BANKING UNION

Thomas F. Huertas (*)

(*) Thomas F. Huertas is a partner in the financial services risk practice at Ernst & Young LLP and was formerly Alternate Chair of the European Banking Authority and Member, Executive Committee at the UK Financial Services Authority.
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Banking union is the cornerstone of a broader policy framework[1] that aims to break the link between sovereigns and banks, so that:

— neither the euro nor Member States are at risk from banks; and

— banks are not at risk from sovereigns.

If successful, banking union will also deepen integration within the Euro zone in what is arguably the key sector of the economy. This should promote both stability and growth.

What will it take for banking union to be successful? That depends above all on whether the new regime is rigorous or lax. Over the long term, only a rigorous approach will work. But that requires an appropriate institutional framework. Starting with supervision runs the risk that banking union will remain partial. Indeed, if banking union stops at supervision, that will make things worse, not better.[2] The Single Supervisory Mechanism (SSM) should be integrated with the framework for provision of liquidity from the central bank and broadened out – as the Council and Commission have proposed – to include reform of resolution regimes and deposit guarantee schemes.

1 Banking union

Banking union consists of five elements:

— Regulation.

— Supervision.

— Provision of liquidity from the central bank.

— Resolution.

— Deposit guarantee schemes.

Banking union will be an exercise in 'variable geometry'. Although regulation will continue to apply at the EU level, full banking union will only apply within the Euro zone. Member States outside the Euro zone will not be required to join the SSM (but may 'opt-in' via so-called close cooperation agreements). Banking union will effectively be embedded within the single market and measures will be taken to assure that banking union is consistent with the single market.

Even though the European Council (2013) has set a tight timeframe for its enactment into legislation and implementation into practice, banking union will remain a 'work in progress' for some time. Not only will the SSM require extensive preparation, but legislative action will be required to reform both resolution regimes and deposit guarantee schemes in the

1 As Hermann van Rompuy (2012) President of the European Council noted banking union is part of a much broader programme to create a 'genuine' economic and monetary union. This programme includes measures to coordinate fiscal and economic policy as well as measures to create banking union. See European Council (2012).

2 As Elliott (2012, p. 14) comments, "practically all policy analysts argue that there are serious problems and dangers in designing bank supervision before knowing how resolution and guarantees will work." See also Huertas and Nieto (2012), IMF (2013, p. 4) and Wyplosz (2012, p. 12).

EU. The ECB is already working with national supervisory authorities (NSAs) to establish the SSM, so that it can become operational as scheduled in March 2014. The Council has set June 2013 as a target for agreement on the Bank Recovery and Resolution (BRR) Directive as well as for agreement on the Deposit Guarantee Scheme (DGS) Directive – after allowing time for transposition into national legislation, these measures to harmonise national approaches to resolution and deposit guarantees would also become effective in 2014. Finally, the Council has endorsed the Commission's intent to introduce by the summer of 2013 a Single Resolution Mechanism (SRM) for countries participating in the SRM. It may therefore be two or more years before the Euro zone has a fully operational SSM and SRM and quite a bit longer before the Euro zone has a single deposit guarantee scheme. This extended transition may pose significant risks.

2 Regulation remains at EU level

Regulation sets the rules to which banks must adhere and the framework within which supervisors conduct supervision. This will – possibly with one very important exception – remain at EU level. Legislation approved by the Council and Parliament would continue to set the overall foundation for regulation. The European Banking Authority (EBA) would fill in the details through the development of binding technical standards.[3]

However, the introduction of banking union within the Euro zone requires an adjustment in the voting procedures at the EBA. Under banking union it is envisaged that the ECB would 'coordinate and express' the views of the Member States within the banking union [EC (2012c)]. This effectively grants the ECB a veto over any decision that the EBA might wish to take: the EBA cannot enact any measures without the concurrence of the seventeen Euro zone Member States that will – via the coordination that the ECB will provide – vote as a bloc. To assure that the ECB could not simply impose its views on the EBA, approval of binding technical standards will require a 'double majority' of Member States within the banking union and of Member States outside the banking union.[4]

The exception to keeping regulation at the EU level is likely to be the regulation of bank structure. Although the Liikanen (2012) report recommended measures to ring fence trading activities be taken at EU level, the Commission has not as yet introduced legislation. That has created scope for individual Member States to go their own way. The UK has elected to put the ring fence around retail and commercial banking [HMT (2013)], whilst France and Germany have each elected to introduce variants of Liikanen. Even if the Commission does introduce legislation, it may be difficult to override national legislation, especially if banks have already taken significant steps toward implementation. So single market will have a single regulator (the EBA) but it may not have a single structure.

