



HOUSE OF LORDS

European Union Committee

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7th Report of Session 2012–13

# **European Banking Union: Key issues and challenges**

Report

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References in footnotes to the Report are as follows:

Q refers to a question in oral evidence;

Witness names without a question reference refer to written evidence.

## SUMMARY

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A European banking union is urgently required in order to restore credibility and stability to the euro area banking system, and to break the vicious cycle between banks and sovereign states. The UK has made clear that it will not participate in a banking union, although other non-euro Member States may well wish to do so. Nevertheless the consequences for this country could be momentous. There is a significant risk that the UK will be marginalised as banking union participants move towards closer integration. This in turn threatens to fracture the single market, as the authority of EU-27 bodies such as the European Banking Authority and the European Systemic Risk Board comes under threat. The Government's assurances about the impact on the City of London may prove misplaced. The Government must do all in their power to ensure that London's pre-eminence as a financial market is not imperilled and that the integrity of the single market is retained. UK isolation in debates of such fundamental importance would be disastrous.

The original banking union proposals set out a three-pronged approach: a Single Supervisory Mechanism, a common resolution mechanism and a common deposit insurance scheme. We regret that this coherent model has already been undermined by political pressure, led by Germany. Banking union requires all three of these elements if it is to be effective.

However we welcome the publication of the Single Supervisory Mechanism proposals as a significant first step towards banking union. We agree that the European Central Bank, to be given ultimate supervisory responsibility for every euro area bank, is the only organisation with the necessary credibility and authority to take on this role. But the concentration of so much power in one institution means that powerful safeguards must be put in place.

It is vital that there is no conflict of interest between the ECB's supervisory and monetary policy tasks. The ECB needs to be fully accountable, both to the European Parliament and to national parliaments, in the exercise of its supervisory powers. There must be equality in the supervisory decision-making process within the ECB between euro area and non-euro area Member States who wish to participate. Equally, the role of the EBA in representing all 27 Member States must not be undermined and the Commission must defend the integrity of the single market as a whole.

The Commission's original proposals do not go nearly far enough to meet these concerns. It is highly uncertain whether these safeguards can be put in place within existing treaty constraints. European legislators need to decide whether treaty change is a price they are willing to pay in order to create a viable banking union. Adopting rushed and deficient legislation would be the worst of all possible outcomes.



# European Banking Union: Key issues and challenges

## CHAPTER 1: INTRODUCTION

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1. The continuing euro area crisis, and the strain that it has placed on the EU banking sector, has given rise to calls for reform of the way the banking sector operates and is regulated. The June 2012 report of the President of the European Council, Herman Van Rompuy, *Towards a Genuine Economic and Monetary Union*,<sup>1</sup> proposed an integrated financial framework elevating responsibility for bank supervision to the European level, and providing common mechanisms to resolve banks and guarantee customer deposits. These proposals were envisaged as the three core elements of a so-called European “banking union”.
2. In light of this, we decided to launch this inquiry into *European Banking Union: Key issues and challenges*. At the time of writing this report, only the Single Supervisory Mechanism proposals had been published. Our report analyses these proposals, the significant strengthening in the powers of the European Central Bank (ECB) that they would entail, and the implications for EU-27 organisations such as the European Banking Authority (EBA) and the European Systemic Risk Board (ESRB). The report also considers the further steps towards banking union that may follow in due course.
3. Although the Government have made clear that the UK will not participate in a banking union, the implications, both for the UK and the single market, will be profound. It is important in this context to distinguish between the operation of a harmonised regulatory framework for the single market in financial services across the EU-27 and the introduction of a banking union whose primary aim is to secure the position of the euro area. The Government argue that the Single Supervisory Mechanism, and the UK’s decision not to participate, should not and need not adversely affect London’s position as the leading financial centre in Europe, nor undermine the single market. The strength of this argument may soon be tested.
4. In the course of this inquiry we received evidence from 34 witnesses, and heard oral evidence in London and in Brussels from academics, MEPs, banking sector representatives, thinktanks, leading officials, and key figures including the Chairman of the EBA, Andrea Enria; the Vice-President of the ECB, Vitor Constâncio; the German Ambassador to the UK, Georg Boomgaarden; the European Commissioner for Internal Market and Services, Michel Barnier; and the Financial Secretary to the Treasury, Rt Hon Greg Clark MP. In addition, the President of the European Council, Herman Van Rompuy, helpfully met the Committee to discuss the proposals.<sup>2</sup> We are grateful to all of our witnesses for their assistance. We are also grateful to Professor Eilís Ferran, Professor of Company and Securities

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<sup>1</sup> Report by the President of the European Council, Herman Van Rompuy, *Towards a Genuine Economic and Monetary Union*, June 2012: [http://ec.europa.eu/economy\\_finance/focuson/crisis/documents/131201\\_en.pdf](http://ec.europa.eu/economy_finance/focuson/crisis/documents/131201_en.pdf).

<sup>2</sup> See Appendix 4.

Law, University of Cambridge, who acted as Specialist Adviser for this inquiry.

5. We have produced our report in time for the important discussions scheduled for the December 2012 European Council. Those discussions will not mark the end of the debate, neither can the proposals be expected to solve all of the problems in the euro area. Yet banking union will have fundamental implications for the future shape of the euro area and of the EU as a whole. We will continue our analysis of the banking union proposals as they develop during 2013. In the meantime, **we make this report to the House for debate.**

### The inquiry in context

6. “Europe is once again going through a period of heightened tensions. The crisis surrounding sovereign debt and the weakness of the financial sector, together with persistent low growth and macroeconomic imbalances, are slowing down economic recovery and creating risks for the stability of Economic and Monetary Union (EMU).”<sup>3</sup> Thus stated the Conclusions of the June 2012 European Council.
7. That month Spanish ten-year bond yields had hit a euro-era high, and recapitalisation of its seriously indebted banking sector seemed inevitable. As we reflected in our February 2012 report on *The euro area crisis*, the fundamental problem for Spain (and for the euro area as a whole) was the systemic link between its struggling banks and an indebted sovereign state.<sup>4</sup> The plight of the fourth largest economy in the euro area threatened to overwhelm the resources of its rescue funds, the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM), placing the future of the currency union itself at risk. In the words of the conclusions of the June 2012 Summit of euro area Member States (held in parallel with the European Council), it was now imperative to break the vicious cycle between banks and sovereign states.<sup>5</sup>
8. The euro area Summit envisaged that, once an effective Single Supervisory Mechanism was established involving the ECB for banks in the euro area, it could be possible for the ESM to recapitalise banks directly.<sup>6</sup> Following this, the ‘Four Presidents’<sup>7</sup> were invited by the Council to develop by the end of 2012 “a specific and time-bound road map for the achievement of a genuine Economic and Monetary Union”.<sup>8</sup>

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<sup>3</sup> European Council, 28/29 June 2012, Conclusions.

<sup>4</sup> House of Lords European Union Committee, 25th report (2010–12), *The euro area crisis* (HL 260), paras 21–3.

<sup>5</sup> Euro area Summit Statement, 29 June 2012:

[http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/131359.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf)

<sup>6</sup> *ibid.*

<sup>7</sup> The President of the European Council (Herman Van Rompuy); the President of the European Commission (José Manuel Barroso); the President of the Eurogroup (Jean-Claude Juncker); and the President of the European Central Bank (Mario Draghi).

<sup>8</sup> June 2012 European Council conclusions, *op. cit.*

9. The banking union agenda has developed rapidly (see Box 1 below). Before examining the proposals in detail, three central questions need to be addressed:
- Is a banking union necessary?
  - What constitutes an effective banking union?
  - Who will be the members of a banking union?

### BOX 1

#### Timeline of developments

June 2012: Publication of the Recovery and Resolution Directive proposals.
June 2012: Publication of the Van Rompuy report <i>Towards a Genuine Economic and Monetary Union</i> .
June 2012: Meeting of the European Council and euro area Member States. Four Presidents asked to develop “a specific and time-bound road map for the achievement of a Genuine Economic and Monetary Union”.
September 2012: Publication of the Single Supervisory Mechanism legislative proposals, including a proposed ECB Regulation, a proposed EBA Amending Regulation, and the Commission Communication <i>A roadmap towards a Banking Union</i> .
September 2012: Publication of the Van Rompuy <i>Issues Paper on Completing the Economic and Monetary Union</i> .
October 2012: Publication of the Van Rompuy <i>Towards a Genuine Economic and Monetary Union: Interim Report</i> .
October 2012: Meeting of the European Council. It was proposed to produce a legislative framework for the proposals on a Single Supervisory Mechanism by the end of 2012, with implementation to follow in 2013.
December 2012: Target deadline for agreement of the legislative framework of the Single Supervisory Mechanism and the Recovery and Resolution Directive, as well as the two existing proposed elements of the “single rulebook”, the Capital Requirements Directive and Regulation (CRD IV) and the recast Deposit Guarantee Schemes Directive.
December 2012: Publication of the Van Rompuy <i>Towards a Genuine Economic and Monetary Union: Final Report</i> .
December 2012: Meeting of the European Council.
2013: Proposed date for implementation of the Single Supervisory Mechanism. Prospective date for publication of further steps towards banking union, including a common resolution scheme, and, possibly, a single deposit insurance scheme.
Date to be confirmed: Possibility of the ESM engaging in direct recapitalisation of euro area banks.

### Is a banking union necessary?

10. Jean Pisani-Ferry, Director of Bruegel, described the June 2012 Council Summit as a watershed when the focus shifted from crisis management and fiscal discipline to a recognition of the need to tackle the vicious cycle between banks and sovereign states.<sup>9</sup> Mr Enria said that the choice was a stark one: either sever this “dangerous interconnection” or risk the break-up of the currency union.<sup>10</sup>
11. Representatives of the banking sector acknowledged the systemic weaknesses of EMU that the financial crisis had revealed. Barclays highlighted the over-exposure of some banks to commercial real estate and to sovereign debt.<sup>11</sup> HSBC argued that the existing economic imbalances between Member States had deepened as some became dependent on their domestic banks to absorb new debt issuance.<sup>12</sup>
12. In our report on *The future of economic governance in the EU*, published in March 2011, we concluded that the interconnection of the sovereign debt and banking sectors was one of the principal causes of the euro area crisis. We highlighted the risk of a vicious cycle between sovereign debt and a weakened banking sector.<sup>13</sup> The escalation of the crisis since that report was published has reinforced these conclusions.
13. **We regret that it has taken so long for European leaders to bring forward concrete proposals to deal with the systemic deficiencies in the design of EMU. We welcome the necessary and long-overdue steps that have now been taken towards the introduction of a banking union. The June 2012 European Council was a watershed in acknowledging the imperative need to break the vicious cycle between banks and sovereign states. Yet the path to banking union will be far from straightforward.**

### What constitutes an effective banking union?

14. The *Towards a Genuine Economic and Monetary Union* report proposed that a European banking union should have three legs, as set out in Box 2 below:
  - A Single Supervisory Mechanism (SSM);
  - A European resolution scheme;
  - A European deposit insurance scheme.<sup>14</sup>

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<sup>9</sup> Q 40.

<sup>10</sup> Q 82.

<sup>11</sup> Barclays.

<sup>12</sup> HSBC.

<sup>13</sup> House of Lords European Union Committee, 12th report (2010–12), *The future of economic governance in the EU* (HL 124), Chapter 2.

<sup>14</sup> Alternatively described as a European deposit guarantee scheme.

**BOX 2****The proposals of the June 2012 report *Towards a Genuine Economic and Monetary Union*<sup>15</sup>**

- (i) “**Integrated supervision** is essential to ensure the effective application of prudential rules, risk control and crisis prevention throughout the EU. The current architecture should evolve as soon as possible towards a single European banking supervision system with a European and a national level. The European level would have ultimate responsibility. Such a system would ensure that the supervision of banks in all EU Member States is equally effective in reducing the probability of bank failures and preventing the need for intervention by joint deposit guarantees or resolution funds. To this end, the European level would be given supervisory authority and pre-emptive intervention powers applicable to all banks.”
- (ii) “A **European resolution scheme**<sup>16</sup> to be primarily funded by contributions of banks could provide assistance in the application of resolution measures to banks overseen by the European supervision” with the aim of providing for an orderly winding-down of non-viable institutions, thereby protecting taxpayer funds.
- (iii) “A **European deposit insurance scheme**<sup>17</sup> could introduce a European dimension to national deposit guarantee schemes for banks overseen by the European supervision. It would strengthen the credibility of the existing arrangements and serve as an important assurance that eligible deposits of all credit institutions are sufficiently insured.”

The deposit insurance scheme and the resolution fund could be set up under the control of a common resolution authority.

15. In its *Roadmap towards a Banking Union*, published in September 2012, the European Commission accepted that a complete banking union would require not only a single supervisory mechanism but also an integrated crisis management framework and a common system for deposit guarantees.<sup>18</sup> The proposals for a Single Supervisory Mechanism were published in September 2012, and we analyse them in Chapters 2 and 3. As we show in Chapter 4, the proposals for a European resolution scheme and, in particular, a European deposit insurance scheme, have proved politically contentious for net contributor Member States, notably Germany. As a result, legislative proposals for the second and third legs have yet to be brought forward.
16. Although President Van Rompuy told us that the SSM proposals should be the focus for now,<sup>19</sup> many were doubtful that this was enough. Sharon Bowles MEP, Chair of the European Parliament Economic and Monetary Affairs (ECON) Committee, told us that, “you have not got a proper

<sup>15</sup> *op. cit.*

<sup>16</sup> Not to be confused with the harmonised scheme envisaged in the Recovery and Resolution Directive (see Chapter 4).

<sup>17</sup> Not to be confused with the proposed recast Deposit Guarantee Schemes Directive.

<sup>18</sup> COM (2012) 510.

<sup>19</sup> Appendix 4.

banking union”.<sup>20</sup> The International Centre for Financial Regulation (ICFR) did not believe, in view of the “clear fault lines among Member States”, that the full framework was achievable in a single leap.<sup>21</sup>

17. **The three-pronged approach, outlined in the June 2012 report, *Towards a Genuine Economic and Monetary Union*, of a Single Supervisory Mechanism, a common resolution mechanism and a common deposit insurance scheme, constituted a firm and effective foundation on which to base the banking union proposals. This coherent model has already been undermined by political pressure, led by Germany. We regret that the controversial nature of the European resolution scheme, and, in particular, the European deposit insurance scheme, means that it is politically unrealistic to expect all three elements of the banking union to be taken forward quickly or in a united manner.**

### Who will be the members of a banking union?

18. The stated purpose behind the banking union proposals is to stabilise the euro area and secure the future of the single currency. All 17 euro area Member States will therefore participate.
19. A more complex debate concerns the position of the ten non-euro area Member States, the so-called ‘Outs’. The Commission has stated that all such Member States will be able to participate in banking union through a ‘close cooperation’ agreement. The Financial Secretary to the Treasury told us that the term ‘Outs’ was itself a misnomer, and that the banking union proposals needed to be viewed in a dynamic rather than a static context. Member States were under different obligations as regards their eventual membership of the single currency, and the extent of their banking sectors’ interrelationship with the euro area varied considerably.<sup>22</sup>
20. This conundrum was described by one of our witnesses as the concept of variable geometry:<sup>23</sup> the banking union proposals will apply to euro area and non-euro area Member States in different ways, and non-euro area Member States will not approach the proposals in a uniform manner. Those that intend to join the single currency in due course may very well take a different view from the UK. The UK Government have made clear that they will not participate. Some non-euro area Member States may participate from the start, and others may join later. Membership of the banking union and the single market will not correspond. The strain on the single market will be compounded by the potential impact of the proposals on the relative powers and influence of the ECB (focussed as it will be on those Member States participating in banking union) and the EBA (with its clear remit to defend the interests of the single market as a whole). So, as we consider in

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<sup>20</sup> Q 19.

<sup>21</sup> International Centre for Financial Regulation (ICFR).

<sup>22</sup> Q 225.

<sup>23</sup> Mr Pisani-Ferry, Q 46. The European Commission defines “‘variable-geometry’ Europe” as “the term used to describe the idea of a method of differentiated integration which acknowledges that there are irreconcilable differences within the integration structure and therefore allows for a permanent separation between a group of Member States and a number of less developed integration units.” See [http://europa.eu/legislation\\_summaries/glossary/variable\\_geometry\\_europe\\_en.htm](http://europa.eu/legislation_summaries/glossary/variable_geometry_europe_en.htm).

Chapter 5, the implications of banking union for the UK, and for the single market as a whole, are profound.

21. **In any assessment of the banking union proposals it is necessary to keep in mind the concept of variable geometry. These significant reforms will impact upon euro area and non-euro area Member States, and the banks and other credit institutions that operate within them, in different ways. Non-euro area Member States themselves will not approach the proposals in a uniform manner: it is not clear that many will follow the UK in staying out of banking union.**

## CHAPTER 2: THE SINGLE SUPERVISORY MECHANISM AND THE ROLE OF THE ECB

22. On 12 September 2012, the Commission published its Proposal for a Council Regulation conferring specific tasks on the European Central Bank (ECB) concerning policies relating to the prudential supervision of credit institutions<sup>24</sup> (referred to as “the ECB Regulation”). The proposal forms the central plank of the Single Supervisory Mechanism, and Box 3 sets out its main components.

