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## Introduction

The European Union (EU) is an economic, political, partly administrative and judicial union of 28 European states which is based on multilateral agreements and operates through a number of supranational institutions and organs as well as multilateral negotiated decisions. During the past decades, the EU member states continuously extended its jurisdiction<sup>1</sup>, thus promoting unanimous and supranational decision-making as well as increasing the compatibility of national administrations and economies, i.e. European integration.

The global financial and economic crisis, which broke out in 2007, resulted in European national economies entering a path of spiral decline and many banks needing to be bailed out (saved financially) by the state, in order for national financial systems as well as for the European financial economy in general not to experience a further decline<sup>2</sup>. This triggered a sovereign debt crisis within the EU with several states facing serious economic problems and some being threatened by insolvency. These developments led to the realization that the European financial economy and especially its banking system had to be regulated and made more transparent, so that future crises could be avoided / mitigated more effectively. The idea of a European banking union might have been born a few years earlier, but the European bank crisis and subsequent sovereign debt crisis lent credibility to the arguments for its establishment.

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<sup>1</sup> The two relevant meanings of "jurisdiction" according to the online Merriam-Webster Dictionary:

- a) "the authority of a sovereign power to govern or legislate",
- b) "the limits or territory within which authority may be exercised".

<sup>2</sup> When important financial institutions such as large banks go bankrupt, the trust of investors and other participants of the financial economy is severely shaken, thus reducing liquidity of capital (for further information research online). Also, the interdependence of financial market participants results in the bankruptcy of one financial institution causing further bankruptcies. This possibility is referred to as the systemic risk of a certain financial system/market.

The aim of this study guide is to explain the nature of such a banking union, analyse the technical details and requirements of a potential implementation, present the arguments in favour and against as well as the most important national policies on this issue and provide some ideas for the implementation of a banking union.

First, I would like to give you a clear picture of the current legal personality and the competences of the European Union (EU), though. This will facilitate a comprehensive understanding of the gravity of our objective as well as the technical and legal details of a potential implementation. I will then go on to briefly present the European System of Central Banks (ESCB) and the European Central Bank (ECB). Before reaching the core aspect of our topic, the implementation of a banking union, I will also provide some insight into the nature and function of the European single market, which is a secondary aspect of our objective and will be dealt with in parallel.

### Current legal personality<sup>3</sup> and organs of governance of the EU

According to the Official website of the European Union (<http://europa.eu/>), “the conferral of legal personality on the Union means that it henceforth has the ability to conclude and negotiate international agreements in accordance with its external commitments, to become a member of international organisations and to join international conventions, such as the European Convention on Human Rights (ECHR).” Evidently, the legal personality of the EU constitutes a milestone in European integration with its jurisdiction / fields of competence (fields where the EU has certain rights, sometimes more than the individual member states, in exercising executive and legislative powers) being the second and complementary such milestone (a short reference follows in the next sub-chapter).

Since the core aspect of our topic is the implementation of measures on a supranational and, specifically, on an EU level, you need to be well-acquainted with decision-making procedures inside the EU as well as its organs of governance. According to the Official website of the European Union (<http://europa.eu/>):

“In the EU's unique institutional set-up:

- the EU's broad priorities are set by the European Council, which brings together national and EU-level leaders,

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<sup>3</sup> Organizations, businesses and all non-human entities in general (i.e. all non-natural persons) need to be covered by / defined in law in a certain way, in order to have legal rights and obligations. Otherwise, businesses could not be sued, for instance. Therefore, all non-natural persons are given a legal personality which defines those rights and obligations as well as any additional legal characteristics, thus making them legal persons.

- directly elected MEPs represent European citizens in the European Parliament,
- the interests of the EU as a whole are promoted by the European Commission, whose members are appointed by national governments [and]
- governments defend their own country's national interests in the Council of the European Union.”

There are several EU institutions, including the European Central Bank (ECB) which is of paramount importance to our topic; the above points list only the most important of them. Please read [http://europa.eu/about-eu/institutions-bodies/index\\_en.htm](http://europa.eu/about-eu/institutions-bodies/index_en.htm) and have a look at the [related Wikipedia article](#) before reading on, in order to have a clearer picture of EU legislatures and executive organs.

### EU Competences

According to the Official website of the European Union (<http://europa.eu/>):

“The Treaty on the Functioning of the EU (TFEU) distinguishes between three types of competence and draws up a non-exhaustive list of the fields concerned in each case:

- exclusive competences (Article 3 of the TFEU): the EU alone is able to legislate and adopt binding acts in these fields. The Member States’ role is therefore limited to applying these acts, unless the Union authorises them to adopt certain acts themselves;
- shared competences (Article 4 of the TFEU): the EU and Member States are authorised to adopt binding acts in these fields. However, Member States may exercise their competence only in so far as the EU has not exercised, or has decided not to exercise, its own competence;
- supporting competences (Article 6 of the TFEU): the EU can only intervene to support, coordinate or complement the action of Member States. Consequently, it has no legislative power in these fields and may not interfere in the exercise of these competences reserved for Member States.”

