The December 2012 agreement on EU bank supervision is a good first step towards an effective banking union.

Blog Admin

In December 2012 European finance ministers reached an agreement that will create a single European system of bank supervision, with the European Central Bank in charge of directly overseeing some of Europe's largest banks. **Jacopo Carmassi**, **Carmine Di Noia** *and* **Stefano Micossi** *welcome the agreement as a good first step towards a European banking union and discuss a number of critical issues on which the ECOFIN compromise has significantly improved the European Commission proposal.*

In a highly integrated financial system, such as in the EU, taming moral hazard and excessive risk taking requires a banking union built on three pillars: a European system of banking supervision, European deposit insurance and a European system of crisis management and resolution. The three functions are intimately interconnected, and only their joint management can eradicate the expectation of national bailouts from the system and thus establish proper incentives against reckless risk-taking by banks in the internal market.

In September 2012, the European Commission tabled its proposal for the creation of a single EU system of bank supervision, on which the European Parliament and the Council fruitfully worked in the ensuing months, leading finally to a positive compromise within the ECOFIN Council on December 2012. Under the agreement, a Single Supervisory Mechanism (SSM) will be set up comprising the European Central Bank (ECB) and the national bank supervisors. The SSM will acquire full competences for banking supervision for eurozone member states and other Union members willing to join, including: bank authorisation; setting up of extra capital and liquidity requirements; evaluation of bank corporate governance and internal controls; performance of stress tests; consolidated supervision; early intervention. The agreement does not cover deposit insurance and crisis resolution but the European Council has asked the co-legislators to come to a swift agreement on the Commission harmonisation proposals on these matters (published in July 2010 and June 2012), already under consideration before the European Parliament and Council, and to present, immediately after, a fresh proposal for the creation of a European system for bank resolution.

The agreement on banking supervision

The agreement on banking supervision provides a solid first step towards banking union. A number of critical issues had emerged with regard to the September 2012 EU Commission proposal, notably concerning the scope of application of the SSM (euro and non-euro EU countries), the relationship between the ECB and national supervisory structures, and the risk of contamination between monetary policy and bank supervision. On all scores, the ECOFIN compromise has achieved satisfactory solutions.

European Central Bank Credit: Jim Woodward (Creative Commons BY)

First, the SSM will involve all eurozone members, but non-euro EU member states may join the mechanism on a voluntary basis under a 'close cooperation' arrangement and, if they did, they would have full voting rights in the new ECB Supervisory Board. Non-euro member states will retain the possibility to terminate the arrangement in case of disagreement with specific supervisory decisions, notably when these decisions are taken by the ECB Governing Council as a modification of the Supervisory Board proposal.

This is a pragmatic solution implemented as a matter of internal ECB organisation, but it cannot eliminate completely the different treatment of euro and non-euro member states. It should be recalled that Article 127(6) of TFEU is not restricted to the eurozone and may therefore apply to all EU members. However, Article 42(1) of the ECB Statute states that ECB decisions are not legally binding for non-euro member states of the Union. This legal obstacle could only be fully overcome by amending the ECB Statute – which would have required Treaty change, albeit with the simplified revision procedure of Article 48(6) of TEU. This possibility may have to be taken into consideration again at a later stage.

A second crucial aspect that has been effectively handled by the ECOFIN compromise concerns the scope of powers of the SSM and the allocation of supervisory tasks between the Union level and the national level. The new supervisory system will apply to all banks, but with different responsibilities for the direct exercise of supervisory powers on the basis of systemic relevance of banks. The ECB will dispose of direct oversight powers for the most significant banks (e.g. with total assets exceeding € 30 billion or 20 per cent of domestic GDP) and those having requested financial assistance from the EFSF/ESM, while national supervisors will retain direct powers on the others; the ECB will verify the correct application of common supervisory powers by national authorities and will be allowed to advocate powers also on less significant banks to ensure the consistent application of high supervisory standards. The European and national level will be jointly responsible, within the SSM, for the implementation of the common supervisory policy and will be subject to a duty of cooperation and an obligation to exchange information.

This approach is an important move towards a truly federal system, as advocated by Carmassi, Di Noia and Micossi: the beauty of this system is that cases can be handled at the right level and any unnecessary centralisation of powers and duplication of structures is avoided, in full accordance with the principle of subsidiarity. Such an approach will also be able to capitalise on existing national supervisory structures and their expertise, rather than building up wholly new structures.

A third crucial issue concerns a potential conflict between objectives: since the SSM will operate under the responsibility of the ECB Governing Council, it will be of paramount importance to avoid any contamination between monetary policy and bank supervision. Since monetary policy objectives are clearly enshrined in the Treaty, it is not likely that one of the two functions is weakened to favour the other: the true risk is that disagreements between the ECB and national supervisors on interventions on individual banks may jeopardise the independence of the ECB Governing Council. The adopted solution appears effective: a new Supervisory Board established within the ECB and separate from the monetary policy Governing Council will perform all supervisory tasks and will propose draft decisions to the Governing Council; the latter will be allowed to object in exceptional circumstances within a short time limit.

A fourth point regards the role of the European Banking Authority (EBA), which would be in charge of ensuring not only a single rulebook, but also uniform supervisory practices (the “supervisory handbook”), that are essential for preserving the integrity of the internal market. The agreement includes a change in the voting mechanisms of the EBA, with a double majority of countries both inside and outside the SSM, aimed at avoiding any bias in favour of member states participating in the SSM. The compromise refers to the possibility of EBA participation to the Supervisory Board as an observer: however, full and effective coordination between the EBA and the ECB would require the presence of the EBA chairman as a full voting member.

Last but not least, the new supervisory mechanism includes very significant powers of early intervention for the ECB: the introduction of a system of Prompt Corrective Action, as in the US FDIC model, would represent a crucial further improvement to eradicate supervisory forbearance and prevent losses from mounting while banks “gamble for resurrection”. Such a system would entail an obligation for supervisors to act when bank capital falls below certain preannounced thresholds, with increasing intensity of remedial actions as the capital position deteriorates.

Readers may also be interested in the paper, Carmassi, J., C. Di Noia and S. Micossi (2012), Banking Union: A federal model for the European Union with prompt corrective action, CEPS Policy Brief No. 282, 18 September.

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