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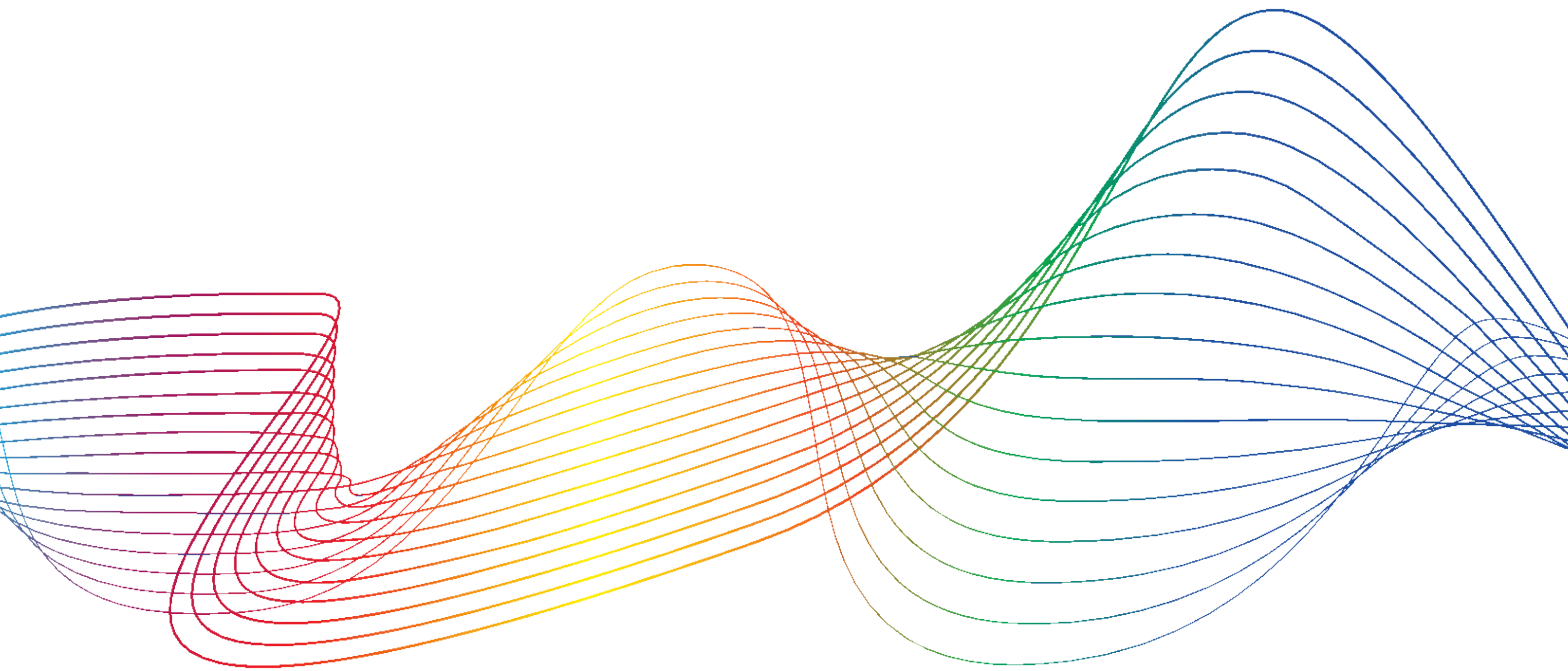
A contribution from the Chair and Vice-Chairs of the Advisory Scientific Committee to the discussion on the European Commission's banking union proposals

André Sapir, Martin Hellwig and Marco Pagano



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* This document was written by, and under the sole responsibility of, the ASC Chair (André Sapir) and Vice-Chairs (Martin Hellwig and Marco Pagano) who greatly benefited from discussions with ASC members prior to the publication of the Commission proposals.

A contribution from the Chair and Vice-Chairs of the Advisory Scientific Committee to the discussion on the European Commission's banking union proposals[*]

I. Introduction

1. Currently, bank supervision, resolution and deposit insurance arrangements in the European Union are still essentially national matters. The joint sovereign debt and banking sector crisis that has affected the euro area for several years has shown that this state of affairs is unsustainable. Given the significant cross-border externalities of the decisions of banks and bank supervisors, it is now widely recognised that the creation of a European banking union is necessary to ensure the stability of the European financial system. This would entail setting up a European supervisor, a European resolution authority and eventually a European deposit insurance system.

2. The establishment of a European banking union received support from European leaders at their June 2012 summit. The summit conclusions stated that "The Commission will present Proposals on the basis of Article 127(6) for a single supervisory mechanism shortly … When an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM [European Stability Mechanism] could, following a regular decision, have the possibility to recapitalize banks directly".