### BOX 3

#### The main components of the ECB Regulation<sup>25</sup>

- The conferral on the ECB of specific tasks concerning policies relating to the prudential supervision of all euro area credit institutions.
- A non-euro area Member State and the ECB could enter into ‘close cooperation’. The ECB would then carry out its supervisory tasks in relation to credit institutions established in that Member State.
- The ECB would have ‘exclusive competence’ for a list of prudential supervisory tasks including authorisation and licensing, oversight of compliance with prudential regulatory requirements, conducting stress tests, consolidated supervision of groups, and early intervention. The ECB would be responsible also for coordinating and expressing a common position of the competent authorities of participating Member States in EBA decision-making contexts.
- The ECB and the national prudential supervisors would together form the Single Supervisory Mechanism. National supervisors would be required to assist the ECB and comply with its instructions. National supervisors would remain responsible for supervisory tasks not transferred to the ECB.
- The ECB’s supervisory objectives would be the promotion of the safety and soundness of credit institutions and the stability of the financial system, with due regard for the unity and integrity of the single market.
- An ECB Supervisory Board would be set up to achieve due separation between the supervisory and monetary policy functions. The ECB Governing Council would remain ultimately responsible for supervisory decision-making, subject to the possibility of delegation to the Supervisory Board of clearly defined tasks and related decisions.
- The ECB would be required to act independently in carrying out supervisory functions. It would be accountable to the EU Institutions and to the Eurogroup.

<sup>24</sup> Defined as an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account; or an electronic money institution. See Article 2(3) and Article 4(1) of Directive 2006/48/EC.

<sup>25</sup> COM (2012) 511. See EMs 13682/12, 13683/12 and 13854/12. See also Appendix 5 for more details.

### Why is a Single Supervisory Mechanism necessary?

23. The June 2012 *Towards a Genuine Economic and Monetary Union* report argued that a Single Supervisory Mechanism was essential to ensure the effective application of prudential rules, risk control and crisis prevention throughout the EU, thereby ensuring that the supervision of banks in all EU Member States was equally effective in reducing the probability of bank failures and preventing the need for intervention by joint deposit guarantees or resolution funds.<sup>26</sup>
24. The significance of this proposal was widely appreciated. Karel Lannoo, Chief Executive Officer, Centre for European Policy Studies, stressed the importance of eliminating the “home bias” prevalent in national supervision.<sup>27</sup> HSBC argued that without a single supervisory framework it would be difficult to justify the application of European funds to support failing banks.<sup>28</sup>
25. Mr Enria regarded the proposal as “a key element of the pathway to restoring viability in the banking sector.”<sup>29</sup> Ambassador Boomgaarden stressed that many banks would welcome central supervision as creating a level playing field and reversing the “renationalisation of banking” that had taken place since the crisis took hold.<sup>30</sup>
26. The introduction of a Single Supervisory Mechanism is a necessary step if confidence in the EU banking sector is to be restored. Whilst it does not in and of itself constitute a full banking union, it is an important first step in that direction.
27. **Given the systemic weaknesses in the euro area banking sector that the financial crisis has brought to light, a system of single banking prudential supervision is now urgently required. The significance of this proposal as a first step towards a full banking union should not be underestimated. The following questions need to be addressed:**
  - **Is it appropriate for the ECB, as is proposed, to take on prudential supervisory tasks and, if so, what will the impact be on its monetary policy responsibilities?**
  - **What will be the impact on the ECB’s governance structure?**
  - **Which banks should be directly supervised by the ECB, and what will be the impact on the role of national supervisors?**
  - **What accountability mechanisms need to be put in place?**
  - **What will be the impact on non-euro area Member States?**
  - **What is a realistic timetable for these reforms to be introduced?**
  - **Do these reforms require treaty change?**

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<sup>26</sup> *Towards a Genuine Economic and Monetary Union*, June 2012, *op. cit.*

<sup>27</sup> Q 65.

<sup>28</sup> HSBC.

<sup>29</sup> Q 82.

<sup>30</sup> Q 177.

### A supervisory function for the ECB?

28. The key element of the proposal is for the ECB to take on supervisory powers over euro area banks. Several witnesses were strongly in favour. Mr Lannoo argued that, if the ECB was to continue providing liquidity to the market, then it also had the right to possess the necessary information on national banking systems. He felt that, of all the institutions in the euro area, it was the one with the most political credibility.<sup>31</sup>
29. HM Treasury asserted that the ECB was an appropriate organisation to take on the central supervisory role.<sup>32</sup> They pointed out that 11 out of 17 central banks in the euro area already perform microprudential supervision. They made the comparison with the proposal in the UK to transfer supervision to the Bank of England, and said that the crisis had highlighted the importance of uniting monetary policy and supervisory functions in one body.<sup>33</sup>
30. Others had significant concerns. Kern Alexander, Professor of Law and Finance, University of Zurich, felt that the ECB was ill-suited to the role because of the restrictions on its function under the EU Treaty. In his view, it would be more logical for the EBA, ESMA and insurance authorities to work together to undertake surveillance of the whole system.<sup>34</sup> Mats Persson, Director, Open Europe, feared that, given that many euro area banks rely on cheap ECB liquidity to stay afloat, the proposals could in fact reinforce the link between sovereign states and the banks.<sup>35</sup>
31. Mrs Bowles told us that many in the European Parliament would have preferred the EBA to take on this role,<sup>36</sup> although she and Mr Lannoo acknowledged that this could be problematic because of the *Meroni* Doctrine.<sup>37</sup> Thomas Wieser, President, Euro Working Group, was more pragmatic, arguing that central banks taking on supervisory functions was “a second-best solution” but that, in the current circumstances, it was the best way forward.<sup>38</sup>
32. The Vice-President of the ECB, Vitor Constâncio, told us that the ECB had long believed that it should be involved in supervision. He argued that there was a “global tendency to shift supervision ... towards central banks”, citing recent developments in the US (through the Dodd-Frank Act) and the UK.<sup>39</sup> In his view, it was no longer possible to distinguish the microsupervision of individual institutions from what was going on in the financial sector as a

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<sup>31</sup> QQ 56–9.

<sup>32</sup> HM Treasury.

<sup>33</sup> QQ 221, 236.

<sup>34</sup> QQ 106, 108. ESMA is the European Securities and Markets Authority.

<sup>35</sup> Q 197.

<sup>36</sup> Q 23.

<sup>37</sup> QQ 23, 61. The ‘*Meroni* Doctrine’ is derived from Case 9/56 *Meroni v High Authority* [1957–8] ECR 133. The legal principles set out in *Meroni* have retained their vitality notwithstanding that the case was decided in the era of the European Coal and Steel Community and the EU institutional architecture and legal framework have moved on very considerably since then. Under *Meroni* EU Institutions may not delegate discretionary power that implies a wide margin of discretion which may make possible the execution of actual economic policy. Only clearly defined executive powers the exercise of which can be subject to strict review in the light of objective criteria can be delegated. *Meroni* is not an obstacle to the conferral of tasks on the ECB because Article 127(6) TFEU provides for the possibility of delegation.

<sup>38</sup> Q 75.

<sup>39</sup> See Appendix 6.

whole. Although he conceded that there was a potential risk to the central bank's reputation and the potential for conflict with its monetary policy role, he believed the risks were exaggerated, at least in the ECB's case, because its mandate made clear that "price stability comes first".<sup>40</sup>

33. While we acknowledge that there are arguments on both sides of the debate, it is our view that the ECB is best placed to take on supervisory responsibilities. The ECB retains greater credibility than other EU institutions and, as the current global trend in this direction shows, the financial crisis demonstrated the importance of drawing together responsibility for supervision and monetary policy within one institution. However, it should be noted that some, for instance in Germany, argue that the ECB's 'one country, one vote' decision-making rules are ill-suited for the supervision of national banking sectors of widely differing size. Ambassador Boomgaarden told us that there was no such proposal "on the table at the moment".<sup>41</sup> However, Mr Rathi said that this was a "live discussion" and that the larger euro area Member States were arguing for greater recognition of the size of their financial sector.<sup>42</sup>
34. **There is an active debate about the appropriateness of a central bank taking on supervisory functions alongside its core monetary policy role. The US and the UK themselves are moving towards drawing such functions together in one organisation, and the majority of national central banks within the euro area already do so. A Single Supervisory Mechanism is vital if confidence in the euro area is to be restored. Giving this responsibility to the ECB is the only viable option. However this would represent a momentous step, creating a significant concentration of power in one institution, with huge implications for the ECB's role. Given the ECB's overriding focus on the euro area as opposed to the EU-27, it would also have consequences for the shape of the EU as a whole.**

### **Supervisory powers, monetary policy and the ECB governance structure**

35. Drawing together supervisory and monetary policy functions in one organisation is transparently fraught with difficulties. Both Mr Persson and Professor Alexander warned that the ECB might be tempted to use monetary policy inappropriately, by lowering interest rates or loosening liquidity conditions, in order to stabilise the banking sector.<sup>43</sup> Mr Wieser said that the firewalls between the two functions needed to be as "tall, thick and impenetrable" as possible.<sup>44</sup>
36. The Commission's proposal acknowledged the danger of a conflict of interest. It proposed that, in relation to supervisory tasks, "all preparatory and executing activities within the ECB will be carried out by bodies and administrative divisions separated from those responsible for monetary policy. To this end a supervisory board will be set up that will prepare decisions on supervisory matters. The Governing Council will be ultimately

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<sup>40</sup> Q 158.

<sup>41</sup> Q 180.

<sup>42</sup> Q 217.

<sup>43</sup> Q 198, Professor Alexander.

<sup>44</sup> Q 75.

responsible for taking decisions but may decide to delegate certain tasks or decision-making power to the supervisory board.”<sup>45</sup>

37. Ahead of the October 2012 Summit, it was reported that the European Council’s legal service had concluded that the proposal went beyond the powers permitted under law to change governance rules at the ECB. The legal service found that, without altering EU treaties, it would be impossible to give the Supervisory Board any formal decision-making powers, since such powers are vested in the ECB Governing Council. It was reported that the legal service had sketched out a possible legal compromise whereby the Supervisory Board could prepare draft supervision decisions, so long as the final say remained with the Governing Council.<sup>46</sup>
38. The October 2012 Summit Conclusions stressed the “need to ensure a clear separation between ECB monetary policy and supervision functions”.<sup>47</sup> Following the Summit, Mr Constâncio revealed that a compromise had been agreed to reinforce the separation by minimising as much as possible the role of the Governing Council in supervision.<sup>48</sup> Ambassador Boomgaarden confirmed that “we are on the way to doing this inside the ECB but with a separate supervisory body.”<sup>49</sup>
39. **There should be neither a conflict of interest, nor a perception of a conflict of interest, between the ECB’s supervisory and monetary policy tasks. We recognise the difficulties in designing a structure that overcomes this dilemma whilst at the same time complying with the legal requirements of the Treaty on the Functioning of the European Union (TFEU) and the ECB Statute. As negotiations progress, the following principles should be observed:**
- **The need for full separation of personnel between the supervisory and monetary policy tasks;**
  - **The need to grant the proposed Supervisory Board wide decision-making autonomy;**
  - **The need to minimise the role of the Governing Council in relation to supervision as far as is possible under the Treaty framework;**
  - **The need to ensure that it is clear which body within the ECB has ultimate responsibility in a crisis.**

**Without such principles the credibility of the Single Supervisory Mechanism will be significantly undermined. Whether these principles can be observed without recourse to treaty change is open to question.**

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<sup>45</sup> COM (2012) 511.

<sup>46</sup> ‘Europe banking supervisor plan ‘illegal’’, by Alex Barker, *Financial Times*, 17 October 2012.

<sup>47</sup> European Council, 18/19 October 2012, Conclusions:  
[http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/133004.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/133004.pdf)

<sup>48</sup> Q 157.

<sup>49</sup> Q 184.

### Which banks should the ECB supervise and how should its relationship with national regulators work?

40. The effectiveness of the SSM will be determined by the extent and nature of the supervisory regime. In other words which banks will be supervised, and to what degree? We were told that there were some 6000 banks in the euro area (and 8000 banks across the EU as a whole).<sup>50</sup> The majority of witnesses argued that all 6000 euro area banks should be brought within the Single Supervisory Mechanism,<sup>51</sup> although Rosa Lastra, Professor in International Financial and Monetary Law, Queen Mary University of London, suggested a ‘Champions League model’ with only the larger institutions subject to European supervision.<sup>52</sup>
41. There are sound reasons for an inclusive approach. Smaller and medium-sized EU banks, such as Northern Rock in the UK, or the *cajas* (regional savings banks) in Spain, found themselves at the centre of the financial crisis.<sup>53</sup> Barclays pointed to the dangers created by the significant interdependence of banks that had come to light during the financial crisis.<sup>54</sup> Others stressed the need for supervisory consistency across all banks.<sup>55</sup> Mr Enria told us that, if banks of all sizes were not included, in a moment of distress there might be a flight of deposits from one set of banks to the other.<sup>56</sup>
42. Given the resource implications and the need for expertise in national banking cultures, most acknowledged that it would not be possible for the ECB to be engaged in intensive supervision of all 6000 banks.<sup>57</sup> Mr Pisani-Ferry suggested that a reasonable compromise would be for the ECB to have the necessary authority to cover all banks whilst delegating supervision where appropriate.<sup>58</sup> Barclays described this as a ‘hub and spoke’ model, relying on national supervisors acting in effect as a branch of the ECB.<sup>59</sup>
43. Such a system would require close and effective cooperation between the ECB and national supervisors.<sup>60</sup> However, some witnesses foresaw tensions.<sup>61</sup> Philip Whyte, Senior Research Fellow, Centre for European Reform, suggested that the ECB would have fewer qualms about closing down an insolvent German *Landesbank* than German authorities would have.<sup>62</sup> Prior to the October 2012 Summit there had been much reporting of German objections to an inclusive model because of the impact on *Landesbanken* (regionally organised state-owned institutions specialising in wholesale banking). Ambassador Boomgaarden stressed that European supervision

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<sup>50</sup> Q 155 (Mr Constâncio).

<sup>51</sup> See for example Q 25 (Mrs Bowles).

<sup>52</sup> Q 106.

<sup>53</sup> Q 106 (Professor Lastra); HSBC.

<sup>54</sup> Barclays.

<sup>55</sup> QQ 131, 134 (Mr Harding).

<sup>56</sup> Q 91.

<sup>57</sup> See for instance Q 46 (Mr Pisani-Ferry); Q 134 (Mr Kibble); Barclays; and Lloyds Banking Group.

<sup>58</sup> Q 43.

<sup>59</sup> See Q 129 and Barclays.

<sup>60</sup> See for instance Q 98 (Commissioner Barnier); Q 181 (Ambassador Boomgaarden).

<sup>61</sup> See for instance Q 45 (Mr Pisani-Ferry).

<sup>62</sup> Q 197.

should concentrate on the systemically important banks, with the majority remaining under the national supervisory authorities.<sup>63</sup>

44. The Summit Conclusions stated that “the ECB will be able, in a differentiated way, to carry out direct supervision.”<sup>64</sup> Mr Constâncio confirmed that the ECB would directly supervise the 25 or 30 most significant banks, and that supervision would be decentralised to national supervisors for other banks. However, national supervisors would act in accordance with approved guidelines and would be required to follow the ECB’s instructions. In addition, the ECB would have authority to call in any banks that required more direct attention.<sup>65</sup>
45. Mr Whyte was not clear how this compromise would work in practice. He was concerned that there would continue to be “policies of forbearance driven by local political considerations.”<sup>66</sup>
46. The Financial Secretary to the Treasury agreed that, initially, the ECB would be supervising the supervisors, but emphasised that this was an important first step.<sup>67</sup> He also stressed that it was not proposed to create a set of institutions divorced from national supervisory authorities requiring “a whole set of people to be magicked up from nowhere.”<sup>68</sup>
47. **It is unrealistic to expect the ECB to engage in intensive supervision of all 6000 euro area banks. Yet the dangers created by the significant interdependence of banks that came to light during the financial crisis demonstrate that it is not only large credit institutions that pose a threat to the financial sector. A sensible compromise would be for the ECB to direct the conduct of supervision by national supervisors, and for the ECB itself to focus on day-to-day supervision of only the largest cross-border and systemically important banks, but with the power quickly to assume responsibility for the supervision of smaller banks as required.**
48. **This model can only work if there is close and positive cooperation between the ECB and national supervisors. The ECB must also have the means to eliminate national supervisory bias where it occurs. The proposed supervisory arrangements must be stress-tested against conditions of acute crisis, setting out clearly who is in charge, the relationship between the parties involved, and how the chain of command will operate. Given that a banking crisis originating amongst participating Member States would inevitably spread to London and the single market as a whole, the Government must ensure that the UK is able to influence decisions on the design of the supervisory framework.**

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<sup>63</sup> Q 173.

<sup>64</sup> October 2012 European Council conclusions, *op. cit.*

<sup>65</sup> QQ 153, 155.

<sup>66</sup> Q 196.

<sup>67</sup> Q 213.

<sup>68</sup> Q 236.

### Accountability of the ECB

49. Article 130 TFEU sets out the independence of the ECB as follows:
- “When exercising the powers and carrying out the tasks and duties conferred upon them by the Treaties and the Statute of the ESCB and of the ECB, neither the European Central Bank, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Union institutions, bodies, offices or agencies, from any government of a Member State or from any other body. The Union institutions, bodies, offices or agencies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the European Central Bank or of the national central banks in the performance of their tasks.”
50. The Commission proposal stated that the ECB would be subject to strong accountability mechanisms to the European Parliament and the Council/Eurogroup, including regular reporting requirements, answering questions and the presentation of an annual report.<sup>69</sup> President Van Rompuy stressed that the ECB was more accountable to the European Parliament than people thought, although he foresaw an evolution of the European Parliament’s role.<sup>70</sup>
51. Others argued that the accountability provisions did not go far enough. Philippe Lamberts MEP told us that it was unhealthy in a democracy to concentrate too much power in one institution. He and Professor Alexander were concerned that the ECB might find it difficult to adapt from its “corporate culture of non-accountability”.<sup>71</sup> Mr Enria stressed the need for “parliamentary control of the use made of European taxpayers’ money. It cannot be only the Council or closed circles of civil servants who oversee the process.”<sup>72</sup>
52. We also considered whether the ECB needed to be accountable to national parliaments as well as the European Parliament. Professor Lastra expressed concern about the lack of sufficient accountability mechanisms in the EU as a whole, and stressed the need for accountability at a national level.<sup>73</sup> Ambassador Boomgaarden argued that there was a need for “democratic legitimisation” at national level for decisions to close down a bank or change its management.<sup>74</sup>
53. The October 2012 Council conclusions baldly stated that “accountability takes place at the level at which decisions are taken and implemented.”<sup>75</sup> However Mr Constâncio acknowledged that the ECB’s interaction with the European Parliament and the Council would have to be more frequent and open than had been the case with monetary policy, and that the ECB would need to be “totally open” about the supervisory decisions that it took.<sup>76</sup> We

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<sup>69</sup> COM (2012) 511, *op. cit.*

<sup>70</sup> Appendix 4.