There are some additional “special competences”, too. Further information on: [http://europa.eu/legislation\\_summaries/institutional\\_affairs/treaties/lisbon\\_treaty/ai0020\\_en.htm](http://europa.eu/legislation_summaries/institutional_affairs/treaties/lisbon_treaty/ai0020_en.htm). The areas of competence are defined in articles 3,4,5,6 of the [CONSOLIDATED VERSION OF THE TREATY ON THE FUNCTIONING OF THE EUROPEAN UNION](#) (on pages 5,6,7 – please read), published by the Official Journal of the European Union.

## The European System of Central Banks<sup>4</sup> (ESCB) and the European Central Bank (ECB)

Please read the tabs entitled “ECB mission”, “Eurosystem mission” and “Strategic intents” on [this page](#) of the official website of the ECB. Please also read the text for slide 1 on [this page](#) of the same website before carrying on. Reading the text for some of the other slides would also be beneficial.

### EU Single Market

“The single market (sometimes called the internal market) describes the EU project to create free trade within the EU and to mould Europe into a single economy.”

- <http://www.civitas.org.uk/eufacts/FSECON/EC1.htm>

According to the Official website of the European Union (<http://europa.eu/>)<sup>5</sup>: “

#### 2. How the single market looks today:

##### a. Physical barriers:

- i. All border controls within the EU on goods have been abolished, together with customs controls on people. [...]
- ii. The Schengen Agreement, which was signed by a first group of EU countries in 1985 and later extended to others (although Ireland, the United Kingdom, Cyprus, Bulgaria and Romania do not participate), governs police cooperation and a common asylum and immigration policy, so as to make it possible to completely abolish checks on persons at the EU’s internal borders [...]

##### b. Technical barriers:

- i. For the majority of products, EU countries have adopted the principle of mutual recognition of national rules. Any product legally manufactured and sold in one member state must be allowed to be placed on the market in all others.
- ii. It has been possible to liberalise the services sector thanks to mutual recognition or coordination of national rules concerning access to or practice of certain professions (law, medicine, tourism, banking, insurance, etc.). Nevertheless, freedom of movement for persons is far from

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<sup>4</sup> According to [this Wikipedia article](#), “a central bank, reserve bank, or monetary authority is a private institution which manages a state's currency, money supply, and interest rates. Central banks also usually oversee the commercial banking system of their respective countries. In contrast to a commercial bank, a central bank possesses a monopoly on increasing the amount of money in the nation, and usually also prints the national currency, which usually serves as the nation's legal tender.” Please research online for further information about the role of central banks in financial economy and financial politics.

<sup>5</sup> At: [http://europa.eu/abc/12lessons/lesson\\_6/index\\_en.htm](http://europa.eu/abc/12lessons/lesson_6/index_en.htm).

complete. Obstacles still hinder people from moving to another EU country or doing certain types of work there.

- iii. Action has been taken to improve worker mobility, and particularly to ensure that educational diplomas and job qualifications (for plumbers, carpenters, etc.) obtained in one EU country are recognised in all the others.
- iv. The opening of national services markets has brought down the price of national telephone calls to a fraction of what they were 10 years ago. [...]

c. Tax barriers:

Tax barriers have been reduced through the partial alignment of national VAT rates. Taxation of investment income was the subject of an agreement between the member states and some other countries (including Switzerland) which came into force in July 2005.

d. Public contracts:

Regardless of whether they are awarded by national, regional or local authorities, public contracts are now open to bidders from anywhere in the EU as a result of directives covering services, supplies and works in many sectors, including water, energy and telecommunications.

### 3. Work in progress

a. Financial services:

The EU's action plan to create an integrated market for financial services by 2005 has been completed. This cuts the cost of borrowing for businesses and consumers, and will offer savers a wider range of investment products — savings plans and pension schemes — which they will be able to obtain from the European provider of their choice. Bank charges for cross-border payments have been reduced.

b. Administrative and technical barriers to free movement:

EU countries are often still reluctant to accept each other's standards and norms or, on occasion, to recognise the equivalence of professional qualifications. The fragmented nature of national tax systems also hinders market integration and efficiency.

c. Piracy and counterfeiting:

Protection is required to prevent piracy and counterfeiting of EU products. The European Commission estimates that these crimes cost the EU thousands of jobs each year. This is why the Commission and national governments are working on extending copyright and patent protection.”