3. On 12 September 2012 the European Commission presented three documents relative to the European banking union:

    i. A communication outlining the Commission's overall vision for the banking union, covering the single rulebook and the single supervisory mechanism, as well as the next steps involving a single bank resolution mechanism.

    ii. A Council regulation conferring powers on the European Central Bank (ECB) for the supervision of all banks in the euro area, with a mechanism for non-euro area countries to join on a voluntary basis.

    iii A regulation of the European Parliament and of the Council aligning the existing regulation on the European Banking Authority (EBA) to the new set-up for banking supervision in order to make sure that EBA decision-making remains balanced and that the EBA continues to preserve the integrity of the Single Market.

    In these documents, the Commission endorses the view that a European banking union should be set up, that it should be " composed of a single supervision mechanism, a European deposit insurance scheme and a common resolution system" and that the proposed single supervision system only constitutes "a first step towards the banking union".

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II. General comments

4. In its July 2012 report entitled "Forbearance, resolution and deposit insurance", the Advisory Scientific Committee (ASC) of the European Systemic Risk Board (ESRB) welcomed the initiative of the June summit, but also expressed concern that no mention was made of bank resolution and restructuring. It strongly insisted that " ... credible [European] supervision must be backed by workable [European] institutions and procedures for resolution and restructuring". In the spirit of this report, we welcome the vision expressed in the Commission's communication but wish to reiterate the same concern, in particular as regards leaving the issue of resolution for later. We also wish to express some concerns about the effectiveness of the proposed regulation conferring specific tasks on the ECB.

5. The ASC report already fully supported the view that a European banking union should ultimately comprise a European supervisor, a European resolution authority and a European deposit insurance scheme. According to the report, " ... a European supervisor should be given the competence, or co-competence, to supervise banking institutions, assess their practices and solvency positions, and to call for interventions by the deposit insurance and resolution authority". The report also recommended that if " ... intervention by the [European resolution] authority is called for, it should have a mandate to take control of the bank, with wide discretion in respect of what strategy to pursue, with the ultimate aim of recapitalising and eventually reprivatising the viable parts of the business, possibly including the merging of business lines of different banks".

6. The ASC report also considered that the transfer of competence from national to European authorities for supervision and resolution must go hand in hand. In many respects, existence of a workable resolution regime is a prerequisite for the effectiveness of a supervisory mechanism. By contrast, the creation of a European deposit insurance system could come later; on this point, the ASC report was clear to the effect that moral hazard effects of deposit insurance can only be avoided if effective resolution and supervisory mechanisms are in place.

7. In the remainder of this document we assess the Commission's proposals. Our commentary is divided into two parts. First, we assess the proposed Council regulation for a single supervisory mechanism. Second, we assess the communication by focusing on the envisaged future steps in the construction of the banking union with respect to bank resolution and restructuring. We do not assess the proposed new regulation on the EBA, as it mainly provides the amendments to Regulation (EU) No 1093/2010 that will be necessary in order to take into account the proposed single supervisory mechanism.

III. Positive aspects of the proposed single supervisory mechanism

The Commission's proposal for a Council regulation on bank supervision contains a number of positive elements.

8. The single supervisory mechanism will cover all banks. We appreciate that this poses an enormous challenge for the single supervisory mechanism. We also expect that, especially during a transitional period, a fair amount of supervisory work will continue to be carried out by national supervisors. However, we consider it important that, in principle, all banks should be under the competence of a European institution. It would be highly problematic if the single supervisory mechanism were limited, for instance, to the 25 or so globally systemic institutions, as some have suggested in public discussion. At this point, some of the most fragile institutions, those posing the most serious risks for the European financial system, belong to the group of nationally (as opposed to globally) systemic institutions; it is particularly important to apply the mechanism to these very fragile institutions. As for the thousands of locally active and very small banks, while each one of them individually may not be systemically important, parallel behaviours and parallel risk exposures of such institutions may create systemic risks on a wider scale. Therefore it is important that European authorities should, in principle, be in a position to control systemic risks stemming from these institutions as well.

9. While the ECB will have the lead role in the single supervisory mechanism, within the ECB there must be a clear institutional separation of supervisory functions from monetary policy functions. ASC members have raised the concern that ECB responsibility for banking supervision might ultimately divert monetary policy from the objective of monetary stability and price stability; some ASC members would therefore prefer that the ECB should not be entrusted with supervisory tasks at all. Other ASC members have pointed to the need for monetary policy to be informed about the state of the financial system. We believe that an institutional arrangement that assigns responsibility for supervision to the ECB while providing for a clear institutional separation of functions might be well suited to address both concerns. However, the details of the institutional framework must be properly adapted to meet these concerns.

