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MEMO

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Towards a banking union

At the European Council of 28/29 June, EU leaders agreed to deepen economic and monetary union as one of the remedies of the current crisis. At that meeting, the leaders discussed the report entitled 'Towards a Genuine Economic and Monetary Union'¹, prepared by the President of the European Council in close collaboration with the President of the European Commission, the Chair of the Eurogroup and the President of the European Central Bank. This report set out the main building blocks towards deeper economic and monetary integration, including banking union.

On 12 September, the Commission will present proposals to design a single banking supervision mechanism in the euro area, further strengthening its response to the current crisis. This proposal will not change rule-making for the single market of 27 countries, but change the way in which banks in the Euro area will be supervised; hence it will fully preserve the integrity of the single market. A single supervision mechanism, built around the European Central Bank (ECB), will be a major step forward. It will send a strong political signal of credibility to our partners and to global investors. It will show once again the irreversibility of the euro.

The remaining building blocks for a genuine Economic a Monetary Union will include not only the remaining pillars of the Banking Union (single rule book for financial institutions in the single market, strengthening deposit guarantee schemes, and establishing national resolution funds and legislation), but also an integrated budgetary framework (Fiscal Union), an integrated economic policy framework (Economic Union) and a strengthened democratic dimension (Political Union).

1. What do we want to achieve with banking union?

1.1 What is the banking union that we wish to implement?

When the financial crisis spread to Europe in 2008, we had 27 different banking regulatory systems in place, all based on national rules and national rescue measures. Some form of European coordination existed but it was related to exchanges of information and rather informal cooperation procedures.

This was not sufficient to respond to the financial sector crisis and its contagion to sovereigns. A fully-fledged banking union will be key to supporting economic and monetary integration. Pooled monetary responsibilities have indeed spurred closer economic and financial integration, and increased the possibility of cross-border effects in the event of bank crises.

¹ http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131201.pdf

Common and more integrated banking supervision for the Euro area is one important pillar to make sure that supervision abides by the highest standards. This will build the necessary trust between Member States which is a condition for using common backstops, notably the direct recapitalization by the ESM of banks. Once common supervision for the Euro area is in place, the Commission's intention is to build on existing proposals for deposit guarantee schemes and bank recovery and resolution, moving towards a more integrated approach also in these areas.

1.2 Why do we want to achieve this banking union?

- **To break the link between Member States and their banks:** Between October 2008 and October 2011, European countries have mobilised €4.5 trillion in public support and guarantees to their banks. This is not acceptable. With its proposal on capital requirements for banks ("CRD IV") made in July last year, the Commission wants to ensure that the capital of banking institutions is sufficient both in quantity and in quality to face future shocks. The future European Stability Mechanism (ESM) could have the possibility to recapitalise banks directly once a single supervisory mechanism is established for banks in the euro area. This will contribute to breaking the vicious circle between banks and sovereigns as the ESM loans would not add to the debt burden of countries facing intense market pressure.
- **To restore the credibility of the financial sector:** The proposals already tabled by the European Commission to improve regulation of the financial system represent a solid basis to go further in the harmonisation of our rules, which will be made easier in the framework of a banking union. The European single supervisory system for banks will enable a fully rigorous and independent supervision of our banking sector. Giving to the ECB the ultimate responsibility for supervision of banks in the euro area will contribute to increasing confidence between the banks and in this way increase financial stability in the euro area.
- **To preserve tax payers' money:** In early June, we proposed EU rules for bank recovery and resolution. To make sure that supervisory authorities have all the tools they need to deal with bank failures without taxpayers' money. This also aims to protect taxpayers' money and deposits.
To make sure that banks serve society and the real economy: With our financial regulation agenda, we are improving financial markets' effectiveness, integrity and transparency in order to make sure that the funds available finance the economy.

2. EU banking union: what have we done so far?

For each of the four pillars of the banking union (i.e. single rulebook; supervision; deposit guarantees; and bank resolution), the Commission has already taken action providing a solid basis for developing them further.

2.1 Measures to allow for more integrated banking supervision

Three European supervisory authorities (ESAs) started work on 1 January 2011 to provide a supervisory framework:

- the **European Banking Authority** (EBA) which deals with banking supervision, including the supervision of the recapitalisation of banks, as well as the coordination and dispute settlement of national supervisors
- the **European Securities and Markets Authority** (ESMA) which deals with the supervision of capital markets; and
- the **European Insurance and Occupational Pensions Authority** (EIOPA), which deals with insurance supervision.