3 The Single Supervisory Mechanism is the core of banking union

Under the Single Supervisory Mechanism (SSM) the European Central Bank (ECB) will together with the national supervisory authorities constitute a single supervisory system responsible for supervision of all banks in the Euro zone [Constâncio (2013)]. As the European Council (2012) decision states:

> The SSM will be composed of the ECB and national competent authorities. The ECB will be responsible for the overall functioning of the SSM. Under the proposals, the ECB will have direct oversight of Euro zone banks, although in a differentiated way and in close cooperation with national supervisory authorities.

3 Such standards require the concurrence of the Commission (and are actually issued by the Commission) and are subject to review by the European Parliament.

4 This provision will remain in effect as long as there are at least four Member States outside the Single Supervisory Mechanism.

The ECB will take 'direct' responsibility for the supervision of all banks headquartered in a Euro zone Member State that have a certain size (assets in excess of €30 billion or above 20% of the Member State's GDP). Banks below this threshold will remain the supervisory responsibility of the Member State in which the bank is headquartered. Based on this division of labour, the ECB will directly supervise all (approximately 140) systemically important Euro zone banks, accounting for approximately 80% of the aggregate assets of the Euro zone banking system. NSAs will supervise the remaining banks. But all supervision will be done in accordance with policies and procedures set by the ECB and the ECB "can decide to transfer to direct supervision any bank or group of banks that may be considered relevant or the origin of systemic risk" [Constâncio (2013)].

In taking up these new responsibilities, the ECB will, together with national supervisors and the Member States themselves, have to resolve a number of practical issues. These include (i) organisational issues, (ii) any entry conditions on banks that the ECB will impose, and, most importantly (iii) the approach that the ECB will take to supervision: will it be rigorous or lax?

3.1 ORGANISATIONAL ISSUES

The main organisational issues concern how to govern the relationship of the SSM to (a) the national supervisory authorities, (b) the Governing Council of the ECB and (c) Member States who elect to "opt-in" to the SSM by concluding close cooperation agreements.

The SSM will not replace national supervisory authorities (NSAs). NSAs will continue to exist and will retain responsibility for consumer protection, payment systems and citizens' access to bank accounts and services and other aspects of conduct supervision as well as for the supervision of smaller institutions not subject to the SSM. The question is what role, if any, the NSAs should continue to play with respect to the supervision of institutions that will be 'directly' supervised by the ECB.

Although the ECB can execute many supervisory tasks (e.g. peer analysis) centrally, and although the ECB can centrally set the methods that supervisors should follow, much of the interaction with banks will – if supervision is to be fully effective – have to take place locally, where the banks are headquartered, rather than centrally from the headquarters of the ECB in Frankfurt. That would require the ECB to build up a local presence throughout the Euro zone, either directly (e.g. via transfer of supervisory staff from the NSAs to the ECB) or indirectly via building multinational supervision teams and/or concluding cooperation or agency agreements with NSAs. Under such a cooperation or agency agreement, the ECB would give direction to the NSA and take final supervisory decisions with respect to the bank(s) concerned, possibly (but not exclusively) upon the recommendation of the NSA. Although the former direct approach is likely to be more effective over time, the latter agency approach may be more feasible both from a timing perspective (given the tight timetable for implementation of the SSM) as well as from a political perspective (the cooperation or agency approach preserves a greater role for the NSAs. This may be relevant, given that the adoption of the SSM requires unanimous approval from the Member States.)[5]

However, the cooperation or agency approach carries risks, particularly if the NSAs retain either implicitly or explicitly (a) the power of initiation (the NSAs indicate the issues the ECB should consider), (b) the right of recommendation (the ECB can only take decisions

5 Note that the preservation of existing roles is not the only way to accord ongoing influence to the NSAs. It would also be possible to assign individual NSAs with the lead responsibility for certain functional areas and/or certain types of risk (e.g. the NSA in one Member State would become the centre of expertise for the SSM with respect to operational risk; a second NSA for credit risk, etc.).

on recommendations from a NSA[6]) and/or the right to participate in any supervisory decision that the ECB may make (e.g. via subjecting such decisions to a vote by the proposed Supervisory Board of the ECB). The more power the NSAs retain, the less direct the supervision of the ECB will be and the greater will be the risk that the ECB is captured by the NSAs (and by extension policymakers in Member States as well as the banks themselves).