10. We very much welcome the principle that, in acting under the proposed regulation, the ECB would be independent also in its supervisory function, and that there would be no interference from other EU institutions or from Member State governments. It would be desirable to have this principle extended to national supervisors as well. While appreciating the legal arguments that speak against such independence, we note that the existing arrangements have not prevented financial institutions from building up risks in the years before the crisis, and that these arrangements contribute to fragmenting the European financial system. To the extent that national supervisors have influenced financial institutions within their jurisdiction to invest or disinvest in different Member States, they may actually have contributed to the reduced diversification in banks' portfolios that has occurred over the past five years.

11. We also welcome the proposed distribution of roles between the ECB, acting as European supervisor, and national supervisors. National supervisors will continue to play an important part in banking supervision, but they will follow the instructions given by the ECB in carrying out their tasks to the ECB in all activities for which it has been assigned responsibility. It is important to use the knowledge and expertise of national supervisors in their domains. At the same time, it is also important that the ECB should have ultimate control in all areas for which it is given responsibility. In this way, the problem of coordination between national supervisors, when both the home and the host countries belong to the euro area would be eliminated; in the

past, this problem was never fully resolved despite the creation of colleges of supervisors for banks operating in several EU countries.

12. It is important that the ECB's competence should cover all aspects of banking supervision and that it have all the requisite investigative and supervisory powers. In particular, the ECB should be able to exercise these powers directly over the financial institutions concerned. If, for practical reasons, the exercise of these powers by the ECB requires the assistance of national supervisors, as envisaged in Article 5 of the proposed regulation, it should be possible for such assistance to take the form of secondments of national supervisors' staff working on tasks directly coordinated by the ECB, as foreseen by Article 25, rather than national authorities simply executing such tasks "wholesale" under instructions from the ECB.

IV. Critical aspects of the proposed single supervisory mechanism

Several aspects of the Commission's proposal for a single supervisory mechanism seem critical. On these aspects, it is desirable that the regulation be as clear and as strong as possible.

13. We consider it important that the ECB should play the lead role in the single supervisory mechanism, not only for "Pillar 1" of the Basel Accord, which will be covered in the proposed Capital Requirements Regulation (CRR), but also for "Pillar 2", which will be covered by the proposed Capital Requirements Directive (CRDIV). The regulation gives the ECB all Pillar 2 powers designed in CRDIV but it must be legally watertight on this matter.

14. Whereas much of the regulatory discussion focuses on Pillar 1 of the Basel Accord because that is where the "hard rules" are formulated, much of the discussion about supervisory activity concerns Pillar 2, because that is where supervisory authorities are called upon to exercise their judgement in matters not fully determined by hard rules. It is precisely in such matters that the problem of governance of supervision, be it national or European, is central. Therefore it is of the utmost importance that any move towards a banking union should provide clarity as regards Europe's strong role in these matters. If Pillar 2 supervisory competences are not clearly transferred to the lead institution, there will be a serious risk that the single supervisory mechanism involving the ECB might not be effective.

15. For any proposed system of rules, it is desirable to have an account of how a hypothetical case would be handled. A key case would be a bank that has made a significant number of dubious loans. If the bank is weak, it may not want to write down these loans and the supervisor may not want to put much pressure on the bank. However, as explained in the July 2012 ASC report, such "double forbearance", that is, of the bank towards its loan customers and of the supervisor towards the bank, can be very detrimental to the economy and the financial system. To assess what the proposed new regulation means in practice, one must consider whether the regulation would enable the European supervisor to act upon a more sceptical view of loan performance than might be held by the national supervisor. One must also consider on what grounds the European supervisor might force a recapitalisation or closure of the bank if the more pessimistic view of prospective loan performance leads to the conclusion that the bank's solvency is in doubt. Unless the scope of the powers are set down

clearly and legally conferred on the ECB as the lead institution in the single supervisory mechanism, the mechanism cannot be effective.

16. In summary, it is necessary to avoid a situation where the ECB is fully responsible but has at best partial control over banking supervision. It is therefore essential that the ECB should have sufficient resources to meet its demanding new responsibility. A discrepancy between responsibility and effective control on the part of the ECB might prevent the move towards banking union from making the hoped for contribution to resolving the current problems in Europe. It might also lead to a loss of credibility for the ECB, not only in its role as supervisor but also more broadly. This would be a serious setback for the euro area where the ECB at present is the only effective institution. The risks are enormous.