The 27 national supervisors are represented in all three supervisory authorities. Their role is to contribute to the development of a single rulebook for financial regulation in Europe, solve cross-border problems, prevent the build-up of risks, and help restore confidence. Individual ESAs have specific roles: for example ESMA is the EU supervisor of credit rating agencies, while EBA and EIOPA carry out "stress tests" of their respective sectors. EBA has also overseen the current recapitalisation exercise of EU banks. ESMA can ban products that threaten the stability of the overall financial system in emergency situations.

In addition, the European Systemic Risk Board (ESRB) has been tasked with the macro-prudential oversight of the financial system within the Union.

This new financial supervision framework has been in place since November 2010.

EBA has quickly established its credibility as a new body, delivering within the constraints of the rules agreed by the Council and the European Parliament, which are centred on an approach of EBA coordinating national supervisors. EBA will remain a key player of the banking union. For more information on the 2010 financial supervision package, see [MEMO/10/434](#).

On 12 September, the Commission will present a regulation establishing an ambitious single supervision mechanism for banks in the Euro area. The Commission expects these proposals to be adopted by the end of the year, in order for the new system to enter into force early in 2013, as a key component of a banking union.

This proposal will address the key questions of the concrete functioning of the new supervisory role for the ECB; the relationship between national supervisors and the ECB; defining the relationship between euro area countries and those not participating in the euro. In addition, the Commission will present an amending regulation clarifying the role and governance of the European Banking Authority in this context.

2.2 Towards a single rule book for the banking sector

The European Council of June 2009 unanimously recommended establishing a single rulebook applicable to all the financial institutions in the single market.

With its proposal on capital requirements for banks ("CRD IV") made in July last year (see [IP/11/915](#) and [MEMO/11/527](#)), the Commission launched the process of implementing for the European Union the new global standards on bank capital agreed at G20 level (most commonly known as the Basel III agreement). It is recalled that banking institutions entered the crisis with capital that was insufficient both in quantity and in quality, leading to unprecedented support from national authorities.

Europe is playing a leading role on this matter, applying these rules to more than 8,000 banks, representing 53% of global assets. The Commission proposals are currently being discussed by the Council and the European Parliament and the Commission is determined that an agreement be reached shortly.

With this legislation the Commission also wants to set up a governance framework giving bank supervisors new powers to monitor banks more closely and take action through possible sanctions when they spot risks, for example to reduce credit when it looks like it is growing into a bubble. European supervisors would intervene in some cases, for example when national supervisors disagree in cross-border situations.

Further, the completion of the financial regulation agenda forms integral part of the banking union. In this vein, it is recalled that the Commission is also working:

- to examine reform of the structure of the banking sector through the work of the high-level expert group headed by Erkki Liikanen (see [MEMO/12/129](#));
- to regulate shadow banking (see [IP/12/253](#));
- to make credit ratings more reliable (see [IP/11/1355](#));
- to tighten rules on hedge funds (see [IP/09/669](#)), short selling (see [IP/10/1126](#)) and derivatives (see [IP/10/1125](#) – regulation in force since 16 August 2012);
- to revise current rules on trade in financial instruments (see [IP/11/1219](#)), market abuse (see [IP/11/1217](#) and [IP/12/846](#)) and investment funds (see [IP/10/869](#));
- to curb banking pay practices that encourage recklessness (see [IP/09/1120](#));
- to reform the audit (see [IP/11/1480](#)) and accounting (see [IP/11/1238](#)) sectors.

2.3 Action taken to offer more protection to bank depositors

Thanks to EU legislation, bank deposits in any Member State are already guaranteed up to €100,000 per depositor if a bank fails. From a financial stability perspective, this guarantee prevents depositors from making panic withdrawals from their banks, thereby preventing severe economic consequences.

