

## Banking Union: A federal model for the European Union with prompt corrective action

Jacopo Carmassi, Carmine Di Noia and Stefano Micossi

No. 282, 18 September 2012

The European Commission has published its proposals for the transfer of supervisory responsibilities to the European Central Bank (ECB),<sup>1</sup> under Article 127(6) of the TFEU, providing a comprehensive and courageous ‘first step’ towards a European banking Union, the other steps being European deposit insurance and resolution procedures. However, on a number of issues the Commission’s chosen path raises questions that should be brought out in the open and fully recognized before final deliberation by the Council.

### Contents of banking union

In a highly integrated financial system, such as in the European Union, taming moral hazard and excessive risk-taking requires a consistent set of regulatory incentives, based not only on common rules but also on integrated supranational powers in banking supervision, deposit insurance and crisis management, including resolution. The three functions are intimately interconnected, and only their joint management can eradicate the expectation of national bail-outs from the system and thus establish proper incentives against reckless risk-taking by banks in the internal market.<sup>2</sup> The Commission proposal covers bank

---

<sup>1</sup> Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, COM(2012) 511 final, Brussels, 12.9.2012; Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards its interaction with Council Regulation (EU) No.../... conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, COM(2012) 512 final, Brussels, 12.9.2012; and Communication from the Commission to the European Parliament and the Council, A Roadmap towards a Banking Union, COM(2012) 510 final, Brussels, 12.9.2012.

---

<sup>2</sup> Schoenmaker & Gros (2012) stress that a system with centralized supervision at the ECB but national deposit insurance and resolution arrangements would not be ‘incentive compatible’ and therefore would not work: instead, they argue that a centralization of all three functions is necessary to establish a well-functioning banking union. Their proposal on institutional arrangements entails the creation of a European Deposit Insurance and Resolution Authority (EDIRA), different from the ECB; our scheme, as will be discussed, is slightly different in that it places the ECB at the heart of the system for the exercise of all powers at EU level (while placing elsewhere the management of attendant insurance and resolution funds).

Jacopo Carmassi is an economist at Assonime, the Association of Joint Stock Companies incorporated in Italy. Carmine Di Noia is Deputy Director General and Head of Capital Markets and Listed Companies at Assonime. Stefano Micossi is Director General of Assonime, Visiting Professor at the College of Europe in Bruges, Member of the Board of Directors of CEPS and Chairman of the Board of CIR Group.

CEPS Policy Briefs present concise, policy-oriented analyses of topical issues in European affairs, with the aim of interjecting the views of CEPS researchers and associates into the policy-making process in a timely fashion. Unless otherwise indicated, the views expressed are attributable only to the author in a personal capacity and not to any institution with which he is associated.

Available for free downloading from the CEPS website (<http://www.ceps.eu>) • © CEPS 2012

supervision and part of crisis management but – by necessity, in view of the scope of the legal basis provided by Article 127(6) – not deposit insurance and resolution.

On this, the Four Presidents’ Road Map<sup>3</sup> (henceforth the Road Map) speaks of “single European banking supervision and a common deposit insurance and resolution framework” (see p. 4), potentially opening the way to a different legal regime for the two latter domains. Under previous Commission proposals for the harmonization of deposit insurance (as under their proposal of July 2010)<sup>4</sup> and resolution (following their recent proposal of June 2012)<sup>5</sup>, these domains would be governed by harmonized rules but the administration of the systems would remain basically national (Carmassi et al. 2012). However, in its Communication on the banking union, the Commission has announced its intention to propose to establish “a single resolution mechanism which would govern the resolution of banks and coordinate in particular the application of resolution tools to banks within the banking union” (p. 9).

As to **deposit insurance**, the first paramount requirement is that deposit insurance should only protect depositors and never be used to cover bank losses and shield bank managers, shareholders and creditors. Furthermore, deposit insurance must be centralized to provide not only equal incentives to bank shareholders and managers with *ex-ante* funding and risk-based fees throughout the internal market, but also full risk pooling and an adequately funded insurance fund across the banking system at EU level, so as to be able to cushion large shocks affecting one of the largest cross-border banks.

