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Up-to-the-Minute Analysis from
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Banking Union: Getting the Big Picture Right
Walk-Up to the 19-20 December 2013 European Council

A sense of weary *ennui* seems to be accompanying the run-up to the final European Council of 2013, to be held on 19-20 December 2013, less than a week before Christmas.[1] There is only minimal buzz in the usually excitable Brussels, comparatively light media coverage, and jaded indifference from the public. Yet this is the summit slated to finalise the shape of European banking union, the most momentous initiative since Economic and Monetary Union was launched in 1989. It stands to be, in the words of Alex Barker and Peter Spiegel of the *Financial Times*, "the biggest surrender of sovereignty since the creation of the single currency."[2] Previous gatherings have pushed many key banking union decisions to this make-or-break, end-of-the-year meeting, the last European Council possibly still on time to move matters forward in the narrow legislative window remaining before the European Parliament elections of 22-25 May 2014. And the summit is to be preceded by a last-minute gathering of finance ministers to iron out remaining differences – the sort of cliffhanger that ordinarily electrifies European Union watchers. In addition, besides banking union, this summit is to take decisions on the new, and much-trumpeted, "contractual arrangements" and associated "solidarity mechanisms," as well as take stock of progress on enacting the Compact for Growth and Jobs.

So why the pervasive indifference? Why, indeed, was there more anticipation ahead of the monthly meeting for the European Central Bank (ECB) on 05 December, than there currently is for the upcoming gathering of heads of state and government? A first reason may be cast as positive: EU summits are no longer really seen as the "make-or-break" events in which they had been cast by the persistent economic crisis, with delegations dancing on the brink until late at night to avoid imminent disaster. The calming of markets that has been attained, primarily via ECB President Mario Draghi's "whatever-it-takes" pledge in July 2012,

[1] This Economic Intelligence briefing is the fifth in a series devoted to pre- and post-European Council analysis. Previous briefings are available on the Lisbon Council website at http://www.lisboncouncil.net and http://www.lisboncouncil.net/chiefeconomist.
[2] Alex Barker and Peter Spiegel, "EU Sets Out Framework for Banking," *Financial Times*, 11 December 2013.

is a major achievement. The other side of this coin is, however, political complacency, which is by definition inimical to resolute action. Indeed, it is the latter prospect – that complacency will prevail and that nothing truly new will surface at such political gatherings – that underlies the lack of interest in the summit, and the attention paid instead to the ECB's deliberations, seen by many as "the only game in town." This was already evident at the Economic and Financial Affairs Council meeting of 15 November 2013, which issued a four-page statement on "EU banks' asset quality reviews and stress tests, including on backstop arrangements."[3] These are key issues to successful banking union and yet the statement went largely unnoticed, even in the specialised press and the normally hyperactive social media. Peter Spiegel, *Financial Times'* Brussels bureau chief, explained it thus in a tweet: the conclusions "are nothing you haven't heard a million times already."[4]

This sense of repetition built up during the extended negotiations on Germany's grand coalition agreement, when the debate at European level came to a standstill and positions remained largely frozen – though, importantly, agreement was reached on the framework for a single supervisory mechanism on 15 October 2013.[5] The German coalition agreement did little to move things forward; on the contrary, in some areas (notably direct bank recapitalisations by the European Stability Mechanism), it restricted the scope further.

It is thus with diminished expectations that observers await this year-end gathering of EU heads of state and government. On the plus side, this means the scope for upside surprises rises.

The Imperative of Effective Governance

The fine points of banking union, and particularly of bank recovery and resolution, are fraught with technical details which, while vital in their own right, risk obfuscating the one overriding requisite of a successful resolution regime. That is that bank resolution be handled in a swift and orderly manner, an outcome which in turn depends on the regime's governance and decision-making mechanisms. That is not to detract from crucial aspects such as the proper balance between bail-outs and bail-ins; the hierarchy of creditors in the latter case; the extent of risk-sharing; and – perhaps most importantly of all – the existence of an adequate common backstop that would truly delink weak sovereigns from banking sector risks, breaking the related "doom loop." Commentators have rightly paid much attention to all of these aspects, but comparatively lesser attention has been devoted to the

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[3] Council of the European Union, *Council Statement on EU Banks' Asset Quality Reviews and Stress Tests, including on Backstop Arrangements*, Brussels, 15 November 2013. http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/139613.pdf

