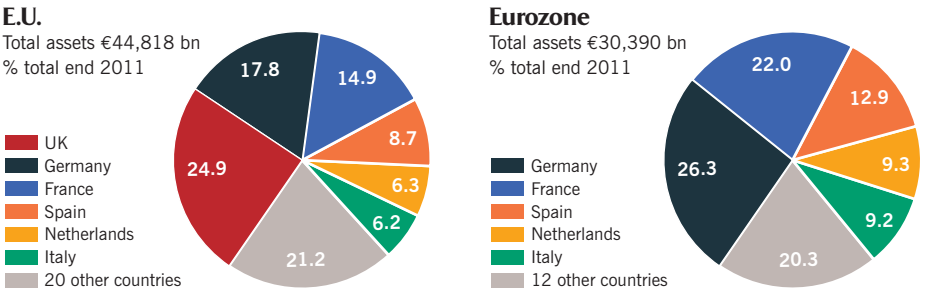
The President of the European Commission, José Barroso, spoke in favour of a banking union at the informal European Council meeting held on 23 May; and the formal Council meeting on 28-29 June endorsed a report by its President, Herman Van Rompuy, and others proposing further integration of the European financial sector, fiscal matters and economic policy, including a single bank supervisor.

On 12 September, the European Commission published its proposals for a Single Supervisory Mechanism (SSM), under which the European Central Bank (ECB) will assume responsibility for supervising all banks in the Eurozone by the end of 2013. The Commission also proposed to strengthen the powers of the European Banking Authority (EBA) – which regulates banks (as opposed to supervising them).

For a good summary of the background to the Commission's proposals, take a look its Memo/12/656, issued on 10 September: http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/12/656&format=HTML&aged=0&language=EN&guiLanguage=en

TABLE 1: SHARE OF BANK ASSETS IN THE E.U. AND EUROZONE

SOURCE: EUROPEAN CENTRAL BANK



European Central Bank to start supervising banks from 1 January 2013

Under the Commission's proposals, the ECB will be able to choose to assume supervisory authority over any credit institution from 1 January 2013. All Eurozone banks of "major systemic importance" will automatically fall under ECB supervision from 1 July 2013 and all Eurozone banks will fall under the ECB from 1 January 2014.

As supervisor, the ECB will be responsible for licencing banks and monitoring their compliance with capital, leverage and liquidity requirements. More significantly, it will be empowered to carry out "early intervention measures" when a bank breaches or risks breaching regulatory capital requirements.

The devils are in the details

However logical the arguments for banking union may be, many challenges – both political and practical – will need to be addressed before its implementation.

Even before the Commission published its proposals, the German government made clear its belief that the new single supervisor should have jurisdiction only over large banks. Writing in the Financial Times on 30 August, German Finance Minister Wolfgang Schäuble argued that the supervisor should have direct oversight only over banks that pose a risk at a European level. "This is not just in line with the tested principle of subsidiarity," he explained. "It is also common sense; we cannot expect a European watchdog to supervise directly all of the region's lenders…effectively."

In contrast, the French authorities favour oversight of all Eurozone banks, citing the fact that many of those that have caused problems in the Eurozone have been mid-sized (such as the Spanish savings banks, Anglo-Irish and Northern Rock) rather than the region's giants.

It is easy to discern national interests at stake in this debate: Germany has many medium sized banks that it sees as central to the industrial fabric of the country. German politicians don't want to lose control over them. The French financial system is dominated by five large institutions.

Another difficult issue will be the division of functions between the new Eurozone supervisor and the national supervisors. The formal position will be that national supervisors will be responsible for all tasks not explicitly conferred on the ECB, but since, according to the Commission, all key tasks related to financial stability will be conferred on the ECB, its hard to see much of significance being left at the national level.

Take the following example: CRD4/CRR gives national supervisors the ability (but not the obligation) to quench dangerous asset growth though temporary higher capital requirements – the "Counter Cyclical Buffer" (CCB). What will happen if the European supervisor believes that the CCB should be deployed in a country, but the national supervisor does not?

Then there is the issue of the ten non-Eurozone countries whose banks will not fall under the new Single Supervisory Mechanism. The Commission's proposals provide for such countries to enter into "close cooperation" arrangements with the supervisor but such cooperation is entirely voluntary. In practical terms, the E.U.'s biggest banking system – that of the United Kingdom – will remain outside. British Banks account for 25% of the E.U.'s €44,818 bn in assets (see table 1).

The European Banking Authority will be setting regulations for the E.U. 27, but supervision will be enforced by the SSM in the Eurozone and by ten different supervisors outside it.

In simple terms, if the ECB thinks a bank looks weak, it can impose remedial actions, and if the bank does not comply, the ECB can withdraw its license.