The legal basis of the rules on deposit insurance, including the creation of a European deposit insurance fund and attendant fees, would remain that of Article 114 TFEU, and therefore be decided by ordinary legislative procedure. The accumulation and pooling of funds would only start within the new system, and thus not affect accumulated insurance funds, in line with transitional arrangements proposed by Gros & Schoenmaker (2012).

There is a question of where to place the **administration of the insurance fund**. In our view, a separate section of the European Stability Mechanism (ESM) could well perform this purely financial function, while all the supervisory actions relating to risk assessment and other controls of insured entities should be brought under the ECB supervisory powers. As indicated in the Road Map, the ESM will also act as ‘fiscal back-up’ to the insurance fund, but this should be only in the case of a crisis affecting the entire banking system, and never to cover losses stemming from individual bank insolvency.

As to **crisis management powers**, they must be attributed to the EU level in order to establish a credible threat that bank shareholders and managers will be fully liable for the consequences of imprudent behaviour and will under no circumstances be bailed out by national authorities with taxpayers’ money, so as to fully eradicate from the system all possibility for supervisory forbearance at national level. However, as we shall argue, while this requires strong common resolution rules, it does not require all resolution powers to be moved to the EU level.

An important matter to be decided here is where to place **the borderline between supervisory corrective action and resolution proper**. On this, the Commission proposal (Article 4.1k) includes, amongst supervisory powers to be transferred to the ECB, early intervention “including recovery plans and intra-group financial support arrangements”, with the proviso that these powers will be exercised “in cooperation with the relevant resolution authorities”. It would be preferable in this regard, however, to be more explicit and bring under the supervisory umbrella of the ECB all crisis-management measures that do not involve winding up the banks: therefore including the power to order the suspension of dividends, recapitalization, management changes, asset disposal and bank restructuring, up to the creation

<sup>3</sup> European Council (2012), “Towards a genuine monetary and economic union”, Report by the Presidents of the European Council, the European Commission, the Eurogroup and the European Central Bank, Brussels, 26 June.

<sup>4</sup> Proposal for a Directive of the European Parliament and of the Council on Deposit Guarantee Schemes [recast], COM(2010)368 final, Brussels, 12.7.2010.

<sup>5</sup> Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010, COM(2012) 280/3, Brussels.

of a 'bad' bank. If it was clarified that these powers belong to the exercise of supervision, then the need for the ECB to coordinate with national resolution authorities would vanish. With these powers in the hand of the ECB – as they are under the US FDIC system and in some EU member states – deterrence would be sufficiently strong and supervisory forbearance at national level would be precluded.

Were this to be the chosen approach, **resolution** would become a residual function that, under common rules preventing national authorities from making good on the losses incurred by shareholders and creditors, may well be performed by national authorities of the parent company according to national rules. This would have the advantage of removing from the discussion questions of harmonization, let alone centralization, of bankruptcy rules.<sup>6</sup>

This approach does not eliminate the need for a European **banking resolution fund**. Rather than covering losses emerging from liquidation, its task should be to provide capital, in case of need, to the 'good bank' carved out by (European) supervisors to preserve deposits, sound commercial loans and other assets, and worthy systemic functions relating to the payment infrastructure (Carmassi et al., 2010). This approach was notably shared by a 2010 Commission Communication on resolution funds<sup>7</sup> and therefore should be readily acceptable to the Commission. In view of its limited scope, such a fund would not have to be very large; its resources could be raised by means of a small surcharge over the deposit insurance fee and be managed by the ESM together with the deposit insurance fund.<sup>8</sup>

As will be discussed below, the centralization of administrative powers does not require that they be always exercised at the central level for all banks

and in all circumstances; indeed, a **'federal' organization** in the exercise of these powers seems desirable and even necessary. What is important, however, is that the legal powers of supervisory decisions firmly reside at the supranational level, in this closely following the legal set-up of competition policy.