Much will depend on how policy-makers are able to reconcile two different precepts, namely, (i) the need to separate the conduct of supervision from the conduct of monetary policy and (ii) the provisions of the Treaty that prohibit the Governing Council of the ECB from delegating to anyone else its responsibility to take decisions for the ECB (ultimately, therefore, the Governing Council has responsibility for both supervision and monetary policy). To assure that supervision is 'independent,' it is proposed that the ECB set up a supervisory board consisting of representatives from national NSAs and from the ECB[7] to take supervisory decisions subject to ratification by the Governing Council. However, discussion continues as to whether the Chair of such a supervisory board or a Member of the Governing Council should take executive responsibility for the SSM.

That decision will help determine whether member States outside the Euro zone elect to conclude cooperation agreements with the ECB to 'opt-in' to the SSM. For a number of Member States outside the Euro zone, the domestic banking system is dominated by subsidiaries or branches of banks headquartered in a Euro zone Member State.[8] As a result, financial stability in such a non-Euro zone Member State can be heavily influenced by supervision of the parent enterprises in the home (Euro zone) Member State. Opting-in to the SSM therefore presents such non-Euro zone Member States with the opportunity to influence the stance that the supervisor of the parent bank may take – provided such Member States have a vote in the SSM supervisory board and provided this board, rather than the Governing Council, exercises the executive authority within the SSM. If real power rests with the Governing Council (on which non-Euro zone Member States cannot vote), it is unlikely (even though the SSM may provide 'better' supervision) that non-Euro zone Member States will elect to opt in to the SSM.

3.2 ENTRY CONDITIONS

A second practical consideration concerns the condition of the banks for which the SSM assumes supervisory responsibility. Should the transfer of authority occur on an "as-is" basis, or should banks be required to undergo an "entrance exam" to demonstrate that they are in good condition before the ECB assumes responsibility?[9] The answer depends on how banks that failed such an entrance exam would be treated. Would they be recapitalised, and, if so, by whom, national authorities or the ESM (see comments on resolution, below).

3.3 THE ECB'S APPROACH TO SUPERVISION

Finally, and most importantly, the ECB must decide upon the approach that it will take to supervision. Will the SSM merely be a scaled–up version of the current national approach,

6 This is an unlikely outcome as it would effectively amount to co-determination or sharing of authority between the ECB and the NSA.
7 The ECB representatives on the supervisory board would not be involved in monetary policy decisions.
8 To a lesser extent, there are also Euro zone Member States (e.g. Estonia, Finland) whose systemically important banks are headquartered in a Member State outside the Euro zone. These Euro zone Member States also have a strong interest in cooperation with the 'headquarters' Member States.
9 Constâncio (2013) notes that the launch of the SSM "will be associated with a comprehensive review of participating banks' balance sheets. The objective of this review is to identify legacy problems and start with a system that avoids reputational risks for the SSM down the line. This process may have financial implications if impaired assets have to be written down".

or will the European approach be rigorous enough to break the link between banks and sovereigns?[10]

The answers to a few simple questions should indicate the direction the SSM will take. How will the SSM ask banks under its supervision to treat Euro zone government bonds? Will it continue to allow banks to hold such bonds in the banking book, to hold such bonds at historic cost, to accord such bonds a zero risk weight and to exempt such bonds from large exposure limits? Or will the SSM require banks to hold such bonds in the trading book (so that they are marked to market and subject to capital requirements for interest rate risk)? If the SSM allows banks to continue to hold Euro-government bonds in the banking book, will it force banks to value such bonds at the lower of cost or market and/or set limits on the amount of such bonds from a single issuer that a bank may hold?[11]

To break the link between banks and sovereigns, limits must be set on the amount of bonds from a single issuer that a bank may hold. With such a limit, the default or rescheduling of a sovereign's debt need not necessarily bring down immediately the banks incorporated in that jurisdiction. Without such a limit the tendency of banks to amass vast quantities of bonds issued by the sovereign of the jurisdiction in which they are incorporated could continue unabated. The link between banks and sovereigns would remain intact.