[4] See https://twitter.com/spiegelpeter/status/401390462243987456. The same can be said of the various initiatives under the Compact for Growth and Jobs, whose disappointing results were recognized by the European Commission in its first stock-taking in June 2013. See European Commission, *The Compact for Growth and Jobs: One Year On* (Brussels: European Commission, 2013). http://ec.europa.eu/commission_2010-2014/president/news/archives/2013/06/pdf/2_en.pdf

[5] Council of the European Union, *Council Approves Single Supervisory Mechanism for Banking,* 15 October 2013. http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/139012.pdf

governance of the resolution regime itself. Yet, without an efficient decision-making framework, the resolution process risks unravelling in its first true cross-border test.

Bank resolution is, to put it in layman's language, no picnic. Though signs of trouble may be present for some time, the need for a bank wind-up can occur suddenly, possibly triggered by an unexpected exogenous event. The realisation that a bank is nearing resolution can dry up capital funding or generate deposit runs, especially as bail-in provisions become stricter, as indeed planned. The decisions surrounding resolution raise difficult burden-sharing issues, involving the distribution of costs between various claimants and taxpayers and, potentially, choices about the distribution of losses between taxpayers of different countries. These clearly need to be treated with care and confidentiality to minimize defensive plays and/or alarmed reactions, and to achieve least-cost resolution. In short, it is an emergency setting that requires decisiveness, discretion, speed and operational independence.[6]

These are in fact the strongest arguments in favour of a resolution mechanism that is truly "European" and "single" as implied by its acronym – a European SRM. To be sure, there are also the broader European integration arguments but, even for those who do not share these ideals, the pragmatic imperative of an efficient and orderly regime entails a single, centralised fund endowed with a nimble governance framework. The compromise in the making has been criticized mainly for its lack of a common backstop and for failing to truly break – as repeatedly vowed by European leaders – the "vicious circle between banks and sovereigns." While these critiques are fully on-the-mark, our main concern is that – even if these details were improved over time, as well they might – the regime may be derailed before that by what is in fact its main flaw – its governance mechanism: a convoluted and labyrinthine decision-making process that stands in the way of efficient resolution.

The irony is that such a governance flaw should arise once again, even though it is generally recognised that the euro area crisis itself has to a large extent been a crisis of governance. The latter, in turn, has been spawned by the reliance on an exclusively intergovernmental approach in the euro area's overall crisis management.[7] Although the underlying *realpolitik* constraints are material, it is regrettable that the creation of a resolution mechanism has to again rely on an intergovernmental agreement, as was the case for the establishment of the ESM. This approach may also conflict with the tight calendar for the approval of the SRM, as it could create difficulties in the negotiations with the European Parliament, which traditionally dislikes pacts outside existing EU treaties.

'Committees in a Crisis Don't Work'

Even accepting the inevitability in the present political reality of an intergovernmental approach, one cannot but be concerned by the unwieldy decision-making process that underlies the draft agreement currently under discussion. In essence, the proposed system would reportedly work as follows: a new "resolution board" *made up of national authorities*

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[6] See Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions*, October 2011. http://www.financialstabilityboard.org/publications/r_111104cc.pdf

[7] For a critique of these arrangements, see Alessandro Leipold, *Making the European Stability Mechanism Work* (Brussels: Lisbon Council 2012). www.lisboncouncil.net//index.php?option=com_downloads&id=765

[emphasis added] would play – in the words of the Lithuanian Presidency's draft terms of reference – "the central role at the European level in all phases relating to resolution."[8] It is this board (where the European Commission would sit only as an observer) "which takes the decisions on resolutions and EU institutions will only exercise an ex post control of those decisions."[9] In practice, the European Commission would have a mere up-or-down say on the board's decisions. If the European Commission were to disagree with the resolution board, the decision would be put in the hands of the member states (i.e., the minister-level Council of the European Union), which would decide by majority vote. Were the ministers not to rule within a given period of time, the board's decision would enter into force automatically, the European Commission's objection notwithstanding.

