HOUSE OF LORDS

EU ECONOMIC AND FINANCIAL AFFAIRS SUB-COMMITTEE

European Banking Union: Key issues and challenges

Written Evidence

Contents

Professor Kern Alexander, Senior Research Fellow, The Centre for Financial Analysis and Policy University of Cambridge, and Professor of Law and Finance, University of Zurich—Written evidence

In June 2012, the European Commission proposed a draft Directive on Recovery and Resolution to empower member states to develop robust resolution regimes for banks, certain investment firms, and financial conglomerates and groups. Later that same month, the European Council of Ministers issued a Decision to create a Euro area Banking Union designed to build a more effective banking supervision regime in the Euro area.[1] The draft legislation creating a Euro area Banking Union was proposed on 12 September 2012 in the form of a Council Regulation[2] conferring bank supervisory powers on the European Central Bank, and another Regulation amending the European Banking Authority's powers regarding its interaction with the ECB in respect of the supervision of credit institutions.[3]

Although the proposals have been praised as necessary regulatory reforms to restore Euro area financial stability and to enhance banking regulation, they raise important institutional issues regarding the effectiveness of EU financial regulation and its implications for UK regulation. The proposals also raise important legal issues regarding the extent and scope of the ECB's competence to supervise banks and financial groups under the EU Treaty. This note will address these issues and argue that the proposals are at odds with each other in certain key areas which may undermine their ultimate effectiveness as regulatory reforms.

Commission's Draft Directive for Bank Recovery and Resolution

During the financial crisis of 2007-09, most EU states did not have effective bank resolution and recovery regimes to ensure an orderly restructuring or winding-up of a failing bank or financial institution. When a number of major European banks began to fail in 2008, including Fortis, Dexia and the Royal Bank of Scotland, the absence of an effective resolution and recovery framework led EU Member State authorities to engage in a chaotic scramble to freeze and seize assets located in their jurisdictions in order to pay creditors and depositors of distressed financial institutions in their countries. Moreover, national authorities resorted to *ad hoc* measures to provide state guarantees and inject capital into failing financial institutions.[4] The crisis demonstrated the EU's lack of a clear and predictable legal framework to govern how a distressed financial institution would be reorganized or liquidated in an orderly manner without undermining financial stability. To reduce the likelihood of future bailouts and disorderly restructurings, the European Commission proposed on 6 June 2012 a draft

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[1] Council, Conclusions, 29 June 2012, EUCO 76/12., p. 3.

[2] Commission, Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, COM(2012) 511 final, Brussels, 12.9.2012.

[3] Commission, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority)

[4] According to the IMF estimates, crisis-related losses incurred by European banks between 2007 and 2010 were close to €1 trillion or 8% of the EU GDP. In addition, between October 2008 and October 2011, the Commission approved €4.5 trillion (equivalent to 37% of EU GDP) of state aid measures to financial institutions. See http://www.g20.org/images/stories/docs/eng/washington.pdf (last visited 9 August 2012).

Directive on a Framework for Bank Recovery and Resolution ("BRRF").[5] The BRRF would apply to all EU credit institutions, certain investment firms, financial groups and conglomerates and aims to reduce the risk and impact of financial failures on the financial system.[6]

The BRRF provides new resolution tools and powers for Member State supervisory authorities to ensure that uninterrupted access to deposits and payment transactions is maintained during periods of market stress or when an individual bank or banking group becomes insolvent.[7] Member State authorities would be empowered to sell viable assets of the bank and to apportion losses in an equitable and organized manner by requiring, for example, that certain creditors incur losses on their claims against the distressed financial firm. The BRRF is not intended to replace Member State bank insolvency laws and regulations, but rather to enhance and provide minimum powers across the EU for Member State authorities to require banks and financial groups to recapitalize or restructure creditor claims during periods of market stress in order to reduce the likelihood of a bank becoming insolvent and to mitigate the impact of a bank resolution or insolvency on the financial system.[8]

The BRRF attempts to improve the conditions for the establishment and functioning of the EU internal market by proposing minimum harmonizing legislation that delegates authority to the European Banking Authority (EBA) to draft and propose technical implementing standards for Member States to adopt for their resolution regimes.[9] These tasks conferred on the EBA are closely linked to the subject matter of the BRRF, which is to promote more harmonized Member State resolution practices that will reduce barriers to the internal market. The BRRF's scope of application extends widely to include all credit institutions, investment firms subject to capital requirements of at least €730,000, any financial institution engaged in a wide range of financial services which is a subsidiary of a credit institution and which is subject to consolidated supervision at the level of the parent company.[10] The BRRF's coverage runs parallel with the Capital Requirements Directive,[11] which harmonizes capital, liquidity, and governance arrangements for financial institutions and banking groups. The CRD is a maximum harmonization directive, the requirements of which Member States may not depart from except in specified circumstances, whereas the BRRF is a minimum

[5] Commission Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms, COM(2012) 280/3. The draft Directive is also known as the Crisis Management Directive.

[6] The draft Directive was based on an earlier Commission Communication published in 2009 entitled an 'EU Framework for Cross-Border Crisis Management in the Banking Sector', which analysed gaps and weaknesses in the EU legal framework governing bank resolution. See Commission Communication on an EU Framework for Cross-Border Crisis Management in the Banking Sector, COM(2009) 561 final. Later, in December 2010, the Council of Ministers (ECOFIN) adopted conclusions calling for a more comprehensive Union framework to regulate financial markets, including crisis prevention, management and resolution.

[7] The European Commission proposal has incorporated some of the international standards on bank resolution adopted by the Financial Stability Board, 'Key Attributes of Effective Resolution Regimes for Financial Institutions', (July 2011) (BIS: Basel). See http://www.financialstabilityboard.org/publications/r_111104cc.pdf (last visited 8 August 2012)

[8] See BRRF, Recital 1provides 'adequate tools to prevent the insolvency of credit institutions or, when insolvency occurs, to minimise negative repercussions by preserving systemically important functions of the failing institution'.

[9] The legal basis for BRRF is Article 114 of the Lisbon Treaty (TFEU) which provides for the establishment of EU bodies and institutions that are vested with responsibilities for contributing to the harmonization of laws and facilitating their uniform implementation by Member States.

[10] BRRF, Article 1. A €730k firm is defined as such under Article 9 of Directive 2006/49/EC (the Recast Capital Adequacy Directive).

[11] Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions, [2010] OJ C 293/1; and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions, [2009] OJ L 94/97.

harmonization directive based mainly on general principles, recommendations and minimum powers for resolution authorities. Member states are afforded discretion to design a recovery and resolution regime that fits their own economic circumstances and domestic legal frameworks. Member State authorities will be required to implement most requirements of the BRRF by 1 January 2015, whilst the Directive's more controversial bail-in requirements discussed below must be implemented by 1 January 2018.

Each Member State is required to designate a resolution authority to exercise powers under the BRRF.[12] States are free to decide whether or not the resolution authority will be a separate authority or combined institutionally with the bank supervisor, central bank or some other authority. However, where supervisory and resolution authorities are located within the same institutional structure, the BRRF requires that functional separation and independence between the authorities be demonstrated and there must be safeguards against conflicts of interests.

Each financial institution, covered investment firm and parent entity subject to consolidated supervision will be required to prepare a recovery plan as a condition for authorization.[13] Article 4 prescribes the information to be included in the firm's recovery plan, including its business strategy, organisational structure, expected funding sources, and risk management. The Directive also requires that the EBA and Commission adopt technical implementation standards on the minimum content to be provided by institutions in their recovery plans.[14] Article 5 requires institutions to submit their recovery plans for approval to the resolution authority. In reviewing the proposed recovery plan, the resolution authority must consider whether the plan can restore the firm's viability and financial soundness in difficult market circumstances without having adverse impact on the financial system. Authorities have the power to require firms to adopt any measure which the authority believes is necessary to overcome potential impediments or deficiencies in the implementation of the firm's plan.

The resolution authority will be required to develop resolution plans for each financial institution that is not part of a group and for each group subject to consolidated supervision.[15] Unlike the recovery plans which are prepared by the regulated entity or group, the resolution plans are prepared by the resolution authority in consultation with the regulated entity or group. Resolution plans are required to show how crucial payment functions and business lines can be separated economically and legally so as to ensure continuity of the bank's services to depositors and other customers. The plan must also provide an assessment of the institution's resolvability and a list of measures to address or remove impediments to resolvability. A feasibility assessment of alternative resolution strategies and how they could be financed without the assumption of extraordinary public support must be included, along with an analysis of the impact of the plan on other institutions within the group.[16]

[12] Article 3 BRRF.
[13] Article 5 BRRF.
[14] European Banking Authority, EBA Discussion Paper on a template for recovery plans, 15 May 2012 (EBA/DP/2012/2) (containing draft template with information to be provided in recovery plan).
[15] Articles 9-12 BRRF.
[16] Article 10 BRRF.

The EBA will propose guidelines and technical standards seeking to promote supervisory convergence in the development of resolution plans and in proposing scenarios to be used for testing the robustness of resolution plans. The BRRF envisages that the resolution plans should be able to respond to a range of market developments including idiosyncratic risks and market-wide stress scenarios. The BRRF contains a number of other important provisions that will be briefly mentioned. Articles 31-64 authorize Member State authorities to apply resolution tools against financial institutions and groups when they do not satisfy prudential standards, or when certain early intervention trigger points are reached. For example, the authority can compel the institution to sell a business, or an institution can have all or part of its assets transferred to a 'bridge institution', usually state-owned. The authority can also engage in asset separation by transferring viable assets to third party purchasers, thus allowing non-viable assets to be wound down in the original institution or in a bridge bank. Authorities will also be encouraged to use bail-in measures that allow institutions to recapitalize themselves whilst in distress by imposing losses on priority creditors and other unsecured creditors according to their ranking only after shareholders' interests have been extinguished. Depositor claims will be treated *pari passu* with priority unsecured creditors.[17]

The BRRF proposes harmonized principles and enumerates a set of resolution tools that encourage Member State authorities to intervene in the institution's risk management and strategy, but Member States are free to adopt divergent approaches in deciding whether and when to use these tools. Although the EBA will publish guidelines on how and when Member State authorities should use resolution tools, Member States will have ultimate discretion to decide whether or not to adopt these tools in their legal and regulatory frameworks. This may create incentives for states to adopt light touch approaches to resolution practice and potentially lead to regulatory arbitrage within the Union. The Commission recognizes this by stating expressly that the draft Directive provides a minimum harmonization framework that is meant to allow Member States to experiment with different resolution approaches and to use their discretion in the exercise of resolution powers. Nevertheless, more legal certainty should be provided that establishes clearly that the resolution tools supersede existing domestic law and related EU law. It is not enough to provide a harmonized set of principles and a proposed resolution framework to be applied in a discretionary manner by Member States. An effective EU resolution regime must consist of precise legal powers for Member State authorities to impose specific corrective measures on weak and failing financial institutions and groups at the early intervention stage before insolvency.

The UK approach to resolution

The UK Banking Act 2009 provides a state of the art regime for resolution of deposit-taking banks and building societies. As mentioned above, the BRRF draws considerably on the principles and practices set forth in the UK's special resolution regime. The Banking Act's special resolution regime creates a special resolution authority (SRA) within the Bank of England that can decide how to resolve a bank or building society which has not complied with applicable prudential regulatory requirements. The SRA can exercise stabilization powers to transfer property and shares from a failing bank to a state-owned bridge bank or private bank, or place the bank into temporary public

[17] This conflicts with the UK Independent Commission on Banking (Vickers' Commission) proposals which would give retail deposit creditors a priority over the banks priority unsecured bondholders.

ownership with the consent of the Treasury. Although the exercise of these resolution powers can substantially interfere with shareholder rights and other property rights, these powers have the objective of striking a balance between the legitimate rights of bank shareholders, creditors and depositors while preventing a failing bank from causing a systemic crisis.

The UK SRR has been criticised on the grounds that it does not provide an adequate resolution framework for large or too-big-to-fail banks.[18] Indeed, the operational complexity, jurisdictional issues, and political sensitivity of resolving a large cross-border bank require a more robust transnational approach. The UK Banking Bill attempts to address some of these weaknesses by adopting the proposals of the Independent Commission on Banking (ICB), namely, to ring-fence by subsidiarisation a UK retail bank's operations from the rest of the banking group (including separation from investment banking); to impose higher loss-absorbing capital requirements on UK retail bank subsidiaries; and to grant creditor preference to insured deposits with the retail subsidiary.

Another gap in the UK resolution regime is that it does not cover investment banks, insurance firms, financial groups and conglomerates. Although the Financial Services Act 2010 provides powers to support recovery and resolution planning, it does not require UK retail deposit-taking institutions or other UK financial firms to have recovery plans, nor does it subject insurance and investment firms and financial conglomerates (excluding a bank subsidiary) to the resolution regime. The BRRF would address this by requiring member states to extend their special resolution regimes to certain investment banks, insurance firms and financial conglomerates and groups. In July 2012, the UK Treasury issued a consultation that addressed whether or not the UK SRR should go beyond the minimum harmonisation requirements of the BRRF and to extend the recovery and resolution framework to potentially systemic financial infrastructure, such as clearing houses, payment systems, and securities settlement institutions.[19]

Commission's proposed Banking Union and Single Supervisory Mechanism (SSM)

The Heads of State decision[20] on 28 June 2012 to establish a European Banking Union aims to strengthen EU economic and financial governance by providing the ECB with supervisory powers over banks operating in the Euro Area. The Commission proposed on 12 September 2012 two Regulations that would, respectively, create a Single Supervisory Mechanism (SSM)[21] giving the ECB ultimate authority to supervise banks based in the euro area and enabling the European Banking Authority to interact with the ECB in adopting and implementing an EU banking regulatory code.[22] The Commission's proposals for the ECB to exercise competence to supervise credit institutions in the Euro area through the SSM represent a dramatic institutional restructuring of EU banking supervision which will have important implications for the practice of financial regulation in all EU states. Indeed, the proposed Banking Union in the Euro area is

[18] In a recent report, the International Monetary Fund concluded that certain features of the UK SRR – particularly property transfer arrangements to the private sector – could be used to resolve other types of financial firms.
[19] The Treasury's consultation suggests that the UK special resolution regime should extend to insurance and investment services firms, and financial conglomerates and groups.
[20] Council, Conclusions, 29 June 2012, EUCO 76/12., p. 3.
[21] Commission, Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, COM(2012) 511 final, Brussels, 12.9.2012.
[22] Commission, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority)

designed to sever the link between banking fragility and over-indebted sovereign debtors by authorising the European Stability Mechanism (the Eurozone's bailout fund) to recapitalise ailing Euro area banks on the condition that these banks are subject to ECB supervision and strict conditionality.

Euro Area banking union envisions a maximum harmonisation regime for banking supervision in which the ECB will ensure that Euro area banks are supervised according to the requirements of Union law, while the BRRF (as discussed above) provides a minimum harmonisation regime for EU member state resolution authorities to develop robust bank recovery and resolution regimes. It is not clear yet how the Commission will coordinate the banking union proposal with the BRRF. It is imperative that these proposals work together and complement one another in achieving the objectives of enhanced Euro area bank supervision along with effective recovery and resolution programmes for EU banks and investment service firms.

The ECB's supervisory powers would be phased-in over a period beginning from 1 January 2013 with the creation of a Single Supervisory Mechanism (SSM) to oversee banks that have accepted direct capital support from the European Stability Mechanism and 1 July 2013 when the ECB gains supervisory oversight of the most significant credit institutions and financial holding companies[23] until 1 January 2014 when the ECB shall carry out supervisory tasks for the estimated 6000 credit institutions in the Euro area.[24]

The regulation provides that the ECB shall establish a SSM that will be primarily responsible for licensing, monitoring and enforcing prudential regulations against banks based in the Euro area.[25] The ECB will also be empowered to approve bank recovery plans and asset transfers between affiliates within banking groups or mixed financial conglomerates.[26]

But the Regulation does not prescribe any powers for the ECB to resolve a distressed banking or financial institution. Resolution remains the sole responsibility of member state authorities. In some EU states, including Germany, France and Italy, resolution powers are exercised by the banking supervision agencies, while in the UK and other EU states the resolution authority is institutionally separate from the bank supervisor but the discharge of their responsibilities is coordinated by statute.[27] Under the BRRF, resolution funds and their financing are the responsibility of member states. For Euro area states, however, it is envisaged that the BRRF could be amended to allow the ECB to be involved in providing liquidity support to banks and financial groups subject to a resolution procedure and in administering a Euro Area resolution fund.
The proposals to give the ECB authority to act as the primary supervisor of banks in the euro area confronts two important obstacles: 1) institutional, and 2) legal.

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[23] Commission, Proposal for a Council Regulation conferring specific tasks on the European Central Bank, COM(2012) 511 final, Brussels, Art 27 (1).
[24] Art 27 (2).
[25] Art 4 (1)-(4).
[26] Art 4 (1)(k).
[27] See Financial Services and Markets Act 2000, s 7. Section 7 sets out the two main conditions that trigger the special resolution regime (SRR): (i) the bank is failing or is likely to fail, and has failed to satisfy the threshold conditions for permission to carry on regulated activities set out in the Financial Services and Markets Act 2000 section 41; and (ii) it is not reasonably likely that without the stabilisation powers the bank can take action to satisfy the threshold conditions.. See also Threshold Conditions (Banking Act 2009) Instrument 2009. For a description of what is covered by the threshold conditions and how they are applied, see the FSA Handbook, available at http://fsahandbook.info/FSA/html/handbook/COND/2 .

Institutional. In an era where global financial policymakers have accepted the importance of macro-prudential regulation and the coherent exercise of supervisory practices extending from licensing to resolution, it is striking that the draft Regulation creating the SSM only provides ex ante prudential supervisory powers for the ECB, without any mention of resolution powers. Indeed, the notion of prudential supervision has evolved substantially since the global financial crisis began in 2007 to take on a more macro-prudential perspective that includes both *ex ante* prudential regulatory rules involving capital adequacy, liquidity buffers, fit and proper and leverage limits, and *ex-post* crisis management practices involving prompt corrective action and recovery and resolution plans. Most regulators now agree that effective regulation requires a seamless process from crisis prevention through crisis management.

Under the proposed Regulation, however, 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. The ECB's ultimate effectiveness, therefore, under these proposals can be called into question. Is it really realistic to create the ECB with *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 other types of financial rescues? The necessary link between crisis prevention and crisis management is ignored in these proposals and without an 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.

Furthermore, ECB officials have signalled that they are willing to play a role in supervising large Eurozone banks. In June 2012, ECB Vice President Vitor Constancio supported the proposal for the ECB to be the bank supervisor. He claimed ECB had expertise and infrastructure to conduct supervision. However for the ECB to take on the supervision objective might bring it into conflict with ECB's 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 which might conflict with its price stability objective. However, Mario Draghi in early July 2012 set forth conditions that he argues are necessary to make the plan work and protect ECB's reputation. He said that supervision and monetary policy must be 'rigorously separated'. He also said national supervisors should play a significant role in any Eurozone supervisory plan.

The second obstacle is *legal*. Article 127 (6) of the EU Treaty (TFEU) provides that:

> The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.

Under EU law, European institutions have legal competence to exercise powers that are specifically conferred. Under the Treaty, the ECB does not have conferred power to exercise supervision over credit institutions unless it is provided by unanimous consent of EU states. The Commission's proposed Regulation relies on Article 127 (6) as a treaty basis to confer bank supervisory powers on the ECB. According to the language of Article 127 (6), however, the ECB can only have supervisory powers conferred on it 'concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.' This means it can only have bank supervisory powers conferred on it under this provision, not resolution powers, nor other supervisory powers over insurance firms and probably not for financial holding companies and conglomerates as well. The restrictive language of Article 127 (6) is presumably why the Commission's proposed Regulation was designed specifically for banks and credit institutions and did not include wider powers, such as resolution.

In addition, the lack of ECB legal competence to engage in bank resolution under the Regulation means that the ECB would have no power to order member state resolution authorities to take a bank into resolution. Moreover, the ECB itself could not exercise resolution powers, such as nationalising the assets of a Euro area bank, nor transferring the assets of a distressed bank to a private purchaser, nor transferring a distressed bank's assets to a bridge bank. The ECB could not even order competent resolution authorities in Euro area states to perform these resolution functions. This legal obstacle obstructs the ability of the ECB to perform effective banking supervision and supports the view that the ECB should not be granted banking supervisory powers unless the Treaty is amended to provide it expressly with enlarged powers to operate a bank resolution regime.

Summing up

An effective EU banking regime must consist of the following: effective prudential regulation and supervision to reduce systemic risk, deposit guarantee schemes to reduce the likelihood of a bank run, liquidity assistance from central banks to solvent banks experiencing temporary funding problems, and an effective resolution regime to mitigate the social costs of bank failure. The European Commission's proposed Directive on a Bank Recovery and Resolution Framework is an important step toward building a more effective cross-border EU regulatory regime. The BRRF proposal recognizes the important link between crisis prevention and crisis management and therefore supports other important regulatory reforms designed to stabilize the European financial system.

Much of the BRRF is modelled on the UK special resolution regime. However, it would require the UK to expand the scope of its resolution regime to include investment banks, insurance firms and financial groups. But the BRRF is a minimum harmonisation regime, meaning that it does not restrict the UK from expanding its resolution regime to cover other areas of regulatory concern, such as systemically important financial market infrastructure, or from providing greater protections to certain stakeholders, such as depositors. The ECB is expected to have authority to ensure compliance with European banking rules, such as capital adequacy. The Commission's proposal however does not address how the ECB's vast new supervisory powers will interact with member state resolution powers, nor does it address the legal question of whether it can do so under the Treaty. These outstanding issues suggest that continued work on a European Banking Union is needed in order to design a more effective institutional framework that can achieve regulatory objectives while overcoming outstanding legal issues.

1 October 2012

Professor Kern Alexander, Senior Research Fellow, The Centre for Financial Analysis and Policy University of Cambridge, and Professor of Law and Finance, University of Zurich—Oral evidence (QQ 103–118)

Evidence Session No. 8. *Heard in Public.* *Questions 103 - 118*

TUESDAY 9 OCTOBER 2012

11.25 am

Members present

Lord Harrison (Chairman)
Viscount Brookeborough
Lord Flight
Lord Hamilton of Epsom
Lord Jordan
Lord Kerr of Kinlochard
Baroness Maddock
Lord Marlesford
Baroness Prosser
Lord Vallance of Tummel

Examination of Witnesses

Professor Kern Alexander, Senior Research Fellow, The Centre for Financial Analysis and Policy, University of Cambridge, and Professor of Law and Finance, University of Zurich, and **Professor Rosa Lastra**, Professor in International Financial and Monetary Law, Queen Mary University of London.

Q103 The Chairman: Colleagues, we resume from our conversations in Brussels last week on the banking union and the recovery and resolution directive. It is my great pleasure to introduce our two professors, Rosa Lastra and Kern Alexander. We are most grateful to you for coming down today to address us on these ticklish issues. You may know the form that this conversation takes: we will provide a transcript to you. We will send it to you; please do correct it. If you have any inspired thoughts afterwards that are additional and you think would be useful, please do add those in as well, as we want to gather together the best information that we can. We have got Members' declared interests listed at the back for those who wish to consult the interests, and I remind my colleagues just at the beginning—at the opening opportunity they have—to declare them in open committee as well. So, colleagues, let me begin and perhaps address Professor Lastra first of all, and ask whether you can help us by giving some kind of definition of this thing called the banking union, or whether you think it will fulfil the aspiration of putting on a more sound footing and restoring confidence in the euro as well, as clearly this is an element of all that is happening here. Is it sound in itself, and will it fulfil the ambitions that the Commission and others have for it?

