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The EU banking 'union' deal

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Summary

- In Brussels yesterday, Eurozone governments salvaged something from their commitment to put in place plans for a banking 'union' in Europe before the end of 2012. After the high expectations of June this arrangement clearly falls far short of what the market is likely to regard as a genuine banking union. It is, in reality, not a union at all, at least not in terms of genuine risk-sharing. It is a coordination.

- This deal 'Europeanises' an element of Eurozone banking supervision but is hemmed in on all sides by the limits of what Berlin in particular is willing to do at this stage. Because it is limited, the loss in sovereignty is not really balanced by any overall gain in systemic stability, and thus probably no significant gain in market confidence, which is a familiar European problem and irony.

- The complex structures put in place to manage the layers and levels of integration presage the debates ahead on how to manage life in an EU with a least two tiers of membership, if not more. The politically sensitive balancing of the interests of large and small, in and 'pre-in', in and out suggest a model of tiered governance that will inevitably have costs in coherence, efficiency and stability.

- However, one should never underestimate the extent to which EU governance evolves by incremental advance and consolidation. Although it is fraught with potential problems, this agreement Europeanises the principle of banking supervision in the Eurozone and creates a huge new remit for the European Central Bank. Market pressure and internal tension still present a huge problem for the Eurozone as it navigates into this debate, but this is still a new foothold for a redesigned Eurozone banking system.

Another 4am Summit deal, another incremental step towards…what exactly, for European banks? At face value, Eurozone governments have salvaged something from their commitment to put in place plans for a banking 'union' in Europe before the end of 2012. The detail suggests something a lot less than the expectations generated by the June 2012 European Council, but still an evolution in terms of the way Eurozone banks are supervised. This Global Counsel Insight identifies four key elements of the deal this week and asks what they tell us.

The risk pool

The deal agreed by EU Finance Ministers in Brussels agreed to move the power to supervise a tranche of Eurozone banks to the European Central Bank (ECB) by some point in early 2014 at the earliest, although no precise date has been set. The banks in question will be determined on the basis of balance sheet size: those holding assets of more than €30 billion or with balance sheets more than a fifth of the GDP of their home sovereign. This, then, is a rough metric for a definition of a 'Euro-SIFI' – a significantly

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important European banking institution. This will obviously capture all the large Eurozone players – Deutsche Bank, Credit Agricole, BNP Paribas, SocGen, Santander, ING and others.

The definition is obviously a political one as much as an objective one. It will capture the Eurozone's large cross-border banks and many smaller ones, but it will exclude most of the Eurozone's smaller retail banks, and in particular the politically-networked savings banks in Germany, which Berlin has fought aggressively to keep out of the hands of the ECB. Precisely how this supervision will work remains to be specified, but day-to-day interaction will remain in the hands of national supervisors, although the ECB will in theory have a role in setting supervisory parameters for all banks.

As the market digests this outcome the key questions will focus on the extent to which this arrangement actually changes much in terms of banking sector risk-sharing in the Eurozone. If the intended outcome of banking union is to close the wide spreads in capital costs and bank risk exposures between banks and sovereigns in the periphery and in 'sounder' northern jurisdictions, then it is likely to achieve a limited amount.

ECB supervision obviously eliminates an element of national political discretion in assessing the weakness and consequent remedial action required of large Eurozone banks – a persistent problem before and after 2008, in Spain, for example. But it does not pool the resources for resolving or recapitalising Eurozone banks in the way that the ECB is currently pooling resources for sustaining their liquidity through the LTRO. The ECB has in principle the power to take over additional supervision roles and to inject capital through the European Stability Mechanism (ESM), but both are subject to a requirement of unanimous approval by member states. This leaves Eurozone sovereigns pretty much on the hook for banking failures.

Avoiding this was of course was the apparent centrepiece of the June 2012 Council – the agreement to pool resolution authority and deposit insurance, and to allow the ESM to directly recapitalise banks and to take on some of the legacy recapitalisations undertaken since 2008. But this was always something of a political illusion, spun by Italy and Spain in particular, but disowned almost at once by Germany and the Netherlands. Much of the bitter negotiation between then and now has been dominated by the attempt to rebuild a consensus at a much lower level of ambition. So we have a deal on some common supervision, with negotiations on resolution, deposit insurance and a more autonomous system for ESM recapitalisations pushed back into next year, at the very earliest.