<sup>71</sup> QQ 1, 114.

<sup>72</sup> Q 94.

<sup>73</sup> Q 114.

<sup>74</sup> QQ 181, 184.

<sup>75</sup> October 2012 European Council conclusions, *op. cit.*

<sup>76</sup> Q 160.

also note Mr Constâncio's own appearance before us as a useful illustration of how an accountability mechanism of the ECB to national parliaments could operate.

54. HM Treasury highlighted three other issues that needed to be addressed. First, the lack of any internal appeal mechanism in the ECB. Second, a system where the only legal redress was to the European Court of Justice which, given that cases can take two years to work through the system, would not help credit institutions under threat of imminent closure. Third, the question of who was in charge in a crisis when issues of democratic accountability were at their most profound.<sup>77</sup>
55. The principle of ECB independence is a necessary one in terms of the ECB's core monetary policy role. Effective banking supervision also requires independence, but independence in the supervisory context must be balanced by strong accountability mechanisms.
56. **The ECB will become an exceptionally powerful institution if it takes on the proposed supervisory powers. Four principles of accountability need to be borne in mind:**
  - **That the ECB should be fully answerable to the Council and European Parliament for the supervisory decisions that it undertakes;**
  - **That an effective, calibrated and streamlined mechanism of accountability to national parliaments should be established, in particular in relation to individual supervision decisions that have a significant impact on an individual Member State's banking sector. It must be for national Parliaments to set out how any new accountability structures and frameworks should operate in practice;**
  - **That an effective appeals system should be established within the ECB, with a timely and appropriate system of external legal challenge;**
  - **That the accountability mechanism should be able to operate speedily and effectively at moments of acute crisis.**
57. **Judged by these principles, the accountability provisions in the original proposals are patently weak. The ECB must retain full independence in the exercise of its monetary policy role, as well as operational independence in relation to the supervisory function. We also acknowledge the legal constraints presented by Article 130 TFEU. Nevertheless, the case for a strong accountability mechanism is overwhelming. We are heartened by the ECB's acknowledgement that stronger accountability provisions are required.**

### **The impact of the proposal on non-euro area Member States**

58. The Commission proposal suggested that Member States that have not adopted the euro but wished to participate in the banking union would be able to enter into a close supervisory cooperation agreement with the ECB subject to meeting certain conditions. Where such a Member State entered

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<sup>77</sup> Q 215. On the appeals mechanism, see also Q 23 (Mrs Bowles); Q 133 (Mr Harding).

into supervisory cooperation, the ECB would carry out the supervisory tasks conferred on it as regards the credit institutions established in the Member State. A representative of the Member State would be able to take part in the activities of the Supervisory Board.<sup>78</sup>

59. The UK has indicated that it will not participate in the SSM (see Chapter 5). Thus, for the UK, the only change should be that its dealings with other supervisors on home-host issues, consolidated supervision and related matters may be with the ECB rather than individual national supervisors. Yet concern has been expressed to us about the danger of competence creep, whereby the ECB may seek to exert more authority than that presently held by existing national bank supervisors.<sup>79</sup>
60. Other non-euro Member States are likely to wish to participate in the SSM.<sup>80</sup> Mark Harding, Group General Counsel, Barclays, suggested smaller non-euro Member States would benefit from the credibility that the ECB would provide. He also suggested that Sweden may prefer to be involved because of its links with the Finnish banking system.<sup>81</sup> Mr Whyte cited the example of Nordea, which is headquartered in Sweden, but is the largest lender in Finland.<sup>82</sup> We note that German and Austrian-owned banks enjoy a dominant position in several central European Member States.
61. The main bone of contention for Member States such as Sweden, Poland and Hungary has been how to ensure that they would have a full and equal role in the decision-making process. The ECB statutes make clear that only euro area Member States have a vote on the Governing Council, which would legally be required to have the final say in any supervisory decisions under the model proposed by the Commission. Commissioner Barnier told us that “legal obstacles” meant that he had not been able to provide sufficient provisions in the original text. He believed, however, that there was “a degree of flexibility so that we might be able to improve this proposal.”<sup>83</sup>
62. We have referred to reports that the Council legal service raised doubts about the legality of the proposed governance structure. It was also reported that the legal service concluded that participating non-euro area Member States would be legally unable to vote on any ECB decisions. However the legal service’s compromise suggestion, referred to above, would have allowed non-euro area Member States to be given full voting rights in the drafting of advice in the Supervisory Board for the Governing Council to act on.<sup>84</sup>
63. The October 2012 Council conclusions referred to the need for “equitable treatment and representation of both euro and non-euro area Member States participating in the SSM.”<sup>85</sup> Following the Summit, Mr Constâncio told us it

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<sup>78</sup> COM (2012) 511, *op. cit.*

<sup>79</sup> Q 115 (Professor Alexander); Q 199 (Mr Whyte).

<sup>80</sup> See Q 6 (Mr Lamberts); Q 198 (Mr Whyte); QQ 219, 225 (the Financial Secretary to the Treasury) for a discussion of the positions of non-euro area Member States.

<sup>81</sup> Q 139.

<sup>82</sup> Q 199.

<sup>83</sup> Q 100.

<sup>84</sup> ‘Europe banking supervisor plan ‘illegal’’, *op. cit.* See above, para 37.

<sup>85</sup> October 2012 European Council conclusions, *op. cit.*

had been agreed to make amendments, but that the precise proposals had yet to be agreed.<sup>86</sup>

64. Nikhil Rathi, Director, Financial Regulations and Market Services, HM Treasury, told us that this remained a sensitive element of the negotiations.<sup>87</sup> Following the November 2012 meeting of EU finance ministers, the Swedish finance minister, Anders Borg, was reported as stating that “either you must change the treaty so it’s clear that every member is treated equitably or you need to move it outside of the ECB.”<sup>88</sup>
65. **Many non-euro area Member States may wish to participate in the Single Supervisory Mechanism. The UK has made clear that it will not do so. It is important that those non-euro area Member States who do wish to participate enjoy *de facto* equality with euro area Member States in the ECB decision-making process. The constraints imposed by TFEU may mean that this ultimately requires treaty change. Interim arrangements need to be devised that are satisfactory to those non-euro area Member States who wish to participate.**

### The timetable

66. An explicit link was drawn at the June 2012 European Council between the proposals for a Single Supervisory Mechanism and any move to allow the ESM to recapitalise banks directly. This link was made in the context of the dire prospects of the Spanish banking sector. In order to allow direct recapitalisation to take place as soon as possible, the SSM was subject to an extremely ambitious timetable, with final agreement sought by the end of 2012.
67. The majority of witnesses criticised the timetable, variously describing it as “unviable”,<sup>89</sup> “very aggressive”, “totally unrealistic”,<sup>90</sup> “hopelessly optimistic”<sup>91</sup> and “utterly stupid”.<sup>92</sup> Mr Whyte said that it was “pie in the sky” to think of this timetable as part of the solution to the Spanish banking crisis,<sup>93</sup> and warned that discussions on the banking union could become an excuse for not addressing the Spanish problem.<sup>94</sup> On the other hand, Mr Enria argued that “when you are in a crisis, policy makers need to get their act together and deal with the issue on the table fast.”<sup>95</sup>
68. Ahead of the October 2012 European Council, President Van Rompuy told us that he hoped to get much of the detail agreed by the Spring of 2013.<sup>96</sup> The European Council subsequently agreed that SSM should be taken forward as a matter of priority, with the objective of agreeing on the

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<sup>86</sup> QQ 157, 159. See also QQ 175, 181 (Ambassador Boomgaarden).

<sup>87</sup> Q 217.

<sup>88</sup> ‘Doubts grow on banking union’, by Alex Barker, *Financial Times*, 14 November 2012.

<sup>89</sup> Q 28 (Mrs Bowles).

<sup>90</sup> QQ 1, 3 (Mr Lamberts).

<sup>91</sup> Q 195 (Mr Persson).

<sup>92</sup> Q 79 (Mr Wieser).

<sup>93</sup> Q 195.

<sup>94</sup> Q 197.

<sup>95</sup> QQ 82, 94.

<sup>96</sup> Appendix 4.

legislative framework by 1 January 2013. Work on operational implementation would then follow during 2013.<sup>97</sup>

69. The Summit conclusions were widely seen as a necessary compromise in light of German concerns, articulated by Ambassador Boomgaarden, that the SSM “has to be successfully established and working effectively before any direct recapitalisation of banks in the euro area by the ESM can take place.”<sup>98</sup> He stressed that “quality goes before speed”, and that direct recapitalisation could only occur once other elements, including a single rulebook and a legal framework, were in place.<sup>99</sup>
70. Following the Summit, Mr Constâncio told us that it was intended that effective supervision would commence in early 2014. He acknowledged that any operation to directly capitalise banks would be delayed until then.<sup>100</sup> Mr Rathi warned that there were many different interpretations as to what the commitment to agreeing a ‘legislative framework’ by the end of 2012 actually meant.<sup>101</sup>
71. Following the meeting of EU finance ministers on 13 November 2012 it was reported that a German-led bloc had demanded that ministers “concentrate on getting the proposal right, rather than obsessing with a fixed timetable”. Commissioner Barnier was reported to have conceded that a deal in December was “possible but difficult” and that, in any case, establishing the SSM was “a necessary, but not a sufficient condition” for direct recapitalisation of banks to take place.<sup>102</sup> The German finance minister, Wolfgang Schäuble, repeated his concern about moving too quickly at a further meeting of finance ministers on 4 December.<sup>103</sup>
72. **Given the complex and controversial nature of the Single Supervisory Mechanism proposals, the timetable for reaching agreement on the proposals by the end of 2012 was wholly unrealistic. The revised aim of agreeing a legislative framework by the end of 2012 remains extremely ambitious, and, even if achieved, will leave significant questions as to how the mechanism will work in practice still to be addressed. The rushed timetable was a direct consequence of the political decision to link implementation of the SSM with the perceived need urgently to recapitalise the Spanish banking sector. This link is a contentious one which constrains the ability to assess the SSM proposals on their own merits. The need to agree legislation quickly does not obviate the requirement for effective scrutiny. The decline in Spanish bond yields since the ECB began to intervene in the secondary markets has eased the immediate pressure for recapitalisation, yet Spain’s prospects remain uncertain. The banking union proposals must not become an excuse for inaction on that front.**

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<sup>97</sup> October 2012 European Council conclusions, *op. cit.*

<sup>98</sup> QQ 172–3

<sup>99</sup> *ibid.*, Q 176. See Chapter 4 for an examination of the single rulebook.

<sup>100</sup> Q 152.

<sup>101</sup> Q 209.

<sup>102</sup> ‘Doubts grow on banking union’, *op. cit.*; ‘Ministers at odds on banking supervision’, by Valentina Pop, *EUObserver.com*, 14 November 2012.

<sup>103</sup> ‘Banking union plan hits wall’, by Alex Barker and Peter Spiegel, *Financial Times*, 5 December 2012.

### The case for treaty change

73. We have referred a number of times to the difficulties that the Commission has faced in seeking to keep its proposal within the constraints of TFEU. In particular, the fraught negotiations about the governance structure, the role of the Supervisory Board and the Governing Council, and the voting provisions for non-euro Member States have been made much more complex by the desire to avoid necessitating treaty change.
74. Negotiators continue to seek a way to provide the necessary safeguards within the constraints of the Treaty. It remains to be seen whether such efforts will bear fruit. We fear that the overriding imperative of avoiding treaty change may produce deficient legislation with counterproductive consequences.
75. **In its design of the proposals the Commission has been constrained by the need to avoid necessitating treaty change. We remain to be convinced that an effective mechanism can be designed within existing treaty constraints. European legislators may ultimately have to decide whether treaty change is a price they are willing to pay in order to bring about banking union. Adopting deficient and counterproductive legislation by way of compromise would be the worst of all possible outcomes.**

### CHAPTER 3: THE IMPACT OF BANKING UNION ON THE EBA AND THE ESRB

76. The second element of the Single Supervisory Mechanism proposals is the proposed Regulation amending the existing Regulation establishing the European Banking Authority (EBA) (referred to as the “the EBA Amending Regulation”). The EBA was established on 1 January 2011 and is a regulatory agency tasked with improving cooperation between national supervisors and continuing the development of a single rulebook for financial services in the EU. We considered its role in our July 2011 report, *The EU Financial Supervisory Framework: an Update*.<sup>104</sup>
77. The SSM proposals bring into sharp focus the role of the EBA. As an EU-wide institution, one of the EBA’s fundamental objectives is to ensure the effective functioning of the single market.<sup>105</sup> The issues of how such a relatively small and newly-established body will interact with such an immensely powerful institution as the ECB, and the potential consequences for the integrity of the single market (which we consider in detail in Chapter 5), will become vital ones to address.
78. The main elements of the Regulation are set out in Box 4.

#### BOX 4

##### The main elements of the EBA Amending Regulation<sup>106</sup>

- In respect of its power to impose a binding decision to resolve a cross-border disagreement between supervisors or to require action in an emergency situation, the EBA could request the ECB to follow its decision but could not require it to do so. The ECB would be required either to comply or to provide adequate justification for non-compliance.
- Stronger decision-making powers would be given to an independent panel with respect to the EBA’s powers relating to breaches of EU law and settlement of disagreements between supervisors. The three-person panel would be required to include at least one member from a non-participating Member State. The decision of the panel would be considered as adopted by the EBA Board of Supervisors unless it was rejected by a simple majority, which would be required to include at least three votes from participating Member States and at least three votes from Member States that were neither participating nor had entered into close cooperation arrangements with the ECB.
- The EBA Management Board would be required to include at least two representatives from Member States that were not participating and which had not entered into close cooperation arrangements with the ECB.
- The voting modalities with respect to EBA decisions on regulatory matters would not be changed. Such decisions would continue to be made on the basis of qualified majority voting in the Board of Supervisors.

<sup>104</sup> 20th report (2010–12), *The EU Financial Supervisory Framework: an Update* (HL 181).

<sup>105</sup> EBA Work Programme 2013: <http://www.eba.europa.eu/cebs/media/aboutus/Work%20Programme/EBA-BS-2012-163-FINAL--EBA-work-programme-for-2013-.pdf>.

<sup>106</sup> COM (2012) 512. See EMs 13682/12, 13683/12 and 13854/12, *op. cit.*

### The relationship between the EBA and the ECB

79. The impact of the ECB's enhanced role on the EBA was a concern for many witnesses. Mr Lannoo was sceptical about whether the EBA could exercise a mediation role between such powerful bodies as the ECB and the Bank of England without being squeezed. In his view, "we have to accept that the EBA will essentially become a standard-setting authority."<sup>107</sup>
80. Significantly, the EBA Chairman, Andrea Enria, agreed that there was a risk of the EBA becoming an "overarching umbrella which had no teeth". He warned that powerful supervisors would put pressure on the EBA to be allowed to tailor such rules to their own circumstances, resulting in a lack of convergence in supervisory practices.<sup>108</sup>
81. Others did not perceive such risks. Ambassador Boomgaarden described the ECB and EBA as "independent of each other so one is not dominating the other."<sup>109</sup> Mr Constâncio stressed that the ECB should be subject to the same procedure of mediation as any other supervisor.<sup>110</sup> Commissioner Barnier pointed out that the EBA Amending Regulation would still grant the EBA, in extreme circumstances, the power to impose a decision on a bank in the euro area.<sup>111</sup>
82. We have previously reflected on the resource challenges that the EBA faces.<sup>112</sup> Mr Enria told us that the EBA continued to be significantly understaffed to the extent that he questioned whether European leaders were seriously committed to its role.<sup>113</sup>
83. **We are concerned that the Single Supervisory Mechanism proposals may seriously undermine the authority of the EBA in its relations with the ECB. It is important to maintain the distinction between the EBA's role in setting rules across the EU and the ECB's role in supervising their operation within the Single Supervisory Mechanism. The ECB has assured us that it should be subject to the same procedure of mediation as any other supervisor. We are concerned that the sheer weight of influence that the ECB would exercise would make parity of treatment difficult to achieve in practice. The EBA needs the necessary resources, capacity and authority if it is to hold effective sway over such a powerful institution, and European leaders must reaffirm their commitment to its role. The Commission's forthcoming Review of the European System of Financial Supervision must, as a matter of priority, identify ways to buttress the EBA's position as defender of the single market.**

#### *a) Voting procedures*

84. The ECB Regulation states that the ECB shall be exclusively competent "to coordinate and express a common position of representatives from

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<sup>107</sup> Q 61.

<sup>108</sup> Q 89.

<sup>109</sup> Q 187.

<sup>110</sup> Q 164.

<sup>111</sup> Q 102.