The EU single market initiative was also directed at the European financial market, in order for increased capital flows (loans, investments, etc.), i.e. increased liquidity, to encourage real economy<sup>6</sup> growth. Of course, the EU single financial market would be complemented by an EU banking union in terms of financial market regulation, supervision and corrective governmental (/ coordinated supranational) action, which is why European financial market integration is an important secondary aspect of our topic and of this study guide. As for the importance of the EU single financial market, according to [this page](#) of the website of the European Commission:

“The single currency was a key step towards the creation of the single financial market. Its introduction immediately removed some obstacles to free capital flows – namely the costs associated with exchanging different currencies. Previously, these costs were a barrier to cross-border investments – today they no longer exist in the euro area.

Backed by the Commission's Financial Services Action Plan – also launched in 1999 – the euro has resulted in a rapid expansion and integration of European bond and money markets. Since the introduction of the euro, cross-border bank deposits have increased, the yields on government bonds have converged, and the interest rates on retail loans, taken out by individual citizens, have also converged.

But harmonisation of the structures and regulations of the financial market sector is also needed to ensure the remaining barriers are removed and efficiency is promoted. For example, barriers arising from different IT systems must be removed through common technical standards; legal issues for company mergers and takeovers must be resolved to enable consolidation among the financial intermediaries; and regulatory issues on how national markets operate must be harmonised to ensure full integration. The White Paper on Financial Services Policy (2005-2010), adopted by the Commission in December 2005, aims to achieve a fully integrated, open, inclusive and efficient EU financial market which completes the single market and contributes to improve EU competitiveness as part of the Lisbon reform process.”

A list of international and EU level measures targeted at the regulation of financial markets can be found here (for those interested):

[http://ec.europa.eu/internal\\_market/publications/docs/financial-reform-for-growth\\_en.pdf](http://ec.europa.eu/internal_market/publications/docs/financial-reform-for-growth_en.pdf)

Additionally, news on EU single financial market infrastructure can be found here (only for those interested):

[http://ec.europa.eu/internal\\_market/financial-markets/news/index\\_en.htm](http://ec.europa.eu/internal_market/financial-markets/news/index_en.htm)

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<sup>6</sup> The non-financial part of economy which actually produces goods and services.

## Economic and Monetary Union (EMU) in the EU

According to [http://ec.europa.eu/economy\\_finance/euro/emu/](http://ec.europa.eu/economy_finance/euro/emu/), it “represents a major step in the integration of EU economies. It involves the coordination of economic and fiscal policies, a common monetary policy, and a common currency, the euro. Whilst all 27 [, now 28 (including Croatia),] EU Member States take part in the economic union, some countries have taken integration further and adopted the euro. Together, these countries make up the euro area [or Eurozone].” Please read the whole page from the above source before moving on, in order to understand the terms economic governance and European integration fully.

Now that the degree of European integration and the most important European mechanisms pertaining to financial markets have been presented, I will move on to the banking union proposals.

## **Definition of Key-Terms**

### Handling / recapitalization / bailout / etc. of troubled banks

Banks threatened by insolvency are saved financially by the state, usually through the purchase of the bank’s bad assets<sup>7</sup>.

### Bank regulation

Legislation and regulations issued by the bank regulatory authority pertaining to the operation of banks which aims at the creation of transparency around the operation and health of the banking sector, at compliance with certain financial safety and stability standards and at the minimization of systemic risk<sup>8</sup> (amongst other objectives) through requirements, restrictions and guidelines.

### Bank supervision

It involves monitoring and examining the condition of banks and their compliance with laws and regulations.

### Deposit guarantees / insurance

“Protection provided usually by a government agency to depositors against risk of loss arising from failure of a bank or other depository institution. Deposit insurance is mandatory, and pays claims from a pool of funds to which every depository institution regularly contributes. However, it covers only a fixed maximum amount

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<sup>7</sup> Having lost much or all of their value.

<sup>8</sup> Due to the high degree of interdependence of financial institutions, one bankruptcy can cause other, financially dependent entities to go bankrupt as well. This possibility is referred to as the systemic risk of a certain financial system/market.

per account holder.”<sup>9</sup> As for their importance: “From the depositors' point of view, this protects a part of their wealth from bank failures. From a financial stability perspective, this promise prevents depositors from making panic withdrawals from their bank, thereby preventing severe economic consequences.”<sup>10</sup>

### Banking union

A union in which one or more of the following aspects of economic and financial policy are centralized and become the exclusive (or shared) competence of one supranational authority: bank regulation, bank supervision, deposit guarantees, handling of troubled banks. In the context of the EU proposals, the ECB and the European System of Financial Supervision (ESFS) would be these supranational authorities. For information about the ESFS as well as the European Banking Authority (EBA) please refer to the official website of the EBA (and please read the page below before moving on):

<http://www.eba.europa.eu/about-us?jsessionId=8BD9588D0BA7E4E62EF1D74B6552C66B>

### EU primary and secondary law

“Primary law, also known as the primary or original source of law, can be seen as the supreme source of law in the European Union (EU). It is at the apex of the European legal order. It consists mainly of the founding treaties of the European Union.”