The ins, the 'pre-ins' and the outs

The deal also produces a complicated solution to the complicated problem of how to deal with the supervision of banks in states that are to be included in the joint banking supervision arrangements, but are not in the Eurozone – usually because they are home to banks with major operations within the Eurozone, or host to banks supervised from within the Eurozone. It also tries to address the concerns of those that are in the EU, but wish to be excluded, notably the UK.

The issue in the first case centres on the ability of states to influence ECB policy despite being legally excluded from the ECB's governance structures because they are not part of the single currency. In this case, the states in question will be given new influence in an ECB supervisory board, separated from the monetary functions of the bank. For some 'pre-in' states with clear intentions (and technically a Treaty obligation) to join the single currency, such as Poland, there was a clear incentive to settle here. For those such as Sweden and the Czech Republic with no medium-term euro vocation, the guarantees were still judged insufficient and they have opted to remain outside the banking arrangements.

Even among the 'ins' and the 'pre-ins' there was a tense debate over the balance of power between large and small states, led by Luxembourg with its disproportionately large banking sector. Smaller EU states resisted attempts to model the ECB's supervisory system on a weighted system closer to that used by the ESM – which gives more weight to larger countries like Germany – in favour a one

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country, one vote model similar to the ECB's own governance. The final outcome was a double system that requires both simple and weighted majorities.

For non-Eurozone states concerned at the weight of the ECB 'bloc' in setting the regulations agreed for the wider European banking market in the European Banking Authority (EBA), the UK has prevailed in its insistence that all EBA actions should be agreed by a double lock that requires the plurality support of both non-Eurozone and Eurozone states. This represents a victory for the UK, although one that is easier to swallow in Frankfurt and Brussels while the UK is joined by Sweden and the Czech Republic outside of collective banking arrangements. Should these states ultimately move into the ECB system it has the potential to evolve into a politically-resented veto for the UK.

Ending in tiers

So what should observers of the EU make of this? There are perhaps four key observations to be made. First, after the high expectations of June this arrangement clearly falls far short of what the market is likely to regard as a genuine banking union. It is, in reality, not a union at all, at least not in terms of genuine risk-sharing. It is a coordination. The expectations generated by the June summit never represented even the true intentions of the Summit participants, let alone the measure of what was politically likely in the Eurozone. In terms of any kind of common backstop for Eurozone banks, ECB liquidity support remains the only real game in town.

Second, this is yet another measure of the painful surrendering of sovereignty that is involved in all of Europe's attempts to shore up the single currency bloc. This deal 'Europeanises' an element of Eurozone banking supervision but is hemmed in on all sides by the limits of what Berlin in particular is willing to do at this stage. Because it is limited, the loss in sovereignty is not really balanced by any overall gain in systemic stability, and thus probably no significant gain in market confidence, which is a familiar European problem and irony. In this case, the difficult tensions in Berlin's own position are key: a general desire to Europeanise governance in the Eurozone, but reluctance to extend Germany's own direct liability for failures elsewhere.

Third, the complex structures put in place to manage the dense networks of sensitive interests and layers and levels of integration presage the debates ahead on how to manage life in an EU with a least two tiers of membership, if not more. The desire to keep the UK engaged in EU governance even as it robustly asserts its non-inclusion in the evolving structures of Eurozone integration is only the most obvious of these, but there are many. The politically sensitive balancing of the interests of large and small, in and 'pre-in', in and out suggest a model of tiered governance that will inevitably have costs in coherence, efficiency and stability.

Finally, though, one should never underestimate the extent to which EU governance evolves by incremental advance and consolidation. Although it is fraught with potential problems, this agreement Europeanises the principle of banking supervision in the Eurozone and creates a huge new remit for the ECB, as well as something of a bully pulpit for applying both transparency and pressure on Eurozone sovereigns in their oversight of large banks.

In this respect, like the small print in the recent draft EU budget on autonomous EU budget capacity, it is a genuine evolution (See GCI 12/39 *The political small print in the EU Budget*). The debate on resolution capability, deposit insurance and direct recapitalisation now has an important ratchet in it. Market pressure and internal tension still present a huge problem for the Eurozone as it navigates into this debate, but this is still a new foothold for a redesigned Eurozone banking system.

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