A second litmus test for the SSM is: how proactive will the ECB be as a prudential supervisor? Will it judge the effectiveness of banks' business models, assess the ability of management to execute its selected strategy, take a forward look at the risks that banks assume and act to intervene when one or more of these areas pose a significant threat to the soundness of the bank and the safety of deposits? Or will the ECB be reactive, as many NSAs have been, or even prone to forbearance?

Much will depend on whether the Euro zone creates a robust resolution regime to which the ECB can hand over a bank that fails to meet threshold conditions. If such a regime is created (see section on resolution below), the ECB can be a much more proactive supervisor, as sending a bank into resolution becomes a credible threat. This in turn will incentivise investors to monitor and control management more closely and induce banks' management to weigh risks more carefully.

4 Monetary policy, macro-prudential supervision and the provision of liquidity to the banking system and economy at large

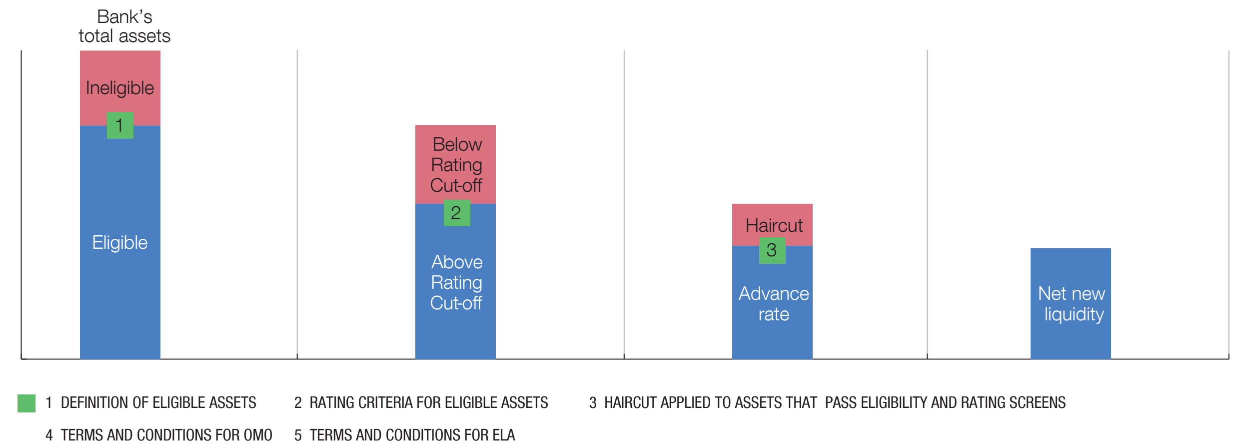
Formally, there will be a degree of separation between supervisory decisions regarding individual institutions and decisions concerning monetary policy (see organisational issues above).

However, the ECB implements monetary policy largely through lending to banks on a collateralised basis via an auction process [ECB (2011)]. Setting the policy rate is but one component of monetary policy. The terms on which the ECB extends credit to the banking system matter as well, for they affect the transmission mechanism by which banks and other financial intermediaries convey the central bank's policy impulses to the real economy.

10 The EBA may also have a role to play here, since it is charged with the development of a single supervisory handbook for the EU as a whole.

11 A rigorous ECB would be more aggressive than national supervisors in forcing banks to take provisions against real estate lending. And, a rigorous ECB would also be stricter than national supervisors in limiting the forbearance that banks provide to SMEs and other borrowers. In addition, the ECB could potentially consider using Pillar 2 to implement CRD IV in a manner that is fully consistent with Basel III rather than deficient [Basel Committee on Banking Supervision (2012)] to the internationally agreed standard.

CENTRAL BANK LIQUIDITY: ECB HAS MULTIPLE LEVERS TO PULL **CHART 1**
Can these be the basis for macro-prudential supervision?