- [http://europa.eu/legislation\\_summaries/institutional\\_affairs/decisionmaking\\_process/l14530\\_en.htm](http://europa.eu/legislation_summaries/institutional_affairs/decisionmaking_process/l14530_en.htm)

“Secondary law comprises unilateral acts and agreements.”

- [http://europa.eu/legislation\\_summaries/institutional\\_affairs/decisionmaking\\_process/l14534\\_en.htm](http://europa.eu/legislation_summaries/institutional_affairs/decisionmaking_process/l14534_en.htm)

Please read through [this](#) and [this](#) legislation summary in that correct order before carrying on.

### Restructuring (finance)

A significant rearrangement of / modification to a financial entity's structure, operations, assets and/or liabilities, in order to improve its financial viability and/or avoid insolvency. “A firm's restructuring may include discontinuing a line of business, closing several plants, and making extensive employee cutbacks.”<sup>11</sup> It may also include “mergers, acquisitions, tender offers, leveraged buyouts, divestitures, spin-offs, equity carve-outs, liquidations and reorganizations”<sup>12</sup> as well as agreements

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<sup>9</sup> Source: <http://www.businessdictionary.com/definition/deposit-insurance.html#ixzz2Xo9JWGsu>

<sup>10</sup> Source: [http://ec.europa.eu/internal\\_market/bank/guarantee/](http://ec.europa.eu/internal_market/bank/guarantee/)

<sup>11</sup> Wall Street Words: An A to Z Guide to Investment Terms for Today's Investor by David L. Scott. Copyright © 2003 by Houghton Mifflin Company. Published by Houghton Mifflin Company. All rights reserved.

<sup>12</sup> For an explanation of some of these terms, please visit the source:

with the creditors and the rights' holders of the entities financial obligations to meet these obligations over a longer period of time and in smaller installments, i.e. debt restructuring (just like the well-known haircut of Greek national bonds).

## Background Information

In this chapter, I will present the key building blocks of a banking union as envisioned by the Eurogroup<sup>13</sup>, the European Council and the Heads of State or Government of the euro area. The repercussions of a potential implementation and some arguments pro and contra presented together with these blocks will help you to gain a complete picture of the debate.

The key building blocks:

### 1. The establishment of a "single rulebook", i.e. unified European bank regulations:

As stated in the above page of the official website of the EBA, prudential regulation and supervision of banks on a European level is already managed to some extent by the EBA. A milestone in the creation of a single rulebook and consequently a level playing field for European financial institutions is the adoption<sup>14</sup> of the Capital Requirements Regulation and the Capital Requirements Directive (CRR & CRD) and their probable entry into force on 01.01.2014<sup>15</sup>. According to [this page](#) of the news section of the website of the European Parliament, they "aim to stabilise and strengthen the banking system by making banks set aside more and higher quality capital as a cushion against crises. The new rules should also foster a convergence of supervisory practices across the EU. [...] The CRR introduces the first single set of prudential rules for banks across the EU. It aims to close regulatory loopholes and create harmonised rules that level the playing field and guarantee legal certainty for all single market players. The CRR rule book should also help to ensure that the Basel

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<http://financial-dictionary.thefreedictionary.com/Restructuring>

<sup>13</sup> An informal meeting of the finance ministers of euro area members.

<sup>14</sup> The two legal documents published in the Official Journal of the EU:

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0001:0337:EN:PDF> (CRR)

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0338:0436:EN:PDF> (CRD)

<sup>15</sup> "As a regulation, the CRR applies directly in every member state. It can therefore impose a single set of rules across the EU, thus leaving no scope for arbitrary interpretation and ensuring certainty as to the law for all EU single market players. [Thus, it will be enforced on 01.01.2014.] The directive, by contrast, will have to be incorporated into the national laws of the member states. The rules on bankers' remuneration and bonuses, prudential supervision, corporate governance and capital buffers will remain the responsibility of the member states' national competent authorities.", according to [this publication](#) of the European Parliament.

III<sup>[16]</sup> international standards for bank capital adequacy are fully respected in all EU member States.”

The adoption of the latest legislative proposal for a thorough revision of the Directive on Deposit Guarantee Schemes by the European Commission<sup>17</sup> will also “create a level playing field” for EU banks, according to Vítor Constâncio, Vice-President of the ECB.

Consequently, unified bank regulations already exist (and that to a degree deemed sufficient by several national policy makers and EU officials). Nevertheless, many states including Germany advocate further integration of bank regulation. All in all, there have not been heard any strong objections to further unification, though.