Professor Rosa Lastra: Thank you, my Lord Chairman. Ladies and gentlemen, it is a pleasure to be here addressing the question of what is a banking union—what is in a name. I would like to start by saying that the term "banking union" is somewhat imprecise; it is a bit of an intellectual accordion. To some extent one can say that, through the directives and regulations, we have already a narrow banking union in the European Union. The proposals that have been put forth by the Commission—published in September, though they were announced in June—go much further than that. They go further in that they propose a broader banking union. The two proposed regulations of September 2012 encompasses supervision to begin with, the single supervisory mechanism, but they announce something else. They announce that they intend the Commission to move beyond single supervision, which will be entrusted to the European Central Bank, to single resolution and single deposit insurance. They do not outline what single resolution and single deposit insurance will be. They just say what single supervision they would like there to be. The problem is the scope of the banking union according to the Commission proposals. You could say that there are two other elements of a banking union that the proposals do not take into account. One is the very fundamental lender of last resort, which is omitted in all the documents, and the other is the concept of macroprudential supervision. I will leave them aside for the time being. I would just like to make one other comment to finish the question, and that is that somehow the proposals suggest that the issues of banking union can be disentangled from the single market in financial services. I disagree; they cannot be disentangled. The success of the single market in financial services depends upon adequate rules on resolution and deposit insurance, in addition to the rules that we already have in other areas. To try to say that there will be an easy co-existence between the two is not correct in my opinion. The jurisdictional domain of the banking union is going to be the eurozone, and this poses a major challenge for the United Kingdom. The City of London has a vested interest, and the United Kingdom Government has an important interest, in keeping a firm voice within the single market in financial services. I think that is a long answer to your question.

The Chairman: Before I come to Professor Alexander, can I ask Lady Maddock, who is particularly interested in the later aspect of what you said, to speak?

Baroness Maddock: Yes, I was in fact going to ask you how realistic the Commission's assertion was that the creation of this banking union would not compromise the integrity of the single market, which you have touched on. It does not seem to be very compatible with the argument that the single market and banking union are in fact mutually reinforcing processes. I do not know if you have anything else to add.

Professor Rosa Lastra: I just say that in my opinion it is a very uneasy co-existence, because the issues of jurisdictional domain of the eurozone and the EU are fundamental for the success of the single market. The challenge for the United Kingdom is that, while the strengthening of the supervisory pillar as well as the economic pillar is part of the inexorable logic, using the words of Chancellor Osborne, of further integration, the needs of the single market in financial services required adequate resolution and adequate deposit insurance, so they cannot be disentangled. The reason why they have been pushed forward with such a tight schedule is one of political expediency and the link between the banks and the sovereigns. The reason is that the banking union plan is seen as a political pre-condition for the European stability mechanism to be able to directly recapitalise the eurozone banks. The German constitutional court on 12 September in its decision on the ESM made it clear that the ESM is in accordance with both German constitutional law and EU law, as long as there are strong conditionality mechanisms. Part of that conditionality, in my opinion, as I read it, is that ECB supervision—let us say, just to give an example of one jurisdiction—of the Spanish banks is a pre-condition for the European Stability Mechanism to be able to recapitalise those banks, hence the political expediency to get this through, perhaps under too tight a schedule to allow for a proper discussion.

Q104 The Chairman: Professor Alexander, on the definition of the banking union and the single market, can I throw in "How realistic is the timetable as well?"?

Professor Kern Alexander: My Lord Chairman, thank you very much for inviting me to appear before you this morning. The timetable is very important. It being as short as it is reflects the nature of the crisis that the eurozone is in. I think it reflects the push to give the ECB banking supervision powers as a political pre-condition, as Professor Lastra says, to have the European stability mechanism bail out weak eurozone banks, like the Spanish banks. So this is all being rushed in order to let the ESM be able to inject capital quickly, as soon as possible—January 2013. I do not think the proposals are well thought out. You asked earlier about the definition of banking union. Let us go back to the paper published by President Van Rompuy in June 2012, and later that was elaborated on in the European Commission communication of September 2012. President Van Rompuy defines banking union essentially to be prudential regulation of credit institutions and financial institutions, deposit guarantee schemes and bank resolution. In those three areas in his paper, and also if you look at the European Commission's road map, they break down what they suggest the banking union might look like. The proposals only give the ECB supervisory powers over credit institutions. They do not give the ECB any authority regarding deposit guarantee schemes or bank resolution frameworks. That is why the proposals are incoherent. An important conclusion can be made on the policy front that, in light of the financial crisis, the new framework of financial regulation focuses on macroprudential regulation. Macroprudential regulation includes not just ex ante prudential supervisory practices, like capital adequacy and licensing of banks; it also includes recovery and resolution plans. It also involves the administration of deposit guarantee schemes. For the ECB to exercise its authority in an holistic way, it needs to have powers in all three areas, which it does not have in the proposal. That is why I think the proposals are very weak.

The Chairman: I think, from the two of you, you are saying that because the origin is the financial crisis, which moves on to how reforms might take place in the banks, this is a deleterious background atmosphere to actually affect what is required in terms of those reforms.

Professor Kern Alexander: Yes.

Q105 Lord Kerr of Kinlochard: We have taken evidence from Mr Enria of the EBA, and we have been trying to work out how this complicated structure, using the EBA while the ECB becomes the supervisor for the member states whose currency is the euro, would all work out. Do you think that the EBA's role would need strengthening, and how do you think the voting rules discussion can be satisfactorily resolved? I will confess that I do not understand it—the double constituencies, that three countries must be found in each of them for a blocking vote to occur. That seems to me to be quite a strange proposal, given that in the ECB proposal we are told that the member states whose currency is the euro will be speaking as one, adopting a common position, so I do not see where the dissenting three from that side are to be found. As for the other three, well, of course, it seems to be a little unrealistic to expect the eurozone states to give a real block to a group that will diminish over time, as countries who are in the second group join the euro, leaving a diminishing group of those who do not want to join the euro with, a block on EBA decision-taking. What is the answer to that situation? It seems to me that it cannot be precisely the proposal that is on the table, but I do not know if there is a good answer.

Professor Kern Alexander: I think this is a complex area, as you have rightly pointed out, and I think few people understand the exact different permutations of how the voting would work. I am not very happy personally with seeing a formulaic approach to resolving internal disputes like this, done with a three-member panel chaired by the EBA supervisory chairman, I believe. I think it reflects in one way that there needs to be a reconsideration about decision-making in the EBA and the role of the ECB and its representation of the 17 eurozone states[28]. I think that the ECB is the big gorilla in the room here and, either through political pressure or through having a super-majority, it is going to find a way to get its way. I think this is an area that needs to be looked at more closely and subject to revision, to ensure the supervisory autonomy of states that are not in the eurozone, because I think that states that are not in the eurozone face certain problems here, as Professor Lastra pointed out on the internal market issues—free establishment and free provision of services. Disputes in this area simply should not be resolved by a three-member panel. These disputes are too important, and also the EBA has its current system of dispute resolution anyway, with the Board of Appeal, et cetera. This is parallel to that. One might consider having disputes channelled through the current procedure rather than adding this new procedure. Generally, having these types of disputes resolved like this is not an appropriate way for having a financial policy framework.

The Chairman: Professor Lastra, could you answer the question of Lord Kerr about the voting proposals, but could I take it a step further about the relationship—the interface—between the ECB and the EBA, which Professor Alexander has mentioned?

Professor Rosa Lastra: Yes. I think that the proposals to grant supervision to the ECB are of fundamental importance, because it (the ECB) will be a very powerful supervisor, something that the European Banking Authority is not. Therefore, the fragile institutional balance for the European Banking Authority, in my opinion, EBA is not a very strong authority—will be further undermined by the establishment of a very strong ECB. There is certainly a concern on the side of the United Kingdom and any other non-euro participant that it will be very difficult for non-euro member states to oppose a position within the European Banking Authority that is set out by the member states of the eurozone, which will obviously, if the proposals materialise and go forth, have the

[28] Note by witness: Generally, the decisions of the EBA Board of Supervisors are taken on a simple majority basis and by a qualified majority for certain acts (art. 44 Reg. 1093/2010). Under Article 19 Reg. 1093/2010, EBA cross-border mediation decisions are taken by an independent panel consisting of the EBA Supervisory Board Chairperson and two members appointed from the Board of Supervisors, excluding parties to the disagreement; and the panel's decision must be approved by a simple majority of the Supervisory Board. However, the Commission's proposed Regulation (COM 2012/512) would adopt a more complex 'reverse voting mechanism' in which panel decisions would be considered adopted, unless rejected by a simple majority consisting of at least three votes from participating (euro) or cooperating (non-euro) member states and three votes from member states neither participating or cooperating. These proposed voting arrangements would provide added safeguards for non-euro EU states, such as the UK, to protect their interests, but they are very complex in their application, thereby undermining transparency and accountability in EBA decision-making.

ECB as their main supervisory authority. So I worry about the disruptive impact that these proposals have on the delicate institutional balance of the European Banking Authority. It seems to me almost like the regulation on the EBA is an afterthought, you know? "We are giving all these powers to the ECB; well, now we need to rebalance the institutional balance within the European Banking Authority." Therefore, of the two proposals Regulations that come together with the communication, one is a strong one and the other is, "Let's try to see how we can fit EBA, which after all deals with the whole single market in financial services, into the banking union". It needs to be further refined; it needs to be thought about. It is a very welcome initiative of this Committee to raise the issues and the inquiry, because these particular issues need to be debated adequately.

The Chairman: Let us go a little further with the ECB. Baroness Prosser?

Q106 Baroness Prosser: Thank you very much, Lord Chairman. For the record, can I just declare my interests as a director of Trade Union Fund Managers and a trustee of the Industry and Parliament Trust. To turn to my question, you have been talking quite a lot now about the supervisory mechanisms. Perhaps I can ask you just a bit further about that. I think it was Professor Alexander who said that the mechanism is designed to cover credit institutions but not, for example, deposit guarantee schemes, but credit institutions are many and various, so I wonder if you can give us some information and your thoughts on what sort of framework you think a supervisory mechanism ought to take in order to cover large national banks, small savings banks, et cetera. The requirements, it seems to me, are going to be many and various.

Professor Kern Alexander: Yes. That is a very good question. My point is that, with the current proposals, we have three European supervisory authorities. This is an organic institutional development, which is more incremental. The concept of banking supervision has changed dramatically since the financial crisis, and we cannot think any longer simply about traditional commercial banks like Lloyds or HSBC. We have to think of other types of credit institutions and other financial firms, and we need to equip supervisors with the powers to exercise oversight of these institutions. The problem with the current EU treaty is that the ECB really can only obtain power to supervise credit institutions as they are traditionally defined, but not the broad number of financial institutions which could pose risk to the financial system. Precisely why we need to have a more coherent framework is the current ESA framework, with the EBA, ESMA and the insurance authorities working together and trying to have surveillance of the whole system, rather than enumerating simply what institutions we are going to be responsible for and "We'll let the member states take care of the rest". I do not think that will create a coherent framework. The current framework we have is more responsible to the extent that it recognises the need for more effective macroprudential regulation and the need to cover financial service firms across the system, to see where the risks are going to, where they are migrating to as they move off the balance sheet of large banking institutions, maybe to the smaller non-bank financial firms. This current proposal does not really give us a coherent model for how to do that.

Professor Rosa Lastra: The ECB has been given supervisory powers according to the only provision in the treaty that allows that transfer of powers. That provision is Article 127.6, which says, "policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings". There is no other provision in the treaty that allows for a change of the institutional balance other than that enabling clause, which still requires unanimity, so it will not go through unless the UK votes in favour of these proposals. I agree with my colleague, Professor Alexander: the concept of prudential supervision has broadened a lot, particularly in the aftermath of the crisis. There is also a relationship between supervision and crisis management, but the concept of prudential supervision still has contours. That is one of the reasons why the ECB has received powers in supervision, but the institutional mechanism to deal with single resolution and deposit insurance, which, of course, relates to the follow-up supervision, is not outlined yet. The very legal basis of the treaty is constraining the range of powers that can be transferred from the national to the supranational arena. I have concerns about the resources that the ECB will have in this humungous task. To supervise—I think the number is around—6,000 institutions is a major endeavour, and I personally have supported in the past what I refer to as a "Champions' league model", in which some of the larger institutions will be subject to European supervision, while the smaller institutions will remain at a national level. However, because of the incident with Northern Rock, and because of the cajas de ahorros in Spain and other banks which are not systemically relevant, at least from a European perspective, and because of the link between banks and sovereigns, the proposals have expanded. They have expanded in the light of the developments of the crisis. As the Lord Chairman said, it is the crisis that in a way is pushing the momentum, and the crisis has developed into a eurozone debt crisis in some of the member states. It is not just a financial crisis; it is a eurozone debt crisis, which in turn is triggering, again, problems in the banking sector. So the European authorities have limited instruments, according to the treaty, to provide for European solutions, but the trend clearly is towards federalisation of supervisory powers.

The Chairman: I am anxious that Lord Flight pursues this one, but would Lord Marlesford just table the question that he has?

Q107 Lord Marlesford: I am interested in the examples that have been given, particularly Professor Alexander's concept of macro-supervision, because of the idea that the ECB can decide which of the 6,000 are worth supervising. As has been pointed out by both our witnesses, I think, you never know where the trouble is coming from. All you can do, surely, is to have the ECB have a role of supervising the supervision—a general role. On what was said about the lack of a lender of last resort, of course there is only one lender of last resort: to be a lender of last resort, you have to have a printing press. The only person with a printing press is the ECB, and the Germans have the key that controls the printing press.

The Chairman: In the absence of the Gutenberg galaxy, Lord Flight?

Q108 Lord Flight: Lord Marlesford has raised some of the issues that I was about to raise. Professor Alexander has, if you like, made it clear that without deposit guarantee arrangements and without resolution arrangements it is like a car without any wheels. Professor Lastra has focused in part already on what my question is about: what is your assessment of the proposed package of powers for the ECB? I see them against the context not only of the rethinking about regulation that Professor Alexander talked about. If you look at the UK situation, there is quite correctly a complete change away from box-ticking to the crucial importance of supervision and knowing what is going on. That really leads straight to Lord Marlesford's point, but I will express it another way. What on earth is going to be the relationship between the existing central banks and the ECB? Is the intent that the ECB sets up a terrific office with branches all over Europe, duplicating what the central banks are doing, at substantial cost, or is it actually that it really should be just telling the central banks what to do and having them do the work for the ECB and reporting into them? That perhaps would make more sense. Then you have the point at which the ECB thinks, "Clearly, Spain's system of regulation is useless and we'd like to get in there and sort it out". It is not really at all clear to me how they think it is going to work, and the list of powers that they have got are really the old-fashioned stuff. What they have not got is the framework to supervise. They need to really copy the UK Financial Services Bill, which is now going through Committee stage of this House.

Professor Kern Alexander: I think the concern about the ECB exercising oversight of financial regulation in the euro area is an important concern that needs to be addressed, not least because what policy makers have agreed internationally at the G20 is that macroprudential supervision is not just about regulating individual banks and individual financial institutions. It is about monitoring and performing surveillance over the whole financial system—and not just the banking system, but the capital markets. We saw in the recent crisis how the wholesale capital markets with collateralised debt obligations and credit derivatives can be the source of systemic risk. I suggest that the ECB does not really have experience as a securities market regulator. You need to have supervisors who have a more holistic or a bigger view of the financial markets. The ECB, in many areas, has performed adequately, given its limited tools in the area of monetary policy, but it has very limited tools and very limited experience as a monetary policy institution. Giving it some power to supervise individual banks is, like you say, having a car without the wheels, but even if you gave it the wheels I do not think that it would be the right institution, because it simply does not have the knowledge or understanding of the wholesale capital markets—the structure of the securities markets. You really need to have regulators who are in touch more with the markets, and not central bank monetary policy managers. That is my institutional objection to the ECB exercising these powers.

The Chairman: Before I ask Professor Lastra to reply, Lord Vallance has a thought, and then Lord Kerr.

Q109 Lord Vallance of Tummel: You have triggered the thought of "Where does the European Systemic Risk Board—the ESRB—sit in all this?" We have looked already at some of the incoherence in terms of the relationship between the ECB and the EBA and the national supervisors, so where does this additional wheel on the machine sit, or does it at all?

Q110 Lord Kerr of Kinlochard: I was just going to ask if Professor Alexander could explain the point he makes very well in his written evidence, that it is the limitation of having to use existing Article 127.6 as the legal base which prevents one getting into wider institutions and, more importantly, into the whole area of resolution. I am going to quote you, Professor, as saying, "the ECB should not be granted banking supervisory powers unless the Treaty is amended to provide it expressly with enlarged powers to operate a bank resolution regime". I think that is the core of your view.

Professor Kern Alexander: Yes.

The Chairman: I am going to ask Professor Lastra to pick up the points from Lord Flight and Lord Marlesford, but also the ESRB one from Lord Vallance. Then we will come back to Professor Alexander.

Professor Rosa Lastra: I am glad you mentioned the ECB because clearly the competencies for macroprudential supervision were given to the European Systemic Risk Board. This very Committee conducted a very good inquiry in 2009 on the difficult balance between the ECB and the European Systemic Risk Board at that time. As my colleague Professor Alexander said, the concept of macroprudential supervision for systemic risk control is one of the novelties in the aftermath of the crisis. In understanding what supervision is about, I often explain to my students that it is like looking at the forest instead of looking at the health of the individual trees. Sometimes by looking at the health of each financial institution, one does not get the amount of leverage, the amount of undercapitalisation or the amount of risk that is in the system. You are right to ask where this leads. Effectively, we will have two institutions, the ECB and EBA. Then we will have an entity that is not per se an institution but is the one that has been given the mandate for macroprudential supervision, namely the ESRB. This leads to a problem of co-ordination. This country, the United Kingdom, has gone through its own problems of co-ordination with its revisions of the tripartite arrangement where the problem is who is in charge. So there are certainly problems of co-ordination among the three authorities and the balance not just of the voting procedures but the scope of competencies. Coming back to your question of what the package of 12 September tries to do, again it is constrained by Article 127.6 and therefore it is a bit illogical, because it does not deal with insurance undertakings and because it does not deal with the fact that supervision and crisis management are part of a seamless process. When you are supervising healthy institutions, you get into trouble and you are all of a sudden supervising troubled institutions. That leads to early intervention—powers that the ECB has. But nothing is said in the proposals about how we move from early intervention to actual resolution and deposit insurance. The Communication that the Commission published—announced that it would look into that. By looking into that, there is a two-track approach. On the one hand, before the end of 2012, the Commission wants to make a decision on three key directives—capital requirements IV, the deposit insurance and the resolution and recovery. At the same time, two of those elements were also part of the banking union following a step-by-step approach. The SSM, the single supervisory mechanism, is only the first step. The second step will be single resolution. Whether they will create a new authority and how they will do it remains to be seen—whether they will establish something like in the US the FDIC, or somehow alter the powers of the ECB and deposit insurance. But they have not really decided how to combine issues that are necessary for the proper functioning of the single market—and I reiterate that those are capital requirements IV, deposit insurance rules and resolution rules, with the next stages of the banking union, which include a single resolution and a single deposit insurance. The package to some extent is incomplete and has inconsistencies.

The Chairman: Professor Alexander, will you answer Lord Kerr's point?

Professor Kern Alexander: I agree with your point that the ECB needs to have broader powers to regulate not just on the ex ante side, licensing, capital requirements, but also to have responsibility for recovery and resolution, which are important powers now recognised internationally by the G20 and the Financial Stability Board. I might also add that in Europe I mentioned securities markets are now recognised as being sources of systemic risk, in the derivatives market in particular. That is why we have requirements under EMIR, the market infrastructure regulation, to move standardised derivative contracts on to exchanges and have them cleared by central counterparties or clearing houses. The European authority with oversight of the clearing houses will be the European Securities and Markets Authority. There is no explanation of how the ECB will interact with ESMA regarding the oversight of centralised clearing, which is now an important requirement of European financial markets for controlling systemic risk and financial stability. That is just another gap. My conclusion would be that to give the ECB regulatory supervisory powers, EU policy makers ought to amend the treaty to make it clear that the powers will be much broader to cover areas such as clearing and settlement as well as the banking supervision and resolution. I see a number of areas where there will be potential financial stability problems in the future for which the ECB will have no oversight whatever. It makes its exercise of this one area of regulation rather disproportionate.

The Chairman: Before I bring in Lord Jordan, I invite Viscount Brookeborough to speak because Professor Lastra has already talked about the important UK role, which he would like to explore.

Q111 Viscount Brookeborough: What is going on at the moment is quite clearly driven by a crisis, but we are also trying to put things in place that can cope in the normal market when there is not a crisis. Professor Lastra said that supervision might be part of crisis management, but surely only when there is a crisis. Should not supervision be a way of monitoring in real time what is going on? It should be preventative. Do you think we can ever get to a stage where supervision can be with a light touch, but everything being so transparent that this person who is God—who simply knows what is going wrong before everybody else—can actually see what is going on and therefore prevent the crisis? Surely the manpower, financing and that sort of thing is very difficult.

Professor Rosa Lastra: That is a very good point. Supervision should be designed for good times. It should be the oversight of the risk management of financial institutions, according to the profit-maximising incentives that they conduct in regular times. The problem is that we are now designing supervision in a post-crisis setting. Therefore, when I was saying before that supervision and crisis management were part of a seamless process, I do not mean that they are identical phases and processes. I am just saying that one leads to the other when you are in trouble. We should go back to a system that, I hope, because of some of the financial services legislation in this country and the Liikanen report, leads to a banking culture that is more preventative in future—that ex ante can prevent the occurrence of these crises and the extraordinary contagion effect of these crises. Yes, we should try to design supervision for good times. The political expediency of these times means that we are designing supervision ex post facto after the crisis. Therefore, we may not get the best design of supervision. We may get very intrusive supervision because we are certainly conditioned by the experience of the financial and sovereign debt crisis.

Q112 Viscount Brookeborough: Is it not because also, in the broadest sense, we consider banking to be morally good and to be a good thing for social advancement, but the very people who are involved in investments and everything else totally ignore that and are in there for the money and to get out of it what they can? There is a catch, is there not?

Professor Kern Alexander: You pointed out that the supervisor was in a position to predict or see when the next crisis might be happening. I am reluctant to think, given the last crisis, that supervisors or anyone will be able to predict the next crisis. That is why regulation has to be focused more on the recovery and resolution area. Before, it was all about how much capital the bank should hold. Even if the bank held a high level of capital, as they did before the crisis, these banks were still sweeping assets off their balance sheets into structured finance entities. The risk was not disappearing: it was simply being shifted around the system. What we need to do in the resolution recovery framework is work out how we bail-in creditors and shareholders to absorb more of the losses when banks fail. That will create more incentive for bondholders and shareholders to encourage management not to take excessive risk. That is why recovery resolution is so important. We will have another crisis and maybe sooner rather than later; I really hope not. But when it happens, we want to be able to spread the cost of recovery around those who can best absorb the loss. That is really what the recovery resolution directive is trying to do.

Q113 Viscount Brookeborough: What risks if any to the UK and other non-participating member states are posed by the proposals for the ECB to develop international relationships on supervision? In particular, is there a serious risk of the ECB becoming the dominant influence over European positions in international fora, with the effect of marginalising non-participating member states? What is the likely impact on member states who wish to participate but are excluded by their own actions from the eurozone?

Professor Kern Alexander: The UK is a member of the G20 and of the Financial Stability Board. I think that the ECB is also a member of the Financial Stability Board. But I do not think that the creation of the ECB and giving it supervisory powers will diminish Britain's role internationally in standard-setting bodies. Britain already plays an influential role in the BIS committees. It has been very influential in the Basel committee and remains influential. The ECB will certainly play more of a role, but the UK will still be influential in international standard-setting bodies.

