



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

<p>June 2012: Publication of the Recovery and Resolution Directive proposals.</p> <p>June 2012: Publication of the Van Rompuy report <i>Towards a Genuine Economic and Monetary Union</i>.</p> <p>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”.</p> <p>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>.</p> <p>September 2012: Publication of the Van Rompuy <i>Issues Paper on Completing the Economic and Monetary Union</i>.</p> <p>October 2012: Publication of the Van Rompuy <i>Towards a Genuine Economic and Monetary Union: Interim Report</i>.</p> <p>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.</p> <p>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.</p> <p>December 2012: Publication of the Van Rompuy <i>Towards a Genuine Economic and Monetary Union: Final Report</i>.</p> <p>December 2012: Meeting of the European Council.</p> <p>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.</p> <p>Date to be confirmed: Possibility of the ESM engaging in direct recapitalisation of euro area banks.</p>
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### 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/cpbs/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.

















































