SOURCE: Author´s elaboration.

Essentially, these terms constitute a set of policy levers that the central bank can pull to promote financial stability, exercise macro-prudential supervision and conduct monetary policy. At various stages in the crisis the ECB and/or the national central banks have pulled each of these levers. Banking union should set the stage for bringing these levers into a more consistent and comprehensive framework for macro-prudential supervision that takes the transmission mechanism more explicitly into account.[12]

The ECB has five principal levers at its disposal (see chart 1):

1 *It can define what assets are eligible for inclusion as collateral with respect to ordinary liquidity operations.* During the crisis the ECB broadened the definition of eligible collateral. This eased credit conditions.

2 *It can limit eligible assets to those that also meet a minimum credit standard.* During the crisis, the ECB has lowered the minimum credit rating that eligible assets must have in order to serve as collateral for open market operations. This also eased credit conditions.

3 *It can set the haircut or advance rate on the actual assets presented for discount at the central bank.* Reducing the haircut (or increasing the advance rate) eases credit conditions.

4 *It can set the terms and conditions for open market operations.* During the crisis the ECB has at various times adjusted the terms on which it meets the bids of banks for funds. It has allowed unlimited borrowing (subject only to provision of qualified collateral), extended the term for which banks could borrow to as long as three years and allowed banks to pre-pay outstanding credit without penalty.

5 *It can set the terms and conditions for emergency liquidity assistance* (CELA). Central banking doctrine holds that ELA should only be provided on the basis of sound collateral to institutions that are viable (solvent) but temporarily illiquid. Currently, the national central banks are the entities that evaluate the collateral banks provide in connection with ELA. National central banks also make the viability determination and national central banks

12 Central banks' macro-economic models generally do not take the transmission mechanism explicitly into account, a defect that may have contributed to the severity of the financial crisis [Huertas (2011), pp. 103-114, 196-197]. See also Pereira (2013).

extend ELA for their own account, subject to approval of the quantity of the credit (but not the quality) from the ECB. Any losses incurred as a result of extending ELA are the responsibility of the national central bank and ultimately, the Member State concerned.

Logically, this allocation of responsibilities should change under banking union. The ECB should assume direct responsibility for the provision of ELA, at least for the institutions for which it exercises direct supervisory responsibility. This would unify decision-making with respect to putting a bank into resolution. Not only would the ECB make the supervisory decision regarding whether or not the bank is meeting threshold conditions, but it would also make the determination as to whether and when the bank's access to liquidity should be cut off. That should limit the possibility of forbearance; particularly if there is a robust resolution regime into which the ECB can put a failed bank (see below).

Decisions on these five variables have important implications for the overall conditions that banks face and the decisions that banks make with respect to credit contraction or expansion. That has certainly been true during the crisis. It would now be beneficial for the ECB to incorporate these elements more formally into a macro-prudential tool kit. That will promote financial stability and increase the effectiveness of monetary policy.

5 Resolution

The failure to link supervision to a credible resolution regime would force the Euro zone at large and the ECB in particular to choose among three unappealing outcomes:

1 Disruption of financial markets and the economy at large (if the ECB were to put a bank into resolution). This could result, if national resolution regimes could not – possibly due to a lack of coordination – resolve a bank in a manner that assured continuity of critical economic functions without taxpayer support.

2 Imposition of significant cost on the European taxpayer. This could result, if a decision were made that the ESM should simply recapitalise failing banks without reform of the resolution regime. That would create very large actual and contingent liabilities for Euro zone taxpayers.

3 Forbearance. Reluctance to countenance either of the first two results dictates that the authorities exercise forbearance. They refrain from putting into resolution banks that fail to meet threshold conditions and provide emergency liquidity assistance to keep them in operation. Under current arrangements this raises the exposure of national central banks and ultimately Member States to the failing bank, strengthening the link between sovereigns and the bank and increasing either the disruption to markets or the cost to the ESM if the bank is ultimately put into resolution.