The Chairman: I know that Lord Hamilton is anxious to ask his set of questions, but I am anxious that Lord Jordan opens up an area that we have not yet explored.

Q114 Lord Jordan: We are talking about the proposal to create what will be one of the strongest financial institutions in Europe and possibly the world, and all I am hearing is you and other people we have met wanting to give them even more powers—all that alongside a complete vacuum in accountability. The Commission asserts that it will be subject to accountability, but that is not the view of some of the parliamentarians who we met. They said that the exclusion of Parliament as a full co-legislator effectively reduces them to a toothless consultative role.

Professor Kern Alexander: I agree with your concern about the lack of accountability. As you know, the ECB now has strong independence in monetary policy. That was intended in the treaty so that it could target price stability and have instruments to do that and not be politically influenced in doing so. However, in bank supervision, I do not believe that the same level of independence is appropriate. Therefore, what has not been thought out at all in this proposal is the degree of accountability that the ECB as the bank supervisor should have to the other EU institutions in particular such as the Council and the Parliament. The ECB now would tell other institutions that it was independent and not supposed to be subject to political pressure. But can you imagine the Council of Ministers and the Parliament debating CRD IV and saying, "This is what we want to do and you, the ECB, will have to do it"? The ECB is not used to taking strong advice like that. There needs to be built into this framework a principle that will make the ECB as a bank supervisor more accountable. Its role as a monetary policy manager is independent and that should be kept, but the Maastricht treaty, which gives the ECB such strong independence powers, will have to be amended to make it more accountable to the other EU institutions such as the Parliament and the Council.

Professor Rosa Lastra: I want to add something to that. Your point is excellent and it is one of my biggest concerns with the proposals. I am pro-European, but it is one of my biggest concerns generally with the European project. Sometimes there is a lack of sufficient mechanisms of accountability. I agree with my colleague Professor Alexander that monetary independence is not the same as supervisory independence. It is not the same for the simple reason that, as long as we continue to have crises, the Governments continue to provide the fiscal back-stop and he who pays the piper calls the tune—the old English saying that I like so much. For supervisory independence there needs to be of course a degree of de-politicisation in decisions. We are talking about degrees of dependence and independence. But the mechanisms of accountability need also to include accountability to national authorities, not only to the European institutions. As long as fiscal policy remains at a national level, and as long as the ESM resources are finite—because the ESM cannot print money and therefore its resources will be finite—the fiscal back-stop of the Governments will dictate that on supervisory decisions the accountability needs to be twofold towards the European institutions on the one hand and towards the national authorities on the other hand. I am concerned about too many powers in one institution because of the lack of tradition of accountability that sometimes we have at a European level. The only point that I disagree with my colleague, Professor Alexander, about is that I think there is a danger that the UK will lose part of its influential voice in supervisory circles if the ECB becomes a strong powerhouse of financial supervision. On that particular point, I hold a different opinion.

The Chairman: I will ask Lord Hamilton to pursue that because this was an interest that we wanted to finish with.

Q115 Lord Hamilton of Epsom: When we talked to Mr Van Rompuy, we were obviously concerned about the damage that might happen to the City of London as one of the principal financial sectors. He was clearly quite unmoved. He said that as we had not signed up to the banking union, what happened to the City of London was our problem. Do you think that the City of London will be damaged, in all likelihood, by this happening?

Professor Rosa Lastra: I think there is a danger. I am not sure whether the damage will happen, but there is a serious risk. It is a matter of great concern for the UK Government to be engaged in the debate, to make sure that the debate and the political move that seems to be gathering momentum towards banking union does not marginalise the position of the United Kingdom, not only in the single market of financial services but as a key financial centre in the world. I do have concerns. There is a serious risk and it is a serious issue. That is why the initiative of this Committee is welcome: to bring adequate debate and scrutiny to this issue.

Professor Kern Alexander: I agree that within the EU the new powers for the ECB as a bank supervisor could be exercised in such a way as to limit market access, although not for discriminatory reasons and not for reasons that would violate the treaty. But the effect of the ECB supervision could potentially be such that it would make it more difficult for firms in the City of London to operate in the eurozone as they are today. I will give an example. The capital requirements directive IV—CRD IV—not only enhances bank capital and has liquidity requirements, importantly, in the EU, it increases the power of host country supervisors. In the EU, we used to have the old home country model where you had a passport and the bank freely did business around the EU fairly unrestrained. Now the host country supervisor under the CRD IV will have significant new powers to review prudential operations of banks coming from other EU states. The ECB would be the host country supervisor for British banks or investment firms that are doing business in the euro area. My concern would be that the ECB, with these new host country powers, would in some way regulate these firms to make it more difficult for them to do business the way that they are today in the euro area. That is a big concern that I have.

Lord Hamilton of Epsom: One of the people who has given written evidence to us, an MEP, said that she did not think that the banking union will ever happen because agreement will never be reached among the member countries. Is she right?

Professor Kern Alexander: I am not an expert on the internal politics. It depends on what the Germans want to do. Do they want to submit all these Landesbanks and these small banks to the supervision of the ECB? How will this proposal play out in German financial policy circles? Because Germany will be paying the bills for the bailout in many respects, whatever they decide to do could easily be exerted on to other countries, especially countries that need to borrow, such as Spain and Italy. I am not as sceptical about the proposal. I think that the proposal is a serious concern, which is why it should be debated and why the UK should try to play a role in trying to change certain parts of it that we have concerns with. But politically it has a lot of support in Germany.

Professor Rosa Lastra: There is certainly a danger that it will either not go through as it is at the moment or that it will take longer. Maybe that is not a bad thing. The concern I have is obviously the development of the crisis. A lot of these issues have been a little bit of fire fighting. It seems at the moment that the situation in my home country, Spain, has settled down, but if it were to reverberate again and threaten the very existence of the euro the proposals may accelerate again. The dynamics of the crisis in the countries that have been suffering a sovereign debt crisis that then has linked into a banking crisis will dictate the speed of adoption of the proposals and the very adoption of the proposals. It is true that at the moment there is a degree of hesitation in some of the so-called creditor nations in the northern part of Europe—Germany, Holland and even some of the newcomers—about contributing to the ESM if the ESM is then going to recapitalise the banks. There is a risk, but the political momentum will be conditioned very strongly by the dynamics of the crisis. If the crisis does not take a new turn for the worse, we should be able to have a thorough debate and a longer period of discussion before the adoption of what could be major changes in the way that we supervise financial markets in Europe.

Q116 Lord Vallance of Tummel: As a postscript, I would like to ask Professor Lastra and Professor Alexander what they feel about the recent Liikanen report on reforming the structure of the EU banking sector, particularly what they feel about the latest variation of what we might call the ring-fencing theme, which is the proposal that proprietary trading and indeed most other significant trading activities should be put in a separate legal entity subject to various thresholds.

Professor Rosa Lastra: The Liikanen report is a thoughtful proposal to try to separate commercial banking from investment banking, like the report in this country that was endorsed by the group presided over by Vickers. It proposes the ring-fencing of trading activities while Vickers proposed the ring-fencing of retail activity. My concern is threefold. It is a case of good intentions but, as usual, the devil can be in the detail. My first concern is that it is legally different from Vickers. It proposes a different solution for the ring-fence and is different from the Volcker rule. If the directive or regulation is adopted into law—and that is a big if—it may provide incentives for financial institutions to go "jurisdiction shopping" that is, opportunities for regulatory arbitrage. Of course, in the case of the UK, if Liikanen becomes law, the UK will have to adopt the Liikanen proposals as long as it remains in the EU and committed to the obligations of the single market. My second concern is that whenever a fence or boundary is established, there is an incentive for institutions to place themselves or part of their business outside of the boundary depending on what is more advantageous. My third and perhaps major concern is that it tries to preserve the universal banking system in Europe to some extent because it proposes to ring-fence trading activities, but does not say that the model has to substantially change. The issue of size is one that needs to be addressed at some point. If you want to reduce taxpayers' liability, you also need to address the issue of size. The reasons for saving troubled banks these days go beyond the protection of insured depositors. Some institutions, as the doctrine says, are too big to fail. The efforts to address the too-big-to-fail issue have so far focused on the "to fail" part—understandably, because that is needed—to make an orderly resolution to create instruments for recovery and resolution, which is something that the UK has been at the forefront of and now the directive in Europe is following through. But we also need to address the issue of size. That is something that neither Liikanen nor Vickers has addressed properly. I would have hoped that the Liikanen report would have been even bolder than it was. Where the report is very good is in endorsing the loss absorbency of debt via bail-in instruments; that seems, both at UK and at European level, to be a concept that is gaining momentum. That is rightly so because it is the right instrument to tackle the bailout policies to avoid taxpayers' money being potentially at risk, by internalising the cost of protecting those institutions. The Liikanen report is a good, sensible report. It could have gone further. I am concerned about the different models that are adopted—Vickers and the Volcker rule—and the incentives that that can create. I would still like the issue of size, which has to do with competition, to be addressed properly.

The Chairman: Professor Alexander, do you identify those same highs and lows?

Professor Kern Alexander: The Liikanen report reflects broadly a move in Europe and the US towards structural regulation. We are moving away from individual firm supervision that relies on risk-based models such as Basel III. Instead, we are saying, "How can we regulate the structure of banking groups so that if they fail it will impose less of a cost on taxpayers?" This is a different model of regulation from what we had before. The Independent Commission on Banking, the Volcker rule and the Liikanen report all reflect different methods of structural regulation. This is the way of the future in financial regulation regarding the banking groups. It is important that they point out that proprietary trading itself can be a source of systemic risk. Therefore, certain types of risky trading activities need to be segregated in a separate subsidiary within the banking group. One of the important aspects of the report is that the separate subsidiary where their risky trading activities are taking place will be regulated to have a recovery plan, which is very important. The Vickers Commission in a way said, "We are focused on retail deposit banks and we do not want the taxpayer subsidy to leak out to investment casino banks. If the casino bank fails, fine, let it fail". This report, by contrast, says, "We are also worried about the investment banking subsidiary. What happens if it fails?" Regulators need to create incentives for them to manage the risk more appropriately. That is why in this report there is a section that deals with the separate subsidiary having to have a recovery plan that shows how it will bail-in creditors and other investors who invested in the subsidiary to absorb losses if the subsidiary were to fail.

The Chairman: I will come back to Lord Hamilton in a minute but I would like to go to Lord Jordan first.

Q117 Lord Jordan: You have already touched on the recovery and resolution directive in answer to other questions, but for the benefit of our inquiry I would like to go over that issue a little more systematically. What is your assessment of the proposed directive to establish a framework of recovery and resolution, of credit investment firms, and what would be the impact of these proposals on the banking union proposals and vice versa? We are told that they want agreement by the end of the year. Most people think that that is not possible. The British Government in particular say, "Slow down, slow down: let us look at it properly".

Professor Kern Alexander: First, the recovery resolution directive is an important first step in Europe in building an institutional model to provide recovery resolution regimes. Most EU states before the crisis, including the UK, did not have special bank resolution regimes or special resolution regimes for financial service firms. Now we see how important it is to have them. As well as having recovery plans, which are plans about the governance of the bank and how they will alter their business strategies if they hit turbulence in the markets, the recovery proposals are important for the corporate governance of banking institutions. The EU proposal reflects this. What is crucial about it is that it provides a minimum harmonisation framework so that it is not having a prescriptive maximum harmonisation approach. It gives member states discretion to adopt their own recovery resolution regimes. Much of it is modelled on the UK special resolution regime at least for deposit-taking banks. The UK Banking Act inspired a lot of the work that went into this directive. So overall the directive is a small step in the right direction. More work needs to be done because it is really about providing a minimum framework to equip regulators to have the powers to develop recovery and resolution frameworks.

The Chairman: Professor Lastra, is the RRD one small step for mankind?

Professor Rosa Lastra: It is an important step. I agree with my colleague, Professor Alexander, that it was one of the pieces that we did not have in the single market and at international level prior to the crisis. It is clear that we do not want the chaotic resolution that we had with Lehman Brothers and we do not want bailouts either. Therefore, we need orderly resolution. That can only be given through adequate rules, and the directive is a good step in that direction. Perhaps from the point of view of UK interests, I have a couple of concerns. One is that although the directive is very much modelled on many of the instruments of the Banking Act 2009, in some aspects it defers—for instance, with regard to depositor preference, intra-group support and co-operation agreements with third countries. Those are important issues for the UK to iron out. With regard to the timetable, the proposal is before the end of the year. As I said, it is an essential piece, not just for the single market but internationally. If we are going to have adequate international banking and finance we cannot continue with a system that privatises the gains and socialise the losses; we need to make appropriate privatisation of the losses among the institutions that are failing. In that sense, the fact that it is an important piece of legislation should not take away the importance of having adequate debate. We need to get the rules right. Therefore, yes, we need recovery and resolution rules, because clearly nobody wants another Lehman Brothers and no one wants a bailout, but those rules need to be adequately designed. Again, it is a good initiative of the Committee to question some of those rules. You have some specific questions that we will not have time to discuss today. I mentioned three and you mentioned a couple also in your questionnaire, and those issues have to be tackled properly. It is not just a matter of having rules, which we need, but of having adequate rules.

Q118 Lord Hamilton of Epsom: On Liikanen and this whole question of dividing the casino banks from the clearing banks, the argument that the big banks have produced is that they are inexorably linked and you cannot cut them. It is like Solomon making his judgment. One of the witnesses who has written in said that the restriction may not be practical for banks that have wholesale loans on their books which have to be hedged and actively effectively risk-managed. That is an example of how they are tied together. Are you happy that the knife can cut them in half?

Professor Kern Alexander: Many banking groups operate functionally as firms, even though they are collections of subsidiaries and branches. Group management of the banking structure can permit this type of proposal, where the bank can manage its wholesale risk on its balance sheet by having an arrangement with its subsidiary that will take on that risk. I do not think that this proposal will really inhibit that because banks operate between the subsidiaries within the banking group structure now. This should not really limit that. There will be flexible ways for the group to manage its risk on the various balance sheets within the group structure.

Lord Hamilton of Epsom: So why not have separate shareholders?

Professor Kern Alexander: Well, there is a concern. They could if they wanted to, but the governance of a subsidiary is something that should be visited. Of course the Vickers Commission said that the retail bank subsidiary will have its own board and it will have a separate governance structure from the rest of the banking group. One of the problems with the Liikanen report might possibly be that it has not addressed how the subsidiary should be governed. Should it have a separate governance structure and board from the rest of the banking group itself?

The Chairman: I will conclude there and invite both of you to write to us, particularly Professor Lastra because she did not have the opportunity to answer that last question and said that there were also interesting questions that the Committee had not tackled or focused on. We would very much welcome your advice on those. As I said earlier, there may be things that you wish to correct when you see the transcript or other items that you would like to ask. I throw one last question in, which perhaps you could write to us about. I identify a Manichaean struggle between the European Commission defending the single market, which is its purpose and raison d'être, with growth of the ECB and the supervisory role plus the EBA's interesting relationship with it. Is that struggle going on, which may be difficult when we make progress on this score? I thank you on behalf of the Committee. This has been a very interesting conversation in the past hour and you have answered very plainly to us some difficult questions which will find their way into the body of our report. For that we are extremely grateful.

Marta Andreasen, Member of the European Parliament—Written evidence

1. What has the euro area crisis revealed about the weaknesses of the EU banking sector? In what ways do you believe that the EU banking sector needs to be reformed?

I can only echo what Christine Lagarde said last year in the USA that the European banking sector is undercapitalised. This has also been demonstrated by the EBA stress tests even though they proved to be inadequate and overoptimistic. Unfortunately the recapitalisation proposed by the EU is procyclical and will if anything reduce lending to those who are in the best position to return to economic growth, SMEs. The banks are not increasing their equity as they should but are instead reducing assets.

2. Steps towards 'banking union' were set out in the Van Rompuy report Towards a Genuine Economic and Monetary Union. How would you define 'banking union' in the EU context? What is your assessment of the report's conclusions, and what will its impact be on existing proposals (such as CRD IV)? What are the key elements of such a banking union if it is to function effectively?

The question is not so much how I define a banking union as how the EU defines a banking union, as their definition will be the one that matters. In the context of Mr Van Rompuy's short report it is implicit that a banking union will encompass the banks of all the Member States, whether or not they are in the Eurozone, and that European supervision would take precedence over national supervision. There is an implicit assumption in the report that the banking system would be subordinated to the interests of the EU, as would the national budgetary systems.

3. The 28/29 June euro area summit statement said that when an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could recapitalise banks directly. What is your assessment of this proposal? How likely is it that this would successfully stabilise the EU banking sector?

As I answer in question 15, it is my opinion that European bank supervision will not come into existence because of the disagreement between member states and the European Institutions. European member states have different needs in this regard with very different banking sectors. They vary from the being a global competitor with a world hub in the UK to being very localised. They have also had very different experiences with the crisis with different solutions with varying degrees of success. They also have different relations to their governments and involvement in the sovereign debt crisis. The proposals of the June Summit require widespread agreement that is not apparent from the major actors. I expect whatever agreement there is for concrete results to be sparse and I doubt that Mr. Van Rompuy's results will match the desire.

4. In January 2012 European Commissioner Michel Barnier set up a high level expert group to explore possible ways to reform the structure of the EU banking sector, including consideration of structural reforms such as activity restrictions as applies under the Volcker Rule, size limits, and structural separation of retail deposit banks from investment banking. What is your assessment of such proposals for structural reforms? Which, if any, would help ensure the future health of the EU banking sector?

I attended the conference in May in the Economics and Monetary Affairs Committee of the European Parliament, of which I am a member, where Mr Volcker and Sir John Vickers spoke on the subject of banking reform. Much as I wanted to accept Sir John's proposals I could not be persuaded that ring-fencing of the retail sector is superior to a formal separation from investment banking. Mr. Volcker's position was that ring -fencing would work when things were going well, but if things deteriorated badly and the protection of separation was needed it would cease to work. I accept the Volcker argument that it is really not possible to have two entirely independent branches performing different functions in the same organisation. Even if they perform independently most of the time, when the organisation comes under duress the two parts will end up depending on each other.

5. The European Commission are expected to present proposals for a single European banking supervisory framework in September. What is the purpose of such a framework, and what key elements need to be included if it is to succeed? How likely is it that such a framework will be adopted?

The Liikanen report of the Commission is expected today to recommend the ring-fencing of trading activities from the retail section of banks. It is my opinion that over the long term these activities are not compatible in the same bank. Even if they can be separated in the short term, in the longer term events will push the two sectors together and I believe it is inevitable that they will become dependent on each other. I would also like to point out that Glass Steagal was in effect for over sixty years during which time there was no banking crisis, but within fifteen years of its dismantling the current crisis occurred. An important reason that they should be separated is that the risk of investment banking is higher and therefore they should be allowed to fail when the time comes; on the other hand retail banking customers expect that the government guarantees their deposits, at least implicitly, and this confidence is vital to the integrity of the system.

6. What is the most appropriate division of responsibility between national and EU supervision under such a framework?

It is my opinion that the UK is perfectly able to supervise its own banking sector without the assistance of, or should I say interference from Brussels. The UK has a banking sector that competes at the highest level in the world. The regulation in the City, flawed as it is considered by some in light of recent lapses, is superior to that of the European Union because it has to regulate players who are competing around the world and can move where they please as market forces dictate. The European Union regulates not from experience in the industry but from preconceived ideas that mostly have a political bias.

14. The Government have made clear that the UK will not take part in the fundamental elements of a banking union, and will neither be part of common deposit guarantees nor come under the jurisdiction of a single European financial supervisor. What is your assessment of this position? How should the UK respond to these proposals?

The government's position is correct on all these elements of the banking union. As I said elsewhere I do not expect even the banking supervisor to come into being as desired and so the other elements will not follow. However if it did come into being and the UK was faced with a European banking union of which it was not a part I think the UK could find itself at a disadvantage for a number of reasons. Firstly the banking supervisor would have authority over banks operating in the EU including ones who were headquartered elsewhere, it would also have authority over banks headquartered in the EU who operated in the UK. It is easy to see how this could result in British banks being at a competitive disadvantage to continental banks.

15. What will be the implications of steps towards banking union for those countries, such as the UK, that intend to stand apart? How realistic is the Government's argument that the UK's non-participation should not and need not adversely affect London's position as the leading financial centre in Europe, nor adversely affect the operation of the single market?

The banking union proposed by the European Union is one part of four so-called "pillars" of a proposed much closer economic and fiscal union. The European Union is haunted by the notion that the future of the world is to be dominated by large national blocks of the size of the United States of America. It foresees a multi-polar world where economic size matters more than anything else and where half a dozen or so blocks dominate. In this world it is essential that Europe is formed into a cohesive block that can compete with the others. This view is flawed in my opinion. Even where there are blocks there is still room for nation states to compete if they are competitive economically and are run efficiently. Alas the European Union is neither flexible nor efficient. In fact it generally has rigid labour laws which are an obstacle to competition and overall one has to say that internal market has failed to live up to its promise.

My opinion is that the banking union will not come into being as there is too much division between the member states.

1 October 2012

Association of British Insurers (ABI)—Written evidence

The UK Insurance Industry

The UK insurance industry is the third largest in the world and the largest in Europe. It is a vital part of the UK economy, managing investments amounting to 26% of the UK's total net worth and contributing £10.4 billion in taxes to the Government. Employing over 290,000 people in the UK alone, the insurance industry is also one of this country's major exporters, with 28% of its net premium income coming from overseas business.

Insurance helps individuals and businesses protect themselves against the everyday risks they face, enabling people to own homes, travel overseas, provide for a financially secure future and run businesses. Insurance underpins a healthy and prosperous society, enabling businesses and individuals to thrive, safe in the knowledge that problems can be handled and risks carefully managed. Every day, our members pay out £147 million in benefits to pensioners and long-term savers as well as £60 million in general insurance claims.

The ABI

The ABI is the voice of insurance, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.

The ABI's role is to:

- Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
- Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
- Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
- Promote the benefits of insurance to the government, regulators, policy makers and the public.

Q1. What has the euro area crisis revealed about the weakness of the EU banking sector? In what ways do you believe that the EU banking sector needs to be reformed?

1. The euro area crisis is of a multifaceted nature. It encompasses a banking crisis, a competitiveness problem and institutional shortcomings in the framework of the European Monetary Union. The banking aspect is therefore only one element of the euro area crisis which has highlighted a strong and complex relationship between the banking sector and public finances.

2. Hence, whether the current euro area crisis may have triggered a banking crisis, or viceversa, is a matter for debate. While in Greece it is the government debt crisis that has caused widespread bank distress, in Spain and Ireland, it is the banks that are putting the government under strain. This goes to shows that the conditions of a country's banking sector and of its public finances are strongly entangled, and that excessive levels of debts in one may easily feed through the other.

3. For insurers, government debt is an important asset class and a key element in achieving financial stability lies in breaking the vicious circle between the banking sector and sovereign credit. As long-term investors insurers have a vested interest in operating in a safe and stable financial environment. We understand the argument that moving to a Banking Union would contribute to making the monetary union more resilient by reducing the correlation between banking and sovereign solvency crisis. Moreover, it would be desirable to reverse fragmentation of markets along national borders that have continue to developed since the onset of the euro debt crisis. Hence a Banking Union may be a necessary step among countries that belong to the euro area to establish a high degree of financial integration.

4. According to prevailing thinking, a Banking Union would consist of centralised bank supervision, bank resolution and deposit guarantee scheme. **It is difficult to see how such a centralised institutional framework can be achieved without a further degree of integration and political union among the euro area.** This leaves the UK in a position of uncertainty as to how to best ensure that City's role as the main financial centre in the EU remains unaffected.