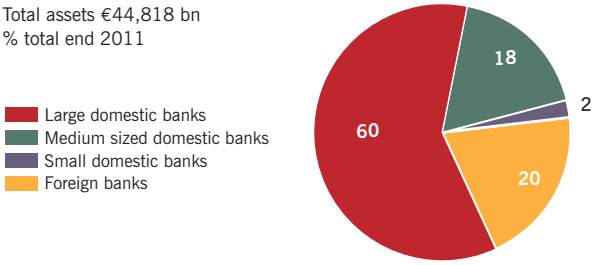
The Commission is asking the European Council to adopt its proposals on the SSM by the end of 2012, in addition to proposals on the other three components of the banking union: CRD4/CRR ("Basel 3 in Europe"), a harmonised deposit protection scheme, and a single European deposit insurance scheme.

You don't have to be a dyed-in-the-wool British Eurosceptic to think that such a timeframe is over-ambitious.

TABLE 2: SHARE OF BANK ASSETS IN THE E.U.

SOURCE: EUROPEAN CENTRAL BANK

Total assets €44,818 bn
% total end 2011



1. Total number of credit institutions: 4,713, of which 3,691 are domestic and 1,022 are foreign controlled subsidiaries and branches.
2. Large domestic banks have more than €214.4bn in assets; medium sized banks have between €214.4bn and €2.1bn; and small banks have less than €2.1bn.

What is behind the urgency for Banking Union?

The urgency arises primarily from the Eurozone's need to be able to recapitalise banks – as opposed to governments – directly. Assistance packages for ailing sovereigns such as Ireland have included funds to strengthen the financial sector, and those that did not routinely included conditions related to financial sector restructuring, such as requirements to close or recapitalise insolvent banks. But there has been no way of enforcing financial sector conditionality, other than by halting disbursement of funds under the package as a whole; and that is a big problem if you believe that weak banks are one of the main causes of Europe's economic and fiscal problems.

Spain's long-awaited request for financial aid – on 5 June it asked for €100bn – brought all the issues into sharp focus. The Spanish government made clear that the money was needed solely for bank restructuring, and not for budgetary support. Furthermore, it said that it did not want to act as a conduit through which money would pass to the banks – if it did, Spain's sovereign debt burden would increase; markets would deem the government's financial condition to have deteriorated; and the government's cost of borrowing would increase. The problem was that the mechanisms created to provide financial aid to troubled economies and, in this case, specifically the European Financial Stability Facility (EFSF) may only lend to governments.

The European Stability Mechanism will lend directly to banks

The EFSF was created as a temporary body. Its successor, the European Stability Mechanism (ESM) has been waiting in the wings for some time. The ESM will be a permanent organisation, established by an amendment to the Lisbon Treaty. The original vision for the ESM was that it would maintain its predecessor's policy of lending only to sovereigns. That changed on 29 June 2012, when the leaders of the Eurozone countries agreed that once an SSM was in place, the ESM would be allowed to lend directly to banks. In other words, once the Eurozone countries had a way of enforcing conditionality for funds disbursed to banks (through the SSM), and a way to anticipate and attempt to prevent bank problems arising in future (ditto), then they were willing to allow support funds to flow directly to banks.

For the supporters of a single Eurozone supervisor, the Spanish bailout demonstrates not only the need for a mechanism to disburse money directly to banks, but also the need for on-going supervision of banks. The Spanish government's request for €100bn came just a few days after Bankia, the country's third largest bank, had asked the government for €19bn. The fact that Bankia was itself a conglomerate created in 2010 from the rubble of seven regional savings banks, and that as recently as February this year the government had announced a bank recapitalisation programme totalling only €50bn, strengthened the belief in Frankfurt and Brussels that national governments and supervisors cannot be trusted to address domestic banking problems in a timely and robust manner. As a result, some people say, the cost of bail-outs – a cost that is now being born largely by the Eurozone taxpayer – becomes greater than it needs to be. ■

New Liquidity Rules: Anti European?!

Jamie Dimon, the chief executive of JPMorgan Chase, famously described Basel 3 as "anti-American." European bankers have not been so blunt, but their objections to Basel's proposed new liquidity ratios are just as strongly held.

French bankers are particularly concerned with the effects that the new liquidity requirements will have on their overseas business – three of the big five banks that dominate French banking have significant overseas operations (BNP Paribas, Credit Agricole and Société Générale). Overseas clients typically need medium/long term dollar funding, but with U.S. money market funds and others withdrawing from Europe, raising long-term dollars is increasingly difficult.

In a presentation to industry experts in Paris in May, BNP Paribas' head of corporate and investment banking, Alain Papiasse, said that the "buy-to-hold" model, which still dominates European finance, is under threat from the new liquidity rules. The French authorities are arguing that any instrument that can be discounted with a local central bank should be deemed "liquid" under the new rules.

The requirement for banks to hold more liquidity could hardly come at a worse time for European banks. The ECB has become the "liquidity provider of last resort" – its Long-Term Refinancing Operations have injected €1,018.5 bn in cheap medium-term funds into the European banking system – most of which the banks have hoarded on their own balance sheets rather than lending out to customers.

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Darien Middle East advises clients on international financial regulation and best practices in risk management and corporate governance. The firm was founded in 2010 by Andrew Cunningham and is based in London. The firm publishes regular briefings on financial markets under the title, Darien Analytics.

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