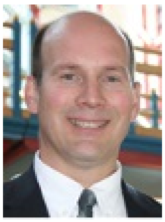
Proposals for a European Banking Union must be redesigned to provide a more accountable and effective institutional framework.

by Blog Admin



The EU's proposed banking union is seen by many as the first step towards resolving the eurocrisis, and under current proposals, by 2014 the European Central Bank (ECB) will be responsible for supervising over 6,000 banks in Europe. **Kern Alexander** *has serious concerns about the accountability and capacity of the ECB in this potential role, and argues that its primary focus of maintaining price stability in the eurozone through monetary policy is very different to that of banking supervision. In order for them to be effective, the proposals must be strengthened with greater mechanisms to ensure that the ECB is adequately accountable for its supervisory decisions.*

In June 2012, as Spanish authorities desperately negotiated with the European Commission over the terms of an EU bailout for the Spanish banking system, the European Union President, Herman Van Rompuy, issued a paper calling for a European Banking Union that would sever the vicious link between banking crisis and sovereign debt crisis. The Van Rompuy paper proposed vast new powers for the European Central Bank (ECB) to supervise over 6,000 banks in the eurozone and to establish an EU-wide deposit guarantee scheme, along with creating an EU-wide bank resolution fund that would administer failing banks without imposing direct costs on taxpayers. The German Chancellor Angela Merkel welcomed the proposals as an important step in obtaining German support for allowing the eurozone bailout fund – the European Stability Mechanism – to recapitalise ailing eurozone banks. European Council Ministers then issued a decision supporting the Van Rompuy proposal, and on 12 September the European Commission proposed a regulation that would provide the European Central Bank with banking supervision powers and another regulation to enable the ECB to interact with the European Banking Authority in executing its supervisory powers.

The ECB's supervisory powers would be phased-in between January 2013 and January 2014 with the creation of a Single Supervisory Mechanism (SSM) that would have an executive board – a Single Supervisory Board (SSB) – which would initially oversee eurozone banks that have accepted bailouts. On 1 July 2013, the ECB/SSB would gain supervisory oversight of the largest cross-border credit institutions and financial holding companies, and on 1 January 2014 its authority would extend to an estimated 6,000 banking institutions across the euro area. The ECB/SSB will be primarily responsible for licensing, monitoring and enforcing prudential regulations, such as capital adequacy requirements, liquidity buffers and leverage limits, against banks based in the eurozone. The ECB/SSB will also be empowered to approve bank recovery plans and asset transfers between affiliates within banking groups or mixed financial conglomerates.

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These proposals represent a dramatic institutional restructuring of eurozone and EU banking supervision and will have important implications for the practice of banking supervision in all EU states. They are primarily designed to sever the link between banking fragility and over-indebted sovereigns by authorising the European Stability Mechanism to recapitalise ailing euro area banks on the condition that these banks are subject to strict ECB supervision and conditionality. The UK government have tentatively supported the proposals, but on the condition that they do not result in limitations on market access for UK banks and financial firms in the eurozone. These sweeping new proposed powers for the ECB raise serious concerns about accountability and institutional capacity to carry out these functions.

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The EU Treaty establishes in Article 130 a strong form of independence for the ECB in deciding what measures it should use to conduct monetary policy and to achieve its primary objective of price stability. Indeed, the ECB's independence is widely considered to be why it has been viewed as a strong and credible institution in managing the value of the euro and maintaining price stability. It is unsurprising therefore why some would advocate that this credibility be extended in the form of banking supervision powers.

Nevertheless, it should be pointed out that monetary policy and banking supervision are very different. Monetary policy usually involves the use of a few macro instruments – i.e., interest rates and the quantity of money – to achieve price stability, a measurable objective often defined as keeping inflation within a range or below a target rate, and involving a more-or-less predictable trade-off between inflation and unemployment. Strong legal guarantees of central bank independence have been considered necessary in fulfilling the price stability mandate. Banking supervision, on the other hand, has a wider number of – often conflicting – objectives: financial stability, investor and depositor protection, consumer protection and tackling financial crime. Moreover, it is much more difficult to measure whether these objectives have been met and what the economic trade-offs are in achieving them. Also, bank supervisors have the power to restrict and restructure property and contractual rights – belonging to individual firms, depositors, shareholders and creditors – and in doing so to utilise a far greater number of regulatory instruments than is available in monetary policy.