Q 4 -In January 2012 European Commissioner Michel Barnier set up a high level expert group to explore possible ways to reform the structure of the EU banking sector, including consideration of structural reforms such as activity restrictions as applies under the Volcker Rule, size limits, and structural separation of retail deposit banks from investment banking. What is your assessment of such proposals for structural reforms? Which, if any, would help ensure the future health of the EU banking sector?

5. We consider that the key driver of structural reform is the public policy objective of financial stability, encompassing the ability of the banking system to withstand the failure of institutions that were perceived as too-big-to-fail without recourse to public money.

6. Insurers have a major stake in banking as investors, as users of bank services and as investors in the wider economy. Hence insurers have a genuine interest in a safe and efficient banking system, which supports long term sustainable growth in the real economy.

7. In our response to the Liikanen High-Level Expert group on reforming the structure of the EU banking sector, we argued that any structural reform for banks must find a balance between financial stability and enabling banks to sustain lending.

8. In principle structural reform has an important role to play in making banks resilient but banks also need to be investible. At present bank debt and equity is not an attractive proposition from the perspective of insurers as a class of investors. Banks need to earn a return on capital in order to be attractive to investors, otherwise the current mix of deleveraging and liquidity support from central banks will have to

continue indefinitely.

9. In the UK we have expressed broad support for the proposals for greater separation between retail and investment banking made by the Independent Commission on Banking led by Sir John Vickers. However, our experience in this context suggests that greater consideration is required of the frictional costs of implementing structural changes; costs of capital to banks will inevitably be a function of the returns that investors will need and their ability to provide capital in the quantities required. We have therefore concluded that the Vickers ring-fence design concept would benefit from some modification and simplification.

10. When linking the debate we are having in the UK around the role and structure of the banking sector with the option of implementing similar reforms at EU level, we would like to highlight that the UK banking landscape is different from some parts of Continental Europe. Banks' balance sheets are proportionally larger in the UK and this reflects the proportionally larger international wholesale and investment banking exposure. We therefore question the suitability of transposing a Vickers style of structural reforms to the EU banking system which differs from the UK and also varies widely from country to country.

11. We note that, at EU level, there are already a number legislative initiatives that are meant to improve the resilience of the EU banking system. However, we regret that there is a notable failure among policy makers to assess the overall effect of the regulatory reform agenda, especially the impact on long-term economic performance. We believe that the combination of new legislative initiatives such as CRD IV and the bail-in tool, which is part of the recovery and resolution draft Directive, is likely to increase bank financing and operating costs at a time when economic conditions will limit returns from banking activity.

12. The proposed regulatory landscape will make it difficult for banks to earn a return on their capital, and therefore to raise funds in the market. **Banking regulation is currently focused on financial stability at the expense of economic growth**. A narrow focus on financial stability might prove to be over cautious and inappropriate in a world of tight credit and rapid deleveraging.

13. **To conclude, great care should be taken when considering any additional reform of the EU banking sector. Any ill-judged structural reform of the EU banking sector could compromise the return to long-term growth. Any resulting lack of confidence in the banking sector will make it much harder to attract new capital from investors for the banking sector, thus compromising the capacity of the banking sector to contribute to the real economy.** Serious losses for insurers as investors will also cause detriment to consumers holding long term investment products and annuities.

BANKING UNION –SUPERVISION

Q 8- What powers and responsibilities is it appropriate for the European Central Bank to possess in relation to supervision and regulation of euro area banks?

14. It is clear that the answer to this question now is different from the one we would have given a few years ago. It is now obvious that the future requires much

greater centralisation of banking oversight. The June euro area Summit also makes it clear that direct recapitalisation of banks by the European Stability Mechanism is conditional on the establishment of a single supervisory mechanism. Hence, recapitalisation of EU banks creates the need for banking supervision at the EU level, which the Commission itself see best allocated within the ECB. This is the logic behind the Commission's proposed regulation published on 12 September to make the ECB the single supervisor in the euro area- with non euro area countries free to participate in the single supervisory arrangement if they wish so "subject to meeting specific conditions."

15. However, in discussing the role of the powers and responsibilities of the ECB in greater detail we would like to make two sets of distinctions first.

16. The first key distinction between a supervisory role - enforcing the rules - and a regulatory role -making the rules - is an important one. We do not believe the ECB can and should have any regulatory tasks. The establishment of rules in the current EU framework is carried out by complex interactions between the Council, the Commission, the European Parliament that culminates in Directives and Regulations. The EBA is the banking regulator for the whole EU, in charge of developing a 'Single Rule Book'.

17. The second distinction is between micro-prudential and macro-prudential supervision, a distinction which we note was expressed very clearly in the House of Lords Report on the Future of EU Supervision and Regulation. As the report describes it: "macro-prudential supervision is the analysis of trends and imbalances in the financial system and the detection of systemic risks that these trends may pose to financial institutions and the economy. The focus of macro-prudential supervision is the safety of the financial and economic system as a whole, the prevention of systemic risk. Micro-prudential supervision is the day-to-day supervision of individual financial institutions".[29] Hence, while we recognise that there are synergies between the two, the focus of macro-prudential analysis differs from the micro-prudential one.

18. We have also seen that, since the financial crisis highlighted the need to focus more on financial stability to detect the risk of systemic failure, the concept of macro-prudential supervision is now embedded in the supervisory architecture in EU and the UK. Since the establishment of the European Systemic Risk Board (ESRB), the ECB has de facto macro-prudential supervisory tasks. Until the emergence of the credit crisis, the ECB played no official role in supervision. The questions brought up again by the Banking Union proposals, is whether the ECB should now play also a role in micro-prudential supervision, especially with regard to the euro area. Through its long-term refinancing operation (LTRO) the ECB has been lending to banks without being able to determine their soundness. Putting the ECB in charge of micro-prudential supervision should enable the ECB to assess risks associated with individual banks. The proposal will bring micro and macro prudential supervision under one roof.

19. We believe that entrusting the ECB with micro-prudential supervisory tasks would be a substantial overhaul of the current system where EU micro-prudential

[29] HOUSE OF LORDS. European Union Committee. 14th Report of Session 2008–09. The future of EU financial regulation and supervision

supervision remains substantially decentralised. The draft Regulation published on 12 September clearly sets out the new supervisory powers for the ECB which are of great significance as they cover all the major prudential powers, including authorisation of credit institutions; compliance with capital, leverage and liquidity requirements; stress tests, assessments for possible public recapitalisations; and early intervention measures when a bank breaches or might beach regulatory capital requirements.

20. In general our view is that effective supervision requires that the supervisors are close to the financial entities they oversee. One of the untested risks in the Banking Union proposals is the enhanced link between the ECB and national supervisors. Currently the EBA has only limited powers overall national supervisors as day to day supervision is conducted at the national level.

21. We also note that discussions about entrusting the ECB with micro-prudential supervisory tasks go back to the De Larosière report which did not support any role for the ECB in micro-prudential supervision on the grounds that no European body should have supervisory power over firms when crisis management remains at a national level. **Hence it is our view that that micro-prudential supervision could not be performed at euro area or EU level without a solid fiscal backing. And crisis management becomes inevitably a key aspect of a Banking Union. There can be no credible Banking Union without a simultaneous fiscal union.**

22. The ECB is the sole institution mentioned in Article 127.6 of the TFEU for the role of supervising banks, thus making the ECB the most obvious candidate for being entrusted with bank supervisory powers. There is no surprise that the legal basis for the draft regulation published on 12 September is precisely Article 127.6 as this is a practical and rapid way to proceed to establish a EU single supervisor without a Treaty change.

23. Moreover, we would like to highlight the fact that the ECB is not entitled by the TFEU – Article 127.6 - to supervise insurance companies. In this regard, the De Larosière report observes: "in a financial sector where transactions in banking and insurance activities can have very comparable economic effects, a system of micro-prudential supervision which was excluded from considering insurance activities would run severe risks of fragmented supervision."[30]

24. While we do not believe that the exclusion of insurance companies is a sufficient reason to prevent the ECB from being invested with responsibilities relating to the supervision of banks, we believe that the exclusion of insurance from ECB's supervisory tasks is an important one that needs to be maintained as it draws a clear distinction between the nature of insurers' business models and the different set of risks that banks pose. Banks borrow short term to lend long term, whereas insurers try to manage their business to match assets to liabilities. Insurers' balance sheets are more stable than banks' balance sheets: premiums are paid in advance, and reserves held to pay the estimate of future claims. Saving policies are subject to penalties for early surrender.

25. Hence, insurers are less likely to suffer from the liquidity problems which affected Northern Rock. Unlike banks that have to return money to depositors on demand, insurers do not need to disburse quickly large amounts of money

[30] The de Larosière Group, Report, 2009.

policyholders. In traditional insurance business payments are reliant on the occurrence of an insured event.

26. In addition, the wind up of insurance business is conducted in an orderly manner over a prolonged period and is not subject to the same time pressures as bank resolution.

27. **In conclusion, due to the specificities of the insurance business models, we believe that the exclusion of insurance from the potential supervisory remit of the ECB should be maintained.** It is our view also that the removing such exclusion would require a Treaty change.

28. However we note that the text of the proposed Regulation setting up the ECB as single supervisor contains ambiguities in the coverage of the entities that the ECB will supervise. For example, the treatment of bank insurance conglomerate needs to be further explained.

Q10. What is your assessment of the proposed Directive (COM (2012) 280) establishing a framework for the recovery and resolution of credit institutions and investment firms? What will be the impact on the proposals of the steps towards banking union (including a resolution framework) as set out in the Van Rompuy report?

29. We already indicated that supervision at EU level can only work with an adequate apparatus to manage a banking crisis. Hence if a Banking Union has to be developed, then it inevitably requires a framework for crisis management and resolution.

30. We note that the proposed Directive on Recovery and Resolution (DRR) was published before the draft Regulation on ECB, hence the draft Directive will need to be amended and brought in line as discussions over Banking Union progresses.

31. Overall we believe that recovery and resolution plans are a useful tool only for banking activities where liabilities are callable on demand, or affected by market sentiment. In the case of insurers, current regulatory requirements (soon to be supplemented by Solvency II) already provide supervisors with extensive powers to intervene. In particular, supervisors have powers to require management of an insurer suffering financial stress to prepare plans showing how the position of the business can be restored. The wind up or run-off of insurance business is conducted in an orderly manner over a prolonged period and is not subject to the same time pressures as bank resolution. Liquidity is not a major factor in resolution given income from contractual premiums. These existing powers provide supervisory authorities with recovery and resolution powers appropriate to insurers therefore no additional measures are needed.

32. Although we support the overall purpose of the Commission's draft Directive for Recovery and Resolution to ensure that banks can fail without creating disruptions for the financial system, we are concerned with the introduction of a bail- in instrument. Bail-in tools will have a significant impact on investment decisions and most likely increase the cost of debt funding and restrict banks' access to finance. We explain our concerns in more detail in our next response.

33. Moreover, we already take note of the Commission's intention to go further than the provisions included in the DRR by creating a single resolution mechanism for the Banking Union. The Commission itself recognises the intrinsic difficulties to coordinate national resolution authorities to deal with banking crises, as it is currently the case with the DRR proposal. The prospect of a Single Resolution Authority for the euro area would inevitably have implications for the resolution of cross-borders banks that have their headquarters in the UK.

(Question 12) What is your assessment of the proposed 'bail-in' tool (Articles 37-38 and 41-50)?

34. For insurers, as investors in government bonds, breaking the link between banks and their sovereigns is fundamental to achieve long-term financial stability. A bail-in regime would have the merit of reducing or eliminating the implicit state guarantee and protecting public funds, as bank creditors will absorb losses rather than taxpayers. The following remarks are mainly reflecting the perspective of insurers as investors in banks.

35. Bail-in introduces additional risks by comparison with traditional bonds. Bail-in bonds are, by their nature, a hybrid between debt and equity. They have none of the potential for growth of equity, and little of the defensive qualities of traditional bonds. Bail-in bonds will not necessarily be suited to all types of banks.

36. Hence, we see many practical challenges in implementing a bail-in bond regime, especially in relation to the difficulty of defining bail-in triggers and the point of non-viability. We are particularly concerned that Articles 23-26 in the DRR contain no specific quantitative benchmarks that would trigger intervention, leaving a substantial degree of discretion to supervisors to decide when to intervene.

37. We do not believe that determining when bail-in should take place should be left entirely to the discretion of authorities. This introduces a huge degree of uncertainty for potential bail-in debt investors who will be unsure when authorities might decide to impose losses, and which claims will be affected. Market uncertainty will be greater the wider the discretion held by supervisors. The presumption is that investors will require a high risk premium to cover the uncertainty.

38. Hence we would favour the use of hard objective triggers, applicable to all creditors, and a short period in which market participants should be allowed to consider a consensual solution before bail-in is applied.

39. In essence we believe that bail-in should be used as resolution tool and as such used for firms that reach the point of non-viability and not as a recovery tool to prevent banks from failing. We are hence concerned that the Commission's proposal leaves the option for a bail-in to be triggered during the recovery phase rather than treating bail-in as a resolution instrument.

40. The introduction of bail-in complicates an already complex structure of bank capital. We are particularly concerned for the consequences that bail-in would

entail for the creditors' hierarchy of capital. It is essential to maintain the sanctity of contract to maintain investors' confidence in the debt markets. We oppose in principle that bail-in powers should be retroactive, as they would be applicable to the outstanding stock of debt. Blurring the hierarchy of the capital structure may restrict future financing programmes by closing down funding avenues, in particular senior unsecured debt

41. Overall, we believe that building a market for bail-in debt will be tricky, particularly as the market is not starting from a solid base. There is a serious lack of appetite among investors for bail in bonds. Insurers fund managers have a wide universe of investible assets open to them where banks assets are a significant part of this universe but are not indispensable. Hence we question the very existence of a market for bail-in bonds given that insurers and pension funds are likely to be attracted to secured or short term lending to banks. ABI members are concerned that regulators' desire for bail-in bonds to form a significant part of banks' capital structure could restrict banks' access to finance, though this may allow a more appropriate pricing of the risk that investors are being asked to face.

42. We note that the UK government intends to implement a bail-in regime as part of the measures recommended by the Independent Commission on banking. It is therefore important that the UK implementation goes *pari passu* with developments at EU level.

43. **Moreover, we would like to emphasise that bail-in should be seen as one of the tools among others to achieve resolution**. Use of bail-in instruments should be smart especially in the current regulatory environment where banks are facing greater capital requirements. Bail-in remains largely untested and it is important that this draft Directive set up the use of bail-in with considerable care.

44. *(See Appendix ABI Bank Debt – Contingent Capital and Bail-In).*

THE IMPACT ON THE UK

14. The government have made it clear that the UK will not take part in the fundamental elements of a banking union, and will neither be part of common deposit guarantees nor come under the jurisdiction of a single European financial supervisor. What is your assessment on this position? How should the UK respond to these proposals?

45. We understand the Government's concerns at some of the fundamental principles that underpin the development of a Banking Union. We also understand the importance of the Banking Union project to euro area Member States who, in light of the current euro area crisis, see a real need to strengthen the current mechanism in order to control the spread of contagion between weak banks and weak sovereigns.

46. We wonder whether a better approach would have been for the UK to sit at the decision-making table as the proposals are developed, as we believe the Banking Union has the potential to result in a fundamental reshaping of the EU in terms of institutions and powers, and British providers of financial services will be affected.

Stepping aside and leaving others to direct the drafting does not allow for UK ideas and principles to be considered which may better shape what comes next.

47. While the Banking Union proposals are targeted at the euro area, there will inevitably be questions arising about the impact on companies based outside the euro area. For example what about euro area headquartered banks that operate branches/subsidiaries in UK – how will they be treated? We believe this remains ambiguous. Moreover, what about UK banks operating in the euro area? The detail of this arrangement will be crucial.

48. Despite this being a Banking Union, the insurance industry is likely to be affected. We note that the definitions of mixed financial holding companies vary across the Banking Union proposals, Financial Conglomerates Directive, Solvency II etc. UK insurance companies that operate cross-border might therefore clearly be captured by the scope of the Banking Union proposals. Furthermore, there are questions about how the ECB could act where there is a trading/counterparty relationship between euro area banks and insurance companies, especially as the TFEU Article 127.6 explicitly prohibits ECB supervision of insurance. As a result greater clarity on the direct implications on insurance companies is needed and in particular with regard to the oversight of UK cross-border insurance groups which operate in the euro area.

49. As explained in our response to question 8, insurance business models differ from banks and traditional insurance business does not generate or transmit systemic risk. **We are therefore concerned by the policy makers' tendency to transpose banking solutions across to the insurance sector as it is nonetheless the case that insurers got through the crisis with much less damage than banks.**

50. The ABI is conscious that the Banking Union proposals will set a precedent and that in the future similar proposals for insurance may be considered. We therefore have an interest in seeing the precedent suitably framed.

51. Furthermore, the Banking Union proposals involve changes to the European Banking Authority (EBA) Regulation. Will this have implications for the future role of European Insurance and Occupational Pensions Supervisory Authority (EIOPA), and European Securities and Markets Authority (ESMA)? Or are EU policy makers content with the each of the ESA being constructed differently?

15. What will be the implications of steps towards banking union for those countries, such as the UK, that intend to stand apart? How realistic is the Government's argument that the UK's non-participation should not and need not adversely affect London's position as the leading financial centre in Europe, not adversely affect the operation of the single market?

16. How do you assess the risk that, as elements of a banking union, including supervision, are addressed by a subset of its members, the Council's role in banking regulation will be undercut, with its legislative debates pre-empted and/or decisions pre-determined in discussion amongst banking union members?

52. There is a serious chance that the Banking Union proposals will be the start of a two tier EU. We remain apprehensive at the idea of the UK being on the side-

lines of a trading bloc of 500 million people, combined GDP of £11 trillion, (40% of UK exports go to the euro area)[31] especially as 24 out of 27 EU Member States are committed to pursuing euro area membership at some point.

53. Being in an outer circle of a maximum of three other Member States would mean all the decisions being taken at another table. While the proposals give the ECB a single supervisor role for euro area banks and the development of the single rulebook to the EBA, we question how this will operate in practice, and whether this would be a suitable and desirable arrangement. Should it be possible to keep a Banking Union and the single market separate, those Member States that belong to the Banking Union are likely to react to proposed legislation as a closer unit in Council and in the EBA. **Inevitably the center of gravity of the new institutional landscape will be the euro area and euro area concerns will dominate policy initiatives.**

54. **We are doubtful of the value of the safeguards proposed in the EBA Regulation to protect the Single Market.** A new procedure to handle disputes or to settle emergency situations or the creation of a new panel of independent experts to deal with breach of EU rules will do little to maintain the influence UK-based providers of financial services might hope for in a single market. The proposed voting rules put the ECB in a favourable position over the EBA. Indeed it is difficult to conceive of any effective safeguards. This might have profound implications for the effectiveness of the UK as an international centre

2 October 2012

[31] FCO "Review of the Balance of Competences between the United Kingdom and the European Union"http://www.fco.gov.uk/resources/en/pdf/publications/eu-balance-of-competences-review.pdf

Association for Financial Markets in Europe (AFME)—Written evidence

1. The Association for Financial Markets in Europe (AFME) welcomes the opportunity to respond to the Sub-Committee's call for evidence.

2. AFME represents a broad array of European and global participants in the wholesale financial markets: our Members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. Whilst AFME is a European trade association, given the importance of the London markets, both to the European Union as a whole and to the many EU and international firms that have operations in, or provide services on a cross-border basis into London, we consider it important to engage proactively and constructively in debates that determine the environment in which our members undertake their business.

3. We welcome the call for evidence, particularly given the importance of the banking sector to the UK and wider European economy. We recognise that the themes of the Sub-Committee's work – to establish whether the proposed actions can adversely affect London's position as the leading financial centre in Europe or undermine the Single Market - are now the central questions to be addressed in the UK against the background of significant regulatory change and restructuring that is underway.

4. Given AFME's role, we have concluded that at this stage we can best contribute to the Sub-Committee's work by providing a high-level response – broadly covering the questions set out in the inquiry document. We hope our contribution provides a fact based overview of the key challenges and areas of concern into which the Sub-Committee might find it helpful to refer to in its deliberations.

<u>Banking reform, banking union and the euro area crisis</u>

5. The banking sectors in Europe are fragmented along national borders: rather than operating as a true single market, the financial crisis has affected the Member States differently, with the extent varying according to the structure of the state specific banking sectors or individual institutions within the system. Whereas for some jurisdictions the authorities' problems centered on the failure of a handful of large institutions, in other countries small regional mutual banks were the root cause of the domestic crisis and the resulting taxpayer bailouts. The consequences were further exacerbated because most Member States did not have adequate crisis management mechanisms for the resolution of banks and thus even relatively small banks were deemed too systemic to fail. Thus the EU dealt with only a few liquidations (as distinct from forced mergers) of small banks, compared to the United States, resulting in much higher overall capital injections in Europe than in the US relative to the associated banking losses.

6. The subsequent national level crisis management actions and regulatory programmes have been important factors in driving the evolution and diversity of the banking sectors in Europe and the systemic weakness of the European banking system. Furthermore, responses to the crisis have added to the

domestication of the banking sectors and banks have sought to revisit their business models in the face of the new regulatory realities. This in turn is reducing the availability of alternative banking service providers and regional competition leading to generic weaknesses in particular regions as local banking sectors may lack the diversity of bank business models, sizes and bank-specific geographical footprints to render them able to absorb losses during prolonged stress periods that impact the particular region.

7. (Banking Union) AFME regards banking union as discussed in the Van Rompuy report presented to the June European Council as an important step in addressing the Eurozone crisis. In this context, the Commission's proposal for the creation of a Single Supervisory Mechanism, represents an important element in restoring confidence in Europe's financial system and wider economy.

   The creation of a strong banking union, built around a credible and effective single supervisor, should break the link between the solvency of Europe's banks and its sovereigns, which has been a significant cause of instability in recent years.
   Of course there are many important challenges which will need to be overcome and issues to be resolved. These include ensuring an appropriate allocation of responsibilities and powers between the ECB and national competent authorities within and outside the banking union; understanding the implications for day-to-day supervision under the new framework; ensuring the effective functioning of the single market in financial services, and achieving transition to the new arrangements in what is very challenging timetable. There is also the challenge of agreeing the common backstop arrangements for resolution and depositor protection which will be proposed later in the process. Moreover, it is still not fully clear how banking union proposals will impact on existing and proposed legislation, such as the Capital Requirements Directive 4, the Recovery and Resolution Directive and the DGS legislation.

   In order to contribute constructively to the work to develop and implement the new arrangements, AFME is working to develop its analysis and suggestions on a number of aspects. In particular it will seek to contribute from the practical perspective of the diverse range of European banks affected in one way or another by the proposed new arrangements. We will be developing our analysis over the coming period and would welcome the opportunity to share this with the Sub-Committee.

8. AFME's view is that structural regulation of banks, including specific controls on particular business activities within a business model, risks producing suboptimal outcomes and is unnecessary or inappropriate for the European banking markets. Before considering the imposition of Europe-wide structural changes, the High-Level Expert Group (HLEG) should examine carefully what incremental benefits such changes might bring about in addition to those likely to result directly or indirectly from already planned regulatory initiatives. These perceived benefits would need to be carefully weighed against the costs of the potential continual slowing of European economic recovery and progress towards the creation of a single European banking market. Structural changes proposed to date, including those related to controlling certain activities, aim to address perceived national issues and are proving challenging to implement for several reasons, including their resulting impact on market liquidity, as well as extraterritorial and boundary issues. Therefore, the feasibility of similar

proposals for structural change being successfully introduced across 27 member states with differing banking and legal systems needs to be carefully considered. The HLEG also needs to examine the potential damage of a one-size-fits-all approach could cause in limiting the diversity and evolution of banking sectors across Europe and thereby reducing the resilience of the system as a whole.