## 2. The establishment of a single supervisory mechanism (SSM):

The SSM-proposal outlines the integration of such a mechanism into the ECB with the full authority of a typical bank supervisor as far as compliance with the single rulebook is concerned. According to the [Statement by Commissioner Michel Barnier following the trilogue agreement on the creation of the Single Supervisory Mechanism for the eurozone](#) (among the European Parliament, Commission and Council), “The governance structure of the ECB will consist of a separate Supervisory Board supported by steering committee, the ECB Governing Council, and a mediation panel to solve disagreements that may arise between national competent authorities and the Governing Council. Clear separation between the ECB’s monetary tasks and supervisory tasks is fully ensured.” The legislative basis of the EBA was also adapted accordingly. It is believed that the SSM will be operational as of mid-2014. The law (to be finalized by an agreement between the European Parliament and the ECB) will apply to all euro area members (more specifically, to all banks situated there) and allow non-members to participate “by establishing a close cooperation between their competent authorities and the ECB. In that case they may, on an equal footing with the euro-area Member States, participate in the activities of the newly created Supervisory Board which is in charge of planning and executing the supervisory tasks conferred upon the ECB.”, according to Commissioner Barnier in the above statement.

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<sup>16</sup> Official webpage: <http://www.bis.org/bcbs/basel3.htm>, related Wikipedia article [here](#).

<sup>17</sup> Brief presentation of current EU deposit guarantee schemes (including the last amendment): [http://europa.eu/legislation\\_summaries/internal\\_market/single\\_market\\_services/financial\\_services\\_banking/l24012b\\_en.htm#amendingacts](http://europa.eu/legislation_summaries/internal_market/single_market_services/financial_services_banking/l24012b_en.htm#amendingacts)

As for the proposed new amendment: “On 12 July 2010, the Commission adopted a legislative proposal for a thorough revision of the Directive on Deposit Guarantee Schemes. It mainly deals with a harmonisation and simplification of protected deposits, a faster payout, and an improved financing of schemes. These proposed amendments follow urgent legislative changes that the Commission proposed in 2008 and that entered into force early 2009.”  
- [http://ec.europa.eu/internal\\_market/bank/guarantee/](http://ec.europa.eu/internal_market/bank/guarantee/)

The current situation is that a political agreement was reached on 18 April 2013 between the European Council and the European Parliament on a regulation conferring supervisory tasks on the ECB. For the comprehensive proposal of the European Commission and some further information please visit:

[http://ec.europa.eu/internal\\_market/finances/banking-union/index\\_en.htm](http://ec.europa.eu/internal_market/finances/banking-union/index_en.htm)

In the debate about the importance of the SSM, the benefits of such a mechanism are clear to all and there have not been heard any strong objections to its implementation. A good example is the speech<sup>18</sup> of Sabine Lautenschläger, Deputy President of the Deutsche Bundesbank and President's Alternate in the Governing Council of the ECB, which was delivered at the Institute of International and European Affairs on 25.06.2013:

“I expect major benefits from the forthcoming European cross-border supervision of banks. The last five years, in particular, have brutally shown us that crises do not stop at national borders, especially in a monetary union. An advantage of the SSM is that it will draw on a broader and better basis of information across the eurozone, thereby making it possible to reveal undesirable developments more quickly. If designed correctly, with a strong arm in benchmarking and peer review, we can uncover trends in individual business lines and risk management much sooner in future. I also expect this to be a major step towards the consistent application of the supervisory rules, as a second pillar of the single rulebook, so to speak. I am hoping that European supervision, in teams of supervisors from various nations, will provide a new approach which incorporates the best elements of each nation’s approach to supervision. This new approach will leave no room for a "home biased" supervisory regime.”

However, Ms. Lautenschläger also recognizes:

“However, the SSM also has some major weaknesses, and I would like to single one out for particular emphasis. It has to do with the fact that the final say on central decisions taken by the ECB – and thus also in the SSM – rests with the Governing Council of the ECB. It is true that these decisions will be prepared in a Supervisory Board, composed of representatives of all eurozone national supervisory authorities and central banks, and that the Governing Council of the ECB can only accept or reject the proposals. A mediation panel would resolve disagreements. However, the Governing Council would have ultimate responsibility no matter what. I have misgivings about this setup, for two reasons. First: this governance structure is quite complex, and its functional viability still needs to be demonstrated. I admit that I side with the sceptics here. Second: it will not be possible here to draw a clear dividing

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<sup>18</sup> To be found here (very interesting, please read):

[http://www.bundesbank.de/Redaktion/EN/Reden/2013/2013\\_06\\_25\\_lautenschlaeger.html](http://www.bundesbank.de/Redaktion/EN/Reden/2013/2013_06_25_lautenschlaeger.html)

line between monetary policy and supervision: the Single Supervisory Mechanism Regulation only goes as far as EU primary law allows.

I therefore see the ECB facing conflicting aims: price stability and a stable banking system. This conflict of aims can threaten the ECB's "internal independence". Over the medium to long term, I believe it is necessary to put the SSM on a sound legal footing; there is no getting around changes to primary law to improve the governance structure and to draw a clear line between the monetary and supervisory functions. I am convinced that we need to tackle the issue of these changes."