V. The need for a resolution mechanism

17. In addition to the single supervisory mechanism, the Commission was apparently envisaging the creation of a European Deposit Insurance and Resolution Authority (EDIRA), which would control a European Deposit Guarantee and Resolution Fund (EDGAR). It is regrettable that the Commission did not also put forward proposals for these other two pillars of a European banking union. Whereas a European deposit insurance scheme is not immediately needed, a resolution authority is essential for the credibility of the single supervisory mechanism.

18. A key element of banking supervision is the competence to close down a bank, i.e. to withdraw the authorisation for an institution to be active in banking. This competence cannot be assessed, however, without considering the consequences of such a decision. This requires: (i) a procedure that minimises systemic fallout from the bank's closure, and (ii) a set of rules for allocating losses and sharing burdens. In the wake of the Lehman Brothers' bankruptcy, governments and supervisors refrained from closing down banks because they did not have suitable resolution procedures in place. In the European context, the problem is exacerbated by issues of burden sharing and fiscal responsibility. If the ECB, in its lead role under the single supervisory mechanism, were to require the closure of a given nationally systemic bank, who would bear the fiscal burden involved? And what procedures would be in place to limit the systemic fallout?

19. These concerns are not just of theoretical interest. The June summit has made the creation of a single supervisory mechanism a precondition for using the ESM to recapitalise banks. The weakness of banks' balance sheets is a major problem. There are two ways to deal with this weakness: closures and recapitalisations. Closures require proper resolution.
Recapitalisations of banks that should be closed down can be very expensive, as well as ineffective. The appropriate way to deal with banks' weakness is to apply a resolution regime, clean up their balance sheets by separating good assets from the bad, and to recapitalise and reprivatize the "good" banks. If the banks' problems arise from market structures involving significant excess capacity, the closures of some banks may be necessary to avoid the return to a situation where banks' survival is highly uncertain.

20. We fully endorse the ASC's position, laid out in its July 2012 report, that a European resolution mechanism and a European supervisory mechanism should come as a package. Without a European resolution mechanism, it will be difficult to address the problems we currently face in Europe. Without a European resolution mechanism, it will also be difficult for the single supervisory mechanism to be effective.

21. Equally, we endorse the ASC's reasoning which concludes that the introduction of European deposit insurance is less urgent. While in the long run it will be desirable to have such a system, if only because of the efficiency of combining resolution and deposit insurance in one institution, having a European system of deposit insurance is not a prerequisite to making resolution and supervision work. The funding that is needed for resolution might come from an industry levy and ESM loans; if bail-ins of banks' creditors become the rule rather than the exception, as they should under an appropriate system of governance for financial contracting, most funding needs will only be temporary so that bridge loans from the ESM should suffice. If deposits are to be exempt from the principle that bail-ins are the rule, deposit insurance can be handled on a case-by-case basis, drawing on existing national deposit insurance facilities.

22. We are aware of the political issues involved in the creation of European resolution and deposit insurance mechanisms. It is therefore understandable that the Commission proposes to first establish the European supervisor and only envisages to create EDIRA after the ECB has demonstrated its ability to run the new system smoothly. However, while this step-wise approach is politically more realistic than a "big-bang" approach, it suffers from the fact that it risks undermining the very credibility of the European supervision system altogether, especially as far as the absence of a European system for resolution is concerned.

23. The Commission correctly states in its communication that the single resolution mechanism " ... would be more efficient than a network of national resolution authorities, in particular in the case of cross-border failures, given the need for speed and credibility in addressing banking crises". It also provides general principles to which the mechanism should adhere, namely those " ... set out in the single rulebook which are consistent with international best practice and in full compliance with Union state aid rules. In particular shareholders and creditors should bear the costs of resolution before any external funding is granted, and private sector solutions should be found instead of using taxpayers' money". In line with the July 2012 ASC report, we strongly support these principles.

24. We observe that the Commission does not provide a timetable for proposing the envisaged "single resolution mechanism". The communication only alludes to the possibility of making a proposal in 2013, after the European Parliament and the Council adopt the proposal for a directive on a common framework for the recovery and resolution of banks, put forward by the Commission in June 2012. We strongly urge the Commission to move this project forward in order to ensure the effectiveness of the single supervisory mechanism.

25. We also recommend that the regulation on the single supervisory mechanism should clearly lay down the relationship between the ECB as the lead supervisory institution and the appropriate national or European resolution authorities. On this point, Article 4(1)(k) of the proposed regulation is not very specific.