Finally, in order to ensure democratic accountability, the ECB "shall be accountable to the European Parliament and the Council" (Article 17 of the Commission proposal) and will submit each year a report to the European Parliament, the Council and the Eurogroup on the execution of its supervisory tasks. This solution seems adequate, mirroring as it does the provisions already applied for monetary policy.

### The scope of application of the regulation

The Commission has taken the view – apparently shared by the ECB and most participants in the debate on banking union – whereby the decision to centralize supervisory powers at the ECB would in the main apply to eurozone members, while non-euro participants could join the common supervisory mechanism under a 'close cooperation' arrangement entailing reduced membership rights (e.g. representation in the Supervisory Board of Article 19 and the possibility of unilateral termination of the cooperation arrangement by the ECB under Article 6). This approach is not required by the Treaty and entails a risk of segmentation of the internal market in banking and financial services, as non-eurozone members of the Union could become lesser participants in the common supervisory mechanisms, to the extent that over time the ECB came to develop more stringent supervisory standards not accepted by non-euro countries.

In this regard, it should be noted that **Article 127(6) is not restricted to the eurozone** and may therefore apply to all Union members – as made explicit by the transitional provisions of Article 139(2c) which mentions other provisions of Article 127 that do not apply to member states 'in derogation' (i.e. not using the euro), but not its paragraph 6. A similar provision is present in Protocol 15 (point 4) regarding the application of Article 127(6) to the United Kingdom and Northern Ireland. A further specific confirmation is provided by Council Regulation n. 1096/2010 of 17 November 2010 "conferring specific tasks upon the ECB concerning the functioning of the European Systemic Risk

<sup>6</sup> It must also be stressed that, were the resolution authority to be supranational, the creation of this new authority could not fall under Article 127(6) and would have to rely on a different legal basis, and attendant powers could not be entrusted to the ECB.

<sup>7</sup> Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank, Bank Resolution Funds, COM(2010) 254 final, 26.5.2010, Brussels, p. 3.

<sup>8</sup> In order for the ESM to play the role we have envisaged on deposit insurance and resolution, its treaty should be amended so as to allow it to perform these functions also for banks of non-euro countries.

Board”, which used Article 127(6) as the legal basis for appointing the ECB President and Vice-President to the ESRB Board and charging the ECB with the specific tasks of setting up and funding the secretariat of the ESRB, which is a body comprising the full membership of the Union and not solely eurozone members.

There is little doubt, more in general, that under the Treaty the ECB is a Union institution, while the restriction of its monetary functions only to certain member states is a ‘temporary’ situation permitted under a derogation from Treaty obligations. In this regard, one may recall that the Road Map had called for “an integrated financial framework ... cover[ing] all EU member states, whilst allowing for specific differentiations between euro and non-euro area member states” (p. 4).

Indeed, one sees no reason why the new common rules on supervision should not apply to the entire Union membership, keeping into account that most arguments requiring banking union are valid independently of whether the country uses the euro – the main exception being those relating to the proper functioning of the monetary policy transmission mechanism.

Should some countries decide not to participate and threaten to exercise their veto power to block the decision, then it would perhaps be preferable to offer them an opt-out rather than to exclude from the start from banking union all member states not participating in the euro.

### The institutional set-up

Three questions must be examined here: i) the separation of monetary and micro-supervisory functions within the ECB, ii) the relationship between the ECB and EBA in the performance of supervisory tasks and iii) the relationship to be established with existing national supervisory structures. As to the first issue, the ECB is at present responsible for carrying the monetary policy functions, defined by Article 127(2) of TFEU, and in addition, its President chairs the European Systemic Risk Board,<sup>9</sup> which is responsible for macro-prudential stability and for which the ECB also provides a secretariat. This supervisory function in reality is little more than a return to the traditional scope of monetary policy in caring for

aggregate financial stability, a role that had been somewhat overshadowed by the sole emphasis placed on price stability in the definition of monetary policy goals.