As the draft terms of reference state unabashedly, this decision-making process would ensure that "the board remains the key decision maker, and therefore the Single Resolution Authority of the participating Member States." While some have welcomed the recognition of a role for the European Commission (initially strongly opposed), it is apparent that in the proposed framework it would in reality be severely circumscribed, and that the pre-eminent role of national representatives on the new "resolution board" and the envisaged to-ing an fro-ing between the board, the European Commission and the Council of the European Union stand to impede orderly and timely resolution. Indeed, it has been calculated that, in a worst case scenario, where there is disagreement among these players, the process of winding up a bank could involve nine committees with up to 143 votes being cast.[10]

Such a set-up replicates that of the European Banking Authority (EBA), whose chief, Andrea Enria, in a disarmingly candid interview, lamented the "impossible" committee-led governance plaguing the EBA, adding: "You need European decision mechanisms rather than having always a committee-type of decision in a crisis. Committees in a crisis don't work."[11] In the same vein, he argued that the process for administering new resolution powers was far too bureaucratic, with excessive input from national government representatives. A similar cumbersome, committee-based structure has hobbled the European Systemic Risk Board, an entity that has been conspicuously absent even when contagion fears – the epitome of "systemic risk" – were at their peak.

As experts at the International Monetary Fund have argued, "governance of the banking union must… promote timely decision making, lest national interests prevail and effectiveness is compromised."[12] A similar consideration was advanced by the ECB in its

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[8] This summary is based on a series of documents, made available via the *Financial Times*. See Peter Spiegel, "EU Banking Union: Leaked Terms of Reference," *Financial Times*, 10 December 2013, and *Ibid.* "EU Bank Bailout Fight: More Leaked Documents," 11 December 2013. In this regard, the extent of leaks in Brussels raises evident concerns about the required confidentiality in resolution deliberations.
[9] Lithuanian Presidency of the EU Council, "Draft Terms of Reference," Brussels, 10 December 2013. https://www.documentcloud.org/documents/894219-terms-of-reference.html
[10] Alex Barker and Sam Fleming, "Rules for Failing Banks Raise Prospect of Eurozone Red-Tape Burden," *Financial Times*, 15 December 2013. The article also notes that, even under a more streamlined version proposed by Commissioner Michel Barnier, a decision would involve around 107 votes from 80-90 people.
[11] Patrick Jenkins and Sam Fleming, "Euro Bank Watchdog Attacks Unwieldy Governance," *Financial Times*, 17 November 2013.
[12] International Monetary Fund, *A Banking Union for the Euro Area* (Washington DC: IMF, 2013). http://www.imf.org/external/pubs/ft/sdn/2013/sdn1301.pdf

opinion on the proposed SRM regulation: "It is of the utmost importance that the SRM's decision-making capacity and voting modalities ensure efficient and timely decision-making, particularly during periods of crisis."[13] These requirements are not assured by the draft agreement, which risks being, rather, a recipe for undue political interference and long negotiations, holding up resolution decisions with possibly serious systemic consequences. Jörg Asmussen, who, as of this writing is still a member of the ECB's governing council but is due to join the new German government momentarily, has expressed concern "over the planned decision-making process between the resolution board, European Commission and Council of Ministers on winding down a bank... It has to be ensured that a bank can be closed in an orderly manner over a weekend" while financial markets are closed.[14] The upcoming European Council would do well to bear these concerns in mind, and to streamline and simplify the decision-making process appreciably compared to the drafts currently circulating. While this may be unlikely at this late stage, the plea remains worth making – if not for now, then for the future, as experience is gained, at (hopefully) not too high a cost.

While there is reason to lament that the SRM as currently envisaged falls appreciably short of a true single authority, and tends to perpetuate (rather than break) the sovereign-bank link, the envisaged agreement does sow the seeds of a common fund over time (a decade) and details may well be improved during that period – in the light of experience and possibly under the pressure of events, as so often happens in Europe. We remain of the view that the banking union project – while falling short of ambitions and requirements in many respects – remains useful in the long run, laying the ground for Europe to have a banking sector less dependent on member states. Provided, that is, the afore-mentioned pressure of events does not truly test the regime's decision-making process via a cross-border banking collapse. It is this risk that should be high in the minds of the heads of state and government as they gather for their last European Council of 2013 to finalise the shape of European banking union for years to come.

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The views expressed in this Economic Intelligence briefing are those of the author alone and do not necessarily reflect the views of the Lisbon Council or any of its associates.

13 European Central Bank, "Opinion of the European Central Bank of 06 November 2013," (Frankfurt: ECB, 2013). http://www.ecb.europa.eu/ecb/legal/pdf/en_con_2013_76_f_sign.pdf
14 Reuters, "ECB's Asmussen Concerned over Complex Bank Resolution Rules," 11 December 2013.

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