<u>The proposed Directive for bank recovery and resolution and European Deposit Guarantee Schemes (DGS)</u>

9. AFME welcomes the proposed Resolution Directive and its objectives, although we believe that there are some areas in which the Directive can be improved and we are closely engaging in that process. Tackling the issue of financial institutions being deemed too-big-to-fail by introducing credible resolution regimes that impose losses on creditors is one of the industry's highest priorities at this stage: until firms are demonstrably resolvable the industry will face relentless pressure for more regulation. On the other hand, once resolution regimes are credibly established, policymakers should be able to re-visit the need for higher capital levels, liquid asset buffers and structural restrictions that hinder growth. It is important to note that the industry's view is that the Directive will be required regardless of the outcome of the Banking Union debate. Even within a Banking Union, it is recognised that a framework will be instrumental in ensuring consistent powers for resolution authorities and arrangements for groups, for example. A framework is needed also for those member states that remain outside of banking union. We discuss below some of the key components of the Resolution Directive, namely the resolution authority and bail-in, while we continue to evaluate other aspects of the Directive such as deposit guarantee schemes/resolution funds.

10. The proposed Directive includes resolution authorities within the EBA framework to coexist with banking supervisors, similar to that of the US FDIC approach. This approach may be efficient from an information sharing and speed of decision-making perspective but there may also be concerns relating to institutional conflicts within the EBA framework as a supervisor and resolution authority may have differing views. In many countries the roles are currently separated so one institution will provide a check on the other. These potential conflicts will need to be managed within the EBA structure, and we suggest that to avoid institutional conflicts, policymakers should carefully consider existing governance models prior to establishing a structure comprising of a combined resolution authority and banking supervisor.

11. AFME and its members welcome the proposal for a bail-in tool. It will provide the basis for many but not all G-SIBs to demonstrate that they are resolvable, depending on the firm specific balance sheet structures and if debt instrument issuance is part of the business model. We believe that the impact on bank funding costs from the bail-in tool will be limited provided that protections are included in the Directive, such as no-creditor-worse-off and respect for the creditor hierarchy (core principles in the proposed Directive) and a requirement for resolution authorities to use the least cost alternative (something we believe should be a core principle of the Directive). For properly functioning financial markets it is important that the implicit state guarantee is removed and creditors are exposed to the full costs and benefits of their investment decisions.

Conclusions

12. Overall, the impacts of structural changes on the supervisory architecture, bank restructuring, regulatory overhaul and the resolution directive are too wide ranging to enable the formation of an objective view of all the consequences that may impact London as a financial centre for Europe and the Single Market. However, the evidence suggests that these changes, together with shifts in market and economic fundamentals and already announced national reform proposals are driving significant structural changes across the industry. This is being manifested in the considerable deleveraging and de-risking of banks' balance sheets as well as in the re-evaluation of business models as institutions seek to narrow both the functional and geographical scope of their activities and steer away from businesses that absorb disproportionate amounts of capital under the new regulatory rules. As a result of these responses to change there is a risk that key European financial centres as well as the future of the single banking market may be undermined. This is due to the likely reductions in cross-border activity, bank business model diversity and geographical footprints, as well as to the higher costs associated with capital markets activity. Unless there is a concerted effort to boost the European capital markets and economic integration in the form of building confidence in the Monetary Union, key European finance centres and the Single Market are the likely to suffer as cross-border transactions, foreign exchange and capital markets activity, parts of the banking sector that London has traditionally prospered on, will be undermined.

13. However, it is worth noting the recent Financial Centre Roundtable discussion in Brussels (6 September), in which Commissioner Barnier highlighted the importance of financial centres supporting economic growth in the EU and linking the Single market to the wider global economy. AFME's view is that with the availability of bank funding in Europe under pressure, it will be vital to reduce Europe's dependence on this source of financing by developing deeper, more liquid capital markets that are linked to other global financial centres and alternative sources of finance. Only by doing so will it become possible to meet the significant corporate debt refinancing requirements that will arise over the next couple of years, and at the same time to satisfy new lending needs. With this in mind, London can have an important role to play in assisting Europe to develop the deeper capital markets that will be essential to ensuring the financing of future economic growth.

1 October 2012

Professor Emilios Avgouleas, LLB, LLM, PhD, Chair in International Banking Law and Finance, School of Law, University of Edinburgh—Written evidence

What has the euro area crisis revealed about the weaknesses of the EU banking sector? In what ways do you believe that the EU banking sector needs to be reformed?

In the aftermath of the Lehman Brothers' bankruptcy government intervention and public bailouts became necessary to save the European banking system from certain collapse. However, when it came to the bailout and restructuring of key cross-border banks, like Fortis and Dexia, where the use of public money was inevitably involved, country regulators became predominantly concerned with serving their national interest through a series of un-coordinated initiatives that might have harmed franchise value (Avgouleas, 2012). In addition, the Icelandic banks' crisis highlighted the limits of the home country approach in the supervision of systemic branches (Turner Review, 2009). Both incidents highlighted serious loopholes in the regulatory edifice of European banking. Essentially, they stretched to their limits the belief that an integrated banking market with free capital flows, in more or less, the same currency, could exist without centralized bank regulation institutions, such as a single supervisor, a common deposit protection scheme and resolution authority, and some sort of fiscal burden sharing arrangements for failing institutions or an EU-wide bailout fund.

Yet the events of 2008 were not the watershed moment in terms of centralization of bank supervision in the Eurozone. This came almost three years later with the realization of the scale of capital injection required by Spanish and other European banks. Accordingly, it is worth considering at this stage the nature of the crisis that currently plagues the Eurozone and why the banking sector is in the eye of the storm (Shambaugh, 2012).

The Eurozone crisis has been the result of four interlocking crises:

(a) a banking crisis of colossal proportions which has found Eurozone banks with questionable asset books, and thus undercapitalized, as they were the principal facilitators of real estate and consumption booms in the periphery of the Eurozone;

(b) a balance of payments crisis caused by (i) internal exchange misalignments within the Eurozone and (ii) other significant competitive advantages that certain members of the Eurozone, mostly belonging to the northern European bloc, enjoy over their counterparts from the South;

(c) lack of growth due to the above factors and the near stagnation conditions experienced by other parts of the global economy;

(d) a sovereign debt crisis that has been caused by a number of different factors: (i) fiscal profligacy and bad governance, as was the case with a number of Southern European countries, (ii) stagnant economies suffering strong balance of payments imbalances, (iii) bank bailouts, (iv) as the result of years of austerity.

Another cause of the Eurozone crisis that is mentioned much less is a marked absence of institutions to absorb the shocks arising within any currency union. Such institutions were not put in place due to both political opposition and a belief that Eurozone markets were sufficiently developed to absorb any shocks. The belief that competitiveness and current account imbalances did not matter in a currency union proved flawed. Equally flawed was the belief that markets possess the power to monitor fiscally undisciplined currency union members through interest rates.

The absence of a common debt issuance facility, of a fiscal union, to absorb the above shocks, and of institutions to prevent a Eurozone banking crisis could prove fatal for the Eurozone. Accordingly, the establishment of a centralized supervision structure with the concurrent introduction of a common deposit insurance scheme and of arrangements to finance resolution of cross-border groups which point towards fiscal burden sharing is an essential step in the proper regulation of systemically important (over a certain size) Eurozone banks. The final piece in the jigsaw would arguably be an independent EU resolution authority.

4. In January 2012 European Commissioner Michel Barnier set up a high level expert group to explore possible ways to reform the structure of the EU banking sector, including consideration of structural reforms such as activity restrictions as applies under the Volcker Rule, size limits, and structural separation of retail deposit banks from investment banking. What is your assessment of such proposals for structural reforms? Which, if any, would help ensure the future health of the EU banking sector?

Since 2008 the regulation of national and global finance has been subjected to continuous reform with a view to battling systemic risk and making financial institutions safe again. Most of these reforms target the conditions that have been understood to serve as the causes of the global financial crisis, namely, perverse incentives, interconnectedness, complexity and lack of transparency, leverage, and too-big-to-fail institutions. The latter have been subjected to four categories of reforms: new capital and liquidity rules, size or activity restrictions, effective recovery and resolution regimes, and rules to bring transparency in OTC markets to contain interconnectedness. All four measures, intend to both make big banks safer and protect the financial system in the event that their failure becomes inevitable.

Several of these new regulations are both major improvements and considerable breakthroughs in regulatory thinking. Yet they are fraught with uncertainty both in their conception and their application. For instance, more capital is indeed seen as the answer to the woes of the banking sector but this may either prove to be an expensive solution or an inadequate one, depending of the type of business risks against which capital will guard. Moreover, while the new modeling approach and macro-prudential regulations are on paper a marked improvement over the previous capital adequacy regime, they nevertheless remain untested and seem very complex. Given expectations of possibly limited effectiveness of capital regulations and of other reform initiatives in the financial sector, the idea of structural reform has taken centre stage. In fact, in the US it entered the statutory book through so-called Volcker Rule in the 2010 Dodd-Frank Act. In the UK draft legislation to implement the recommendation of the Independent Commission on Banking will not take much longer to come before Parliament. However, neither a blanket ban on proprietary trading and shadow banking exposures - the essence of Volker Rule - nor ring-fencing can fully answer the challenges posed by modern finance and make the financial system significantly safer.

Most contemporary finance has a dual utility and speculative function. This fusion of functions has become ever tighter by the use of innovative financial instruments and techniques. A crude distinction between utility and investment banking would simply not suffice. It largely ignores the need to regulate the shadow banking sector and does not address the fragility and dual utility / speculation nature of wholesale banking. In open global markets, wholesale banking is a continuous assessment and forecasting game of, on the one hand, the effective management and competitiveness of individual borrowers, and, on the other, of the gyrations of the economic cycle and of the impact of national and global conditions of supply and demand on specific industry sectors. Thus, loans have to be securitized to limit bank exposure, and credit, exchange and interest rate risks must be hedged, even in the absence of capital regulations fostering such transactions. Yet, the predominantly short-term nature of funding in the shadow banking sector, the interconnectedness it brings, and the lack of any government guarantees meant that with the exception of Northern Rock and a few other mortgage lending banks, the 2007-2009 crisis was not a run on deposits but a run on the liabilities of shadow banks (Gorton and Metrick, 2009).

Structural reform in the banking sector faces two other, nearly insurmountable, obstacles. Identification of the most effective separation model and industry's insistence that the current model of conglomeration is the result of market-driven demand and is still working and delivering rewards in the form of income diversification and economies of scale that may not be delivered by specialized banks.

This insistence begs two questions. Are the benefits of conglomeration clearly identifiable and verifiable? Is it possible that a crisis of this magnitude will not in the end prove transformational for bank structure? These are the questions that have to be looked at by Commissioner Barnier's High Level Group.

One argument supporting large, diverse financial intermediaries is that internal information flows are substantially better and involve lower costs than external information flows available to more narrowly focused firms. Consequently a firm that is present in a broad range of financial markets, functions and geographies can find client-driven trading, financing and investment opportunities that smaller and narrower firms cannot.

Greater diversification of earnings attributable to multiple products, client segments and geographies may be associated with more stable, safer, and ultimately more valuable financial institutions. The lower the correlations among the cash-flows from a firm's various financial intermediation activities the greater are the benefits of diversification. Therefore, in theory, conglomeration should produce higher credit quality and higher debt ratings (lower bankruptcy risk), therefore lower cost of capital than faced by narrower, more focused firms. Likewise, greater earnings stability should boost share prices (Saunders and Walter, 2012).

There is another line of argument that holds that rather than actual economies of scale larger size has enabled big banks to shift the risks of financial innovation to wider society while reaping themselves the rents of the new (financial) technology (Hellwig, 2008; Avgouleas, 2012). Others like Professor Boot argue that technology and disintermediation, due to financial innovation, induced a run for size because the focus of modern banking shifted from being relationship driven business to being a transaction based business, where scale is much easier to build (Boot, 2012).

Another issue that has to be examined by any new regulations intending to alter the structure of the banking industry is to identify banks' key functions and concerns, not only from a public interest perspective, but also from the perspective of a privately owned business that has to make profit and generate returns for its shareholders.

On the basis of the above observations, structural reform is justifiably proving a much bigger challenge than originally anticipated. The inextricable links of wholesale banking with shadow banking make effective structural reform an intellectual and policy-making task of colossal proportions and neither narrow banking models nor previous separation models are a sufficient guide. Accordingly, large-scale authoritative research is required with respect to seven questions relating to the desirability of structural reform:

- Do larger banks (with assets over 100 billion Euros) truly operate a more efficient business to the scale than smaller banks?
- If economies of scale truly exist, who is the beneficiary of such economies the institution or its customers?
- Are big universal banks necessarily better diversified and thus more stable than smaller banks?
- Does structural reform lead to enhanced competition in the banking sector?
- Does enhanced competition lead to more stable banks? – in the subprime and general housing loans market there was too much not too little competition and the consequences were catastrophic
- In the absence of universal structural reform, would cross-border banking suffer, given that foreign entry is the best means to enhance competition in banking markets?
- Finally, as we plan for an uncertain future, would structural reform hinder or facilitate the evolution of retail banking?

Given the complexity of the issue examined by the high level group, I list below three principles that may be taken into account by policy-makers and legislators in search of the best structural reform model.

- First, the banking system must not only be sound and safe, it should also facilitate economic growth by ensuring the smooth flow of credit to households and businesses.

- Second, any structural reform model should not be rigidly polarized. Given the importance of bank lending to corporate businesses in many European countries and the strategic role that universal banks play in their economies, a bipolar approach to separation is bound to prove politically unpalatable;

- Third, structural reform is not possible without a distinction of the kind of risks that banks are and are not able to undertake and manage. Naturally, savings banks should have only limited ability to participate in capital markets and should be able to do so only in order to hedge lending book risks and not to engage in proprietary trading or securities underwriting activities. But this restriction may not be practical for banks that have wholesale loans in their books, which have to be hedged and actively risk-managed. It is, perhaps, arguable, that in this case, caps on assets (position limits) rather than ring- fencing would be the best approach. Caps on assets (position limits), in their economic results, provide constraints on size that may be more effective than any risk-weighted capital or leverage ratios, provided that such limits extend to shadow banking activity. Thus, rigorous research is required to identify the right structural reform model. Arguably, opening requisite lines of enquiry may not prove more challenging than finding proper asset risk weights for capital adequacy purposes.

Banking supervision

5. The European Commission are expected to present proposals for a single European banking supervisory framework in September. What is the purpose of such a framework, and what key elements need to be included if it is to succeed? How likely is it that such a framework will be adopted?

Please see answer to question 1 above.

The proposed Directive for bank recovery and resolution

10. What is your assessment of the proposed Directive (COM (2012) 280) establishing a framework for the recovery and resolution of credit institutions and investment firms? What will be the impact on these proposals of the steps towards banking union (including a resolution framework) as set out in the Van Rompuy report?

13. What is your assessment of the following specific elements of the Commission's proposals, as set out in the Directive, in relation to:

Recovery and resolution planning (Articles 5-12)?

Group recovery and resolution and cross-border activity (including resolution colleges)(Articles7-8,11-12and 80-83)?

Preventative powers (Articles 13 and 14)?

The recovery and resolution framework for credit institutions and investment firms that is introduced by the proposal directive includes critical innovations. The obligation of banks and of important investment firms to draw up recovery and resolution plans (already in force in key member states) and the early intervention powers are to significantly improve the quality of supervision, especially of cross- border groups.

The most important role of resolution plans is to secure that there are no significant impediments, resulting from the legal, operational or business structures of the credit institution, to the effective and timely application of resolution tools and exercise of resolution powers (Avgouleas, Goodhart, Schoenmaker, 2013). In particular, the authorities should satisfy themselves that critical functions could be legally and economically separated from other functions so as to ensure continuity and avoidance of disruption of economic activity in the event of a credit institution failure. In the process, they ensure that supervisors gain a thorough and detailed picture of the institution's (or the group's) structure and business lines. If, following an assessment of the resolution plan, a resolution authority identifies significant impediments, a number of steps may be taken to address or remove impediments:

(a) require the credit institution to draw up service level agreements (whether intra-group or with third parties) to cover the provision of critical economic functions or services;

(b) require changes to legal or operational structures of the entity for which the resolution authority is responsible. Implementation of those changes may reduce structural complexity, making supervision easier and ensuring that critical functions could be legally and economically separated from other functions in the context of exercising the resolution tools;

(c) require the credit institution to limit or cease certain existing or proposed activities;

(d) restrict or prevent the development or sale of new business lines or products;

(e) require the credit institution to limit its maximum individual and aggregate exposures;

(f) require the credit institution to issue additional convertible capital instruments.

Modifications (a) and (b) can significantly simplify the resolution process and minimize disruption of critical functions, in the event of institution failure. In addition, modifications (c) - (f) may significantly strengthen the financial position of the institution concerned. In specific, modification (d) can prevent further weakening of an institution in distress. Moreover, the existence of additional capital cushions in the form of convertible debt can (in conjunction with the debt write down tool) preserve the relevant institution as a going concern and avoid a winding up that would inevitably create market turmoil.

Modifications (c) and (d) give supervisors, through scrutiny of resolution plans, almost unfettered power to interfere with credit institutions' business plans and models and are bound to prove very intrusive. On the other hand, had these powers been available and exercised in the case of the Royal Bank of Scotland and of Northern Rock, it is likely that their failure, due to the gaping holes in their business models and strategies and the way they funded their asset books, would have been avoided or at the very least it would have been less dramatic. Finally, measure (e) will inevitably involve asset sales, which might undermine rather than strengthen financial stability if they lead to fire sales. Thus, apart from the stability of the institution concerned the stability of the financial system should be a consideration when such measures are requested.

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3 October 2012

Barclays—Written evidence

Introduction

- Barclays welcomes the scrutiny of the Committee into this important and complex issue for both the UK banking industry and the UK.
- Barclays is supportive of moves towards banking union for those within the single currency.
- We believe it crucial, and possible, to ensure that the Single Market and the Single Currency are compatible. It is crucial that the banking union contributes to preserving and deepening the Single Market and that the Single Market is in no way undermined. The role of the EBA must, therefore, be clearly outlined and its function as the rule-setter for the EU27 strengthened.
- We are concerned with the proposed timeline of reform for the banking union and that the debate on it may impact upon the delivery of Capital Requirements Directive (CRD IV) and Recovery and Resolution Directive (RRD) in particular.
- As a financial institution active in several EU member states, both inside and outside the Euro area, Barclays will be directly affected by the move to central supervision for the Euro area. We see potential advantages and disadvantages to a scenario in which our primary supervisor is the competent UK authority but our subsidiaries in the Euro area are subject to ECB supervision (depending of course on which entities will be supervised by a single supervisor).
- Given that systemic relevance within the banking sector is not a function purely of size, we believe that banking union should apply to all banks within its geographical confines. This should help address the "too many to fail" and the "too similar to fail" issues.
- Barclays is a strong supporter of the creation of an effective and harmonised resolution regime for Europe. The proposed RRD is the most comprehensive attempt yet to establish such a framework and Barclays is broadly supportive of the Directive as a whole and fully supportive of its overarching objectives.
- In particular we welcome the proposed 'bail-in' tool as it is a critical and central pillar for the effectiveness of the resolution regime as a whole. If correctly designed, a 'bail-in' tool provides the time needed to execute optimal resolution strategies and ensure continuity of critical functions whilst reducing systemic contagion and minimising the cost of failure.

1 What has the euro area crisis revealed about the weaknesses of the EU banking sector? In what ways do you believe that the EU banking sector needs to be reformed?

1.1 The financial crisis in the banking system and the subsequent euro area crisis revealed over-exposure of some banks to certain assets (whether commercial real estate or sovereign debt) and significant levels of inter-dependence between banks operating in affected markets. These two factors have influenced market perceptions of the banking sector and the cost of wholesale funding which, in turn, impacts both the availability and price of credit to the real economy.

1.2 The euro area crisis has highlighted the need for reform of: banks; quality of supervision; and, fiscal policy, amongst other areas. In addition as the euro crisis deepened it had significant impact on the perceived credit of a number of euro zone states creating a negative feedback loop between the sovereign's credit standing and the banking sector.

1.3 The weaknesses in banks have led to the wide recognition of the need for: strengthened risk management to deal with issues of exposure; strengthened resilience to limit the likelihood of failure; enhanced supervisory cooperation; and, resolvability in the banking system to limit the impact of failure if, and when, it occurs again.

1.4 Significant steps have already been taken internationally to strengthen the resilience of banks through actions taken by banks themselves as well as Basel 2.5, and the Capital Requirements Directives (CRD) II and III. Most banks are now considerably better capitalised than they were in 2006/7; they hold substantially higher liquidity buffers; and they have reduced leverage levels. These measures mean that, in several jurisdictions – including the UK – banks are already better able to deal with the euro area crisis than if it had occurred earlier.

1.5 Resolvability is a crucial remaining area of banking reform and implementation of the RRD is imperative. To end the perception of 'too-big-to-fail' and the resulting contingent liability of the taxpayer, all banks must become resolvable. Enabling this will require a package of reforms to develop a resolution framework. The various elements of the resolution package, taken together, could create a capability for resolution that is not dependent on any particular cause or consequences of whatever future bank failure may emerge.

2 Steps towards 'banking union' were set out in the Van Rompuy report Towards a Genuine Economic and Monetary Union. How would you define 'banking union' in the EU context? What is your assessment of the report's conclusions, and what will its impact be on existing proposals (such as CRD IV)? What are the key elements of such a banking union if it is to function effectively?

2.1 The European Commission published proposals for the banking union in September 2012. The banking union looks to create a single supervisory mechanism for banks in the euro area with ultimate responsibility for specific supervisory tasks relating to financial stability lying with the ECB. Notably the banking union is part of a longer term vision for economic and fiscal integration, of which shifting supervision of banks to the European level is a key part of this process.

2.2 We believe that banking union is an extremely important step in the direction of a sustainable long term future for the single currency but that the complexities of constructing such a union cannot be underestimated. The process should not be rushed and so the ambitious timetable outlined by the European Commission is cause for some concern. The banking union should not be a quick fix for the current crisis.

2.3 In relation to CRDIV, the directive will need to be aligned with the new single supervisory mechanism in the banking union. More significantly, we are concerned that the focus on delivering the banking union by end of 2012 may be distracting from reaching political agreement on CRDIV also by end of 2012.

3 The 28/29 June euro area summit statement said that when an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could recapitalise banks directly. What is your assessment of this proposal? How likely is it that this would successfully stabilise the EU banking sector?

3.1 We are broadly supportive of a single European supervisory mechanism. The creation of such a mechanism will enable the ESM to recapitalise banks directly thereby cutting the negative feedback loop that currently exists between sovereign debt and the recapitalisation of banks. However, given the limited resources of the ESM this will not be sufficient should there be a major crisis of confidence in the banking sector leading to deposit flight.

3.2 If the central aim is to break the contagion link between Euro area banks and their sovereigns then, clearly, individual banks will need to be adequately capitalised from diverse sources with less reliance on significant holdings of their own sovereign's debt.

3.3 CRDIV should provide robust direction on capitalisation and liquidity to ensure these objectives are met. Some jurisdictions, including the UK and Switzerland, are already well advanced in achieving high standards of capital for their banking sectors, whilst others still require rigorous bank balance sheet reviews and recapitalisation. When banks are judged to be adequately capitalised and fully resolvable, and the reliance on sovereign debt is lessened, then this 'contagion' link will be broken.

3.4 In the absence of full mutualisation of euro area sovereign liabilities, these steps should sufficiently stabilise the EU banking sector. If the ECB is to be given responsibility for supervision of this process, it will need to be adequately resourced and staffed.