<sup>112</sup> *The EU Financial Supervisory Framework: an Update, op. cit.*

<sup>113</sup> Q 90.

competent authorities of the participating Member States when participating in the Board of Supervisors and the Management Board of the European Banking Authority, for issues relating to the tasks conferred on the ECB by this Regulation.”<sup>114</sup> HM Treasury pointed out that this would effectively require participating Member States to caucus in adopting positions and voting in the EBA.<sup>115</sup>

85. Mr Constâncio agreed that “the logic of monetary union” would lead to euro area countries holding similar views.<sup>116</sup> However, Ambassador Boomgaarden did not feel that caucusing was inevitable, because “the dividing lines on most questions are not between eurozone and non-eurozone member states.”<sup>117</sup>
86. The Commission envisaged that alterations to the voting modalities within the EBA could help to ensure that the ECB was not able to dominate the EBA decision-making process. In the instances where issues are currently adopted by simple majority by the Board of Supervisors, it was proposed that decision-making powers be conferred on an independent panel, with a strong reverse voting mechanism.<sup>118</sup> This was intended to ensure that the decisions prepared by the independent panel were adopted unless they were rejected by a simple majority, including by at least three votes of participating Member States and by three of non-participating Member States. Changes to the voting rules would only affect those decisions made through a simple majority (that is, ‘one country one vote’). These decisions include those in relation to a breach of law, on the settlement of disagreements and on the election of the Management Board.
87. Mr Lamberts emphasised that preserving some form of veto power for the non-euro Member States would create a “perverse incentive because it would give them more decision-making powers by staying out than by being in”.<sup>119</sup> Mr Enria also warned that this could impair decision-making within the EBA. In his view, there was a need to move away from the idea that “good regulations and technical rules in Europe can be done only through national bargaining”.<sup>120</sup>
88. The situation is complicated when one considers the fluid position of the so-called ‘Outs’. The Commission made a commitment to review the voting modalities in order to reflect any future changes in the number of Member States whose currency is the euro or whose competent authorities have entered into a close cooperation agreement, but gave little further detail.<sup>121</sup> Mrs Bowles felt that it was “very difficult to see the way through to a long-term solution that would work for the UK.”<sup>122</sup>

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<sup>114</sup> COM (2012) 511, *op. cit.* See Article 4(1) (l). See Appendix 7 for further details on the role and operation of the EBA.

<sup>115</sup> EMs 13682/12, 13683/12 and 13854/12, *op. cit.*

<sup>116</sup> Q 166.

<sup>117</sup> Q 188.

<sup>118</sup> A reverse voting mechanism means that a decision is deemed to be accepted automatically unless it is blocked by the specified majority.

<sup>119</sup> Q 4.

<sup>120</sup> Q 88.

<sup>121</sup> COM(2012) 512, *op. cit.*

<sup>122</sup> Q 22.

89. The October 2012 European Council conclusions stated that “it is important to ensure a level playing field between those Member States which take part in the SSM and those which do not, in full respect of the integrity of the single market in financial services. An acceptable and balanced solution is needed regarding changes to voting modalities and decisions under the European Banking Authority (EBA) Regulation, taking account of possible evolutions in the participation in the SSM, that ensures non-discriminatory and effective decision-making within the Single Market.”<sup>123</sup> Following the Summit, Mr Rathi confirmed that there was “still some way to go” in ensuring that non-participants’ interests were taken into account.<sup>124</sup>
90. The Government have stressed that the EBA must continue to serve the whole single market, and its voting arrangements must reflect this need.<sup>125</sup> However the unlikelihood of the so-called ‘Outs’ taking a uniform approach to banking union means that this will be difficult to achieve in practice.
91. One potential solution would be to provide for voting strength within the EBA to be weighted according to the size of individual Member States’ financial markets. Mr Persson described this as an interesting proposal. Although he argued that Germany would be supportive of such a mechanism within the ECB Supervisory Board (given the dominant position that they would hold), he did not think they would be so keen in the EBA context (where the UK would have the largest voting weight).<sup>126</sup>
92. **It is in our view inevitable that there will be a convergence towards a single view within the EBA among Member States participating in banking union. This makes it imperative for non-participating Member States to have an effective voice, whilst at the same time ensuring that the decision-making process within the EBA does not become sclerotic. The EBA’s voting arrangements must ensure that it is able to defend the interests of the single market as a whole. A fracturing of the single market must be avoided at all costs. It is however hard to envisage non-participating Member States having a permanent veto, given that their numbers may be small from the start, and may shrink further. In our view, there cannot be an equitable and effective resolution of this dilemma unless the voting arrangements within the EBA reflect the significance of individual Member States’ financial markets within the single market as a whole.**

*b) Asymmetry of binding mediation arrangements*

93. The Government also raised concerns about the proposed asymmetry in binding mediation arrangements in the Amending Regulation, in that “as an EU institution, the ECB cannot legally be bound by EBA decisions on binding mediation, and would be subject to a ‘comply or explain’<sup>127</sup> arrangement, whereas the UK’s (future) Prudential Regulation Authority

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<sup>123</sup> October 2012 European Council conclusions, *op. cit.*

<sup>124</sup> QQ 217, 219, 226.

<sup>125</sup> EMs 13682/12, 13683/12 and 13854/12, *op. cit.*

<sup>126</sup> Q 201.

<sup>127</sup> The ECB is required either to comply with the EBA’s decision or explain its reasons for non-compliance. If the ECB decided not to comply (an eventuality which the Commission regards as “unlikely”), in limited circumstances the EBA could adopt an individual decision addressed directly to the financial institution concerned.

(and other national regulators) would be bound by EBA decisions as at present.”<sup>128</sup> Mr Rathi was clear that the proposal could not stand in its current form. He said that there were two ways to achieve symmetry: either subject everyone to the ‘comply or explain’ arrangement, or find a legal mechanism of binding the ECB into EBA decisions.<sup>129</sup> As we have seen, Mr Constâncio was clear that the ECB “will be bound in the same way as any other supervisor.”<sup>130</sup>

94. **There must be symmetry in the means by which the ECB and non-euro area authorities such as the UK’s Prudential Regulatory Authority are subject to EBA decisions. A solution to this problem must be identified as a matter of urgency.**

### Macroprudential supervision and the ESRB

95. The European Systemic Risk Board (ESRB) was established in 2010, tasked with the responsibility of overseeing risk in the financial system as a whole (referred to as macroprudential supervision). This was in response to the recognition that supervisory arrangements should not only concentrate on the supervision of individual firms but also place emphasis on the stability of the financial system as a whole.<sup>131</sup> We examined its role in our July 2011 report, *The EU Financial Supervisory Framework: an Update*.<sup>132</sup>
96. The ECB Regulation stated that the ECB would have exclusive competence within the euro area over “countercyclical buffer rates and any other measures aimed at addressing systemic or macro-prudential risks in the cases specifically set out in Union acts”.<sup>133</sup> Mr Persson predicted that, as a result, the ESRB would quickly become superfluous. Even now, he told us, “it can issue recommendations and monitor systemic risk, but it cannot really do anything.” He argued that a strengthened ESRB could act as a counterweight to the ECB’s “inherent incentive to look out for the interests of the eurozone.”<sup>134</sup> Professor Lastra feared problems of co-ordination between the ECB, EBA and ESRB.<sup>135</sup> Mr Constâncio asserted, however, that the ESRB could issue recommendations to the ECB in the same way as to any other supervisor.<sup>136</sup>
97. **The need for effective macroprudential oversight was an important lesson learned from the global financial crisis, and the ESRB continues to have a vital role to play. Insufficient consideration has been given to the effect of the Single Supervisory Mechanism proposals upon its position. There must be full analysis of the impact of these proposals on the ESRB in the context of the Commission’s forthcoming Review of the European System of Financial Supervision.**

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<sup>128</sup> EMs 13682/12, 13683/12 and 13854/12, *op. cit.*

<sup>129</sup> Q 229.

<sup>130</sup> Q 165.

<sup>131</sup> See ‘Establishment of the ESRB’, European Systemic Risk Board website: <http://www.esrb.europa.eu/about/background/html/index.en.html>

<sup>132</sup> *The EU Financial Supervisory Framework: an Update*, *op. cit.*

<sup>133</sup> COM(2012) 511, *op. cit.* See Article 4(1)(e).

<sup>134</sup> Q 204.

<sup>135</sup> See Q 110 and Professor Lastra.

<sup>136</sup> Q 167.

## CHAPTER 4: FURTHER STEPS TOWARDS BANKING UNION

98. The Single Supervisory Mechanism proposals outlined in Chapters 2 and 3 do not stand in isolation, but were envisaged as the first building block in a comprehensive banking union. In this chapter, we examine the further steps towards banking union that may follow in due course, namely a common resolution scheme and a common deposit insurance mechanism. In addition, we reflect on the findings of the Liikanen Report on reforming the structure of the EU banking sector, published in October 2012. Before doing so, it is necessary to consider the foundations upon which any banking union would be constructed, namely the so-called single rulebook in financial services.

### The Recovery and Resolution Directive and banking union

99. The three principal elements of the single rulebook are the Commission's proposed amendment of the Deposit Guarantee Schemes Directive (published in 2010), the capital requirements legislative package, known as CRD IV (published in 2011), and the Recovery and Resolution Directive (published in June 2012).<sup>137</sup> This Committee has previously engaged in detailed scrutiny of the first two of these packages,<sup>138</sup> and the Commission has stated that it is seeking to reach agreement on all three proposals by the end of 2012.
100. The third element, the proposed Recovery and Resolution Directive (RRD), seeks to establish a framework for dealing with credit institutions and investment firms in the event of a material deterioration in their financial position. 'Recovery' is concerned with early intervention to restore an institution or financial group's financial strength and viability. 'Resolution' is concerned with ensuring that the failure of an institution or financial group can occur without severe systemic disruption and without exposing taxpayers to loss. Orderly resolution would be necessary in the event that recovery measures are not feasible or prove ineffective. The main provisions of the RRD are set out in Box 5 below. The proposal is a 'minimum harmonisation' directive, meaning that Member States are permitted to go further if they wish.

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<sup>137</sup> Q 212 (Mr Rathi).

<sup>138</sup> Deposit Guarantee Schemes Directive (EM 12386/10): See House of Lords European Union Committee: Economic and Financial Affairs and International Trade (Sub-Committee A), Correspondence with Ministers, May–November 2010, pp. 16–18: <http://www.parliament.uk/documents/lords-committees/eu-sub-com-a/CWM/CwMSubAMay10-Nov10.pdf>; December 2010–May 2011, pp. 12–14: <http://www.parliament.uk/documents/lords-committees/eu-sub-com-a/CWM/CwMSubADec10-May11.pdf>; June–November 2011, pp. 11–13: <http://www.parliament.uk/documents/lords-committees/eu-sub-com-a/CWM/CwMSubAJun11-Nov11.pdf>; and December 2011–May 2012, p. 17: <http://www.parliament.uk/documents/lords-committees/eu-sub-com-a/CWM/CwMSubADec11MAY12FINAL.pdf>. CRD IV (EM 13284/11 and 13285/11): See Correspondence with Ministers, June–November 2011, *op. cit.*, pp. 44–53; December 2011–May 2012, *op. cit.*, pp. 48–52; and House of Lords European Union Committee: Economic and Financial Affairs (Sub-Committee A), Correspondence with Ministers, May–October 2012, pp. 46–47: <http://www.parliament.uk/documents/lords-committees/eu-sub-com-a/CWM/CwMsubA9may31Oct2012.pdf>.

**BOX 5****The main provisions of the Recovery and Resolution Directive<sup>139</sup>**

- It would constitute the first step towards a harmonised EU regime for resolution.
- It would apply in relation to all credit institutions and most investment firms, including financial groups.
- It would require recovery and resolution plans ('living wills').
- It would provide for supervisory early intervention powers where the financial situation of an institution was deteriorating.
- It would specify minimum harmonised resolution tools.
- Resolution tools would include the power to sell businesses to third parties, to transfer a business to a State-owned bridge institution or to transfer bad assets to a publicly-owned asset management vehicle for eventual sale or orderly wind-down.
- Resolution tools would also include bail-in powers, which enable resolution authorities to write down debt or convert it into equity. Bail-in powers would apply to a wide range of unsecured liabilities. Institutions would be required to hold a minimum amount of 'bail-inable' liabilities by 1 January 2018.
- Member States would be required to establish national pre-funded resolution funds.
- It would provide for the use of national deposit guarantee schemes for resolution funding purposes.

101. The Committee currently retains this proposal under the parliamentary scrutiny reserve. We received a substantial amount of evidence on the RRD, which we will take into account in our continued scrutiny of the Directive.
102. The publication of the RRD was followed almost immediately by the June 2012 European Council, which set out the first steps towards banking union, including the possible introduction of a common resolution mechanism. Mr Pisani-Ferry told us that the Commission was aware that the RRD was not fully consistent with the logic of the SSM and at some point it would be asked to come back with further proposals.<sup>140</sup> Mr Lannoo and Mr Persson believed that the RRD had already been overtaken by events.<sup>141</sup>
103. Ambassador Boomgaarden described the RRD as "an essential part of the harmonisation effort."<sup>142</sup> Yet Mr Whyte stressed the limitations of a harmonised approach,<sup>143</sup> arguing that it was "still embedded in the old

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<sup>139</sup> COM (2012) 280. See EM 11066/12.

<sup>140</sup> Q 52.

<sup>141</sup> QQ 68, 205.

<sup>142</sup> Q 189.

<sup>143</sup> Q 195.

system of the pre-banking union world, in which these sorts of things happen at national level rather than at federal or eurozone level.”<sup>144</sup>

104. Attention is therefore shifting from the harmonised model that the RRD encapsulates, to the potential for a common resolution scheme as a key element of banking union. This again brings the concept of variable geometry into focus. Whereas the Recovery and Resolution Directive, as a harmonising measure, would apply across the EU as a whole, a common resolution mechanism would presumably apply only to those Member States who chose to participate in banking union.
105. **The Recovery and Resolution Directive is a necessary step towards strengthening the single rulebook. However, the harmonisation model that it encapsulates is no longer sufficient to ensure the effective operation of the euro area banking sector. While there is a need for further steps towards effective banking union within the euro area in the form of a single resolution mechanism, it is vital that these steps do not risk a deepening split within the single market.**

#### Further steps towards banking union?

106. Besides the Single Supervisory Mechanism, the *Towards a Genuine Economic and Monetary Union* report also referred to two other legs of a banking union: a potential single resolution scheme and a single deposit insurance scheme under the control of a common resolution authority. Even as the SSM proposals emerged, the prospect of the other elements being implemented quickly was receding. German pressure led to references to the proposal for a common deposit insurance scheme being removed from subsequent reports. President Van Rompuy conceded that whilst the common deposit insurance scheme and common resolution scheme were key elements of banking union, there was no consensus on their introduction.<sup>145</sup>
107. Mr Whyte told us that “if that is what you understand by a banking union then Germany does not believe in one. It believes, and has just about conceded, that you can transfer responsibility for supervising systemic banks, particularly in the eurozone. However, it does not believe in a common deposit protection scheme or a common resolution authority, or in having a common fiscal backstop to the eurozone. The question then is: is Germany going to get its way or, as has been the case to some extent for the past two years, is it going to have to give way on some of these issues over an extended timescale?”<sup>146</sup>
108. The conclusions of the October 2012 Summit reflected these tensions. The Conclusions merely noted the Commission’s intention to propose a single resolution mechanism for Member States participating in the SSM once the existing proposals for a Recovery and Resolution Directive and for a Deposit Guarantee Schemes (DGS) Directive had been adopted. There was no reference at all to the proposal for a European deposit insurance scheme.<sup>147</sup> As such, the original banking union model has already been significantly diluted.

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<sup>144</sup> Q 205.

<sup>145</sup> See Appendix 4.

<sup>146</sup> Q 195.

<sup>147</sup> October 2012 European Council Conclusions, *op. cit.*

109. The financing arrangements involved in a single resolution and single deposit mechanism help explain why such further steps are controversial. The Recovery and Resolution Directive requires the establishment of national resolution funds, which will require *ex ante* levies on banks and investment firms. The existing Deposit Guarantee Schemes Directive proposes a similar funding arrangement of *ex ante* levies from the industry, and one option of merging the two funds to create a joint “DGS-resolution fund”.<sup>148</sup> The assumption is that, if either a single resolution or deposit insurance scheme were introduced, it would be funded at the European level, with levies on the banks and investment firms from within the participating Member States. But given that crises affecting banks are commonly macroeconomic in nature, any deposit insurance or resolution fund would be likely to run out of funds and ultimately government support would be needed to ensure credibility.<sup>149</sup>
110. Several witnesses argued that some form of debt mutualisation was therefore inevitable.<sup>150</sup> Barclays felt it difficult to conceive of an effective banking union that did not have a mechanism for mutualising the cost of bank failures.<sup>151</sup> Mr Persson told us that, whilst a joint backstop for Europe’s banks was a logical element of banking union, given that this would make one Member State’s taxpayers liable for those in another, he understood why it was controversial.<sup>152</sup> The UK Government’s view was that mutualised deposit insurance and a single resolution authority were such integral elements of a comprehensive banking union that mutualisation of fiscal risk was inevitable.<sup>153</sup>

*a) A single resolution mechanism*

111. Taking the two proposals in turn, the Commission’s September 2012 paper, *A Roadmap towards Banking Union*, argued that a 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 would be a natural complement to the establishment of a single supervisory mechanism. It would also entail significant economies of scale, and avoid the negative externalities that may derive from purely national decisions.”<sup>154</sup>
112. Mr Enria called for “stronger steps in the euro area towards a common resolution mechanism—maybe also a common resolution authority.”<sup>155</sup> Mr Whyte agreed, stating that “if you are talking about the stability of the eurozone”, keeping resolution at the national level “is not really good enough.”<sup>156</sup> Mr Pisani-Ferry pointed to the inconsistencies that would result from having a single supervisor but with recovery and resolution remaining at

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<sup>148</sup> ‘Bank recovery and resolution proposal: Frequently Asked Questions’, Official website of the European Union: [http://europa.eu/rapid/press-release MEMO-12-416\\_en.htm](http://europa.eu/rapid/press-release_MEMO-12-416_en.htm).