Micro-supervision, the subject of the Commission’s proposal, is an entirely different matter since concern for individual banks’ safety and soundness may at times come into conflict with monetary policy goals (Goodhart & Schoenmaker 1995). The obvious example is when a central bank presiding over an undercapitalized and generally weak banking system may be reluctant to tighten monetary policy for fear of pushing some of the banks under its supervision over the brink. Thus, the **effective separation within the ECB** of the new micro-supervisory powers from macro-monetary policy-making is of paramount importance in order to preserve the integrity of both functions.

In this regard, the Commission proposal does not go far enough, in that the new function is set up as an internal function of the ECB, exercised with delegated powers from the Governing Council of the ECB and under its “oversight and responsibility” (Article 19.3 of the Commission proposal). Under such a set-up, separation seems hardly guaranteed and there is a high risk of contamination between the two functions.

An alternative to be considered is the creation within the ECB of a separate and independent Governing Council responsible for bank supervision, mimicking the structure of the ECB Governing Council, and therefore comprising an Executive Board (of nine members) and the heads of national supervisory structures. The Executive Board would include six members appointed by the EU Council following the same procedure as for the ECB Executive Board, and in addition the Vice-President of the ECB, the chairs of EBA and ESM – which is the common fund in charge of financial assistance to the member states and, in our scheme, the management of deposit insurance and resolution funds. In this manner, there would be an institutionalized connection, but no subordination, within the ECB, of the monetary policy and bank supervision functions. The Commission could attend the meetings of the Governing Council as observer, as in the Commission proposal. The ECB Vice-President would chair the Executive Board of the new supervisor and would report to the Governing Council of the ECB – thus ensuring full and effective mutual flow of information – and the EU Council and Parliament on the execution of

<sup>9</sup> Significantly, the ESRB also has a Vice-Chair from a non-eurozone country.

supervisory tasks.<sup>10</sup> But the Governing Council responsible for supervision would not receive instructions from the Governing Council handling monetary policy.

As envisaged by the Commission Communication – but perhaps not fully yet reflected in legislative texts – the EBA would remain in charge of ensuring not only a single rule book, but also uniform supervisory practices (the ‘hand book’). This latter task will be of paramount importance for preserving the integrity of the internal market even with reference to jurisdictions that were to opt out of centralization of supervisory powers with the ECB. In any event, once it is accepted that the new supervisory arrangements apply in principle to the whole Union, **full and effective coordination with EBA** would be better guaranteed by the presence of its chairman as a full voting member in the Executive Board of the ECB Supervisory Board; in this manner, the EBA would partake in overseeing and enforcing the uniform application of common banking rules.

The third aspect that must be modified in the Commission proposal concerns **the relationship between the Union and the national supervisory structures**. Under the Commission proposal, the ECB would acquire “exclusive competences” in carrying out the tasks listed in Article 4.1, and build up a new administrative structure for its fully centralized exercise. Quite differently, the Road Map had envisaged the creation of “a single supervision system with a European and a national level. The European level would have ultimate responsibility ... and would be given supervisory authority and pre-emptive intervention powers applicable to all banks. Its direct involvement would vary depending on the size and nature of banks.”

An alternative institutional set-up to the Commission proposal, and one more in tune with the Road Map, is offered by the **network model for the enforcement of EU anti-trust law** (Articles 101 and 102 TFEU) contained in Council Regulation 1/2003. Under that model, the centralized enforcer (the Commission) and national authorities have parallel competence to apply EU rules in individual cases; the allocation of cases is governed by

guidelines set out by the EU level; information on individual proceedings flows systematically within the network of competition authorities; and the European authority may advocate any case in order to ensure the consistent operation of the system. The beauty of this system is that cases are almost automatically handled at the right level, thereby avoiding any unnecessary centralization of powers or duplication of structures, in full accordance with the principle of subsidiarity.

There would be two great benefits in adopting such a ‘network’ model for supervision. First, national supervisory structures would be fully incorporated into the new supranational system, thus allowing full exploitation of their expertise and knowledge of national banking structures. Second, the need for fresh human and financial resources to manage the new supervisory tasks of the Union would be minimized, and the national and Union levels would work in a strictly complementary manner.