Apparently, not everyone is satisfied with a legally questionable implementation of the SSM. Although Ms. Lautenschläger agrees that the establishment of the SSM cannot wait, she insists that, on the long term, primary EU law will have to be adjusted. And this is a major issue for debate, since the amendment of primary EU law entails time-consuming and unpleasant referendums with an unpredictable outcome in some EU countries. Therefore, the solidification of the legal basis of the SSM is an aspect which still needs to be addressed.

### 3. The establishment of a Single Resolution Mechanism (SRM):

Banks and other financial institutions require not only supervision, but effective emergency action plans as well. Before and during times of financial distress, a lack of coordination in the set-up of such a plan, a lack of resources for its creation, personal interests and idle attitudes, amongst other factors, often prevent the application of corrective action, which is essential to ensure the financial viability of the concerned entity, when it is most necessary. The set of methods of saving a financial institution/entity from bankruptcy or, at least, making it more profitable and financially viable are commonly referred to as bank recovery and resolution strategies. Since states have a large interest in ensuring the existence of emergency action plans and the appropriate application of bank recovery and resolution strategies, they usually have stringent regulations in place and sometimes offer administrative or even financial aid. However, cross-border banks, i.e. all large and systemically important<sup>19</sup> banks, are not effectively managed by national bank recovery and resolution schemes. With the argument that common European bank regulation and supervision should be complemented by common bank recovery and resolution strategies, in order to address the issue of cross-border banks, to make mitigate systemic risks more effectively and combine EU-level control with EU-level liability, a single resolution mechanism (SRM) has been proposed as the third pillar / key building block of a banking union. It would entail common strategies and

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<sup>19</sup> With a high systemic risk.

relevant regulations for all large EU banks and include a central European resolution agency and a joint European resolution fund.

Before thoroughly explaining the proposal, I will give you an idea of the nature of the said strategies and the scope to which they will be enacted on EU-level. On July 10, 2013, the European Commission is to submit the so-called Bank Recovery and Resolution Directive<sup>20</sup> to the European Parliament and the European Council for adoption. [This press release](#) by the European Commission of the 06.06.2013 presents the key-features of the proposed unified bank recovery and resolution strategies (yet still applied and supervised on a national level, the central European resolution agency and the joint European resolution fund are necessary to coordinate resolution on an EU-level). In brief, “the proposed tools [for bank recovery and resolution] are divided into powers [, i.e. competences of the respective member states and later of the central European resolution agency,] of "prevention", "early intervention" and "resolution", with intervention by the authorities becoming more intrusive as the situation deteriorates.” The first stage includes the obligation of each financial institution to prepare “recovery plans” and “resolution plans” (which together make up what I called emergency action plans), the power of the authorities to “require a bank to change its legal or operational structures, if [...] obstacles to resolvability [are identified]” and intra-group support agreements (several financial institutions, usually related to each other in some way, decide to provide multilateral support to the other group members in times of financial distress). The second stage includes the power of the authorities to “require the institution to implement any measures set out in the recovery plan, draw up an action programme and a timetable for its implementation, require the convening of a meeting of shareholders to adopt urgent decisions, and require the institution to draw up a plan for restructuring of debt with its creditors. In addition, supervisors will have the power to appoint a special manager at a bank for a limited period when there is a significant deterioration in its financial situation and the tools described above are not sufficient to reverse the situation.” The measures and powers of the third stage take the form of extensive restructuring (see “Definition of Key-Terms”) by the authorities, including asset restructuring<sup>21</sup> and de-mergers<sup>22</sup> as well as similar techniques<sup>23</sup>. The Commission’s proposal also mentions the possibility of “resolution funding” by the authorities for effective restructuring over transition periods.

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<sup>20</sup> The relevant press release by the Council of the EU (where EU finance ministers shaped the proposal):

[http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ecofin/137627.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/137627.pdf)

<sup>21</sup> Conversion of company assets of one type into another (through buying and selling).

<sup>22</sup> “A business strategy in which a single business is broken into components, either to operate on their own, to be sold or to be dissolved.” Further information at the source:

<http://www.investopedia.com/terms/d/demerger.asp>

<sup>23</sup> Spinoff: <http://www.investopedia.com/terms/s/spinoff.asp>

Moving to the full implementation of the SRM: The idea of a central European resolution agency has not yet been transcribed into an official proposal, but certain key-features of this resolution entity have already been determined by the European Parliament:

“It is important that the entity responsible for resolution has a broad set of tools available and that it can use these when needed. [The Bank Recovery and Resolution Directive proposed by the European Commission lays the basis for and implements many of these tools.] This means that any potential conflict of interest should be avoided as well as political interference. For this reason we propose a separate entity responsible for the resolution mechanism. [Separate on a European level.] Simultaneously we argue that common insolvency rules<sup>[24]</sup> are necessary, that the Single Resolution Mechanism should take precedence over national legislation and that resolution plans are drafted on the level of the holding. These aspects are necessary to ensure that national interests do not disrupt the notion of a European Single Resolution Mechanism.”