<sup>149</sup> ‘A European Deposit Insurance and Resolution Fund’, Centre for European Policy Studies, May 2012.

<sup>150</sup> QQ 1, 4 (Mr Lamberts); Q 80 (Mr Wieser).

<sup>151</sup> Barclays, Supplementary Evidence.

<sup>152</sup> Q 195.

<sup>153</sup> Q 234 (Mr Rathi).

<sup>154</sup> COM(2012) 510, *op. cit.*

<sup>155</sup> Q 95.

<sup>156</sup> Q 205.

the national level. He argued that, if there were to be a supervisory failure at the European level, national states would not be willing to pay for those mistakes.<sup>157</sup>

113. Others were more cautious. Mr Harding argued that a single resolution mechanism was “not an inevitable or an absolutely necessary thing.”<sup>158</sup> Mr Constâncio saw a common resolution framework as the next step, but only for the largest cross-border banks.<sup>159</sup>
114. **We recognise the political and technical difficulties in moving towards a single resolution mechanism. However, it is a necessary step if the destructive link between banks and sovereign states is to be decisively broken.**

*b) A common deposit insurance scheme*

115. A common deposit insurance scheme is a mechanism specifically intended to tackle the problem of capital flight. Professor Lastra explained that “with perfect capital mobility, in order to prevent a flight of deposits from troubled countries to countries perceived to be ‘safe’, one needs to convince ordinary citizens that a euro in a bank account in one eurozone Member State is worth the same and is as secure as a euro in a bank account in another eurozone Member State”.<sup>160</sup> President Van Rompuy stated this was a logical step once banking union was in place, but it was “a case of first things first”.<sup>161</sup>
116. Ambassador Boomgaarden made clear Germany’s opposition to a single deposit insurance scheme with “centralised credit lines between national intervention funds”.<sup>162</sup> He stressed that further integration was necessary before a centralised scheme could be considered.<sup>163</sup> More recently, in comments delivered to a German mutual banking event in Frankfurt, the ECB President Mario Draghi indicated that plans for a common deposit scheme may not be revived.<sup>164</sup>
117. Mr Wieser felt that a harmonised approach was sufficient, and described himself as “in a minority of one” in Brussels in questioning the importance of deposit guarantee schemes.<sup>165</sup> On the other hand, Mr Lannoo argued that a single deposit guarantee scheme would be crucial in a crisis, given the need for speedy decisions in terms of cost sharing.<sup>166</sup>

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<sup>157</sup> Q 45.

<sup>158</sup> Q 147.

<sup>159</sup> QQ 150, 169. The FDIC has broad statutory authority and wide-ranging powers to act as a receiver in order to liquidate or wind up the affairs of a failed institution, or act as a conservator to preserve the going concern value of the institution, either returning it to health or ultimately resulting in a receivership.

<sup>160</sup> Professor Lastra.

<sup>161</sup> See Appendix 4.

<sup>162</sup> Q 173.

<sup>163</sup> Q 193.

<sup>164</sup> ‘Draghi cedes to Berlin fears on banking union’, by Michael Steen, James Wilson and Alex Barker, *Financial Times*, 8 November 2012.

<sup>165</sup> Q 80.

<sup>166</sup> Q 65.

118. Mr Constâncio told us that common deposit insurance could wait for now, and that the immediate priority should be to proceed with the SSM.<sup>167</sup> HM Treasury acknowledged that the proposal for common deposit insurance had been taken out of the Commission road map under German pressure. However they questioned whether this was a sustainable position.<sup>168</sup>
119. **We understand the controversial nature of the proposal for the introduction of a common deposit insurance scheme, given that it would represent a significant step towards debt mutualisation. Nevertheless, for banking union to succeed and for the euro area to thrive, some form of common insurance scheme for the euro area would make sense. The case for such a scheme should continue to be made in the coming months.**

### **The Liikanen report**

120. In February 2012 Commissioner Barnier established a High-level Expert Group on banking structural reforms, chaired by the Governor of the Central Bank of Finland, Erkki Liikanen. The mandate of the Group was to “assess whether additional reforms directly targeted at the structure of individual banks would further reduce the probability and impact of failure, ensure the continuation of vital economic functions upon failure and better protect vulnerable retail clients.”<sup>169</sup>
121. The Liikanen report was published in October 2012.<sup>170</sup> Its central conclusions are set out in Box 6. In relation to structural reform, the Group concluded that it was necessary to require legal separation of certain risky financial activities from deposit-taking banks within a banking group. In particular, they recommended that proprietary trading and other significant trading activities should be assigned to a separate legal entity if the activities to be separated amounted to a significant share of a bank’s business. This would ensure that retail deposits would no longer directly support risky trading activities.

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<sup>167</sup> Q 150.

<sup>168</sup> Q 234 (Mr Rathi).

<sup>169</sup> ‘High Level Expert Group on reforming the structure of the EU banking sector’, by Erkki Liikanen, 2 October 2012.

<sup>170</sup> *ibid.*

**BOX 6****Key recommendations of the Liikanen report<sup>171</sup>**

- Proprietary trading and other significant trading activities should be assigned to a separate legal entity if the activities to be separated amount to a significant share of a bank's business.
- Banks need to draw up and maintain effective and realistic recovery and resolution plans as proposed by the Recovery and Resolution Directive. The resolution authority should request wider separation than considered mandatory above if deemed necessary.
- Banks should build up a sufficiently large layer of bail-inable debt and such debt should be held outside the banking system.
- There should be application of more robust risk weights in the determination of minimum capital standards and more consistent treatment of risk in internal models.
- There should be an augmentation of existing corporate governance reforms by specific measures to i) strengthen boards and management; ii) promote the risk management function; iii) rein in compensation for bank management and staff; iv) improve risk disclosure and v) strengthen sanctioning powers.

122. Attempts to separate retail banking from more risky activities are by no means a new phenomenon. The USA Glass-Steagall Act (1933), enacted in response to the failure of nearly 5000 banks during the Great Depression, prohibited commercial banks from engaging in the investment business. The Gramm-Leach-Bliley Act of 1999 repealed many of the most essential elements of the Glass-Steagall Act.
123. Interest in structural separation has intensified in the midst of the financial crisis. In the United States, the Volcker Rule, which forms part of the Dodd-Frank Act of 2010, advocates a ban on proprietary trading by commercial banks. In the UK, the September 2011 final report of the Independent Commission on Banking (ICB), chaired by Sir John Vickers, recommended retail ring-fencing of UK banks.<sup>172</sup>
124. The responses of our witnesses to the Liikanen report's recommendations were mixed. Mr Constâncio felt it was an "intelligent compromise between the so-called Vickers proposal and the Volcker rule."<sup>173</sup> Commissioner Barnier agreed.<sup>174</sup> There were, however, some concerns over how the recommendations would be implemented.<sup>175</sup>
125. HSBC argued that, whilst ring-fencing was attractive from a political perspective, there were examples of banks that had failed that would be entirely or substantially inside a retail ring-fence. They felt it unlikely to reduce the probability of bank failure, although it could change the identity

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<sup>171</sup> *ibid.*

<sup>172</sup> Independent Commission on Banking Final Report, September 2011, p. 11.

<sup>173</sup> Q 171.

<sup>174</sup> Q 97.

<sup>175</sup> Q 126 (Mr Harding).

of those who bore the cost.<sup>176</sup> Nationwide Building Society thought that ring-fencing would reduce the risk to taxpayers from future crises.<sup>177</sup>

126. Commissioner Barnier and the Financial Secretary to the Treasury were both confident that the Liikanen conclusions were compatible with the Vickers recommendations,<sup>178</sup> although Professor Lastra had greater concerns.<sup>179</sup> Commissioner Barnier told us that the Commission intended to consult on Liikanen's findings and bring forward legislative proposals before the summer of 2013.<sup>180</sup> We will scrutinise any legislative proposals as they emerge. In the meantime we look forward to the findings of the Parliamentary Commission on Banking Standards, which is considering several of these issues.
127. **While the case for some form of structural separation within the banking sector may be attractive, the devil is in the detail. There remains considerable uncertainty as to how the ringfence proposed in the Liikanen report will function, and questions remain about its compatibility with the recommendations of the UK Independent Commission on Banking (the Vickers report). The Commission is considering the Liikanen report and we will scrutinise its legislative proposals as and when they emerge. In the meantime we look forward to receiving the findings of the Parliamentary Commission on Banking Standards on its consideration of these issues.**

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<sup>176</sup> HSBC.

<sup>177</sup> Nationwide Building Society.

<sup>178</sup> QQ 97, 235.

<sup>179</sup> Q 116.

<sup>180</sup> Q 97.

## CHAPTER 5: THE IMPACT ON THE UK AND THE SINGLE MARKET

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128. The impact of the banking union proposals on the UK and the single market are profound. The Government's decision to stand apart will have significant consequences for the UK financial sector. There are also repercussions for the UK's role within the EU, should the euro area (and potentially other Member States) pursue deeper integration. Concerns have also been expressed that deeper integration of an inner core of Member States could lead to a fracturing of the wider single market.

### The impact on the UK and its financial sector

129. The Government have repeatedly stated that the UK will not participate in the banking union proposals, on the grounds that the measures logically flow from monetary union and are designed to secure the success of the single currency.<sup>181</sup> The Royal Bank of Scotland agreed with this approach.<sup>182</sup> On the other hand, given its position as a financial institution active in a number of Member States both inside and outside the euro area, Barclays perceived advantages (including a level playing field for conducting business in the EU and less supervisory divergence) and disadvantages in UK participation in banking union.<sup>183</sup>
130. Many were concerned about the potential impact of banking union on the UK financial sector. Mr Harding saw a threat to the provision of cross-border services, which was so fundamental to the success of the City.<sup>184</sup> Barclays warned that UK banks could be subject to deposit flight if the SSM was viewed as a stronger mechanism than that operating in the UK.<sup>185</sup> Mr Persson and HSBC feared that the City of London's success as an entry point to the single market for non-European banks could be put at risk.<sup>186</sup> President Van Rompuy was clear that there would be consequences for London, although he did not specify what they would be.<sup>187</sup>
131. On the other hand, Richard Kibble, Group Director, Strategy and Corporate Finance, Royal Bank of Scotland, and the ICFR pointed out that similar concerns were expressed in 1999 at the time of the creation of the euro, but that no such shift in financial activity had materialised.<sup>188</sup> Ambassador Boomgaarden told us that the UK was too big to be marginalised<sup>189</sup> and Mr Persson indicated that the risk of marginalisation was more of a concern for a country such as Sweden than for the UK.<sup>190</sup>

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<sup>181</sup> Q 212; Letter from the Financial Secretary to the Treasury to Lord Boswell, Chairman of the House of Lords European Union Committee, 3 October 2012: <http://www.parliament.uk/documents/lords-committees/eu-sub-com-a/EuroCrisis/31012EACGovResponse.pdf>.

<sup>182</sup> Royal Bank of Scotland.

<sup>183</sup> Barclays.

<sup>184</sup> Q 148.

<sup>185</sup> Barclays.

<sup>186</sup> Q 199, HSBC.

<sup>187</sup> See Appendix 4.

<sup>188</sup> Q 148, International Centre for Financial Regulation.

<sup>189</sup> Q 192.

<sup>190</sup> Q 199.

132. The Government have stated that the UK financial services industry “will remain an unparalleled global financial centre outside the banking union. It will continue to offer strong and well-respected regulation and supervision, as well as culture, diversity and access to top quality services and skilled workforce that is unmatched in other financial centres. Clustering effects mean that there are national, regional and global services and clients within close proximity. All of these advantages will remain in place with a banking union across the euro area.”<sup>191</sup> The Government must work to ensure that the UK retains such competitiveness advantages, rather than assuming that they will always remain.
133. **The UK’s decision not to participate in the banking union proposals could have significant consequences. While the precise impact on the UK financial services industry is difficult to predict, a degree of marginalisation will be inevitable as the euro area (and possibly other Member States) take steps towards deeper integration. We fear that the Government’s assurances that the pre-eminence of the UK financial sector will persist may prove misplaced. We urge them to do everything necessary to ensure that London’s leading position is not imperilled by the move towards a banking union.**

### The impact on the single market

134. In the various documents relating to the banking union proposals there is a repeated explicit commitment to preserve the “integrity of the Single Market”.<sup>192</sup> This in itself hints at the nervousness of EU leaders about the potential impact of these proposals. Mr Pisani-Ferry highlighted the concern that the euro area would begin to speak with one voice on single market issues.<sup>193</sup> Professor Lastra told us that there would not be an easy co-existence between the single market and banking union.<sup>194</sup> In her view, issues of jurisdictional domain haunted the proposals.<sup>195</sup>
135. On the other hand, Mr Constâncio argued that “the emergence or appearance of a new supervisor that in some way substitutes for several supervisors does not change at all the concept of the single market”.<sup>196</sup> Commissioner Barnier assured us that he was committed to finding “the right methodology within the EBA” to address the concerns over the voting mechanisms (as we explored in Chapter 3).<sup>197</sup> We note the view of *Which?* that it would be inevitable that participating Member States would begin to develop common positions ahead of Council meetings.<sup>198</sup>
136. On the other hand, some witnesses stressed the risks to the single market of not taking action. The Association for Financial Markets in Europe (AFME) highlighted the fragmentation of banking sectors along national borders in

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<sup>191</sup> Letter from the Financial Secretary to the Treasury, 3 October 2012, *op. cit.*

<sup>192</sup> October 2012 European Council Conclusions, *op. cit.*

<sup>193</sup> Q 48.

<sup>194</sup> Q 103.

<sup>195</sup> Professor Lastra.

<sup>196</sup> Q 156.

<sup>197</sup> Q 102.

<sup>198</sup> *Which?*

the wake of the crisis.<sup>199</sup> The ICFR agreed that the crisis had thrown the process of financial integration into reverse.<sup>200</sup>

137. The UK has its own obligation to defend the single market and the level playing field that it seeks to create. We were therefore concerned when HM Treasury stated that, while it was a key priority of the UK to ensure that any single supervisory rulebook kept to the key design principles of the single market, this was in order to “ensure that the Bank of England remains free to supervise banks in the way it sees fit.”<sup>201</sup>
138. **While the banking union proposals are essential to restore the credibility and integrity of the EU banking sector, we are deeply concerned that closer integration of an inner core of Member States could threaten the integrity of the single market. It is inevitable that euro area countries and other participating Member States will converge towards common positions in a number of areas. This may place an EU-27 single market under severe strain, in particular if a majority of non-euro Member States choose to participate in banking union. The implications for the UK’s position within the EU are troubling. We urge the Commission, as champion of the single market, to do all it can to preserve this most fundamental element of the EU project. The UK Government need to do likewise.**

### The UK’s engagement with the EU

139. Given the UK’s decision not to participate in banking union, we have considered how the Government should seek to engage in these issues. The Association of British Insurers stressed the importance of the UK remaining at the “decision-making table”.<sup>202</sup> Mr Persson was not impressed with the Government’s tone in negotiations, “in particular when lecturing the Germans to press ahead with a severe form of eurozone fiscal and banking union that Britain itself ... wants absolutely nothing to do with.”<sup>203</sup>
140. The sensitivities of the UK’s engagement with the banking union proposals are compounded by the fragile nature of the UK’s relationship with the EU. The International Centre for Financial Regulation indicated that the UK was struggling to get its views heard in Brussels.<sup>204</sup> Mr Whyte pointed out that many European countries blamed the financial crisis on “Anglo-Saxon capitalism”. There was also a perception that the Government had sought to exploit the euro area crisis to get a better deal for the UK.<sup>205</sup>
141. The Government assured us that the UK was not becoming isolated nor losing influence within the EU, and that they were fully engaged in the negotiation process, although they were aware of the sensitivities in laying down demands to which the UK will not be subject.<sup>206</sup> Yet the Government’s negotiating position across a number of issues has been contentious,

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<sup>199</sup> Association for Financial Markets in Europe (AFME).

<sup>200</sup> ICFR.

<sup>201</sup> HM Treasury, Supplementary Evidence.

<sup>202</sup> Association of British Insurers.

<sup>203</sup> Q 208.

<sup>204</sup> ICFR.

<sup>205</sup> Q 208.

<sup>206</sup> Q 216; Letter from the Financial Secretary to the Treasury, 3 October 2012, *op. cit.*

including the veto of the fiscal pact last December, the proposed repatriation of powers in relation to justice and home affairs measures, as well as recent arguments over the EU budget. These tensions have exacerbated the problems faced by the UK in seeking to exert a positive influence on the banking union proposals. Mr Whyte pointed out that “there is a growing perception across Europe that the UK is on its way out of the EU, so why bend over backwards to accommodate the UK if we are?”<sup>207</sup>

142. **Even though the UK is choosing not to participate in the banking union proposals, the issues that we have examined in this report will have a significant impact on this country. The UK must retain an influential voice in discussions of the future of the EU financial sector. This is necessary not only for the financial health of the UK financial sector but, given London’s status as the world’s leading financial centre, for the EU as a whole. We urge the Government to ensure that the UK is able to exert a positive influence on these discussions. While we do not seek in this report to analyse the policies which the Government should pursue to achieve these ends, we would emphasise that it is our intention to report further on these matters and other aspects of the future development of European banking union during 2013. UK isolation in debates of fundamental importance not only for the euro area, but for the single market and the UK financial sector itself, would be disastrous.**

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<sup>207</sup> Q 208.