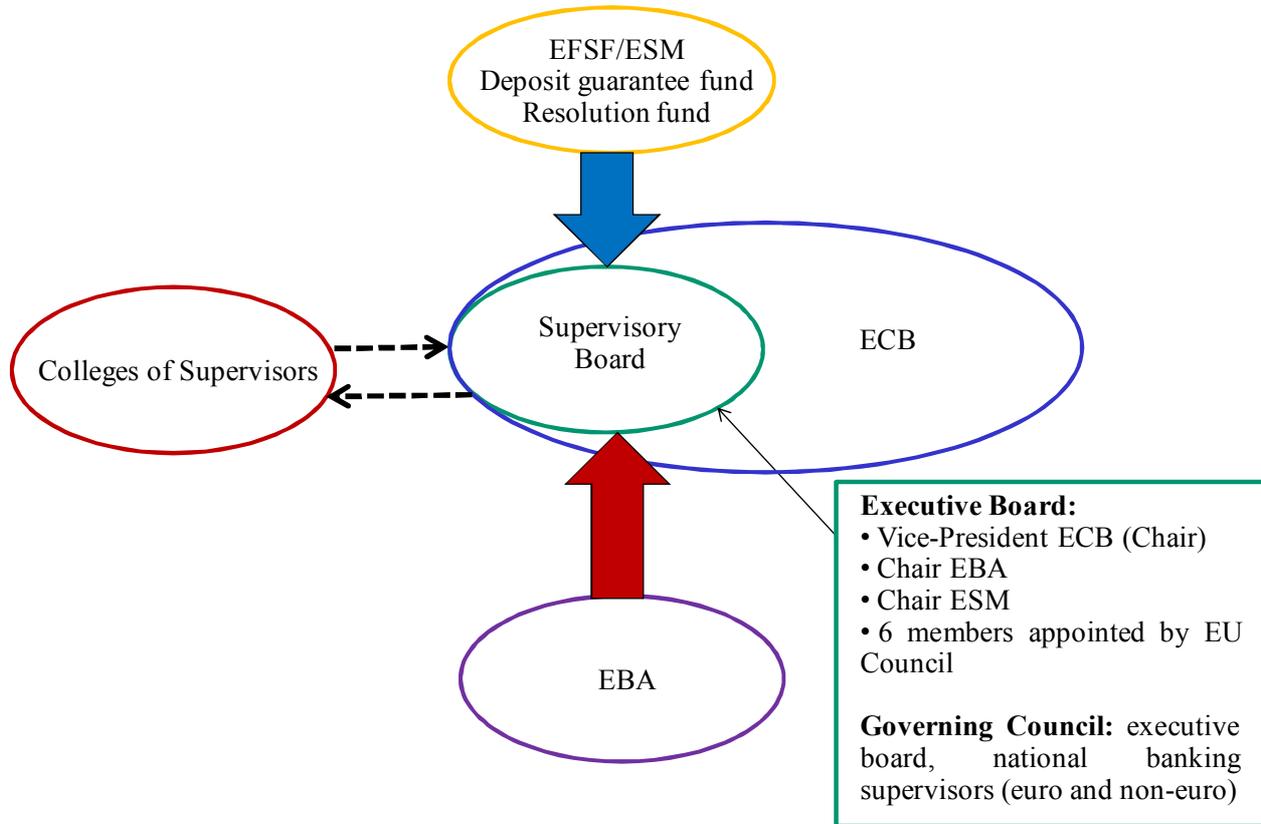
A point that deserves specific consideration in this context concerns the role of **Colleges of Supervisors** of cross-border banking groups. These would be supervised on a consolidated basis, as already envisaged in the Commission proposal (Article 4.1i). In the Commission proposal, these bodies would disappear for banks concentrating their activities solely in the eurozone, but would remain to manage home and host relations between euro and non-euro jurisdictions. In our approach, the Colleges would survive in all cases and become an executive arm of the ECB for all cross-border Union banks.