4 In January 2012 European Commissioner Michel Barnier set up a high level expert group to explore possible ways to reform the structure of the EU banking sector, including consideration of structural reforms such as activity restrictions as applies under the Volcker Rule, size limits, and structural separation of retail deposit banks from investment banking. What is your assessment of such proposals for structural reforms? Which, if any, would help ensure the future health of the EU banking sector?

4.1 Barclays welcomes the work of the Liikanen High Level Group and we await its recommendations which are due out shortly

4.2 Much has been done to make the banking system safer and to better protect depositors and taxpayers and there is little evidence to suggest that structural separation would enhance financial stability, and in some cases would make matters worse.

4.3 Looking briefly at structural reform that is likely to be assessed and considered by the Liikanen Group:

- The Volcker Rule in Dodd Frank: is currently very different in draft from the original intention. It is worth noting that:
  - the assumption that proprietary trading was an influential factor in bank instability is a thesis which has not been proven by the available evidence;
  - the Rule, as currently drafted, will negatively impact the price of liquidity, and market volatility.
  - The implementation of Volcker has proved to be complicated and has since been delayed.
- The Vickers or ICB proposals / UK Banking Reform: includes a number of important recommendations and considerations. The cost implications of the headline recommendation, retail ring-fencing, will depend on how flexibly it is designed. We await draft legislation which is due in the next few days

4.4 There a range of bank business models in existence – the diversity of operating models matches the nature of the complex market in which they operate
4.5 There has been considerable focus on the universal banking model. A considered approach is needed when addressing both the benefits of the universal banking model as well as any challenges regarding stability. The ICB's final recommendations recognised the benefits of the universal banking model and sought to preserve them through the retail ring-fence recommendations.
4.6 We believe that the measures which would help ensure the future health of the banking system in the EU, and elsewhere, should include:
- A resolution regime that enables the relevant authority to separate financial assets and liabilities within a non-viable institution.
- Resolution plans to aid an orderly wind-down as well as supporting market confidence.
- Operational subsidiarisation to ensure the continuity of critical infrastructure.
- A bail-in regime (explored further in response to question 12) to share the burden of failure amongst creditors and enable an orderly wind-down.
- Changes to market infrastructure (e.g., central clearing) to reduce the potentially disruptive impact of a failure on counterparties.

Banking supervision

5 The European Commission is expected to present proposals for a single European banking supervisory framework in September. What is the purpose of such a framework, and what key elements need to be included if it is to succeed? How likely is it that such a framework will be adopted?

5.1 The banking supervisory framework, as outlined by the European Commission, includes a Single Supervisory Mechanism (SSM) which will have direct oversight of banks to enforce prudential rules in a strict and impartial manner and perform effective oversight of cross border banking markets.
5.2 Whilst the proposal has been made, we envisage problems with the European Commission's projected timetable of adoption by end of 2012 and for the SSM to transition in from the beginning of 2013. The Commission's proposals are hugely important for the future of sound and resilient banking supervision and it is crucial that debate is not hurried, despite the need for quick resolution to the ongoing Euro area crisis.
5.3 Any move to banking union must deliver high-quality supervision of those banks that are within its remit. This is a prerequisite for Member States accepting the mutualisation of the costs of bank failure either through a single deposit insurance scheme or through a single resolution fund. It should be possible for Member States (especially those not within the Banking Union) to merge, in effect, their resolution funds for banks with their deposit insurance schemes, especially if these funds are to be prefunded. This would maximise the efficient use of both funds and bureaucratic machinery.
5.4 It is clear that there are potential practical issues in the delivery of supervision throughout the banking union such as the availability of suitably qualified supervisors and their proximity and understanding of the banks they will supervise. There are approaches that could be envisaged that would deal with these issues, for example using national central banks, or other supervisory bodies, to deliver supervision locally. If there is to be a single supervisor, it should have a broad remit. A body overseeing only a small number of the very largest of the Euro area banks seems not

to represent a meaningful banking union. Nor does it necessarily make sense from a financial stability and supervisory perspective. Given that systemic relevance within the banking sector is not a function purely of size, we believe that banking union should apply to all banks within its geographical confines. This should help address the "too many to fail" and the "too similar to fail" issues. This points to a hub and spoke model with the ECB as the hub (perhaps with a particular interest in the largest institutions) and national prudential supervisory authorities as the spokes delivering day to day supervision, especially of local banks.

5.5 It is crucial that banking union contributes to preserving and deepening the Single Market which should be in no way undermined. The role of the EBA must, therefore, be outlined clearly and its function as the rule-setter for the EU27 strengthened. It should have the resources necessary to carry-out the tasks assigned to it and it must have a governance structure to ensure any currency zone blocs within it cannot de-facto combine to ensure policy is created to entirely reflect their own views at the expense of others. The EBA also must not lead to discrimination between EU banks – or other market infrastructure - based on their location or the identity and status of their supervisor. EU regulation and technical standards should be applied equally to all banks, with consistently high standards.

6 What is the most appropriate division of responsibility between national and EU supervision under such a framework?

6.1 Any move to banking union must deliver high-quality supervision of those banks that are within its remit.

6.2 The division of responsibility between national and EU supervision will need to be guided by:

- The need to solve issues caused by the current supervisory framework, i.e., over simplistic assessment by national regulators of the financial situation of national banks, and regulatory forbearance by national regulators, e.g. Spain's Bankia and Belgium's Dexia
- The need to ensure that entities are supervised

6.3 In order to tackle these problems, we think it would be sufficient to limit supervision at EU level to the technical elements of prudential supervision, i.e. assessment of own funds, liquidity and large exposure restrictions. For example, national regulators could remain responsible for elements of prudential supervision that are more judgement led such as assessment of suitability of shareholders and members of management bodies and key function holders and governance arrangements. In addition certain areas of supervision such as ICAAP and authorisation requirements for acquisitions of qualifying holdings could be shared between national and EU level.

7 In what way, if at all, should supervisory powers vary depending on the size and nature of banks?

7.1 We are of the opinion that supervisory powers should vary depending on systemic importance of banks for the Euro area. Only cross-border banks or banks with a systemic importance for the Euro area should be subject to more intense supervision at the EU level.

7.2 The supervisory powers and regulatory requirements should also be flexible to the level of resolvability of a particular institution.

8 What powers and responsibilities is it appropriate for the ECB to possess in relation to regulation of the European banking sector, and in particular in relation to supervision of euro area banks? How should the ECB be held accountable for the exercise of such responsibilities?

8.1 We consider that the ECB's responsibilities, as they are currently drafted, are broadly suitable although we have some concerns.
8.2 It is our view that the ECB's power should be limited to prudential supervision (see answer to question 6), and in particular, to fulfil this role, it is important that the ECB have the powers that would allow it to gather information directly from banks to assess these aspects of prudential supervision, such as capital, liquidity, and large exposure supervision, and including powers to sanction lack of co-operation in this process.
8.3 Finally, it is essential that the ECB has a satisfactory long term framework for accountability vis-à-vis the European Parliament, Council, the participating national competent authorities, as well as European and national courts.

European Deposit Insurance schemes

9 What is your assessment of the Van Rompuy proposals for a European deposit insurance scheme for banks, to be overseen under the new European banking supervisory framework and with the ESM as a fiscal backstop? What is the purpose of the proposal and what will its impact be on the existing Deposit Guarantee Schemes Directive proposal? Is it likely to be effective? How likely is it that such proposals will be enacted?

9.1 At the time of writing, the Van Rompuy proposals were at the highest level of generality, and it is not perhaps fair to judge them as a fully worked-through proposition. It is not clear that the impact on existing EU legislative proposals was considered, and the concepts as outlined cut across, not only the proposed amendment to the Deposit Guarantee Schemes Directive, but also the recently proposed RRD.
9.2 The idea of a European deposit insurance scheme was not proposed within the banking union proposals. Instead, upon agreement of the existing DGS and Bank Recovery and Resolution proposals, the Commission will propose a single resolution mechanism
9.3 It is clear that the objective of creating resolution and deposit insurance schemes funded by the industry is to break the link between the solvency of the banking sector and the solvency of individual Member States. Seen against this objective, there is an internal logic to the proposals.
9.4 A European deposit guarantee scheme will however expose the banking systems of participating Member States to the health of the banking systems of all the others. So the health will depend – to some extent – on the quality of supervision in each individual state, or of the single supervisor if one is created. The consequences of the supervisory failure of one will be felt by the banking systems of all. This is unlikely to be acceptable unless the quality of supervision is both raised and made more homogeneous across participating states, either through the adoption of not just common rules but also common standards of supervision, or through a single European supervisory body. Unless such a supervisory level playing field can be achieved, the proposal may struggle to obtain support.
9.5 It is likely that some EU Member States – not least the UK – will be unwilling to enter into such burden-sharing and common supervision arrangements in any

event. This has the potential over the longer term to raise significant issues for a single market of the EU 27, both in terms of the dynamics of rule making and the setting of supervisory standards, and in terms of market access.

The proposed Directive for bank recovery and resolution

10 What is your assessment of the proposed Directive (COM (2012) 280) establishing a framework for the recovery and resolution of credit institutions and investment firms? What will be the impact on these proposals of the steps towards banking union (including a resolution framework) as set out in the Van Rompuy report?

10.1 Barclays strongly supports the creation of an effective and harmonised resolution regime for Europe. The proposed Directive is the most comprehensive attempt yet to establish such a framework. Barclays is broadly supportive of the Directive as a whole and fully supportive of its overarching objectives.

10.2 Barclays has been at the forefront of this work (recovery and resolution planning): we have invested significant resources to ensure we can be a test case and have worked closely with the US and UK authorities.

10.3 Most importantly, the Directive has the breadth of scope and most of the key elements required to enable an effective framework to be established. We will look to continue to work directly with the Commission, as well as through the industry and with other authorities, to help get the detail right.

10.4 It is imperative that the banking union debate does not impact on the RRD and that the Directive continues to set a framework for the EU27 as a whole.

10.5 Key aspects of the proposals that will be vital in the establishment of an effective regime include:

- Proposals for broad and inclusive debt write-down (or bail-in) powers at the point of resolution but which respects both the 'No Creditor Worse Off' principle and Creditor Hierarchy more generally.
- A strengthened cross-border framework with resolution colleges operating under direction from home authorities, and where resolution actions, such as bail-in, can be effective regardless of location or jurisdiction.
- Requirements for individual institutions, and regulators, to produce recovery and resolution plans with reference to stress scenarios outlined by the EBA while maintaining the flexibility to respond to different circumstances by having a menu of recovery actions.

11 What will be the impact of the Directive upon the European Banking Authority (EBA)? Are the new responsibilities proposed under the Directive for the EBA appropriate?

11.1 The RRD provides new responsibilities to the EBA in the area of cross-border group resolution and relations with third countries

11.2 *Cross border group resolution*:

- The draft directive proposes to set up a resolution college for each cross-border group and gives a new role to the EBA.
- The EBA would be a member (without voting rights) of each cross-border resolution college. In the event of a dispute in the resolution college between one or more members and the relevant group-level authority, the EBA would have a binding mediation role provided the dispute relates to: group recovery

and resolution planning; the removal of barriers to resolution; intra-group financial support arrangements; and deployment of the special manager tool and/or in resolution action.

- This would suggest that a final decision of the EBA would be binding upon the relevant authorities of individual Member States. The decision making rule will, therefore, not lie with the relevant authorities of the individual Member States, where the final decision will impact.
- We think it is appropriate to bring this within the EBA's existing binding mediation role. First of all, the mere existence of a binding mediation mechanism will help the decision making process in the resolution colleges (as the members of the college will want to avoid having to refer the decision to the EBA). Secondly, in the absence of a binding mediation tool, a risk of gridlock could exist within resolution colleges, which is something that needs to be avoided in a resolution context.

11.3 *Relations with third countries*:

- The Commission and the EBA are assigned responsibilities in establishing agreements with third country authorities on cooperation in the resolution planning and process.
- Whilst we agree with the benefits that this measure would bring, in terms of reducing the inevitable complexities and discrepancies that might arise if 27 Member States had each to enter individually into cooperation agreements with the relevant third countries, we do question why the EBA is given this power rather than the relevant national resolution authority or, as the case may be, the relevant resolution college. We think that these entities would be best placed to assess the appropriateness of recognition

12 What is your assessment of the proposed 'bail-in' tool (Articles 37-38 and 41-50)?

12.1 We welcome the proposed 'bail-in' tool as it is a critical and central pillar for the effectiveness of the resolution regime as a whole.

12.2 If correctly designed, a 'bail-in' tool – which could be described as recapitalisation in resolution – provides the time needed to execute optimal resolution strategies and ensure continuity of critical functions whilst reducing systemic contagion and minimising the cost of failure. Fundamentally, bail-in can be an effective tool to share the burden of failure with creditors, avoid taxpayer bail-outs, and have less of a contagion impact than insolvency.

12.3 The Directive rightly proposes extensive bail-in powers with a broad set of liabilities in scope, whilst still respecting the creditor hierarchy under most circumstances.

12.4 There are, however, certain aspects of the proposals which we believe could be improved if the effectiveness of the tool is to be maximised and negative economic consequences are to be minimised.

12.5 We noted in the proposal that liabilities with an original maturity of less than one month are out of scope. We would not support any exclusion that differentiates between liabilities of the same class based on maturity. In particular:

- Excluding short term liabilities would incentivise or create: a) a reliance on short term funding; b) a direct conflict with the incentives implied by the Liquidity Coverage Ratio (LCR) as short term assets are required to balance the liabilities;

which in turn means there is, c) reduced ability to direct cash towards more economically useful purposes including investment in the business.

- It creates de facto depositor preference as the maturity exclusion would effectively exempt uninsured deposits from the tool, thus deviating from the ranking of liabilities in insolvency.

12.6 The proposal for a minimum requirement of bail-inable liabilities is concerning. We understand that the UK Government is keen to ensure that the proposed minimum requirement for eligible liabilities complements the Independent Commission on Banking's recommendation on Primary Loss Absorbing Capacity (PLAC), however this does not appear to be the case:

- If the requirement – it has been suggested at 10% of total liabilities – is not calculated on a risk-weighted basis there could be some perverse incentives not conducive with sensible balance sheet management;
- It would effectively amount to a Tier 3 capital requirement at odds with both Basel 3 capital requirements and the UK's proposals for the PLAC.
- Taken with other requirements above, and including the Global Systemically Important Bank (G-SIB) capital buffer proposals, it will lead to further complication for the market in an already complicated new system.

12.7 Some have expressed the concern that bail-in could exacerbate contagion as banks are unlikely to fail individually and that bail-in will be a source of contagion in a situation where multiple banks face difficulties at the same time. However, even though bail-in may have greater contagion impact to other banks than bail-out, government support implies contagion to the sovereign, and bail-in will certainly have less contagion risk than insolvency, due to avoiding a firesale of assets, large legal costs and long delays in returning client assets.

13 What is your assessment of the following specific elements of the Commission's proposals, as set out in the Directive, in relation to:

a. **Recovery and resolution planning (Articles 5-12)?**
b. **Group recovery and resolution and cross-border activity (including resolution colleges) (Articles 7-8, 11-12 and 80-83)?**
c. **Preventative powers (Articles 13 and 14)?**
d. **Intra-group financial support (Articles 16-22)?**
e. **Early intervention measures, including the 'Special Manager' tool (Articles 23 and 24)?**
f. **The various resolution tools, including sale of business, bridge institution and asset separation (Articles 31-55)?**
g. **Cooperation with third country authorities (Articles 84-89)?**
h. **The proposed system of financing arrangements (Articles 90-99)?**

13.1 <u>Recovery and resolution planning</u>

- Recovery and resolution plans are of central importance to the wider crisis management framework and will play a critical role in ensuring banks can be resolved safely and without taxpayer support.
- There has been considerable work in the industry and with the regulators to ensure that there are full and detailed plans containing all relevant information required to separate financial assets and liabilities.

- We believe that large financial groups subject to consolidated supervision should not need to submit entity-level recovery plans as has been suggested in the proposals.
- The Directive suggests that technical standards should be drafted on a range of scenarios. We think that incorporating an assessment of the effectiveness of the recovery actions under a range of scenarios is a good idea. However, this will be a qualitative and not a quantitative assessment. This will be incorporated into the next iteration of our recovery plan.

13.2 Cross border resolution (including resolution colleges):

- Barclays supports the strengthened cross-border framework set out in the Directive. Resolution colleges of supervisors could, and should, be efficient at managing the cross-border resolution requirements of an institution albeit under the necessary guidance and direction of the home authorities.

13.3 Preventative powers:

- We view resolution planning as a collaborative dialogue between the firm and the resolution authority. We are somewhat concerned that the Directive requires resolution authorities to make assumptions on the resolvability of firms without granting the firms the right to review and challenge the assumptions used.
- We seek clarification as to whether being deemed resolvable means that it is credible and feasible to resolve a bank under any one of the RRD resolution tools (i.e., transfer to private purchaser, bridge bank, asset separation vehicle and bail-in) or combination of these tools, or whether instead a bank needs to demonstrate it is resolvable under all four resolution tools.

13.4 Intra-group financial support:

- Although we note that this proposal is optional, there is a danger it will drive national protectionism and create the wrong incentives for firms to support their operations. It may make it more difficult for resolution authorities to execute a resolution along regional lines
- It may lead to trapped pools of capital and liquidity that cannot be redeployed in a crisis outside the narrow borders defined in the agreement.
- This would not forbid a firm from providing support as and when required. For example, if a subsidiary is in danger of breaching its regulatory minimum ratios, it will complete a capital application and the parent will provide a capital injection subject to usual internal governance arrangements.
- We note that the UK Government has understandably expressed concerns about increased contagion risks within a group if intra-group financial support is triggered.

13.5 Early intervention measures, including the 'Special Manager' tool:

- We believe that a bank's management should remain in charge throughout the recovery phase. Otherwise there is a concern that it will undermine management actions, complicate Directors' duties and liability and lead to market perception that the institution is rapidly approaching resolution, which could be self-fulfilling if there is a run.
- The appointment of a 'special manager' should be reserved solely as a resolution tool to avoid the risk of self-fulfilling spiral occurring from market reaction to an early intervention from the authorities.

13.6 The various resolution tools, including sale of business, bridge institution and asset separation:

- We support the authorities having a suite of tools to be able to resolve firms efficiently.

13.7 Cooperation with third country authorities:

- This is largely a sovereign issue. Generally we believe that non–EU branches of EU-banks or EU-branches of non-EU banks would be more efficiently resolved by the home authority.

13.8 The proposed system of financing arrangements:

- We have some concerns about the proposal for an EU system of national resolution funds (building up a fund of at least 1% of insured deposits over 10 years) with rights to borrow from each other. The proposal helpfully allows resolution funds and DGS to be combined. However, the borrowing provision opens a channel for contagion, exposing the system of one country to the banking and supervisory failures of another, without the authorities of the borrowing state being accountable to the Parliament or the authorities of the lending state or states.
- A resolution fund may be used by the resolution authority when applying the resolution tools either as genuine financing, or to absorb the costs of resolution; the levy would be an additional tax on the banking system. We also think there is a need for further clarity around the application of bail-in to DGS.

The impact on the UK

14 The Government have made clear that the UK will not take part in the fundamental elements of a banking union, and will neither be part of common deposit guarantees nor come under the jurisdiction of a single European financial supervisor. What is your assessment of this position? How should the UK respond to these proposals?

14.1 As outlined above, Barclays is supportive of moves towards banking union for those within the single currency. We believe it crucial, and possible, to ensure that the Single Market and the Single Currency are compatible.

14.2 As a financial institution active in several EU member states, both inside (through branches and subsidiaries) and outside the Euro area, Barclays will be directly affected by the move to central supervision for the euro area. We see potential advantages and disadvantages to a scenario in which our primary supervisor is the competent UK authority but our subsidiaries in the Euro area are subject to ECB supervision (depending of course on which entities will be supervised by single supervisor).

14.3 Potential advantages include more of a level playing field for conducting business in the EU, for example via less regulatory forbearance for competitors covered by single supervisor, less divergence in asset valuation, reporting, and Risk Weighted Assets (RWAs) comparability in the Euro area. It could also contribute to less supervisory divergence on passporting activities and simpler college of supervisor arrangements.

14.4 On the other hand, UK banks could be at risk from deposit-flight if the EU central scheme was viewed as stronger than that of the UK. UK banks could face higher funding costs than those seen to be 'backed' by the ECB if it was viewed by the market to be stronger or more likely to support its banks than the Bank of England.

14.5 The key to mitigating that risk, in our view, is involvement to the extent possible in contributing to the debate on reform of our supervisory and legislative architecture and more broadly to our common future together in the European Union.

14.6 While the Treaty requires unanimous agreement for the transfer of banking supervisory powers to the ECB, Member States which wish to exercise their veto need to do so carefully if not to undermine their position. Following the December 2011 Summit, the majority of EU member states opted to set up their own intergovernmental treaty via "fiscal compact". This option is open again and would presumably be pursued in favour of agreement to any EU27 solution that required too much negotiation with any one member state. A key safeguard must be to ensure the banking union does not lead to discrimination between EU banks – or other market infrastructure - based on their location or the identity and status of their supervisor.

15 What will be the implications of steps towards banking union for those countries, such as the UK, that intend to stand apart? How realistic is the Government's argument that the UK's non-participation should not and need not adversely affect London's position as the leading financial centre in Europe, nor adversely affect the operation of the single market?

15.1 The answer to this question is likely to be found in the debate that will ensue about banking union for the next few months.

15.2 In some respects, as a UK headquartered institution, the potential disadvantages for Barclays mirror quite closely those for the UK as a whole. There is the potential for diminished opportunity for involvement in the EU rule making process and a general marginalisation from the centre of influence.

15.3 In addition, particular attention has to be paid to ensure that there is no fragmentation of the efficiency of the provision of capital to businesses and access of consumers to retail markets. The Single Market is a vital asset for the EU27 and this should remain so.

15.4 It is imperative that both Government and industry alike pay close attention and remain engaged in this debate and look to ensure that appropriate safeguards are included around the operation of the EBA, as well as cooperating to understand the ECB's mandate and how it's role will evolve – as currently drafted the scope of the ECB could extend considerably.

16 **How do you assess the risk that, as elements of a banking union, including supervision, are addressed by a subset of its members, the Council's role in banking regulation will be undercut, with its legislative debates pre-empted and/or decisions pre-determined in discussion amongst banking union members?**

16.1 It is difficult to predict how the dynamics of the relationship between countries within the single supervisory mechanism will operate within Council. Although not directly applicable to national Governments, Article 5 (4) of the Regulation conferring tasks on the ECB, does state that "National competent authorities shall follow the instructions given by the ECB", which may pose issues with

Finance Ministers who look to their national competent authority for advice before agreeing their negotiating position. In addition, and although we do not envisage that votes will simply pass to the ECB - it is imperative that the euro area/ SSM votes be coordinated appropriately to reflect the interests of those outside the euro area.

1 October 2012

Barclays and Royal Bank of Scotland—Oral evidence (QQ 119–148)

Evidence Session No. 9. *Heard in Public.* *Questions 119 - 148*

TUESDAY 16 OCTOBER 2012

11.20 am

Members present

Lord Harrison (Chairman)
Viscount Brookeborough
Lord Dear
Lord Flight
Baroness Hooper
Lord Jordan
Lord Kerr of Kinlochard
Baroness Maddock
Lord Marlesford
Baroness Prosser
Lord Vallance of Tummel

Examination of Witnesses

Mark Harding, Group General Counsel, Barclays, and **Richard Kibble**, Group Director, Strategy and Corporate Finance, Royal Bank of Scotland

Q119 The Chairman: Mr Harding and Mr Kibble, we resort again to our inquiry into the banking union and the recovery and resolution directive. We are most grateful to the two of you for coming before us today. I have to tell colleagues that Jonathan Gray, who attended our session with the academics last week, has unfortunately fallen ill and will not be able to appear before us today, so it is double the work for you gentlemen.