## CHAPTER 6: SUMMARY OF CONCLUSIONS

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### Chapter 1: Introduction

143. We regret that it has taken so long for European leaders to bring forward concrete proposals to deal with the systemic deficiencies in the design of EMU. We welcome the necessary and long-overdue steps that have now been taken towards the introduction of a banking union. The June 2012 European Council was a watershed in acknowledging the imperative need to break the vicious cycle between banks and sovereign states. Yet the path to banking union will be far from straightforward. (para 13)
144. The three-pronged approach, outlined in the June 2012 report, *Towards a Genuine Economic and Monetary Union*, of a Single Supervisory Mechanism, a common resolution mechanism and a common deposit insurance scheme, constituted a firm and effective foundation on which to base the banking union proposals. This coherent model has already been undermined by political pressure, led by Germany. We regret that the controversial nature of the European resolution scheme, and, in particular, the European deposit insurance scheme, means that it is politically unrealistic to expect all three elements of the banking union to be taken forward quickly or in a united manner. (para 17)
145. In any assessment of the banking union proposals it is necessary to keep in mind the concept of variable geometry. These significant reforms will impact upon euro area and non-euro area Member States, and the banks and other credit institutions that operate within them, in different ways. Non-euro area Member States themselves will not approach the proposals in a uniform manner: it is not clear that many will follow the UK in staying out of banking union. (para 21)

### Chapter 2: The Single Supervisory Mechanism and the role of the ECB

146. Given the systemic weaknesses in the euro area banking sector that the financial crisis has brought to light, a system of single banking prudential supervision is now urgently required. The significance of this proposal as a first step towards a full banking union should not be underestimated. The following questions need to be addressed:
- Is it appropriate for the ECB, as is proposed, to take on prudential supervisory tasks and, if so, what will the impact be on its monetary policy responsibilities?
  - What will be the impact on the ECB's governance structure?
  - Which banks should be directly supervised by the ECB, and what will be the impact on the role of national supervisors?
  - What accountability mechanisms need to be put in place?
  - What will be the impact on non-euro area Member States?
  - What is a realistic timetable for these reforms to be introduced?
  - Do these reforms require treaty change? (para 27)
147. There is an active debate about the appropriateness of a central bank taking on supervisory functions alongside its core monetary policy role. The US and

the UK themselves are moving towards drawing such functions together in one organisation, and the majority of national central banks within the euro area already do so. A Single Supervisory Mechanism is vital if confidence in the euro area is to be restored. Giving this responsibility to the ECB is the only viable option. However this would represent a momentous step, creating a significant concentration of power in one institution, with huge implications for the ECB's role. Given the ECB's overriding focus on the euro area as opposed to the EU-27, it would also have consequences for the shape of the EU as a whole. (para 34)

148. There should be neither a conflict of interest, nor a perception of a conflict of interest, between the ECB's supervisory and monetary policy tasks. We recognise the difficulties in designing a structure that overcomes this dilemma whilst at the same time complying with the legal requirements of the Treaty on the Functioning of the European Union (TFEU) and the ECB Statute. As negotiations progress, the following principles should be observed:

- The need for full separation of personnel between the supervisory and monetary policy tasks;
- The need to grant the proposed Supervisory Board wide decision-making autonomy;
- The need to minimise the role of the Governing Council in relation to supervision as far as is possible under the Treaty framework;
- The need to ensure that it is clear which body within the ECB has ultimate responsibility in a crisis.

Without such principles the credibility of the Single Supervisory Mechanism will be significantly undermined. Whether these principles can be observed without recourse to treaty change is open to question. (para 39)

149. It is unrealistic to expect the ECB to engage in intensive supervision of all 6000 euro area banks. Yet the dangers created by the significant interdependence of banks that came to light during the financial crisis demonstrate that it is not only large credit institutions that pose a threat to the financial sector. A sensible compromise would be for the ECB to direct the conduct of supervision by national supervisors, and for the ECB itself to focus on day-to-day supervision of only the largest cross-border and systemically important banks, but with the power quickly to assume responsibility for the supervision of smaller banks as required. (para 47)

150. This model can only work if there is close and positive cooperation between the ECB and national supervisors. The ECB must also have the means to eliminate national supervisory bias where it occurs. The proposed supervisory arrangements must be stress-tested against conditions of acute crisis, setting out clearly who is in charge, the relationship between the parties involved, and how the chain of command will operate. Given that a banking crisis originating amongst participating Member States would inevitably spread to London and the single market as a whole, the Government must ensure that the UK is able to influence decisions on the design of the supervisory framework. (para 48)

151. The ECB will become an exceptionally powerful institution if it takes on the proposed supervisory powers. Four principles of accountability need to be borne in mind:
- That the ECB should be fully answerable to the Council and European Parliament for the supervisory decisions that it undertakes;
  - That an effective, calibrated and streamlined mechanism of accountability to national parliaments should be established, in particular in relation to individual supervision decisions that have a significant impact on an individual Member State's banking sector. It must be for national Parliaments to set out how any new accountability structures and frameworks should operate in practice;
  - That an effective appeals system should be established within the ECB, with a timely and appropriate system of external legal challenge;
  - That the accountability mechanism should be able to operate speedily and effectively at moments of acute crisis. (para 56)
152. Judged by these principles, the accountability provisions in the original proposals are patently weak. The ECB must retain full independence in the exercise of its monetary policy role, as well as operational independence in relation to the supervisory function. We also acknowledge the legal constraints presented by Article 130 TFEU. Nevertheless, the case for a strong accountability mechanism is overwhelming. We are heartened by the ECB's acknowledgement that stronger accountability provisions are required. (para 57)
153. Many non-euro area Member States may wish to participate in the Single Supervisory Mechanism. The UK has made clear that it will not do so. It is important that those non-euro area Member States who do wish to participate enjoy *de facto* equality with euro area Member States in the ECB decision-making process. The constraints imposed by TFEU may mean that this ultimately requires treaty change. Interim arrangements need to be devised that are satisfactory to those non-euro area Member States who wish to participate. (para 65)
154. Given the complex and controversial nature of the Single Supervisory Mechanism proposals, the timetable for reaching agreement on the proposals by the end of 2012 was wholly unrealistic. The revised aim of agreeing a legislative framework by the end of 2012 remains extremely ambitious, and, even if achieved, will leave significant questions as to how the mechanism will work in practice still to be addressed. The rushed timetable was a direct consequence of the political decision to link implementation of the SSM with the perceived need urgently to recapitalise the Spanish banking sector. This link is a contentious one which constrains the ability to assess the SSM proposals on their own merits. The need to agree legislation quickly does not obviate the requirement for effective scrutiny. The decline in Spanish bond yields since the ECB began to intervene in the secondary markets has eased the immediate pressure for recapitalisation, yet Spain's prospects remain uncertain. The banking union proposals must not become an excuse for inaction on that front. (para 72)
155. In its design of the proposals the Commission has been constrained by the need to avoid necessitating treaty change. We remain to be convinced that an effective mechanism can be designed within existing treaty constraints.

European legislators may ultimately have to decide whether treaty change is a price they are willing to pay in order to bring about banking union. Adopting deficient and counterproductive legislation by way of compromise would be the worst of all possible outcomes. (para 75)

### **Chapter 3: The impact of banking union on the EBA and the ESRB**

156. We are concerned that the Single Supervisory Mechanism proposals may seriously undermine the authority of the EBA in its relations with the ECB. It is important to maintain the distinction between the EBA's role in setting rules across the EU and the ECB's role in supervising their operation within the Single Supervisory Mechanism. The ECB has assured us that it should be subject to the same procedure of mediation as any other supervisor. We are concerned that the sheer weight of influence that the ECB would exercise would make parity of treatment difficult to achieve in practice. The EBA needs the necessary resources, capacity and authority if it is to hold effective sway over such a powerful institution, and European leaders must reaffirm their commitment to its role. The Commission's forthcoming Review of the European System of Financial Supervision must, as a matter of priority, identify ways to buttress the EBA's position as defender of the single market. (para 83)
157. It is in our view inevitable that there will be a convergence towards a single view within the EBA among Member States participating in banking union. This makes it imperative for non-participating Member States to have an effective voice, whilst at the same time ensuring that the decision-making process within the EBA does not become sclerotic. The EBA's voting arrangements must ensure that it is able to defend the interests of the single market as a whole. A fracturing of the single market must be avoided at all costs. It is however hard to envisage non-participating Member States having a permanent veto, given that their numbers may be small from the start, and may shrink further. In our view, there cannot be an equitable and effective resolution of this dilemma unless the voting arrangements within the EBA reflect the significance of individual Member States' financial markets within the single market as a whole. (para 92)
158. There must be symmetry in the means by which the ECB and non-euro area authorities such as the UK's Prudential Regulatory Authority are subject to EBA decisions. A solution to this problem must be identified as a matter of urgency. (para 94)
159. The need for effective macroprudential oversight was an important lesson learned from the global financial crisis, and the ESRB continues to have a vital role to play. Insufficient consideration has been given to the effect of the Single Supervisory Mechanism proposals upon its position. There must be full analysis of the impact of these proposals on the ESRB in the context of the Commission's forthcoming Review of the European System of Financial Supervision. (para 97)

### **Chapter 4: Further steps towards banking union**

160. The Recovery and Resolution Directive is a necessary step towards strengthening the single rulebook. However, the harmonisation model that it encapsulates is no longer sufficient to ensure the effective operation of the euro area banking sector. While there is a need for further steps towards

effective banking union within the euro area in the form of a single resolution mechanism, it is vital that these steps do not risk a deepening split within the single market. (para 105)

161. We recognise the political and technical difficulties in moving towards a single resolution mechanism. However, it is a necessary step if the destructive link between banks and sovereign states is to be decisively broken. (para 114)
162. We understand the controversial nature of the proposal for the introduction of a common deposit insurance scheme, given that it would represent a significant step towards debt mutualisation. Nevertheless, for banking union to succeed and for the euro area to thrive, some form of common insurance scheme for the euro area would make sense. The case for such a scheme should continue to be made in the coming months. (para 119)
163. While the case for some form of structural separation within the banking sector may be attractive, the devil is in the detail. There remains considerable uncertainty as to how the ringfence proposed in the Liikanen report will function, and questions remain about its compatibility with the recommendations of the UK Independent Commission on Banking (the Vickers report). The Commission is considering the Liikanen report and we will scrutinise its legislative proposals as and when they emerge. In the meantime we look forward to receiving the findings of the Parliamentary Commission on Banking Standards on its consideration of these issues. (para 127)

#### **Chapter 5: The impact on the UK and the single market**

164. The UK's decision not to participate in the banking union proposals could have significant consequences. While the precise impact on the UK financial services industry is difficult to predict, a degree of marginalisation will be inevitable as the euro area (and possibly other Member States) take steps towards deeper integration. We fear that the Government's assurances that the pre-eminence of the UK financial sector will persist may prove misplaced. We urge them to do everything necessary to ensure that London's leading position is not imperilled by the move towards a banking union. (para 133)
165. While the banking union proposals are essential to restore the credibility and integrity of the EU banking sector, we are deeply concerned that closer integration of an inner core of Member States could threaten the integrity of the single market. It is inevitable that euro area countries and other participating Member States will converge towards common positions in a number of areas and this is only likely to increase should further steps towards fiscal and, ultimately, political union, be taken. This may place an EU-27 single market under severe strain, in particular if a majority of non-euro Member States choose to participate in banking union. The implications for the UK's position within the EU are troubling. We urge the Commission, as champion of the single market, to do all it can to preserve this most fundamental element of the EU project. The UK Government need to do likewise. (para 138)
166. Even though the UK is choosing not to participate in the banking union proposals, the issues that we have examined in this report will have a significant impact on this country. The UK must retain an influential voice in discussions of the future of the EU financial sector. This is necessary not

only for the financial health of the UK financial sector but, given London's status as the world's leading financial centre, for the EU as a whole. We urge the Government to ensure that the UK is able to exert a positive influence on these discussions. While we do not seek in this report to analyse the policies which the Government should pursue to achieve these ends, we would emphasise that it is our intention to report further on these matters and other aspects of the future development of European banking union during 2013. UK isolation in debates of fundamental importance not only for the euro area, but for the single market and the UK financial sector itself, would be disastrous. (para 142)

## APPENDIX 1: EU SUB-COMMITTEE ON ECONOMIC AND FINANCIAL AFFAIRS

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The members of the Sub-Committee who conducted this inquiry were:

Viscount Brookeborough  
 Lord Dear  
 Lord Flight  
 Lord Hamilton of Epsom  
 Lord Harrison (Chairman)  
 Baroness Hooper  
 Lord Jordan  
 Lord Kerr of Kinlochard  
 Baroness Maddock  
 Lord Marlesford  
 Baroness Prosser  
 Lord Vallance of Tummel

### Declaration of Interests

Viscount Brookeborough  
*None relevant*

Lord Dear  
*None relevant*

Lord Flight  
*Senior Non-executive Director, Metro Bank plc (retail bank)*

Lord Harrison  
*None relevant*

Lord Hamilton of Epsom  
*Non-Executive Director, Jupiter Dividend and Growth Trust PLC (investment trust)*  
*Director, IREF Global Holdings (Bermuda) Ltd (property fund)*  
*Director, IREF Australian Holdings (Bermuda) Ltd (property fund)*  
*Non-Executive Director, MSB Ltd (management consultancy)*

Baroness Hooper  
*None relevant*

Lord Jordan  
*Chairman, Homes and Communities Pension Scheme*

Lord Kerr of Kinlochard  
*Non-executive Director and Senior Independent Director, Scottish American Investment Co Ltd*  
*Member, Advisory Board, Edinburgh Partners*  
*Chairman, Centre for European Reform (London)*  
*Vice President, European Policy Centre (Brussels)*

Baroness Maddock  
*None relevant*

Lord Marlesford  
*Independent National Director, Times Newspapers Holdings Ltd*  
*Non-executive Director, Gavekal Research (Hong Kong)*  
*Advisor to Sit Investment Associates Minneapolis*  
*As a farmer —payments are received through the EU CAP*

Baroness Prosser

*Director, Trade Union Fund Managers  
Trustee, Industry and Parliament Trust*

Lord Vallance of Tummel

*Member, Supervisory Board, Siemens AG  
Member, International Advisory Board, Allianz SE*

The following Members of the European Union Committee attended the meeting at which the report was approved:

Lord Boswell (Chairman)  
Lord Bowness  
Lord Dear  
Baroness Eccles of Moulton  
Lord Foulkes of Cumnock  
Lord Harrison  
Lord Maclennan of Rogart  
Lord Marlesford  
Baroness O’Cathain  
Lord Richard  
Baroness Scott of Needham Market  
Lord Teverson  
Lord Tomlinson  
Lord Trimble  
Baroness Young of Hornsey

A full list of registered interests of Members of the House of Lords can be found at <http://www.parliament.uk/mps-lords-and-offices/standards-and-interests/register-of-lords-interests/>

## APPENDIX 2: LIST OF WITNESSES

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Evidence is published online at <http://www.parliament.uk/hleua> and available for inspection at the Parliamentary Archives (020 7219 5314)

Evidence received by the Committee is listed below in chronological order of oral evidence session and in alphabetical order. Those witnesses marked with \* gave both oral evidence and written evidence. Those marked with \*\* gave oral evidence and did not submit any written evidence. All other witnesses submitted written evidence only.

### Oral evidence in chronological order

**	(QQ 1–18)	Philippe Lamberts, Member, European Parliament
**	(QQ 19–39)	Sharon Bowles, Member, European Parliament
**	(QQ 40–53)	Bruegel
**	(QQ 54–70)	Centre for European Policy Studies
**	(QQ 71–81)	Euro Working Group
**	(QQ 82–96)	European Banking Authority (EBA)
**	(QQ 97–102)	Commissioner Michel Barnier
*	(QQ 103–118)	Professor Kern Alexander, Senior Research Fellow, The Centre for Financial Analysis and Policy, University of Cambridge, and Professor of Law and Finance, University of Zurich
*		Professor Rosa M. Lastra, Centre for Commercial Law Studies, Queen Mary University of London
*	(QQ 119–148)	Barclays
*		Royal Bank of Scotland (RBS)
**	(QQ 149–171)	European Central Bank (ECB)
**	(QQ 172–194)	Georg Boomgaarden, German Ambassador to the UK
**	(QQ 195–208)	Centre for European Reform
**		Open Europe
*	(QQ 209–237)	HM Treasury

### Alphabetical list of all witnesses

- \* Professor Kern Alexander, Senior Research Fellow, The Centre for Financial Analysis and Policy University of Cambridge, and Professor of Law and Finance, University of Zurich (QQ 103–118)
- Marta Andreasen, Member, European Parliament
- Association of British Insurers (ABI)
- Association for Financial Markets in Europe (AFME)
- Professor Emilios Avgouleas, LLB, LLM, PhD, Chair in International Banking Law and Finance, School of Law, University of Edinburgh
- \* Barclays (QQ 119–148)

- \*\* Commissioner Michel Barnier (QQ 97–102)  
BlackRock [submission accepted on a confidential basis and not published]
- \*\* Georg Boomgaarden, German Ambassador to the UK (QQ 172–194)
- \*\* Sharon Bowles, Member, European Parliament (QQ 19–39)  
British Bankers' Association (BBA)
- \*\* Bruegel (QQ 40–53)  
Building Societies Association  
Professor Andrew Campbell, Professor of International Banking & Finance  
Law, School of Law, University of Leeds
- \*\* Centre for European Policy Studies (QQ 54–70)
- \*\* Centre for European Reform (QQ 195–208)  
John Chapman  
John Chown  
City of London Corporation
- \*\* European Banking Authority (EBA) (QQ 82–96)
- \*\* European Central Bank (ECB) (QQ 149–171)
- \*\* Euro Working Group (QQ 71–81)
- \* HM Treasury (QQ 209–237)  
HSBC  
International Centre for Financial Regulation (ICFR)  
Italian Federation of Credit Cooperative Banks (Federcasse)
- \*\* Philippe Lamberts, Member, European Parliament (QQ 1–18)
- \* Professor Rosa M. Lastra, Centre for Commercial Law Studies, Queen  
Mary University of London (QQ 103–118)  
Lloyds Banking Group  
Lloyds Consulting Associates (LCA Europe Ltd)  
Nationwide Building Society
- \*\* Open Europe (QQ 195–208)
- \* Royal Bank of Scotland (RBS) (QQ 119–148)  
Which?