Despite some improvements, for the time being these bodies are weak instruments in the hands of the parent company national supervisors and provide for limited exchange of information between the home- and host-country supervisors of the group. The establishment of Union supervision offers the opportunity to turn them into effective supranational supervisory structures, acting under instructions by the ECB, with full powers to control and inspect all branches and subsidiaries of cross-border banking groups – thus getting rid of the current artificial task allocation between home- and host-country control while at the same time making full use of existing supervisory structures. The Colleges would deliver their supervisory reports, including any proposal for remedial action, to the ECB Supervisory Board, which would deliberate on the report’s conclusions and recommendations, and entrust the Colleges for their implementation.

<sup>10</sup> The choice of the ECB Vice-President would facilitate the splitting, within the ECB, of responsibility and communication for monetary policy and supervision, in line with Lannoo (2012, p. 4).

The institutional set-up that has been proposed is diagrammed in the figure below.

*The institutional architecture of the European banking union*



## Supervisory approach

The financial crisis highlighted, among many regulator failures, a widespread tendency by national regulators and supervisors to side with their troubled banks in hiding information from the public, delaying loss recognition and postponing corrective action, thus magnifying eventual losses (Calomiris & Herring 2011, Carmassi & Micossi 2012). When the crisis struck, it has not been unusual for national regulators to cover losses in opaque manners to protect not only creditors but also shareholders and management. Transferring supervisory powers to the Union level should go most of the way in removing supervisory forbearance from the system; however, the system would be strengthened further by the adoption of Prompt Corrective Action as under the US Federal Deposit Insurance Corporation (FDIC) system, which entails stronger incentives for supervisors to act in the general interest of depositors and investors and to eschew capture by regulated entities.<sup>11</sup>

<sup>11</sup> Benston & Kaufman (1997).

Two features of the system are worth stressing. The first one is reliance on public indicators of bank capital weakness to signal the need for corrective action, based on a set of preannounced thresholds corresponding to remedial actions of increasing intensity. The second is an obligation for supervisors to act when the thresholds are crossed: in other words, supervisory action is mandatory.<sup>12</sup>

Adoption of such a system was discussed by the Basel Committee on Banking Supervision but never agreed upon, not surprisingly with constant opposition by national supervisors in European countries who wanted free hands in managing banking crises. Now that the failures of the system have been exposed, including rampant forbearance by national supervisors, the time should be ripe to move to a US-type system.

Thus, there should be a system of capital thresholds requiring supervisors to act with

<sup>12</sup> More precisely, some actions are mandatory and others are left to the discretion of supervisors; see Table 10 in Eisenbeis & Kaufman (2007).

remedial measures of increasing intensity as the specific thresholds are trespassed; however, the precise application of instruments within each 'capital zone' should involve some discretion by supervisors, who would have to motivate their decisions. Or, more flexibly, the system could entail a presumption, rather than a rigid obligation, to act and apply measures appropriate to each capital zone, with full public accountability of the specific choices made.

As for the capital indicators, the FDIC has referred to a combination of risk-weighted and unweighted capital ratios. However, overwhelming new evidence has shown that risk-weighted capital ratios are not reliable indicators of weakening capital and risk positions of banks requiring enhanced supervisory action. Straight (unweighted) leverage ratios, on the other hand, seem to provide consistent forecasts of emerging trouble sufficiently in advance for supervisors to intervene in a timely fashion (Haldane, 2012). One additional finding by this literature is that in building these ratios, and attendant capital thresholds triggering supervisory action, reference should be made to the evolution of the market value of equity relative to book value (see also Calomiris & Herring 2011). Of course, building a reliable system of thresholds will require extensive empirical work to properly calibrate relevant capital indicators and capital zones; this is a work that the ECB and EBA may well undertake after the decision is made to move to the new system of prompt corrective action.

### In conclusion

The European Commission has prepared a courageous and comprehensive proposal for the centralization within the ECB of supervisory powers, in the context of a banking union that will also comprise deposit insurance and resolution. The proposal would be greatly strengthened by enlarging its scope of application to the entire Union, rather than an undetermined eurozone-plus Union membership. EBA should remain in charge of all secondary rule-making in the domain of banking, including supervisory standards, and to this end its chair should be included in the new supervision Executive Board. Finally, supervisory standards should be broadened to include all crisis management powers under a prompt corrective action system à-la-FDIC. Our blueprint for the governance of banking union under this approach is depicted in our figure.