To remedy this situation, the authorities must reform resolution. The proposed Bank Recovery and Resolution (BRR) Directive makes a start in line with the recommendations of the Financial Stability Board (2011) with respect to key attributes for resolution regimes. When implemented, the BRR would harmonise resolution tools across all EU Member States. This would over time assure that

— Each Member State has the same resolution tools for banks and a designated resolution authority empowered to take rapid decisions with respect to how a bank should be resolved. This is an essential precondition, if resolution is to achieve the objective of assuring continuity of critical economic functions.

— Such resolution tools allow the resolution authority to bail-in various bank liabilities so as to assure that investors and creditors of the bank bear loss before taxpayers. This provides a statutory basis for bail-in that banks can and should complement with contractual provisions.

— Such resolution authorities cooperate with one another. The Directive envisions the formation of bank-specific resolution groups consisting of the resolution authorities of each Member State in which the banking institution has a presence. This group would take a collective decision with respect to the resolution of a banking enterprise headquartered in an EU Member State. However, it is extremely unlikely that such a resolution group could reach an agreement within the time frame required to implement the resolution of a systemically important financial institution while limiting total losses to taxpayers.

For Member States in the banking union, it makes sense to go a step further and create a single resolution mechanism (SRM) that would pick up where the SSM leaves off. This is exactly what the European authorities propose to do [Van Rompuy (2012)]. The SRM would effectively take the hand-off from the SSM as and when the ECB took the decision to put a bank under its supervision into resolution.

To administer the SRM the Commission proposes to create a European Resolution Authority (ERA) that would implement a single resolution process across the Euro zone Member States. This will streamline if not fully centralise the operation of resolution groups (in that the ERA will act for all Member States in the banking union), but some further adjustment may be required to assure that the ERA can effect resolution within the very tight (generally no longer than 48 hours) timeframe required in order to assure continuity of critical banking services.

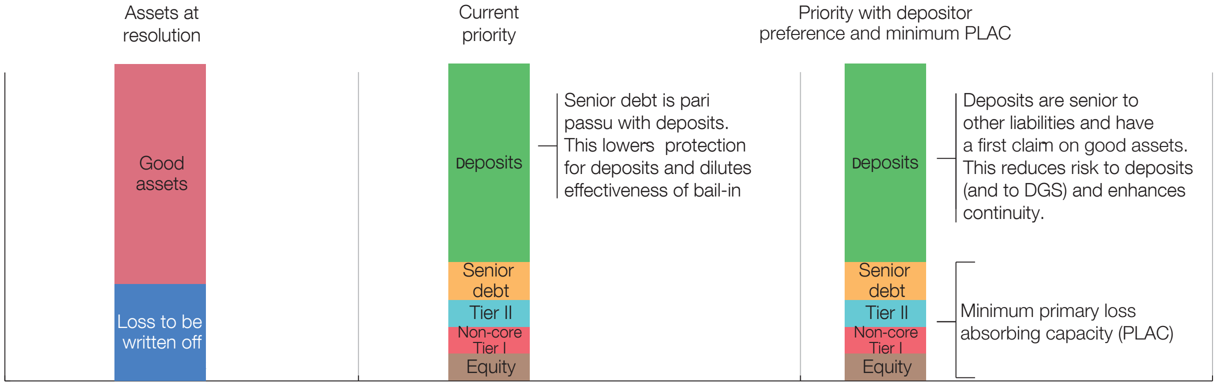
Perhaps the key question is the risk to which depositors should be exposed – particularly after the agreement of the Euro zone finance ministers [Eurogroup (2013)] to bail-in uninsured deposits at two large banks in Cyprus. Deposits are the quintessential customer obligation, allowing the depositor to make and receive payments and providing the customer with liquidity. Access to deposits is one of the critical economic functions whose continuity resolution procedures should seek to assure.

The current priority ranking of deposits does not promote this result (see chart 2). At present deposits rank pari passu with senior debt. Although losses will go through a so-called waterfall, with equity taking first loss, then non-core Tier I capital and then Tier II capital, the waterfall stops when it comes to the next level. If losses exceed the total of the bank's outstanding capital instruments (equity, non-core Tier I capital, Tier II capital), this excess loss should be shared pro rata among the senior unsecured creditors of the bank, i.e. the depositors and the holders of the bank's senior debt.