Banking supervision has been subjected to greater accountability mechanisms by allowing, for example, that firms and individuals be consulted before they are subjected to controls and that the content of regulations are clearly ascertainable in advance and proportionate to achieve a legitimate regulatory aim and can be challenged by those subject to them before a fair and impartial tribunal. Unlike monetary policy, banking supervision requires different institutional mechanisms to ensure a more equal balance between the independence and accountability of the bank supervisor. The ECB's strong form of independence – as established by the Treaty – is inappropriate as a policy matter for a modern bank supervisor, and without adequate accountability mechanisms would likely contravene the legal principle of the rule of law.

Moreover, the exercise of macro-supervision and regulation will require the ECB/SSM to take decisions that may impinge on member states' economic policies and affect economic policy management by other EU institutions, such as the Parliament, Council and Commission. For example, if the ECB/SSB were to decide to impose countercyclical capital requirements or loan to value or loan to income limits, it would have a direct effect on the terms of financial contracts used on a daily basis by consumers and businesses. The exercise of these powers would raise questions regarding the ECB's accountability for these decisions to member states and EU institutions. The ECB's limited form of accountability – presently only being required to give oral evidence to the European Parliament to explain its policies – in terms of its governance structure to other EU institutions and to member states would be inadequate for the exercise of bank supervision powers.

The proposals also do not address the ECB's institutional limitations as a bank supervisor. In an era where global financial policymakers have accepted the importance of macro-prudential regulation as extending from licensing to resolution, it is striking that the proposal for an ECB/SSM only provides *ex ante* prudential supervisory powers for the ECB, without any mention of bank resolution powers. Most regulators now agree that effective regulation requires a seamless process from crisis prevention through crisis management, but under the proposals the ECB would not be authorised to engage in crisis management, nor would it be permitted to resolve a too-big-to-fail bank, or to use public funds to finance a bank bail-out. Under these proposals, the ECB's ultimate effectiveness can be called into question.

Is it really realistic to give the ECB *ex ante* responsibilities for micro and macro-prudential supervision while not having the authority to resolve, bail-out, nationalise or unwind a large cross-border bank or to engage in other types of financial rescue? The necessary link between crisis prevention and crisis management is ignored in these proposals and without adequate recognition of the ECB's role in bank resolution, the proposed regulations are destined to fail to achieve their objective of controlling systemic risk and enhancing macro-prudential regulation in the euro area. In addition, the ECB becoming a bank supervisor might bring it into conflict with its main objective of price stability. According to this view, the ECB might be tempted to lower interest rates or to loosen conditions for bank access to liquidity in order to stabilise the banking sector, but this might lead to easier terms of credit thereby interfering with its price stability objective. However, the proposed regulation attempts to address this potential conflict by requiring that bank supervision decisions and monetary policy be strictly separated, but both are ultimately accountable to the ECB's Governing Council.

The Commission's proposals do not provide the necessary institutional mechanisms to ensure that the ECB/SSM is adequately accountable for its supervisory decisions to those subject to its controls and to other EU institutions and member states. This can be attributed to the ECB's strong form of independence that is set forth in the Treaty. This is particularly problematic given the anticipated broad range of powers that the ECB is expected to exercise as a macro-prudential supervisor that will likely have a direct impact on economic policy. Furthermore, the proposals do not address the institutional limitations that could potentially restrict the ECB's legal authority under the Treaty to engage in macro-prudential supervision, nor do they stipulate how the ECB would interact with member state authorities with respect to bank resolution. These outstanding issues suggest that continued work on a European Banking Union is needed in order to design a more accountable and effective institutional framework that can better achieve regulatory objectives.

Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

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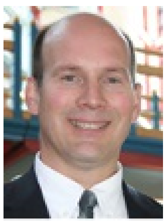

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