### APPENDIX 3: CALL FOR EVIDENCE

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The House of Lords EU Sub-Committee on Economic and Financial Affairs, chaired by Lord Harrison, is launching an inquiry into reform of the EU Banking Sector. We invite you to contribute evidence to this inquiry.

The ongoing euro area crisis, and the strain that it has placed on the EU banking sector, has led to calls for reform of the way in which the banking sector operates and is regulated. Proposals for an EU Directive on bank recovery and resolution were published in June. However, these proposals have already been subsumed into a wider debate about the steps towards “banking union” that are needed if the financial crisis is to be resolved.

The June 2012 report of the President of the European Council, Herman Van Rompuy, *Towards a Genuine Economic and Monetary Union*, proposes a vision for a stable and prosperous EMU based on “four essential building blocks”, including an integrated financial framework elevating responsibility for bank supervision to European level, and providing common mechanisms to resolve banks and guarantee customer deposits.

At a summit on 28–29 June 2012, euro area leaders confirmed their intention to “break the vicious circle between banks and sovereigns”, including through the development of a single banking supervisory mechanism, with a key role for the European Central Bank (ECB). These proposals are expected to be published shortly. At the same time, President Van Rompuy has been commissioned to develop “a specific and time-bound road map for the achievement of a genuine Economic and Monetary Union”.

Although the Government have made clear that the UK will not take part in the fundamental elements of a banking union, the implications of these developments for the UK cannot be ignored. The Government argue that the UK’s non-participation should not and need not adversely affect London’s position as the leading financial centre in Europe, nor undermine the single market. The strength of this argument may soon be tested.

The Sub-Committee welcomes evidence on the proposals that have been set out so far, and, given that this is a fast-moving agenda, also welcomes further evidence on the proposals for reform as they continue to take shape in the coming weeks and months.

**Particular questions raised to which we invite you to respond are as follows (there is no need for individual submissions to deal with all of the issues, and witnesses are also invited to deal with any additional issues or proposals that emerge in the weeks and months after the Call for Evidence is published):**

#### **Banking reform, banking union and the euro area crisis**

- (1) What has the euro area crisis revealed about the weaknesses of the EU banking sector? In what ways do you believe that the EU banking sector needs to be reformed?
- (2) Steps towards ‘banking union’ were set out in the Van Rompuy report *Towards a Genuine Economic and Monetary Union*. How would you define ‘banking union’ in the EU context? What is your assessment of the report’s conclusions, and what will its impact be on existing

proposals (such as CRD IV)? What are the key elements of such a banking union if it is to function effectively?

- (3) The 28/29 June euro area summit statement said that when an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could recapitalise banks directly. What is your assessment of this proposal? How likely is it that this would successfully stabilise the EU banking sector?
- (4) In January 2012 European Commissioner Michel Barnier set up a high level expert group to explore possible ways to reform the structure of the EU banking sector, including consideration of structural reforms such as activity restrictions as applies under the Volcker Rule, size limits, and structural separation of retail deposit banks from investment banking. What is your assessment of such proposals for structural reforms? Which, if any, would help ensure the future health of the EU banking sector?

### **Banking supervision**

- (5) The European Commission are expected to present proposals for a single European banking supervisory framework in September. What is the purpose of such a framework, and what key elements need to be included if it is to succeed? How likely is it that such a framework will be adopted?
- (6) What is the most appropriate division of responsibility between national and EU supervision under such a framework?
- (7) In what way, if at all, should supervisory powers vary depending on the size and nature of banks?
- (8) What powers and responsibilities is it appropriate for the ECB to possess in relation to regulation of the European banking sector, and in particular in relation to supervision of euro area banks? How should the ECB be held accountable for the exercise of such responsibilities?

### **European Deposit Insurance schemes**

- (9) What is your assessment of the Van Rompuy proposals for a European deposit insurance scheme for banks, to be overseen under the new European banking supervisory framework and with the ESM as a fiscal backstop? What is the purpose of the proposal and what will its impact be on the existing Deposit Guarantee Schemes Directive proposal? Is it likely to be effective? How likely is it that such proposals will be enacted?

### **The proposed Directive for bank recovery and resolution**

- (10) What is your assessment of the proposed Directive (COM (2012) 280) establishing a framework for the recovery and resolution of credit institutions and investment firms? What will be the impact on these proposals of the steps towards banking union (including a resolution framework) as set out in the Van Rompuy report?
- (11) What will be the impact of the Directive upon the European Banking Authority (EBA)? Are the new responsibilities proposed under the Directive for the EBA appropriate?

- (12) What is your assessment of the proposed ‘bail-in’ tool (Articles 37–38 and 41–50)?
- (13) What is your assessment of the following specific elements of the Commission’s proposals, as set out in the Directive, in relation to:
- (a) Recovery and resolution planning (Articles 5–12)?
  - (b) Group recovery and resolution and cross-border activity (including resolution colleges) (Articles 7–8, 11–12 and 80–83)?
  - (c) Preventative powers (Articles 13 and 14)?
  - (d) Intra-group financial support (Articles 16–22)?
  - (e) Early intervention measures, including the ‘Special Manager’ tool (Articles 23 and 24)?
  - (f) The various resolution tools, including sale of business, bridge institution and asset separation (Articles 31–55)?
  - (g) Cooperation with third country authorities (Articles 84–89)?
  - (h) The proposed system of financing arrangements (Articles 90–99)?

### The impact on the UK

- (14) The Government have made clear that the UK will not take part in the fundamental elements of a banking union, and will neither be part of common deposit guarantees nor come under the jurisdiction of a single European financial supervisor. What is your assessment of this position? How should the UK respond to these proposals?
- (15) What will be the implications of steps towards banking union for those countries, such as the UK, that intend to stand apart? How realistic is the Government’s argument that the UK’s non-participation should not and need not adversely affect London’s position as the leading financial centre in Europe, nor adversely affect the operation of the single market?
- (16) How do you assess the risk that, as elements of a banking union, including supervision, are addressed by a subset of its members, the Council’s role in banking regulation will be undercut, with its legislative debates pre-empted and/or decisions pre-determined in discussion amongst banking union members?

The deadline for written evidence is **Monday 1 October 2012**.

#### **APPENDIX 4: NOTE OF THE SUB-COMMITTEE'S MEETING WITH HERMAN VAN ROMPUY, PRESIDENT OF THE EUROPEAN COUNCIL, 2 OCTOBER 2012**

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Lord Harrison thanked President Van Rompuy for agreeing to meet with the Sub-Committee. He asked him to provide an overview of the current challenges facing the EU, and of the extent of his role in addressing them.

President Van Rompuy replied that in the two-and-a-half years since he took on the post, there had been one over-riding task—to address the economic and financial crisis. Agreement had been found on new mechanisms, new rules and a new treaty. Steps that would have been unthinkable three years ago had been undertaken because there was no other option. He pointed out that there were 17 “lively democracies” in the eurozone, and 27 in the whole Union, so these steps had taken time to agree. He conceded that sometimes the response had been too little, too late. The need for unanimity in the European Council meant that much preparatory work was required to ensure that the Conclusions of each meeting were acceptable to everybody.

The President said that the EU was in a better place than a few months ago. No-one was now speaking about imminent eurozone collapse. Although the problems had not disappeared, things were “on the right track” but the EU might ultimately need to give Greece more time. The new Greek government was doing a good job in difficult circumstances. The programme of reforms already agreed to were a massive adjustment in its primary balance. He acknowledged that this was deflationary but said that, in the case of Greece, there was no other option. And without the bailout loan and debt write-offs, it would have faced a far more drastic situation. He asserted that Greek competitiveness was improving. He said that the problems in Cyprus and Spain were also important but they did not threaten the existence of the eurozone.

The President added that the other big challenge was to deepen EMU. His interim report, drafted in cooperation with the Presidents of the Commission, ECB and Eurogroup, would be ready in time for the October Council. Draft Conclusions would be sent to Member States that evening. He stressed that it was very much an interim report intended to clarify concepts and test the degree of support for various ideas. There would be most detail on the Single Supervisory Mechanism. He said that “Banking Union”, as it was called by some, had two other components. On deposit guarantee schemes, he was looking for progress on the existing Commission proposal. He said that mandatory lending between Member States would be “dealt with separately”, in the language of the draft Conclusions. There was currently no agreement on mandatory lending so it had to be postponed. On banking resolution, there would be a single resolution authority common for the eurozone, but these steps were for later. He conceded that there was no consensus on many elements, in particular in relation to debt mutualisation.

Another chapter in the interim report was on fiscal union. President Van Rompuy said that it would already be an achievement if agreement could be reached on the “two pack” currently before the EP. Going further than that on the “discipline” side would mean touching on core issues of national sovereignty. On the “solidarity” side, a new—and embryonic—idea of fiscal capacity for the eurozone in the form of a supplementary budget was being explored, based on the idea that monetary union requires fiscal capacity, but there were different ideas about the

objectives of such a budget, for instance to deal with asymmetric shocks or to help countries undertake structural reforms, as well as providing possible incentives. These ideas were at an early stage.

Regarding economic union, the Country-Specific Recommendations and the Macro-economic Imbalances Procedure were already in place. There was now a new idea of developing individual “contracts” for Member States on reforms and their implementation, with the Member State, Commission and Council working together.

Overall the EU had already done a lot. Going further was a problem for many Member States, not only the UK. Therefore, at this stage, the focus would be on a single supervisory mechanism and to start to explore new ideas for fiscal capacity and contracts with Member States.

In November there would also be a separate European Council meeting on the Multiannual Financial Framework (MFF). This would begin on Thursday 22 November and go on until the Sunday if necessary. The MFF was an important issue, but was only 1% of EU GDP; in fact the current arguments concerned what amounted to less than 0.1% of EU GDP. The President did not underestimate the political ramifications but said that Member States “must stay cool and rational”. Agreement must be found—if the European Council could not agree on this, on what could it agree? And it would be even more difficult to find agreement later.

Lord Harrison asked about the Liikanen report and the timetable for Banking Union.

President Van Rompuy replied that he hadn’t yet seen the Liikanen report. On the timetable, there was a link between the Single Supervisory Mechanism and recapitalisation of banks. It had been agreed to proceed with recapitalisation once an effective supervisory mechanism was in place. He stressed that a decision must be made as soon as possible: he hoped to get much agreed in the Spring. He intended to ask the European Council to approve “broad outlines” so that the Council (ECOFIN) and the EP could seek agreement before the end of year, with the details following thereafter.

Lord Harrison agreed that this seemed a more realistic timetable.

Lord Jordan asked what needed to be done to ensure that the ECB was democratically accountable for its new powers.

The President said that this was part of the solution which had to be found. The ECB was much more accountable to the European Parliament than people thought, appearing before its ECON Committee at least four times a year, and at least once a year before the plenary. Therefore this was more than simply a dialogue; if the ECB took on supervisory powers, then he foresaw an “evolution” of the European Parliament’s role.

Lord Kerr asked about the link between the ECB and the EBA, and President Van Rompuy’s statement that the division of responsibility would be clear and workable. He asked whether the President agreed with the Commission’s proposal to change the EBA’s voting rules.

President Van Rompuy said that what he personally thought was not important—his role was to find agreement. He stressed that the EBA would keep its current competencies—the single rulebook, common standards and so on, and would ensure the integrity of the single market. But, when there was a single supervisor

for the eurozone 17 or more, the EBA's voting rules would have to be adapted so that those outside the mechanism did not feel discriminated against. That was a political problem that needed a solution. The Commission's proposal was not the end of the road.

Baroness Prosser said that not everyone was happy with the idea of being supervised and regulated, and that not all banks were the same. She asked whether the supervisory mechanism should cover all institutions.

President Van Rompuy stressed the need to phase in supervision, starting with the largest and most systemically important banks, to ensure that a supervisory infrastructure could be developed. After bilateral meetings with Member States and the European Parliament, he believed that this was something on which there was widespread support, but that it was necessary to find agreement on the pacing of this: "the who and the when". But the principle of eventually supervising all institutions starting with the largest and most systemically important, was reasonable to most Member States.

Lord Marlesford questioned whether it was right to refer to Spain as a minor problem when the markets said otherwise.

President Van Rompuy stressed that Spain was not a minor problem, but rather not an existential problem. At present the interest rate spread was below 6%. As a former economist, he questioned why an interest rate of 6% should be unsustainable for a limited period. He stressed that the interest rate of average debt in Spain was lower, and some perspective was necessary. If spreads went up significantly, then there was a possibility of asking for help, as indicated by the June decision. Not every Member State was keen for this to happen, not least because there was a need to ask the Bundestag and other national parliaments, following which the EFSF could proceed to intervene in the primary market, and the ECB in the secondary market, essentially working as a lender of last resort.

Lord Flight asked about deposit guarantee schemes and how President Van Rompuy's call for a deposit insurance scheme related to the existing Deposit Guarantee Schemes Directive. He said that the US had found that deposit guarantee schemes were crucial to stopping retail bank runs.

The President said that this was a logical step once banking union was in place, but it was "a case of first things first". Deposit insurance would contain an element of debt mutualisation, which was very difficult at this stage. It was not possible to solve all the problems at the same time. A single supervisory mechanism was the first priority.

Lord Kerr asked whether he was content to see the implementation of the 2010 Deposit Guarantee Schemes Directive and the Recovery and Resolution Directive for now, and whether the single supervisory mechanism was the priority for the October Council meeting.

President Van Rompuy agreed with both points.

Lord Hamilton asked what the impact would be on the City of London of the UK not participating in banking union.

President Van Rompuy said that we all had to make choices and draw our own conclusions from that choice. If the UK chose not to be a part of banking union there would be consequences for London. Nevertheless the EBA would be there

and there was the guarantee of the single financial market, which was in itself the biggest guarantee.

Lord Hamilton asked if there would in effect a eurozone voting bloc within the EBA.

President Van Rompuy conceded that this was difficult. It was necessary to find ways to ensure the UK was not in an isolated position with decisions being taken by “continentals”. He said he understood that point and that it needed to be looked at. He believed that there was openness in the rest of the EU to addressing this issue.

## APPENDIX 5: THE PROVISIONS OF THE ECB REGULATION<sup>208</sup>

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- The conferral on the ECB of specific tasks concerning policies relating to the prudential supervision of credit institutions.
- All Euro area credit institutions regardless of size or business model would be included. The ECB would therefore have prudential supervisory responsibilities for the 6000 or so deposit-taking banks located in the euro area.
- The ECB would have ‘exclusive competence’ for a list of prudential supervisory tasks:
  - the authorisation and licensing of credit institutions;
  - the assessment of acquisitions and disposals of holdings in credit institutions;
  - ensuring compliance with EU capital, liquidity and related requirements and, in cases specifically set out in Union acts, setting higher or additional requirements;
  - applying capital buffers, including setting countercyclical buffer rates and other measures aimed at addressing systemic or macro-prudential risks;
  - overseeing robust and sound internal governance, internal assessment and risk management arrangements, strategies, processes and mechanisms;
  - carrying out supervisory stress tests;
  - carrying out consolidated supervision over credit institutions’ parents established in participating Member States;
  - participating in consolidated supervision in relation to parents not established in a participating Member State;
  - participating in supplementary supervision of financial conglomerates;
  - early intervention in a credit institution that did not meet or was likely to breach prudential requirements, in coordination with relevant resolution authorities;
  - coordinating and expressing a common position of the competent authorities of participating Member States in EBA decision-making contexts for issues relating to the tasks conferred on the ECB;
  - performing host state supervisory responsibilities in relation to euro area branches of credit institutions established in non-participating Member States.
- The ECB would be equipped with supervisory and investigatory powers for the purposes of carrying out the tasks conferred on it. The ECB would also have the power to impose administrative financial sanctions. The

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<sup>208</sup> COM (2012) 511, *op. cit.* See EMs 13682/12, 13683/12 and 13854/12, *op. cit.*

ECB would have the same rights and obligations as national competent authorities under EU law with respect to the exchange of information.

- Pending the conferral of resolution powers on a European body, the ECB would be expected to coordinate with national authorities to ensure a common understanding about respective responsibilities in a crisis.
- The ECB and the national competent authorities (i.e. bank prudential supervisors) would together form the Single Supervisory Mechanism.
- National competent authorities would remain responsible for supervisory tasks that were not transferred to the ECB.
- National competent authorities would be required to assist the ECB in the areas in which it would have exclusive competence and must comply with the ECB's instructions. It would be for the ECB to define the framework and conditions under which prudential supervision was conducted at a national level. The ECB could arrange for the exchange and secondment of staff.
- The ECB could levy proportionate fees on credit institutions.
- The ECB would be required to budget separately for the carrying out of supervisory tasks.
- The objectives that the ECB would be required to pursue in carrying out its supervisory tasks would be the promotion of the safety and soundness of credit institutions and the stability of the financial system, with due regard for the unity and integrity of the single market.
- The ECB would be required to ensure due separation between the supervisory and monetary policy functions. An ECB Supervisory Board would be set up to achieve separation. The membership of the Supervisory Board would comprise representatives of the ECB and of the national competent authorities. The Supervisory Board would be responsible for planning and executing the supervisory tasks conferred on the ECB. The Governing Council of the ECB might delegate to the Supervisory Board clearly defined supervisory tasks and related decisions about an individual institution or set of institutions. Subject to this possibility of limited delegation, the Governing Council would be ultimately responsible for decision-making with respect to supervision.
- The ECB would be required to act independently in carrying out the tasks conferred on it. It would be accountable to the European Parliament and to the Council, and would be required to report annually to the Parliament, the Council, the Commission and the Eurogroup. The Chair of the Supervisory Board could be required to appear before relevant Committees of the European Parliament. The ECB would be required to answer questions put to it by the European Parliament or the Eurogroup.
- A non-participating Member State and the ECB could enter into 'close cooperation'. The Member State would be required to meet certain conditions, including undertaking to abide by and implement relevant ECB acts. When a close cooperation arrangement was in place, the ECB would be required to carry out its supervisory tasks in relation to credit institutions established in that Member State. A representative of the relevant Member State's competent authority would be entitled to take part in the activities of the ECB Supervisory Board.