In contrast, if deposits have preference, the waterfall contains an additional level. If losses exceed the total of the bank's capital instruments (equity, non-core Tier I and Tier II capital), loss is then allocated to the holders of the bank's senior debt before any loss is attributed to the bank's deposits. Depositor preference lowers the risk of deposits (and the risk to the deposit guarantee scheme), particularly if there is also a requirement that the bank maintain outstanding a minimum amount of primary loss absorbing capacity (equity, non-core Tier I capital, Tier II capital and senior debt subject to bail-in). However, the proposed bank recovery and resolution (BRR) Directive leaves the priority of deposits unchanged and fails to require banks to issue a minimum amount of bail-in-able debt.

RESOLUTION: THE IMPORTANCE OF DEPOSITOR PREFERENCE

CHART 2



SOURCE: Author´s elaboration.

Accordingly, the ECB may wish to consider introducing a supervisory requirement that banks under its direct supervision maintain a minimum amount of primary loss absorbing capacity. This would lower the risk of deposits and reduce risk to the deposit guarantee funds, even if depositor preference is not formally introduced. To the extent that a bank elected to meet this requirement with senior debt, such debt should be subject to bail-in (as both a statutory and contractual matter) and subordinated to deposits.

Attention also needs to be paid to arrangements for the resolution process. This starts with the decision to pull the trigger. Will this require a formal decision of the entire supervisory board, or will such a decision be taken by a smaller executive group? How will the supervisory decision to withdraw authorisation be coordinated with the decision of the ECB with respect to refusing or discontinuing ELA? Measures will have to be taken to assure rapid decision-making and maintenance of confidentiality.

The resolution process also needs attention. What role will the ESM play, once the SSM comes into operation, and how might this change if the European Resolution Authority (ERA) is created?

As outlined above, the ESM should be available to directly capitalise banks once the SSM comes into operation. Until the point where the SSM commences operation, the ESM will continue to provide funds to the Member State seeking restructuring assistance (which may in turn utilise some or all of those funds to recapitalise failing banks). To effect the transition from the old ESM regime (lending to Member States only) to the new (direct recapitalisation of banks as a permissible use of ESM funds), it is proposed that banks undergo an ‘entrance exam’ to identify any legacy losses. These would be the responsibility of Member States under current resolution approaches, and any recapitalisation required would come from investors or from Member States, not the ESM. This was the approach adopted in the case of Cyprus, and the presumption is that a similar approach would be followed in other Member States, should resolution of failing banks be required as part of an overall restructuring programme.

Upon commencement of the SSM, the ESM would be able to recapitalise banks directly. But the terms and conditions on which it would do so remain open to debate. Does tapping the ESM to recapitalise a failing bank require the Member State in which the bank is headquartered to agree to a more general restructuring and monitoring programme? In other words, does recourse to the ESM carry conditionality for the Member State seeking assistance? Secondly, where would the ESM stand in the queue of capital providers to the failing bank? First in line, or last, only after investors have been bailed in? Would ‘investors’ include uninsured depositors?

Under a rigorous regime, there should be no presumption that the ESM would simply replenish the capital of any bank that fails to meet threshold conditions. Recourse to the ESM should be a last resort, only after investors (but not necessarily uninsured depositors) have been fully bailed in, and the terms on which the ESM injects new money (if at all) should be 'last-in, first out' basis with the same type of conditions that a private equity investor would insist upon. As a new investor the ESM should primarily be responsible for assuring that the bank has sufficient funds for a fresh start, not for bearing losses arising from the failed bank's past mistakes. Such losses should belong to investors, not taxpayers. To assure that this would be the case, the ESM should have a strong interest in the supervisor's taking prompt corrective action. If the bank goes into resolution as soon as it fails to meet threshold conditions, this will minimise losses to investors as well as to the ESM (as an investor of last resort).

Finally, consideration needs to be given to how a European Resolution Authority would improve the resolution process. It should certainly streamline decision making, but this may require changes to the BRR, particularly with respect to resolution groups. It may also receive authorisation to build up a resolution fund to bear any losses that it may incur in connection with resolving failed banks. If so, this fund should be tapped before there is any recourse to the ESM.