We will be making a record of the conversation we have today. We will send that to you. We would be grateful if you could look at it and correct it. In the light of the conversation and exchange that we have, if there is anything that you would wish to add later on, we would be grateful for that as well. We continue to update the information on a very fast-moving target.

Perhaps, when the opportunity arises, each of you could introduce yourself and say who you are, the position you hold and the interest you have. I remind colleagues who have not declared interests before that if they could so do before they take the floor this morning I would be very grateful indeed. This meeting is being recorded on the website. I am always alert to tell colleagues that any comments they make should be made sotto voce, and should at least be interesting in case they are picked up on the website.

Mr Harding, perhaps we will start with you. Could you help us first of all on the banking union, by defining what you think and understand might be a banking union as proposed, and whether it will achieve one of the ulterior motives, which is to provide a sound footing and restore confidence in Europe in terms of the banks and in the euro itself?

Mark Harding: Certainly. Perhaps I can start by explaining my involvement in EU affairs. In Barclays, as General Counsel, I am responsible for legal affairs. I have had a long-standing involvement in EU matters from past lives, and I chair our strategy group on EU matters. It is a world that I inhabit.

On banking union, clearly, what we have in front of us is a first step in what might be described as full banking union. The idea behind banking union clearly is that the EU should create a collection of measures that, together, will provide stability in the banking system, in particular by breaking the link between the sovereign and banks within the system. One part of that obviously is the single supervisory mechanism that we have already had some details of. Clearly you cannot have banking union without having some unified system of supervision of banks within that union, so this is clearly a first step. Others, I am sure you are aware, have concluded that there should be some mutualisation of deposit guarantee schemes and the recovery resolution measures that are to some extent out there, in the recovery resolution directive that has already been published. Together, that package—no doubt there are other bits and pieces around the edges—comprises the central parts of what would be regarded as a banking union package, however large that union is in terms of member states and, indeed, banks participating in it.

Q120 The Chairman: Mr Kibble, would you like to introduce yourself and perhaps just think about the banking union?

Richard Kibble: Sure. Hello everyone. I am Richard Kibble. I am the Group Director of Strategy and Corporate Finance at RBS. My responsibilities include regulatory strategy; I guess that is what makes me the right person to come and speak to you today. I have a team reporting to me that looks at the strategic consequences of regulation for the Royal Bank of Scotland going forwards.

I reiterate a lot of what Mark has said, in the sense that what is on the table today is a proposal that has some components in it that make sense relative to the underlying objective of stabilising the eurozone by driving more distinction between sovereigns and banks. The components that have been laid out, on the surface, look broadly sensible: the idea of a European-level supervisor and the two elements of mutualisation of prospective costs. That broad design sounds like it will do the part of the job that is envisaged by this step.

Q121 The Chairman: When we were in Brussels taking evidence, we found some scepticism about the timetable—I will ask you to comment on that—but also about the sequencing of steps that are proposed.

Richard Kibble: As Mark has said, in the way this is laid out, as I am sure you know, the first step that is envisaged is the creation of the single supervisory mechanism, and in particular it is proposed to bring the systemically important banks under the jurisdiction of the ECB. The creation of the SSM ought to be done by 1 January 2013. I would say that we need to get moving and create momentum behind this concept. Having a plan like that is broadly plausible, in the sense that there is a small number of large institutions, so the number of nodes, if you like, is relatively contained. But it is definitely ambitious to do that. Then we sweep into the other components that are either on the timetable anyway, around the recovery resolution directive and the deposit guarantee, and the second step—the SSM completed by the beginning of 2014. It is an ambitious timetable, but we need to show progress.

The Chairman: Too ambitious?

Richard Kibble: That will be determined by how this plays out with the partners in the decision-making process. We are definitely running short on time and there is a lot to do. The important thing for us is that there is the desire to set in train the sequence of events that will get to something that looks credible. There is pragmatism around the way it has been constructed, to try to create the sense that there is momentum behind getting to this solution.

Q122 The Chairman: Mr Harding, I ask you the same question. Could you also include a reflection on CRD IV, because we are trying to complete that? Does it bump up against what is proposed?

Mark Harding: It is a very good question. I suppose that it is important to distinguish between the period before implementation and the period after. I am talking now about the banking union and the proposals for the single supervisory mechanism. Clearly, it is going to be extremely tight getting that in by 1 January next year. We feel that it is important that we get that right, rather than get it quick. The difficulty of trying to rush this one is the risk of getting the design wrong and then having to live with it. If it took a little bit longer to get the design right, and some of the issues that still need to be addressed, I, for one, would be happy for it to be delayed a little. The implementation rather depends, after that, on how much is in practice going to change and when. Clearly, the ECB is going to have to take responsibility for the essential elements of prudential supervision from whatever the date is; let us say 1 January next year. In practice, the big question—and I am sure that some of your other questions will come on to this—will be how much that will really be operative from then and how much they will still have to rely on the working mechanisms within member states that still exist.

One of the problems in the period between now and implementation is—among other things—some of these other directives which, as you quite rightly suggest, it is bumping up against. One of the problems, one of the issues that is very important to the UK, is this question of what it does to, particularly in this case, the European Banking Authority and the voting arrangements in that, and an understanding of what the voting arrangements will be, and therefore the ability of member states, particularly out member states, to ensure that the binding mechanisms—the rules that are written under these directives—will not necessarily operate against the interests of a country such as the UK. Quite apart from the amount of time—the parliamentary, policy-making timetable—available between now and the beginning of the year, the question is about whether, from a political point of view, countries like our own are going to be willing to sign up for measures when they are perhaps concerned about the voting structures within the EBA, which is an essential part of the implementation of all these directives.

The Chairman: We will come on to that. Baroness Prosser would like to pursue a particular interest.

Q123 Baroness Prosser: Thank you very much, Lord Chairman. Good morning. Continuing with the discussion on banking union itself, the Commission asserted that the creation of banking union must not compromise the unity and integrity of the single market. Mr Harding, particularly in your written evidence, you have argued that it is both crucial and possible for the single market and the single currency to be compatible. Would you expand on that for us, please?

Mark Harding: Certainly. With the obvious caveat that theory and practice might diverge here, in principle the two can co-exist without damage to the single market. I would not like to maintain that that is certain. Clearly, if appropriate checks and balances are not placed on, among other things, the voting mechanisms, the risk is that we may have a situation where there is, in effect, a block vote by those countries that are within the single supervisory mechanism co-ordinated by the ECB. We need the checks and balances. If those are put in place, if the Commission does its job as the guardian of the single market, one could foresee the two being compatible. Of course, there will be a number of pressures that might militate against that. In principle, however, the two can be made to work together. The question is how that would work in practice.

Q124 Baroness Prosser: What sort of pressures are you thinking of?

Mark Harding: For example, there may be situations in which it is in the interests of the countries within the single supervisory mechanism—for these purposes I assume it is the eurozone countries, but obviously it could be extended beyond that—to adopt rules that give advantage to those within binding technical standards, for example, under the European Banking Authority powers, and might facilitate business within that zone, and might in fact cause a problem for countries that are outside it. Of course, the smaller the number of countries that are outside it, the greater that risk will inevitably be: that decisions are taken within that authority which are in the interests of the eurozone ins and which might restrict availability of, for example, the treaty freedoms—particularly the freedom to provide cross-border services, which is crucial to the banking industry in particular.

Q125 The Chairman: Mr Kibble, do you want to answer that?

Richard Kibble: I echo much of what has been said. There is a conceptual opportunity for these things to be aligned. The devil is in the detail in terms of how this gets worked through, but it is possible that we can make the two things compatible.

Q126 Lord Vallance of Tummel: I declare two interests: first, as a member of the international advisory board of Allianz SE, the financial services company; and another as a member of the supervisory board of Siemens AG, which has a banking licence.

Moving on to structural reform, I know that the banking fraternity is not overly enthusiastic about structural reform and ring-fencing. As between the three main contenders—Vickers, Volcker and, more recently, Liikanen—which do you think is the best approach and why? Secondly, as there are quite possibly going to be different approaches under different jurisdictions, what sort of problems will that give for cross-border banking groups?

Richard Kibble: That is a good question. With the proviso that Liikanen has not really come up with a lot of detail about how it is going to work yet, although the principles are apparent, to focus on Liikanen and Vickers and the compatibility between them—there is an assertion by Liikanen that it will be made compatible with Vickers—it seems that, from a structural standpoint, they are coming at a similar solution from different ends of the spectrum. They basically say that there needs to be partitioning, in some way, of the market-risk-related activity from the retail deposits. Vickers has started with retail deposits; Liikanen has started with the market-risk-taking unit. In that way, they are similar, and there is a claim by Liikanen that they are going to be made compatible, so they are broadly equivalent. By the way, the reason why that needs to be ironed out, to take us as an example, is that there is currently a risk that RBS would have to apply two separate ring-fences. Our US subsidiary would have to sit outside both the Vickers-defined ring-fence and the Liikanen-defined ring-fence. That is a potential challenge, and we are interested to understand how Liikanen will resolve that, but the claim is that that will be resolvable.

If you look at the other elements around bail-in capital, which was the other important aspect to which you alluded in your introductory comments, we as an industry and at RBS specifically are much more enthusiastic about that type of construct, and see the value of that. It seems as though, again, there are some differences in detail, but they are quite convergent in terms of bail-in capital and being a critical part of the solution.

Those two, on the surface, seem like they may be convergent as constructs. They certainly are claimed to be compatible. In terms of arguing which is better, it is clear that we would prefer to be more reliant on RRD-type constructs rather than structural constructs. We like the bail-in constructs but, given the need for a structural change of some sort, that is what it is. That is where it is coming out. The Volcker one starts from a different place on the continuum in terms of what activity it is trying to separate; it is by nature different. Do we think that that is better? In some ways it is solving a slightly different problem. It is not easy to argue which one is better. If you could choose, you would probably choose Volcker on the structural side, but given that we are subject to the other two, we are looking more at the compatibility of the other two.

Mark Harding: I largely agree with that. One of my colleagues described the difference between Liikanen and Vickers as a question of whether six and six made 12 or six and six made 12. That probably illustrates that it is not entirely clear whether the Liikanen proposals are effectively just looking from the other end of the telescope at the structural reform issue. We have a problem, because it is not spelt out in a great deal of detail. One of the questions that arise is whether they are in fact going to try to harmonise them, or whether they are effectively going to give a pass to any countries that adopt, for example, Vickers. So the UK would effectively be exempted from that; I have heard a suggestion to that effect from the Liikanen proposals. Since they are nothing more than proposals, and not Commission proposals either, and that Commissioner Barnier has indicated that he is consulting on it and the Commission will come up with its own proposals, we will have to wait and see whether the two are effectively to be made compatible and harmonised.

As for which we would go for, to be honest, we are where we are on the ICB now. While one might question whether structural reform of this kind does in fact add to our systemic stability, we are very much for getting on with this now that we are out with the ICB. From pretty well every point of view, we would now just go to the ICB and get on with it. That would involve, obviously, concentrating on ring-fencing the deposit-taking bit of it. There are some technical issues with Liikanen, depending on how it comes out, on how we propose to treat market making, and the possibility is that that might get split off from other investment baNking activities. It is very difficult to know how you would split some of these activities and it is unclear how that would work. My guess is that Liikanen, when it is looked at in more detail, and if any proposal of this kind comes forward, will be revised. As it currently stands, there probably are some issues with it. Personally, we would go to the ICB and get on with it.

Q127 Lord Vallance of Tummel: Picking up on the point you made earlier, Mr Kibble, you used the word "partitioning". Is it actually possible to get a clear-cut partition that will work? Or will there not always be ducking and diving under or over the top of the partition?

Richard Kibble: Again, it is a matter of degree, given that we are consciously in a grey world here rather than a total separation of worlds. We are talking about exactly what is specified and the spirit of what is specified. As you know, the spirit of this is to prevent funding flows from, effectively, the deposit-taking base into the capital markets and that sort of activity. I am reasonably confident that that will be enactable. Certainly, for our institution, we are under way in planning how that would work for our capital markets activity, such that it is not reliant on any funding flows other than those raised directly by that entity. That aspect of ring-fencing, if we want to use that term, is perfectly workable. As Mark says, we are engaged in getting on with it, really.

Q128 Viscount Brookeborough: If you do partition them, will that make the retail sector, as opposed to the capital sector, less profitable? Will you have to add cost? Does one finance the other? How would that work?

Mark Harding: It is a very good question. It will add to the overall cost of the delivery of financial services.

Viscount Brookeborough: What about day-to-day banking for the public?

Mark Harding: The cost of funding the bank as a whole will go up, and it will have to be passed down to both the retails and the wholesale side. Inevitably, it will increase the cost of the provision of retail financial services, not so much because of the avoidance of direct subsidy but because the structural changes will create an increase in funding costs for the whole institution. That will have to be borne and is one of the ongoing costs. It will inevitably do as you say.

The Chairman: Mr Kibble, the same?

Richard Kibble: Yes. You have effectively removed a cross-subsidy benefit for the total funding cost of the organisation. It has to go somewhere, so it will flow back down to the clients.

Q129 Lord Flight: Can I ask you for a little more detailed comment on the framework of the proposals for the ECB to take over the role of regulator within the eurozone? It is sort of an obvious principle that if you want good common standards you have to give responsibility to one body. The ECB is the obvious candidate. I do not really understand how they are going to interact with the existing central banks, or what will be the view of the central banks. Is the ECB going to set up regulatory operations all over the eurozone? We know that Germany thinks that the existing arrangements in Spain are not up to much. I do not yet really understand what the detailed proposals are. To whom is the ECB going to be accountable? It looks as if the EBA will have ultimate policy decision powers. What is the position, say, with banks headquartered in the UK outside the eurozone? They are not bound by this but have subsidiaries and branches doing business within the eurozone. How does the regulatory responsibility work there? What flaws do you see in the proposals? Finally, we certainly encountered at the Commission the strong view that small banks are as dangerous as large banks and, therefore, you have to let the ECB be responsible right the way down to stop those little Austrian banks causing a crisis. I do not have a clear vision of how all this is intended to work.

The Chairman: I think that this is a multi-tasking question.

Mark Harding: I have some sympathy with all of your questions, because I am not sure that any of us have great wisdom on a lot of the subjects. That reflects a degree of uncertainty.

Lord Flight: What would you suggest?

Mark Harding: There are a number of issues here. To some extent, the proposals out there represent a relatively pragmatic approach to one conundrum, which is how you suddenly have a fully functioning central supervisor, which is clearly not going to happen as of 1 January next year. What is quite clearly envisaged is that, while the ECB will obviously have to expand its staffing—I have heard numbers in the very low hundreds bandied about for the additional tasks—it clearly is intending to focus centrally on the significant prudential issues, leaving—as, indeed, the draft envisages—the day-to-day supervision of conduct of business-type activity, consumer protection and that sort of thing to national states. Having talked to at least one of the smaller states which is likely to be in at the banking supervisory level, it is wondering whether what we are effectively going to have is a bifurcation of their current staff into a collection of them who will effectively be a branch of the ECB going forward, with the rest of them doing what they are doing.

Lord Flight: So split rather like in the Financial Services Bill.

Mark Harding: In many ways it is very similar. That is probably the way that they will have to do it. In terms of accountability, there are a collection of issues. Clearly there are some accountability provisions baked in there; it is not right to call them half-baked, but they are not very substantial. This is one of the issues already signalled by the Government here about the accountability of the ECB. It has some accountability to Parliament. That is enshrined in its current role as guardian of monetary policy; because of that role, it has independence enshrined in the Maastricht treaty.

In relation to financial supervision of banks, there is a question of whether the current accountability mechanisms are sufficient to ensure that they can be called to account in appropriate circumstances. The EBA in many ways has a role in that regard, if there is a dispute on the application of the EBA's rule or the directives by the ECB as supervisor. But it is not really overseeing the ECB as such, so there are some issues in that area that need to be addressed.

Q130 The Chairman: We will be coming to those. I wondered whether Mr Kibble wanted to respond to Lord Flight's concerns about the ECB. I will tack on: where do you get fully fledged supervisors from off the shelf?

Lord Flight: The FSA.

Richard Kibble: The way we think this through, to take Ulster Bank as an example—it is our subsidiary in Ireland and currently regulated by the Central Bank of Ireland—under this scenario, with a similar characterisation to the one that Mark has just put forward, we would envisage a separation between prudential and conduct regulation, as is laid out. The prudential regulators, perhaps the very same people whom we currently deal with in the Central Bank of Ireland, will put on the ECB team jersey and be effectively a subsidiary of the ECB and will regulate us, going forward, with that perspective. Ulster Bank is not a systemically important bank at the European level, so it will come in on the second wave, I guess, but we can anticipate that that is how the structure will work. Where you get these regulators, in large part, is from existing national regulatory organisations. That is likely to be the answer.

Q131 The Chairman: In the first instance, do they concentrate on the larger banks, given Lord Flight's point about the dangers from smaller banks? Is it doable?

Richard Kibble: That is what is stated anyway in the sequencing, is it not? It will be first of all established for the systemically important banks. So we are going to get that top group looked at. You could think of that as still a top slice of the relevant national regulators, overseen by maybe about 100 or so extra ECB folks centrally. I would envisage that that is where they would build that capability up. As was posed in the question, they then have to think through carefully what is appropriate to drive a central approach versus, even on the prudential front, allowing them to continue locally. Hopefully there will be a pragmatic interpretation.

The Chairman: You are nodding away there, Mr Harding.

Mark Harding: Yes. I think one of your questions that sits around this is the extent to which there should be differentiated levels of supervision for banks of different sizes. There are issues that arise with that, if what that results in is effectively different standards of supervision being applied, or different results. We are supporters of the full 6,000 coming in. We do not think that you can pick and choose those who are going to cause an issue; you have to bring the whole lot in. If you are then going to differentiate between them in terms of level of supervision, which may be a sensible thing to do pragmatically, and allow less intensity of supervision or supervision of some aspects being carried out by the national supervisors of banks defined in a particular way as less systemically important, that seems to be a likely path. But it does raise questions about whether we are going to get the level of consistency across the Union envisaged in the question. That would be an important advantage of moving to a single system.

Q132 Lord Flight: Lord Chairman, first, I forgot to declare a key interest as senior NED of Metro Bank. Secondly—this has been touched on—what key flaws, if any, do you see in the framework proposals? What is going to cause trouble?

Mark Harding: In terms of approach to supervision, or in the design?

Lord Flight: It is really the design.

Mark Harding: The design. I think most of the issues are in the accountability area. There is not a lot of detail about precisely how things will work. It is to some extent enabling in the way in which it is written. You could describe that as a flaw. I suspect that, in practice, the only way this gets done any time soon is by it being at a relatively—

The Chairman: Let us explore that. Before Lord Marlesford comes in, Baroness Maddock has an interest in this area.

Q133 Baroness Maddock: I was going to ask you about accountability, because the Commission has asserted that the ECB will be subject to strong accountability provisions, including to the European Parliament and Council, to ensure that it uses its supervisory powers in the most effective and proportionate way. You have already indicated that you are concerned about accountability. Mr Harding, in your evidence to us you stressed the need for member states to have some role, and the national courts as well. Can you and Mr Kibble enlarge on that?

Mark Harding: Yes. I am happy to do that. I think we, or any country that is within this, will be moving to a system that replaces national systems, which generally tend to have some form of appeal or judicial mechanism lying behind them—in relation to individual supervisory decisions, for example—to a system where, of course, you could go to the European Court of Justice, but we know that takes a very long time. There is no built-in judicial or appeal mechanism in the whole thing. That is one of the areas that need to be thought about. I realise all the problems and difficulties with creating that. In terms of accountability to member states, that is a reference really to the role that Council Ministers of national Governments can play in overseeing it. At the moment, most of the weight is put on the Parliament's role and, obviously, the Commission's role. I personally would like to see some greater involvement of member states, although it is again very difficult to do given the treaty arrangements in relation to the ECB.

Richard Kibble: I broadly agree with the dilemma, I guess. We want to empower the ECB to achieve something that then creates a different tension in the system around how we control it. In giving it the power that we seek to give it, that cannot be unchecked, but the way we check it will affect whether it is seen as a credible solution. That is definitely a dilemma. I would go with a lawyer to explain the characteristics of it.

Mark Harding: I do not think there is any very simple straightforward answer to it. Clearly it creates an enormous amount of power in one body, the ECB.

Q134 Lord Marlesford: I would like to pursue your views on the proposed package of powers for the ECB. You both started off by recognising the challenge of the timetable but appearing to accept it. Yet Mr Harding said a moment ago, "Clearly there will not be a fully functioning supervision from 1 January 2013". That, I should have thought, is a glimpse of the obvious. What I find extraordinary is that neither of you has distinguished between regulation and supervision. Regulation is setting the rules; supervision is making sure that they are obeyed. The idea that the ECB can supervise 6,000 banks in the euro area is absurd. Obviously, the only role that it can perform is to supervise the supervisors. Would you agree?

Richard Kibble: Very well put. There is a pragmatic consideration here, which is how quickly we can get to the anticipated ultimate state. It would be unrealistic to say that we are going to get there on 1 January 2013; I do not think that the proposal is to get there on 1 January 2013. I am sure that you know that the sequencing is potentially workable. It may be that 1 January 2013 is still aggressive, but sequencing the important institutions first and acknowledging the fact that they are all already regulated, so creating alignment between the European and national level, is a sort of pragmatic path that looks like it would be workable, maybe over a slightly adjusted timetable but something like this timetable. You would probably naturally do the systemically important ones first. On your question about how on earth we can regulate 6,000 institutions, I would again say that they are all being regulated currently in some form. The challenge—

Lord Marlesford: Supervised, not regulated. I am making an important distinction. Regulation is about setting the rules; supervising is about making sure that they are obeyed.

Richard Kibble: Thank you for clarifying; I was loose in my language. They are being supervised at the moment as well. The challenge is that they have not been supervised to a sufficiently consistent standard. That is what needs to be achieved. The manpower is there, but the alignment in terms of the determination around how this is done is not. In a sense, that is the essence of the whole proposal: either the same or similar resources will be redeployed with an adjusted mandate. On the practical challenges, on whether it is at least feasible, you can describe how that would work from a manpower standpoint. Then you have to ask whether you believe that you can enforce this different mentality, this different mindset, down through the same people. You are going to have to use people in those countries because those countries have different languages and other aspects which mean that you need to use locals to do that. It is not going to be everybody in Germany doing this. It is going to be executed locally. I guess it amounts to a question of whether you believe that you can create that alignment between the central entity and the dispersed elements of that. That is what this proposal seeks to do. I guess that it is aligned with the statement that is coming more broadly from the European Banking Authority around trying to generate consistency around how supervision is done outside of the strict powers, which is to say that there is a desire for supervision to be done on a more consistent basis—that seems sensible, too. That, in tandem with this, gives us a chance for it to work. I do not disagree that it is an ambitious project. It is definitely an ambitious project.

Mark Harding: I just add that it is in some ways a misnomer to say that the ECB will be supervising 6,000 banks. That is the problem: it has been billed as that. They will never centrally supervise 6,000 banks; they will continue to rely on existing resources. We will still have the EBA setting the regulations and the rules. There is one thing that they will clearly not do on day one, but it will happen over time and is maybe where the more profound changes from this will result. There is a whole collection of differences in supervision and the way the regulations are interpreted in different member states, which arise from national characteristics or use of discretions that exist within directives. So, while on the face of it we have a single rulebook, increasingly, from the EBA, in practice the way it is implemented in different member states is quite different. Over time, one would envisage the ECB effectively implementing a much more common set of rules and implementing them in a way that is common across member states. That is clearly not going to happen on day one. It will probably take many years to do but it will be no worse, from that point of view, than it currently is.