However, some countries (primarily Germany) once again have some objections to the proposed way of legislative implementation. According to Ms. Lautenschläger in her abovementioned speech of the 25.06.2013:

“In order to make such a single European restructuring and resolution regime lawsuit-proof, a change to primary law is required here, too. In my view, the current legal framework for the establishment of a special resolution authority for the euro area, with extensive powers of intervention, is insufficient. As a European resolution authority will have extensive powers to intervene, its legal basis must be absolutely watertight. Resolution will invariably be followed by lawsuits – that much is certain.”

A final issue regarding the SRM is the hierarchy of liability to be applied in the resolution of bank. The European Parliament stated, as mentioned above, that “common insolvency rules are necessary”. Please research online for possible insolvency regulations as well as related international standards. An interesting opinion is, again, the one presented by Ms. Lautenschläger in her speech of the 25.06.2013. I strongly recommend that you read it, in order to gain a first experience with insolvency regulation before (potentially) constructing your own proposal on a possible regulation. It is located in section 4 of her speech:

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Tracking Stock: <http://www.investopedia.com/terms/t/trackingstocks.asp>

Carve-out: <http://www.investopedia.com/terms/c/carveout.asp>

<sup>24</sup> The national laws specifying the procedure for the resolution of a bankrupt financial entity (excluding countries), such as a bank, including provisions on the priority of its financial obligations, thus specifying the order in which these are fulfilled. They may be different in each country and a single resolution mechanism requires common legislation on this aspect as part of the single rulebook. Remark: Currently, there is no comparable legislation in place for bankrupt countries.

[http://www.bundesbank.de/Redaktion/EN/Reden/2013/2013\\_06\\_25\\_lautenschlaeger.html](http://www.bundesbank.de/Redaktion/EN/Reden/2013/2013_06_25_lautenschlaeger.html)

4. The establishment of a European recapitalization mechanism for financial institutions located in member states of the banking union:

Since the recapitalization of systemically important banks (in cases of financial failure) cannot be completely avoided, EU members have advocated the establishment of a direct recapitalization mechanism through the European Stability Mechanism (ESM)<sup>25</sup>. However, such a decision would clearly lift liability for individual member states' banks to a euro area level. Initially expressing strong objections to the proposal as a whole, Germany now demands that "we must avoid connecting false expectations with direct banks recapitalization because resorting to the ESM can only happen under strict conditions", according to a statement by Mr. Wolfgang Schäuble, Federal Minister for Finance of Germany. Also, some German voices still reject the idea of ESM recapitalization. [Ms. Lautenschläger's speech](#) again serves as an example; please read section 5.

The issue of shared liability among euro area members for individual financial institutions affects not only European financial market stability, but also the international markets and the general financial stability of the euro area, including states and real economies (the latter in the long run). Shared liability always is a delicate issue and deserves the necessary attention to avoid the increased built-up of systemic risk among countries. In the present example, meaning the one with the ESM, there is even a lack of correlation between the countries participating in the banking union and the ones contributing to the ESM fund for direct bank recapitalization, something which should also not be overlooked. The relevant publication of the Council of the EU outlining specific agreements among the members of the Eurogroup (which is informal, though, as you might remember) can be found here:

[http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ecofin/137569.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/137569.pdf)

5. The establishment of a common system of deposit protection:

Another long term proposal put forward by euro area, ECB and national officials, yet rejected by Germany regards a common system of deposit protection, again with shared liability and this time on the level of the banking union. Yet, the first official

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<sup>25</sup> "The European Stability Mechanism is a permanent crisis resolution mechanism for the countries of the euro area. The ESM issues debt instruments in order to finance loans and other forms of financial assistance to euro area Members States." It was established as part of the euro area's answer to the European sovereign debt crisis. For those unaware of its functions and powers: <http://www.esm.europa.eu/> and <http://www.esm.europa.eu/about/index.htm>

proposal is to be presented in 2014 and no substantial steps have been in that direction so far. Multilateral negotiation is required, in order to determine the political feasibility of such a project first.