Such a resolution fund should also in my view be distinct from any fund that may be built to back the promises of the deposit guarantee scheme. The resolution regime should make clear for which losses such a resolution fund might be responsible. These losses might include compensation to investors whom the resolution regime made worse off than they would have fared under liquidation, but such 'losses' should not necessarily include a provision to recapitalise failed banks, unless this were done as an "investor of last resort" on the last-in, first out private equity terms outlined above.

6 Deposit guarantee schemes

The final question is whether banking union requires a single deposit guarantee scheme, over and above the improvements to national schemes that the enactment of the Deposit Guarantee Schemes (DGS) Directive [EC (2010)] would bring about. The European Council (2013) thinks not. Although the Council endorsed the Commission's intent to introduce a Single Resolution Mechanism (SRM) and a European Resolution Authority, it refrained from calling for a single deposit guarantee scheme at this time.

Is this correct? On the surface, a single European deposit guarantee scheme would assure the man or woman in the street that a euro in a bank deposit in one banking union Member State is just as good as a euro in a bank deposit in another banking union Member State. With such a guarantee there would be no reason to withdraw one's funds from a bank in a Member State whose sovereign was experiencing difficulties in raising debt in private capital markets.

But could such a guarantee be plausibly given? If commercial risk were the only risk facing the deposit guarantee scheme, a single deposit guarantee scheme would be feasible. The commercial risk to the DGS is the risk that the DGS will suffer a loss as a result of a bank's being placed into resolution. The way to address commercial risk is to give deposits preference and require banks to keep outstanding a minimum amount of primary loss absorbing capacity. That will facilitate bail-in and lower the risk to deposits (and to the DGS).[13]

13 It would also facilitate resolution and lower the size of any deposit guarantee fund that might be required. And, if banks subject to the European DGS were exempt from contributions to national deposit guarantee funds, smaller banks would in all likelihood over time seek to become supervised directly by the ECB and become members of the larger European DGS.

But banks also face sovereign risk – the risk that the sovereign will default, the risk that the sovereign will impose one-off levies on deposits [as the Eurogroup (2013) proposed Cyprus do] and the risk that the sovereign will decide to re-denominate its currency (although under the terms of the Treaty, it would have to leave the EU in order to do so). This sovereign risk aggravates the commercial risk – indeed, borrowing costs for firms and households continue to be correlated with the borrowing cost of the sovereign, as are funding costs for banks. A weak sovereign generally means a weak economy, poorer bank asset quality and lower bank income.

Although geographic diversification can help mitigate sovereign risk, it cannot eliminate this risk entirely. In particular, banks (and therefore the single deposit guarantee scheme) would remain exposed to the risk that the sovereign could impose one-off levies on deposits and/or the sovereign could re-denominate the currency (even if this meant leaving the EU).

This poses significant moral hazard issues. If the single deposit guarantee scheme were to cover such risks, the European guarantee would effectively offset much of the economic cost that the levy or re-denomination could cause and thereby make it more likely that a sovereign would adopt such a course of action. That would raise the risk to the single European deposit guarantee scheme, require a larger fund to be accumulated and pose greater contingent risk to whatever backstop the Member States established to assure that the single deposit guarantee scheme could fulfil its obligations. So a single deposit guarantee scheme must very likely await full political union – a state of affairs that is a long way off and may never occur.

Does that mean that banking union must await full political union? No. Banking union requires a single resolution mechanism to complement the single supervisory mechanism, but it does not require a single deposit guarantee scheme. Strengthening the national schemes – as the DGS Directive proposes to do – should be adequate, particularly if deposits are given preference and banks are required to issue a minimum amount of bail-in-able instruments subordinated to deposits.

7 Conclusion

In sum, if banking union is done well, it is very much worth doing. It can break the "bank-sovereign loop," promote financial stability and foster economic growth. But for banking union to be done well, the ECB must in fact as well as in name exercise direct supervision over Euro zone banks. Furthermore, the ECB must be rigorous not lax. That requires national supervisory authorities to cede real authority to the ECB. It also requires that the creation of an effective single resolution mechanism so that banks become 'safe to fail', so that a European Resolution Authority can resolve a failed bank without cost to the European taxpayer and without disruption to the financial system or the economy at large. In short, the SSM is the right first step, but the journey shouldn't stop there. The SRM needs to follow in short order.

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