**APPENDIX 6: COMPARISON OF THE ORGANISATION OF PRUDENTIAL SUPERVISION IN UK, USA AND THE EURO AREA**

	<b>Prudential Regulation Authority (Bank of England)</b>	<b>US Federal Reserve</b>	<b>European Central Bank</b>
<b>Regulatory Role</b>	Prudential supervisor	Prudential supervisor (some supervisory and regulatory responsibilities shared with Office of Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation and other federal authorities, and with bank supervisors of various States).	Prudential supervisor (together with national competent authorities of euro area countries). Possibility for other EU Member States to opt-in.
<b>Primary Prudential Responsibility</b>	Promote the safety and soundness of PRA-authorized persons. Contribute to the securing of an appropriate degree of protection for insurance policyholders.	Provide a safe, flexible, and stable financial system. Work with other federal and state supervisory authorities to ensure the safety and soundness of financial institutions, stability in the financial markets, and fair and equitable treatment of consumers in their financial transactions.	Promote safety and soundness of credit institutions and the stability of the financial system, with due regard for the unity and integrity of the single market
<b>Regulatory Coverage</b>	National: banks, insurers, Lloyd's underwriters and arrangers, certain investment firms. HM Treasury may add other PRA-regulated activities. PRA has powers of direction over financial holding companies and, potentially, non-financial holding companies.	National/Federal: all US bank holding companies (including financial holding companies), state chartered banks that are part of the Federal Reserve System, and savings and loan holding companies. National banks chartered by the OCC are required to be members of the Federal Reserve System. Systemically important non-bank financial firms and financial market utilities can be designated by Financial Stability Oversight Council for supervision by the Federal Reserve.	Regional: all credit institutions established in euro area (including consolidated supervision of financial holding companies and mixed financial holding companies, and participation in supplementary supervision of financial conglomerates). Prudential supervisory remit to extend to credit institutions established in other EU Member States that choose to opt-in.

	<b>Prudential Regulation Authority (Bank of England)</b>	<b>US Federal Reserve</b>	<b>European Central Bank</b>
<b>Associated bodies: macro-prudential oversight</b>	<p>Financial Policy Committee (Bank of England)</p> <p>Can give directions to PRA with respect to the implementation of macro-prudential measures. Can also make recommendations within the Bank, or to other persons including HM Treasury and the PRA.</p>	<p>Financial Stability Oversight Council</p> <p>Plays an important role in designating non-bank financial firms and infrastructures for enhanced supervision.</p> <p>Can make recommendations to the primary financial regulatory agencies for new or heightened standards.</p>	<p>European Systemic Risk Board</p> <p>Body with EU-wide remit. ESRB can issue recommendations and warnings to the Union as a whole, to the European Commission, to Member States, to the European Supervisory Authorities and to national supervisors.</p>
<b>Associated bodies: resolution</b>	<p>Special Resolution Unit (Bank of England)</p> <p>PRA, in consultation with Bank and HM Treasury, makes decision to put bank into special resolution regime. SRU manages the resolution process.</p>	<p>Federal Deposit Insurance Corporation.</p> <p>FDIC has extensive authority to resolve insured banks, non-FDIC institutions and new ordinary liquidation authority (OLA) to close, liquidate and resolve systemically important financial institutions.</p> <p>Invoking OLA and appointment of FDIC as a receiver requires recommendation and vote by the Federal Reserve and designated regulator (e.g. FDIC, Securities and Exchange Commission (SEC), Federal Insurance Corporation for insurance companies) and determinations by Treasury Secretary (in consultation with the President).</p>	<p>Euro area national resolution authorities</p> <p>Withdrawal of banking licence is an ECB task. Under Recovery and Resolution Directive (draft) ECB or national authority must determine that institution is failing. ECB required to cooperate with national authorities to ensure a common understanding about respective responsibilities in crisis. Provision for resolution colleges in Recovery and Resolution Directive.</p>
<b>Associated bodies: deposit insurance</b>	<p>Financial Services Compensation Scheme—up to £85,000 per depositor per bank.</p>	<p>Financial Deposit Insurance Corporation—up to \$250,000 per depositor per insured bank.</p>	<p>Euro area national deposit insurance schemes—up to €100,000 per depositor per bank (EU harmonisation of payout level).</p>

## APPENDIX 7: GLOSSARY OF KEY INSTITUTIONS AND ORGANISATIONS

BCBS	<p>The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. Member countries are represented by their central bank and by their prudential supervisor if it is not the central bank. The members come from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The European Commission and the European Central Bank are observers.</p> <p>The BCBS formulates minimum supervisory standards, guidelines and recommendations. BCBS standards do not have the force of law but can harden into law by being incorporated into national, or in the case of the EU, regional legal systems. The BCBS is responsible for the Basel III Capital Accord (2010, revised 2011), which contains the revised international regulatory standards on bank capital and liquidity.</p>
EBA	<p>The European Banking Authority is a European agency, established by Regulation (EU) 1093/2010 and operational from January 2011. The EBA is based in London. The bank supervisors of the Member States are the voting members of the EBA's Board of Supervisors. The Board of Supervisors makes decisions by simple majority or, on specified matters, by qualified majority voting (QMV). Day-to-day matters are the responsibility of the Management Board, which is comprised of the EBA Chair, six persons elected by and from national supervisory authorities and a representative of the European Commission. The UK is currently an elected member of the EBA Management Board.</p> <p>The EBA's powers include: developing binding technical standards; ensuring compliance with EU law; taking certain action in the event of an emergency situation; and settling cross-border disputes between supervisors by imposing a binding decision. Decisions taken by the EBA in the exercise of its powers must not impinge in any way on the fiscal responsibilities of a Member State. Other areas in which the EBA has responsibilities include writing non-binding guidelines and recommendations, conducting peer reviews, mediating disputes between supervisors on a non-binding basis, promoting supervisory cooperation, convergence and coordination, facilitating home/host Member State relations, and providing opinions to the Union Institutions. The EBA is required to cooperate generally with the European Systemic Risk Board and to collaborate with it on certain specific matters including the development of common approaches to the identification and measurement of systemic risk and stress testing arrangements.</p> <p>The EBA has conducted three rounds of stressing testing (2009, 2010, 2011). It has done so in a bottom-up fashion using</p>

	methodologies, scenarios and key assumptions, which it developed in cooperation with the European Systemic Risk Board, the European Central Bank and the European Commission.
ECB	The European Central Bank is the central bank for the euro. It has performed this role since 1999, and is based in Frankfurt. The ECB is responsible for the determination and implementation of monetary policy for the euro area. In its monetary policy role the ECB's primary statutory objective is to maintain price stability. In performing the supervisory tasks that are proposed to be conferred on it the ECB would be required to pursue only the objectives of promoting the safety and soundness of credit institutions and the stability of the financial system, with due regard for the unity and integrity of the single market. The ECB was created by the Maastricht Treaty which entered into force in 1993. Since November 2009 its legal basis has been the Treaty on the Functioning of the European Union and the Statute of the European System of Central Banks and of the European Central Bank annexed to it.
EIOPA	The European Insurance and Occupational Pensions Authority is the sister EU agency to the European Banking Authority for the insurance and occupational pensions sector. It was established by Regulation (EU) 1094/2010 and has been in operation since January 2011. EIOPA is based in Frankfurt.
ESAs	The European Supervisory Authorities are the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority.
ESCB	The European System of Central Banks is a composite body comprising the ECB and the national central banks of all EU Member States whether or not they have adopted the euro. The ESCB is governed by the ECB's decision-making bodies: the Governing Council and the Executive Board.
ESFS	The European System of Financial Supervision comprises the three European Supervisory Authorities (European Banking Authority, European Insurance and Occupational Pensions Authority and European Securities and Markets Authority), the Joint Committee of the European Supervisory Authorities, the European Systemic Risk Board, and national supervisors. The ESFS is a network that is intended to ensure that the rules applicable to the financial sector are properly implemented.
ESM	The European Stability Mechanism is an intergovernmental institution based in Luxembourg, set up to provide financial assistance to euro area Member States experiencing, or being threatened by, severe financing problems, if this is indispensable for safeguarding financial stability in the euro area as a whole. The Treaty establishing the European Stability Mechanism (ESM) entered into force on 27 September 2012. At the euro area Summit in June 2012 it was agreed that the ESM could have the possibility to recapitalise banks directly once an effective Single Supervisory Mechanism was established. Direct recapitalisation would rely on appropriate conditionality. The initial maximum lending capacity of

	<p>the ESM is set at €500 billion. This is achieved with subscribed capital of €700 billion (€80 billion paid-in capital, the rest callable).</p>
ESMA	<p>The European Securities and Markets Authority is the sister EU agency to the European Banking Authority for securities and markets. It was established by Regulation (EU) 1095/2010 and has been in operation since January 2011. ESMA is based in Paris.</p>
ESRB	<p>The European Systemic Risk Board is responsible for the macro-prudential oversight of the EU financial system. This oversight is intended to contribute to the prevention or mitigation of systemic risks to financial stability in the Union that arise from developments within the financial system, so as to avoid periods of widespread financial distress. The ESRB is also required to contribute to the smooth functioning of the single market and thereby ensure a sustainable contribution of the financial sector to economic growth. The ESRB was established (by Regulation 1092/2010) as part of the same package of EU institutional changes that created the European Banking Authority and the other European Supervisory Authorities. Unlike the European Supervisory Authorities, the ESRB does not have legal personality or any legally-binding powers. The ESRB can issue recommendations and warnings to the Union as a whole, to the European Commission, to Member States, to the European Supervisory Authorities and to national supervisors. The ESRB also has power to request information from a wide range of sources.</p> <p>Voting members of the General Board of the ESRB include the President and the Vice-President of the ECB, the Governors of the national central banks, a member of the European Commission, and the Chairs of the European Banking Authority, European Insurance and Occupational Pensions Authority and European Securities and Markets Authority. There are also non-voting members including one representative from each Member State's national supervisory authorities.</p> <p>The ESRB is based in Frankfurt. The ECB provides its secretariat.</p>
Eurogroup	<p>The Eurogroup is the informal gathering of the finance ministers of the euro area Member States. The Eurogroup President (until the end of December 2012) is Jean-Claude Juncker, Prime Minister of Luxembourg.</p>
FCA	<p>The Financial Conduct Authority will be the UK's financial conduct supervisor from 2013. The FCA will be responsible for regulation of conduct in retail and wholesale financial markets and the infrastructure that supports those markets. The FCA will also have responsibility for the prudential regulation of firms that do not fall under the Prudential Regulation Authority's scope. The FCA's strategic objective will be to ensure that relevant markets function well. The FCA's operational objectives will be to secure an appropriate degree of protection for consumers, to protect and enhance the integrity of the UK financial system, and to promote effective competition in the interests of consumers in the markets. The FCA will be required, so far as is compatible with acting in a way which advances the consumer protection objective or the</p>

	integrity objective, to discharge its general functions in a way which promotes effective competition in the interests of consumers.
FDIC	The overarching mission of the US Federal Deposit Insurance Corporation is to maintain stability and public confidence in the US financial system. The FDIC is responsible for deposit insurance and for the management of the resolution of failing financial institutions. In the aftermath of the financial crisis the FDIC's authority has been extended beyond federally insured banks and thrift institutions to include also non-bank financial companies, and holding companies and affiliates of insured institutions. Banks that are members of the Federal Reserve must insure themselves through the FDIC. Banks that are not affiliated with the Federal Reserve (i.e. state banks without an Office of the Comptroller of the Currency charter and access to the Federal Reserve's payment and liquidity facilities) are often required to insure themselves through the FDIC.
Federal Reserve	The US Federal Reserve, which originated in the Federal Reserve Act of 1913, a measure signed into law in response to a number of financial panics, is the federal supervisor and regulator of all US bank holding companies, including financial holding companies, and state-chartered commercial banks that are members of the Federal Reserve System. The Federal Reserve also has responsibility for the international operations of state member banks and US bank holding companies, and the US operations of foreign banking organisations. The Federal Reserve has been assigned responsibilities for non-bank financial firms and financial market utilities that have been designated by the Financial Stability Oversight Council as systemically important. The Federal Reserve has assumed responsibility for the consolidated supervision of saving and loan holding companies and their subsidiaries. The Federal Reserve seeks primarily to promote safety and soundness, including compliance with laws and regulations.
FPC	The Financial Policy Committee is the UK's macroprudential oversight body. The FPC has been operating on an interim basis since 2011 and will be put onto a formal statutory footing in 2013. The FPC is a Sub-Committee of the Bank of England's Court of Directors. The interim FPC contributes to maintaining financial stability by identifying, monitoring and publicising risks to the stability of the financial system and advising action to reduce and mitigate them. The statutory FPC will assume these functions. The FPC's statutory objectives will be to exercise its functions with a view to (a) contributing to the achievement by the Bank of the Financial Stability Objective, and (b) subject to that, supporting the economic policy of the UK Government, including their objectives for growth and employment. The statutory FPC will have the power to give directions to the Financial Conduct Authority or the Prudential Regulation Authority with respect to the implementation of macroprudential measures. The FPC will be entitled to make recommendations within the Bank, to HM Treasury, to the Financial Conduct Authority and the Prudential Regulation Authority, or to other persons.

FSA	<p>The Financial Services Authority is the single regulator for financial services in the UK. It is responsible for both microprudential supervision and the regulation of conduct of business. In 2013 the responsibility for the prudential supervision of banks, insurers and some investment firms will be formally transferred to the Prudential Regulation Authority. The Financial Conduct Authority will become responsible for conduct of business regulation. The FSA has already changed its operational structure to facilitate the evolution from one unitary regulator to the new ‘twin peaks’ approach.</p>
FSB	<p>The Financial Stability Board was established in April 2009 by the Leaders of the G20 countries as the successor to the Financial Stability Forum. The FSB brings together national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. It coordinates at the international level the work of national financial authorities and international standard-setting bodies. It also develops and promotes the implementation of regulatory, supervisory and other financial sector policies.</p> <p>The FSB’s <i>Key Attributes of Effective Resolution Regimes for Financial Institutions</i> (2011) sets out the core elements that the FSB considers to be necessary for an effective resolution regime. The EU will meet G20 commitments to put in place an effective resolution regime through the adoption of the Recovery and Resolution Directive.</p>
FSOC	<p>The US Financial Stability Oversight Council, established under the Dodd-Frank Wall Street Reform and Consumer Protection Act, is charged with identifying risks to the financial stability of the United States, promoting market discipline, and responding to emerging risks to the stability of the US financial system. The FSOC is a collaborative body chaired by the Secretary of the US Treasury that brings together the expertise of the federal financial regulators, an independent insurance expert appointed by the President, and state regulators. One of the key functions of the FSOC is to designate systemically important non-bank financial firms and financial market utilities for supervision by the Federal Reserve under enhanced prudential standards.</p>
OCC	<p>The Office of the Comptroller of the Currency is an independent office within the US Treasury Department. Its function is to charter, regulate and examine all national banks. The OCC performs regular reviews of national banks to ensure compliance with federal statutes and regulations. All national banks chartered by the OCC are also required to be members of the Federal Reserve and are subject to Federal Reserve oversight. The old Office of Thrift Supervision has become part of the OCC. The OCC also has responsibilities for federal branches of foreign banks.</p>
PRA	<p>The Prudential Regulation Authority, a subsidiary of the Bank of England, will become the UK’s prudential regulator for banks, insurers, Lloyd’s underwriters and arrangers, and designated</p>

	investment firms in 2013. The PRA itself will have the power to designate certain firms with permission to “deal in investments as principal” for prudential supervision by the PRA. The PRA’s general objective is to promote the safety and soundness of PRA-authorised persons. The PRA’s insurance objective is to contribute to the securing of an appropriate degree of protection for those who are or may become policyholders.
SRU	The Special Resolution Unit of the Bank of England plans for and implements resolutions of failing UK banks and building societies under the Special Resolution Regime established by the Banking Act 2009. The SRU works with the FSA on formulating policy for Recovery and Resolution Plans, which all UK deposit-takers are required to have in place. The Government plans to extend the Special Resolution Regime to systemic investment firms, parent undertakings of systemic investment firms and deposit-taking institutions, and central counterparties. Consideration is also being given to the position of other financial infrastructures and insurers.
TFEU	Treaty on the Functioning of the European Union. At the European Council meeting in June 2007, European leaders agreed to adopt a “reform treaty” for the European Union. The Lisbon Treaty, signed on 17 December 2007, entered into force on 1 December 2009. It comprises the Treaty on European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU). Its provisions are incorporated in the existing treaties. <sup>209</sup>

<sup>209</sup> Official website of the European Union, Glossary:

[http://europa.eu/legislation\\_summaries/glossary/treaties\\_en.htm](http://europa.eu/legislation_summaries/glossary/treaties_en.htm)