### References

- Benston, G.J. and G.G. Kaufman (1997), "FDICIA after five years: A review and evaluation", Working Paper 97-01, Federal Reserve Bank of Chicago, Chicago, IL.
- Calomiris, C. and R.J. Herring (2011), "Why and How to Design a Contingent Convertible Debt Requirement", Working Paper No. 11-41, Wharton Financial Institutions Center, Philadelphia, PA, April.
- Carmassi, J., C. Di Noia and S. Micossi (2012), "Banking Union in the Eurozone and the European Union", CEPS Commentary, CEPS, Brussels, June.
- Carmassi, J, E. Luchetti and S. Micossi (2010), *Overcoming too-big-to-fail: A Regulatory Framework to Limit Moral Hazard and Free Riding in the Financial Sector*, CEPS Paperback, CEPS, Brussels, March.
- Carmassi, J. and S. Micossi (2012), *Time to Set Banking Regulation Right*, CEPS Paperback, CEPS, Brussels, March.
- Eisenbeis, R. and G. Kaufman (2007), "Cross-Border Banking: Challenges for Deposit Insurance and Financial Stability in the European Union", Working Paper Federal Reserve Bank of Atlanta, Atlanta, GA, January.
- Goodhart, C. and D. Schoenmaker (1995), "Should the Functions of Monetary Policy and Banking Supervision Be Separated?", *Oxford Economic Papers*, 47, pp. 539-560.
- Gros, D. and D. Schoenmaker (2012), "European Deposit Insurance: Financing the transition", CEPS Commentary, CEPS, Brussels, 6 September.
- Haldane, A.G. (2012), "The dog and the frisbee", paper presented at the Federal Reserve Bank of Kansas City's 36th Economic Policy Symposium, "The Changing Policy Landscape", Jackson Hole, WY, 31 August.
- Lannoo, K. (2012), "The Roadmap to Banking Union: A call for consistency", CEPS Commentary, CEPS, Brussels, 30 August.
- Schoenmaker, D. and D. Gros (2012), "A European Deposit Insurance and Resolution Fund - An Update", CEPS Policy Brief No. 283, CEPS, Brussels, 11 September.



## ABOUT CEPS

Founded in Brussels in 1983, the Centre for European Policy Studies (CEPS) is widely recognised as the most experienced and authoritative think tank operating in the European Union today. CEPS acts as a leading forum for debate on EU affairs, distinguished by its strong in-house research capacity, complemented by an extensive network of partner institutes throughout the world.

### Goals

- Carry out state-of-the-art policy research leading to innovative solutions to the challenges facing Europe today,
- Maintain the highest standards of academic excellence and unqualified independence
- Act as a forum for discussion among all stakeholders in the European policy process, and
- Provide a regular flow of authoritative publications offering policy analysis and recommendations,

### Assets

- Multidisciplinary, multinational & multicultural research team of knowledgeable analysts,
- Participation in several research networks, comprising other highly reputable research institutes from throughout Europe, to complement and consolidate CEPS' research expertise and to extend its outreach,
- An extensive membership base of some 132 Corporate Members and 118 Institutional Members, which provide expertise and practical experience and act as a sounding board for the feasibility of CEPS policy proposals.

## Programme Structure

### **In-house Research Programmes**

Economic and Social Welfare Policies  
Financial Institutions and Markets  
Energy and Climate Change  
EU Foreign, Security and Neighbourhood Policy  
Justice and Home Affairs  
Politics and Institutions  
Regulatory Affairs  
Agricultural and Rural Policy

### **Independent Research Institutes managed by CEPS**

European Capital Markets Institute (ECMI)  
European Credit Research Institute (ECRI)

### **Research Networks organised by CEPS**

European Climate Platform (ECP)  
European Network for Better Regulation (ENBR)  
European Network of Economic Policy  
Research Institutes (ENEPRI)  
European Policy Institutes Network (EPIN)