As for individual member states deposit guarantee schemes, there has been a proposal by the European Commission in 2010 harmonizing the national frameworks, in order to “reduce the risks of financial fragmentation that results from contagion fears<sup>[26]</sup> and is detrimental to the smoothing functioning of the single monetary policy”.<sup>27</sup> The relevant press release can be found here:

[http://europa.eu/rapid/press-release\\_IP-10-918\\_en.htm?locale=en](http://europa.eu/rapid/press-release_IP-10-918_en.htm?locale=en)

Also interesting are the EU FAQs on this issue:

[http://europa.eu/rapid/press-release\\_MEMO-10-318\\_en.htm?locale=en](http://europa.eu/rapid/press-release_MEMO-10-318_en.htm?locale=en)

### Conclusion on the rationale for and against a banking union

The above analysis makes the major advantages of a banking union clear:

- a) Common regulation and supervision would counter the deregulation and mitigate the high systemic risk of the European financial economy as well as the risk stemming from the absence of a separation/safety valve between commercial and investment banks<sup>28</sup>,
- b) Common regulation and common resolution strategies would remove administrative and other barriers to capital flows and cross-border financial transactions, thus further promoting the European integration of financial economies.
- c) Common supervision, common recovery and resolution strategies and centralized recapitalization as well as deposit protection would increase the markets’ trust in the European financial economy.
- d) Common deposit protection policies would “reduce the risks of financial fragmentation that results from contagion fears and is detrimental to the smoothing functioning of the single monetary policy”, as mentioned above.
- e) The administrative costs of bank supervision and resolution are significantly lowered.

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<sup>26</sup> This financial fragmentation can occur when depositors and other creditors lose their faith in a national banking system with the result that capital leaves the country and the domestic financial system loses liquidity.

<sup>27</sup> Source: <http://www.ecb.int/press/key/date/2013/html/sp130212.en.html>

<sup>28</sup> Please research online for further information, as these circumstances constitute factors of the global financial and subsequently economic crisis and thus exceed the scope of this study guide.

However, some important disadvantages are also worth mentioning:

- a) Centralized recapitalization and deposit protection increase systemic risk among the member states of both the euro area and the banking union, while promoting reckless financial policies among nations and individual financial institutions (with the rationale that bail-out will be provided externally, if necessary). This way, the euro as a currency is also more vulnerable to systemically important failures. The financial reputation of the members of the euro area and the banking union might be homogenized.
- b) Common regulation and supervision can be led by (national) political interests, if not implemented correctly and independently.
- c) The weak legal basis of the main instruments of the banking union, the SSM and the SRM, in European law would make the whole system vulnerable to legal prosecution, thus decreasing its effectiveness and efficiency and seriously impeding the application of the single rulebook, as described by Ms. Lautenschläger.

## Major Countries and Organizations Involved

### Germany, Austria, Finland, Norway, Holland

Being the stronger economies of the euro area, they have adopted a skeptical approach to shared liability and increased systemic risk. Common bank regulation, supervision and resolution are warmly welcomed, though.

### Greece, Portugal, Spain, Italy, Ireland, Cyprus

Their financial and economic situation ranges from unstable to catastrophic, while systemic risk in their banking systems has proven to be high and a large portion of their banks are in financial distress. They favor shared liabilities, but reject too stringent common regulations as well as the centralization of strong powers and competences on the grounds of doubts about the proper calibration as well as the timing of the implementation of the banking union, while insisting that a rigorous regulatory and resolution regime would impose limitation on the banks' flexibility in dealing with financial distress.

### UK

“Will there be a space in the EU for countries, such as the UK, that have no intention of ever joining the euro? [...] For Britain – and other non-eurozone countries – there

are two risks: first, that the eurozone 17 starts to write the rules for all 27 member states, using an inbuilt majority in the EU's voting system. Not in the euro, but run by the euro, to paraphrase the famous slogan. Secondly, that the ECB imposes requirements on firms to be supervised by eurozone authorities in order to do business in the eurozone, effectively pushing the City of London "offshore".

- <http://blogs.telegraph.co.uk/finance/matspersson/100020828/britain-and-banking-union-not-in-the-euro-but-run-by-the-euro/>

The above quote neatly sums up many of the concerns of non-euro area members and their financial markets.

## Possible Solutions

The range of specific solutions is vast and cannot be covered in this chapter. I will have to provide you with some general directions:

One important step is the implementation of a banking union suitable to your country's financial policy and in accordance their financial relations with the euro area.

Apart from the debate about the implementation of the key building blocks of the proposed banking union which I have presented above, the international dimension of such a union should not be neglected. The financial stability and systemic risk of the euro area and the EU in general are of international importance, while non-EU countries might decide to adopt similar bank-related legislation and express their interest in integrating their financial market with the euro area's. Even more interesting to non-EU members is the impact of the new regulatory regime on the financial relations between banks covered by the banking union and those not. The banking union regulations for such transactions need to be reviewed and negotiated with the international community.

Finally, there is the question of international organizations like the International Monetary Fund (IMF) and their role in the establishment of the banking union as well as their future role in the provision of emergency financial assistance to banking union members.

All in all, the banking union proposal is multi-faceted and extremely complex issue which needs to be examined carefully, in order to ensure a globally consistent implementation.

Since this study guide will be severely outdated in a few months, I really recommend you to acquire up-to-date information from the internet, once you have read it.

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