In July 2010, the Commission proposed to go further, with a harmonisation and simplification of protected deposits, faster pay-outs and improved financing of schemes, notably through ex-ante funding of deposit guarantee schemes and a mandatory mutual borrowing facility between the national schemes. The idea behind this is that if a national deposit guarantee scheme finds itself depleted, it can borrow from another national fund. This would be the first step towards a pan-EU deposit guarantee scheme. This proposal is still being discussed by the Council and Parliament in second reading. The Commission calls upon the legislators to speed up the process of co-decision on this proposal, retaining the mutual borrowing facility, and agree by the end of 2012.

In managing a number of bank crises over recent years, national authorities have often created a new structure out of the failing bank and transferred some critical functions of the bank to this structure, such as safeguarding deposits. These resolution mechanisms make sure that depositors never lose access to their savings (for example in the case of Northern Rock, the bank was split into a good bank, which contained the deposits and good mortgage loans, and a so-called "bad bank" winding down the impaired loans).

For more information on the Commission's proposal for a European system of deposit guarantee schemes, see [IP/10/918](#).

2.4 Action taken towards a single European recovery and resolution framework

The Commission's proposal on recovery and resolution tools for banks in crisis, adopted on 6 June (see [IP/12/570](#) and [MEMO/12/416](#)), is the last in a series of proposed measures to strengthen Europe's banking sector and avoid the spillover effects of any future financial crisis with negative effects for depositors and taxpayers.

To ensure that the private sector pays its fair share in any future bailouts, the EU has proposed a common framework of rules and powers to help EU countries intervene to manage banks in difficulty. Repeated bailouts of banks have created a situation of deep unfairness, increased public debt and imposed a heavier burden on taxpayers.

A common EU-wide framework for the managed resolution of banks and financial institutions would offer tools to prevent crises from emerging in the first place and address them early on if they do. The proposal also foresees the mechanisms that national authorities need to put in place to resolve banks in an orderly fashion if need be, with a "bail-in" mechanism from 2018 onwards to call on shareholders and creditors when attributing losses of failed banks. The proposal also foresees the creation of national resolution funds paid for by national banks in order to cope with the few cases where bail-in would not offer sufficient resources to pay for restructuring and closing down of banks.

The ultimate aim of the proposal is to make sure that the financial sector pays for its own failings, rather than having to call on taxpayers' money. If a national resolution fund would not have sufficient resources to pay for a restructuring, the proposal asks Member States to investigate the option of an extra levy on its banking sector, before calling on the option to borrow from national resolution funds of other EU Member States.

3. Banking union and bank recapitalisation

The EU has already taken action as regards the recapitalisation of banks in several ways.

For instance, extensive financial sector conditionality has been included in the policy requirements addressed to Member States that have received international financial assistance.

With respect to the banking sector, the required policy measures consist, on the one hand, of the orderly winding-down of non-viable institutions and, on the other hand, of the restructuring of viable banks. Higher capital requirements, recapitalisations of banks, stress tests, deleveraging targets as well as enhancing the regulatory and supervisory frameworks have also been part of the policy initiatives. While not specific to programme countries, these stabilisation measures are most easily implemented in the context of international financial assistance.

The European Financial Stability Facility (EFSF) can provide loans to non-programme euro area Member States for the specific purpose of recapitalising financial institutions, with the appropriate conditionality, institution-specific as well as horizontal, including structural reform of the domestic financial sector.

At the euro area summit on 29 June 2012, it was proposed that once an effective supervisory mechanism involving the ECB was established for banks in the euro area, the future European Stability Mechanism (ESM) could, following a regular decision, have the possibility to recapitalise banks directly.

The ESM will have a lending capacity of €500 billion. For euro area Member States not subject to a programme, the ESM will have the possibility of providing a loan for the specific purpose of re-capitalising financial institutions. The granting of such financial assistance is subject to a positive decision of the Board of Governors of the ESM, i.e. the finance ministers of the euro area Member States. The conditionality attached to financial assistance shall be detailed in a Memorandum of Understanding and will include institution-specific as well as horizontal conditionality. Recapitalisations can also be conducted by a loan accompanied by a fully-fledged macroeconomic adjustment programme. Modalities regarding direct recapitalisation of banks by the ESM will be specified later on but will also be subject to strict conditionality.

Specific bank restructuring under these programmes and instruments goes hand-in-hand with the conditionality of EU state aid rules.

For more information on EU control on state aid to banks and on the crisis regime for state-aid, see previous issue of this memo [MEMO/12/478](#).