The Chairman: Colleagues, time presses on. I am just going to ask for two supplementary questions from Lord Jordan and Viscount Brookeborough before we come to Baroness Hooper.

Q135 Lord Jordan: We encountered an off-the-record assessment that the unseemly haste in instituting this supervisory structure was in order to be in readiness to bail out the Spanish banks. If that proves to be the case, the Spanish banks will become the guinea pig of how this system works. Is that cynical view shared by the banks about the speed with which this is being done?

Viscount Brookeborough: We have got lots of different ideas and different operating units, but we do not have a wired diagram which shows for sure which direction this is all going in. The whole thing keeps on being broken and crossing from one to the other. Can you comment on that? Secondly, if this had all been in place, would we have avoided the crisis that we had? If that is not so, what is the point?

The Chairman: Mr Kibble? Try a bit of cynicism and foreseeing the future.

Richard Kibble: Shall I take your question on Spain, and whether this is a Trojan horse to rescue the Spanish banks? I guess I would say, stepping back, that we have to clarify the problem that this is trying to solve. When you put this in place, it is going to have its first moment in the spotlight. Whenever we put this in place, if we assume that there will continue to be weakness in the eurozone banking sector, there will be the next banks which need to be recipients of whatever largesse this new entity is going to grant. It may well be the case that the current ones in the frame are Spanish, but there are plenty of other distressed banks across the eurozone. It just depends on the time at which we put it in place. I would reassert that the prime purpose of it is to try to inject more stability into the eurozone as a signal, and it is going to have to act to demonstrate that that signal is real. As I say, timing might dictate that the first recipients would be Spanish.

The Chairman: And on Viscount Brookeborough's question?

Richard Kibble: To clarify the question, there is no wiring diagram. I do not think that there is a wiring diagram for the European project as a whole that is very easy to understand either.

Q136 Viscount Brookeborough: But if we have not got that, how on earth can we put it in place by 1 January? This is creating uncertainty.

Richard Kibble: I agree that it has its complexities, in part because it is attempting to be pragmatic. It is trying to encompass existing regulatory constructs nationally, and existing Europe-level initiatives, and to say what is a sensible way of packaging those things to create a slightly larger concept of banking union. That is why it is not as elegant as if you drew it on a blank piece of paper. That is my interpretation.

Mark Harding: Perhaps there is a common thread to the two questions; I might just try to join the two in picking up on what Richard said. I do not think that there is any doubt that one of the principal problems of the ongoing problems in the eurozone is the link between the banking system and the sovereign. If we are to get ourselves out of the situation—collectively, whether we are in the eurozone or not—one of the things that we have to do is implement in one form or another something that we might call banking union. It is not enough to have a single supervisory mechanism, but it is important that we do that and the other two issues that we talked about.

The reason for the Spanish connection is that that is the most urgent presenting problem. They clearly have a problem with the link between their banking system and the sovereign, which is creating problems for their funding; their funding costs are very high. In a sense, yes, it jolly well ought to be urgently done in order to support the Spanish banking system, because that link certainly needs sorting out one way or another. In a sense, call it cynical or not, I think it is a necessary part of solving the eurozone crisis. Whether or not there is a wiring diagram, what they are proposing to do with this is in effect to say—this is an interpretation you will not read anywhere—"Everything carries on as normal, except for the fact that we have some formal powers pulled up into the ECB and we'll work it out as it goes along".

Richard Kibble: That is not how they will say it.

Mark Harding: No, but in practice it is what they are going to do. On whether we would have avoided the current problems, the current macroeconomic problems did not start in the eurozone area in any event—they started in the US. So it would not have solved the bigger problem. Would they have avoided the current disastrous link between the sovereign and the banking system? If you couple it with mutualisation guarantee schemes and probably some further fiscal integration, I think that the answer is probably yes—but it is not sufficient in itself.

Q137 Baroness Hooper: In terms of the need, and indeed the proposals, for the ECB to develop international relationships over its supervision, do you foresee any risk that the UK and other non-participating member states would be marginalised, particularly at international meetings and in international forums?

Mark Harding: Yes, is the answer to that.

Richard Kibble: Yes, there is a risk, and it needs to be worked on. There are some emerging proposals as to the principles behind how that would be worked on. It is not straightforward, as we can all appreciate; it gets back to the conundrum of empowering the ECB's need to solve the eurozone problem without disabling the higher organisation, the EBA, from functioning. That is what needs to happen.

Q138 Baroness Hooper: So is this risk being worked on just by the UK, or do we have active support from the other non-participating member states?

Mark Harding: I think it rather depends where you believe the other non-participating member states believe their interests lie. I do not think we should assume that they all want to be non-participating, so alliances in this area will be somewhat built on sand. One interesting question, if you are a small state, is whether you will not do better to be an in, even if you are not within the euro, on the basis that it provides a degree of imprimatur from the ECB that may be regarded as important. Clearly, there are structural issues about voting at the moment that would probably deter them, but I do not think that we should assume that we will get support. From any state that is determined to stay out we will get support, but I am not so sure that they are all in that camp.

Q139 Baroness Hooper: Can you tell me which ones are?

Mark Harding: No. You hear noises from time to time, when different countries express an interest in being in. For example, Sweden has an issue because the Finnish branches of its operation are within the eurozone, whereas it is out. The Scandinavians may well feel that they would prefer to be in, given the problems that it creates for their banking system.

The Chairman: Colleagues, we must press on.

Q140 Lord Kerr of Kinlochard: I was impressed by evidence that we took from Mr Enria in Brussels that the greatest risk to the EBA was that, to avoid knock-down drag-out fights between the ECB and the Bank of England—the two big beasts in the EBA—rule-making would take place at such a high level of generality and allowing so much discretion that the EBA would be gutted of content and become purely an umbrella. Though Mr Enria did not say so, it seemed to me that one consequence of that would be an effective split in the single market. Do you think that risk is real?

Richard Kibble: I think there are risks to a split in the single market that are bigger than this one, given what is going on more broadly in the macroeconomic domain and the types of changes that each individual country will need to make to get the euro project back on the rails, so to speak. So I think that there are bigger risks to the single market that are unrelated to this particular situation. In this particular question, as I said before, I guess there is a recognition of this issue and determination to solve it. Clearly there is risk, but so far I would hope that the people enlisted to do it will do it. But I cannot deny that it is a risky situation. It is an inevitable consequence of trying to solve what is seen to be the bigger problem, which is euro instability. Doing what is necessary on that front creates a risk.

Mark Harding: I think the intention is clearly to avoid that. There is clearly a lot of talk about the EBA continuing to exercise all the powers that it has in relation to the technical standards and all the mechanisms of running colleges and so on. The more that the powers of the EBA are enshrined in successive pieces of legislation, such as the recovery and resolution directive and others, the more it will be difficult to empty the EBA of its effectiveness and substance. It is a risk and something that we need to be vigilant about, but personally I would be a bit surprised if it was the result. But it clearly is a risk that needs to be watched.

Q141 Lord Kerr of Kinlochard: What do you think about the voting rules issue? I do not really understand the Commission's proposal and I do not see how the Outs can get a blocking minority for ever, given that the Outs largely consist of people who wish one day to be Ins. As the group of Outs shrinks, it seems very unlikely that those left there would be able to block, unless Mr Enria's worry proves right and the whole thing becomes a bit irrelevant.

Mark Harding: I think you have put your finger on a very good point. I think we have that problem from day one of the operation of this, because clearly the UK is not going to be able to operate on a regular basis a blocking minority of the EBA on binding technical standards. It surprised quite a few people that there was not a mechanism already proposed to deal with that problem on a routine basis. Let us assume that the number does not stay at 10 but shrinks; then this becomes more and more acute, and a mechanism is needed to cater for that as well. I agree that that is a real issue in the context of the rule-making powers of the EBA. It is one of the more important things that have to be solved. You are absolutely right that one possible solution is to make it irrelevant and have decisions made elsewhere. That is obviously not intended in the architecture, but this is an important point that needs resolving and one of the most important points going forward for this country.

Q142 Lord Kerr of Kinlochard: Let me take you back to one of the points you made in your written evidence, Mr Harding, for which many thanks—it was extremely detailed and useful. You pointed out that the UK had on the ECB proposal a veto, because it requires unanimity. You then included a rather warning paragraph—a caution—on the use of that veto. Could you speak to that caution? What is your concern?

Mark Harding: Clearly one treads on sensitive ground here, but the risk of marginalisation of the UK is obviously a significant one, not just arising out of this process, of course, but because of all the other things going on in relation to the EU and our relationship with it. Because financial services are such an important part of our economy, it is clearly important that we have a constructive relationship with the EU going forward. Everybody knows that we have a veto, and there is always an implicit threat of the use of that veto. It is clearly in our interests, as a contra point, that this system of banking supervision and all that comes with it is put in place as part of the mechanisms for resolving some of the eurozone problems. So it is a threat that we need to be very careful in exercising, because to be seen to be standing in the way of what we acknowledge is an important part of the solution is something that we need to be careful about doing. We need to be careful about having a constructive relationship going forward, not least because we want to make sure that the treaty freedoms that we have, which enable us to run a successful financial services industry from the UK, are preserved, and that we have a good working relationship with the other member states.

Lord Kerr of Kinlochard: And if, by using our veto under the treaty, we did not permit them to do what they wanted, you say in your evidence that you see a risk that they would do it by intergovernmental agreement outside the treaty, which would increase the difficulties of ensuring coherence?

Mark Harding: Potentially that is the case, not just in this area but in other areas as well. It is the sort of thing that we may have to resort to. Frankly, I find it difficult to envisage that we would want to be in a position where we appeared to be holding up what we all agree is a necessary step. It is very important that we get the detail of this right. I am not advocating us simply throwing up our hands and letting anything happen, but the risk always if we block it is that it happens in other forums or with other legal means.

The Chairman: Do you share that view, Mr Kibble?

Richard Kibble: Yes.

Q143 Lord Dear: Good morning, gentlemen. I turn your attention to the recovery and resolution directive. There are suggestions on the table that there should be a framework for the recovery and resolution of investment firms and credit institutions. There is a timetable for the directive, and the Commission has said that it wants to reach agreement on the package before the end of this year. How would you respond to the view of the UK Government, who said, "We should resist any pressure to proceed with undue haste"? Could we have a general view on that, applying your mind particularly on the question of speed or go-slow?

Richard Kibble: As we have talked about before, it is a critical component of this banking union package, so it is part of the solution that it is necessary to be convincing that at the European level we can intervene when banks are at a failure point, or close to failure point. So it is a necessary part of the package in our view. Clearly, the UK has made progress on this type of concept, in having recovery and resolution plans. I think I would echo something that was said earlier: that these things are critical to get right. We have the signal that we are going to put the construct in place, which is helpful from the standpoint of saying that this whole banking union concept is going to work in breaking the links between sovereigns and banks. But putting something in place that is not yet fit for purpose, if you like, and too early, would be unfortunate. As some of the other Members said earlier, there is every chance that this will be tested relatively quickly once it is put in place, so the timeline needs to be looked at carefully relative to getting the details right.

Lord Dear: We should try to get it right rather than hurrying to some sort of half-baked decision.

Richard Kibble: Yes, that is right. So it is a little bit unknowable how long that means you need. Some drafting has already been done around this, and there are other precedents of similar things. So I do not think that it should take for ever to get something workable.

The Chairman: Lord Dear, before I go to Mr Harding, could you just table your other question?

Q144 Lord Dear: Yes, indeed. I was going to ask you about bail-out tools and whether in general terms you think they would be effective.

The Chairman: You mean bail-in.

Lord Dear: Oh, yes—it was a Freudian slip.

The Chairman: Who would like to bail in on that one?

Mark Harding: I think that there is next to no chance of it being on the statute books by the end of this year.

Lord Dear: We are talking about bail-in, not bail-out.

Mark Harding: I entirely agree with the comment that it is better to get it right. Bail-in stands a very good prospect of being a very useful part of the armoury. Obviously, a number of technical and legislative steps need to be taken to make it work, but in principle the idea that, instead of public money being used to bail out a bank, private money should be used, but technically by a method of what is now called a bail-in, seems clearly as a policy matter a preferable way in which to do things and clearly desirable from pretty much every point of view, if you can make the technicalities of it work. If buyers of debt are still prepared to buy that debt on the basis that they may get bailed in, for example, which we believe they are—it is just a question of price, as it were—then it provides a very good mechanism. A number of studies have been done and they all rely on various hypotheses that cost, or loss as it were, incurred if you make certain assumptions of a certain amount of bail-in-able debt held by a bank would be much less than the cost to the taxpayer of historic bail-outs.

Richard Kibble: I agree that the idea of broadening the group of entities, or the types of financing that would be invoked, is a good idea. Our view is that it should apply to all categories of debt, going forward. We are a little more sceptical on whether there should be a specific category of bail-in-able debt created, but the concept would apply to the whole stack.

Q145 Lord Dear: Could I ask one specific point about special manager tools, and the fact that if they are employed all you do is accelerate the lack of confidence in the distressed institution and that in the end it causes more damage than would otherwise be the case? Do you have a view on that? I know it is a judgment and hypothetical, but it would help us.

Richard Kibble: That relates to the question of central versus local supervision. What is being flagged by the commentary on it is that there is a risk that somebody who is somewhat distant from the situation is inclined to step in rather earlier than you would do if you were closer to the situation and managing it on a more proximate basis. That is what is being flagged as an issue. That then accelerates the downward spiral for that institution; that is what has to be very carefully gauged—this person coming in from the Europe level and saying, "You're now in this special situation". That needs to be done with great care. That is why there is a feeling that there is risk around it.

Q146 Lord Dear: On separation tools, the Government have hinted to us—or more than hinted—that they think that benefits would be unclear. Would you support that view?

Richard Kibble: It is hard to know how to respond to them saying that the benefits are unclear. There is a precedent for how this is done in the UK, under the Banking Act; this is effectively what the Banking Act gives the UK Government the ability to do, and it has already done it with some small building society situations in the UK. It is also analogous to the type of thing that we have done at RBS in terms of separation of our core and non-core banks. Some characterisation like that is useful in these situations. I am not entirely sure what the lack of clarity is, but it seems as if it is a well tested construct that would work in certain situations.

The Chairman: Mr Harding, if you could reply to Lord Dear, then I am anxious to get our last two questions in.

Mark Harding: Two quick points. We would see the special manager as relevant in a resolution, not a recovery, situation. That would avoid the problem that you suggest. On the question of whether the good bank/bad bank is a power worth having, there is some confusion over whether the reason why they have suggested that it might not be relevant is that you can use the other proposal, the bridge bank proposal, to do the same thing.

The Chairman: Lord Flight, very quickly please.

Q147 Lord Flight: What is your assessment of the proposed single resolution mechanism? Do you think that a banking union makes any sense unless you have such from the start? How will it relate to the recovery and resolution directive?

Mark Harding: I think that is a very good question indeed. We do not know, is the answer. A single resolution mechanism to my mind effectively takes the recovery and resolution directive one stage further; instead of relying on a collection of different national resolution mechanisms it creates a single resolution mechanism for the zone in question. That obviously raises questions about how it relates to bankruptcy and insolvency laws in the countries in question and related procedures. It is not an inevitable or an absolutely necessary thing. If one could do it, I can see quite a number of difficulties from getting from here to there, but the recovery and resolution directive is a good first step.

The Chairman: Mr Kibble, you were nodding there.

Richard Kibble: Yes, I agree with the direction of that.

The Chairman: Our final flourish comes from Lord Jordan.

Q148 Lord Jordan: Mr Harding, you talked about the risk of marginalisation to the UK being significant. The UK Government have made it clear that they will not take part in the fundamental elements of the banking union. We questioned senior people in Europe. When we said that there could be very serious implications for the City of London, in a nutshell they said, "That is their problem". How realistic is the UK Government's argument that the UK's non-participation should not and need not adversely affect London's position as the financial centre of Europe? We know that Government tends to echo whatever the City of London says on these matters, so is this a case of both Government and the City being completely wrong on where all this will lead? Like other empires before them, the moment of unthinkable decline begins—is this it for the City of London?

The Chairman: I think that you are being asked to be the noble writer Mr Gibbon on the decline and fall.

Lord Jordan: I was going to quote him.

Mark Harding: You can envisage circumstances, which I hope will never come to pass, where that happens in the single market, which is the tool on which we rely for our international banking system. Domestic banking systems are by their very nature domestic, so retail banking tends to be domestic. The part of the City that is international, whether it is banking or insurance or any other, is the part of the City that operates on a cross-border basis, with investment banking very much an example of that. If one ever got into a situation when that freedom to provide services cross-border, let alone freedom of establishment, was taken away from us, that would be a very difficult problem for the City. I personally do not think that we could continue to thrive in the City if we were in a situation where we were effectively outside those freedoms—a Switzerland or some other location that does not have those freedoms. It would be quite difficult to operate, and not just in banking but more broadly with financial services, in a European context from London. I hope that that situation never arises, but that would be the risk.

Richard Kibble: I guess that I agree with the characterisation of what we need to avoid going forward. One point to note is that in 1999 the creation of the euro was met with similar threats of the demise of London as the centre of financial services, and it has actually thrived on the back of the creation of the euro.

The Chairman: Colleagues, I conclude this session by apologising to Viscount Brookeborough, because he was anxious to pursue the question about the deposit guarantee scheme. I turn to my witnesses and ask them whether they would be kind enough to reply on the question that we have on that and for them to present their comments to us. We would be very grateful, as I would be for any other thoughts that you have, not only now but subsequently, when you look at the transcript and reflect on this session. It has been enormously useful to the Committee in helping us to form our views and conclusions on this matter. We are extremely grateful to the two of you coming today and answering our questions so clearly. I ask you to do that task of checking, and if there is anything else that you feel that you can present to us, we would be very grateful.

Barclays—Supplementary evidence

Annex: Barclays' response to question on Deposit Guarantee Schemes:

1. The European Commission's September banking union package made clear the Commission's view that by the end of 2012 the banking union should mean the adoption of their proposal for a Single Supervisory Mechanism, as well as adoption of the other three components of an integrated "banking union" – the single rulebook in the form of capital requirements (via the existing CRR proposal), a single European recovery and resolution framework (via the existing bank recovery and resolution proposal), and a harmonized deposit protection schemes (via the existing DGS proposal). The latter was proposed in July 2010 by the European Commission but has been deadlocked in the negotiation process for several months now. It seems, therefore, that the most likely impact of the banking union discussion on the proposed Directive on Deposit Guarantee Schemes is to renew the negotiation process with a view to securing its eventual adoption.

2. It is feasible to conceive of progress towards a banking union that did not initially have a centralised deposit insurance scheme, if this were part of a logical plan towards a union that included this. It is difficult to conceive of a banking union that successfully breaks the link between bank and sovereign credit that does not ultimately equip itself with mechanisms for mutualising the cost of bank failures. Further steps to centralised supervision will expose the banking systems of participating Member States to the quality of supervision of the central supervisor. This is unlikely to be acceptable in the longer term unless the quality of supervision is both raised and made more homogeneous across participating states. However, as each national banking industry approaches banking union with its own set of legacy issues to resolve, it is understandable that the banking union is coming into existence without a centralised deposit protection scheme at the outset.

3. Any central deposit insurance scheme could feasibly be limited to the euro area and to any other participants in the banking union. Indeed, given the implicit exposure to the quality of supervision of the central supervisor, it is likely that participation in such a centralised deposit protection scheme would be limited to members of the single supervisory regime. For those who remain outside, the impact will depend on the credibility of national supervision and deposit insurance arrangements compared with those that obtain in the banking union. However, these potential impacts are very difficult to gauge in advance and given the turbulence in the euro area at present, it may even be advantageous to be outside of the back stop regime. Nevertheless, it is possible that at some point, this will increase tensions within the single market of the 27.

4 November 2012

Commissioner Michel Barnier—Oral evidence (QQ 97–102)

Evidence Session No. 7 *Heard in Public.* *Questions 97 – 102*

WEDNESDAY 3 OCTOBER 2012

3.30 pm

Members present

Lord Harrison (Chairman)
Lord Flight
Lord Hamilton of Epsom
Lord Kerr of Kinlochard
Lord Marlesford
Baroness Prosser

Examination of Witness

Commissioner Michel Barnier

Q97 The Chairman: Monsieur le Vice-Président, c'était un grand plaisir pour nous de vous rencontrer ici aujourd'hui. Je voudrais vous remercier très chaleureusement pour nous accueillir ici aujourd'hui pour discuter tous les questions difficiles financières. Thank you very much for seeing us. To put you in the picture, we have had an interesting round of witnesses in our stay in Brussels including meeting Mr Van Rompuy and Chairman Enria yesterday, as well as a lot of parliamentarians, so we have had a very good round. It is splendid that we have an opportunity to see you today to discuss these matters. I know that you are short of time on such a busy day. Would you care to try to outline or define the banking union and reflect on the Liikanen report, which came out today? I am sure that each and every one of us has been speed-reading it. If you have formed any views by now, the Committee would benefit enormously from those. Thanks very much.

Michel Barnier: Thank you very much. I am sorry that I can only spend a short time with you. This is because I will have to take part in the trilogue on the European prudential framework [CRD IV]. We have to reach agreement between the Parliament, the Council and the Commission on this file soon.

Before coming to the Liikanen report, I will say a few words about the global picture regarding what we are working on with you [the UK] and other European Governments in the field of financial regulation. Perhaps you could take a few moments to have a look at the table and the dossier I have given you. It represents the description of the entire set of regulations that we have put on the table of the European Council of Ministers and the European Parliament to implement in Europe the recommendations of the G20 made at the beginning of the crisis. May I switch to French?

Translation: It is a pleasure and a privilege for me to meet you, and it is a pleasure and a privilege for the Director General as well. I hope that you can hear the English spoken on channel 2? The table is simple. It represents a lot of work. It is the entire set of the texts that have been in my remit. They have been prepared with my Director General, Jonathan Faull, and his team, and my cabinet, represented here by Anita, to put in place and implement the decisions of the G20 taken in reaction to the financial crisis.

My Lords, ladies and gentlemen, I am very aware that the single rulebook is very important for all of us and the member states, including yours. The UK is a very important member state. You have a very important financial industry and it is very important that you are on board with the single rulebook. I have made a lot of effort and worked a lot with your country to make sure you are on board. Everything marked in purple in the table represents the texts that have already been adopted, with the support— and sometimes abstention—of the UK Government. The elements in orange are the texts that are in the pipeline, in the process of being discussed. Sometimes they are pretty near to the end of the pipeline. All these proposals constitute the single rulebook for the 27 European Union member states.

There are two pieces of work outstanding in this whole set, and we are working on these very carefully. First of them is shadow banking. We closed our public consultation recently and are currently working on the subject of a potential regulation of shadow banking. The second is the separation and hiving off of risk in the banking sector as a follow-up to the Liikanen Report. So all that I have just presented is the regulatory and supervisory framework for all the players in the European Union. We will possibly touch upon the common supervision in a moment whereby the eurozone countries have decided to go further down the road of single supervision. Although the eurozone countries have compulsory solidarity stemming from the euro, what I wanted to stress here is that the single rulebook is the same for all 27 EU countries. This is a deliberate choice because it is essential for the operation of the single market. I want to touch on the second very important outstanding point I have just mentioned, i.e. the separation of risk in the banking sector. This is important for taxpayers, who have found themselves very often needing to pay for the banking crisis. It is important for the savers as well. Consumers have the right to be protected and respected. In order to prepare the discussion on risk separation, I have asked Mr Liikanen, the governor of the Bank of Finland whom I know well, because we were both Commissioners 10 years ago in this very house, to organise and chair an independent group. Carol Sergeant, a highly respected personality, played an enormous role in that group. The Liikanen group worked for eight months. There was a lot of listening going on. Mr Liikanen went to the US and looked at the Volcker rule; he also looked at the UK and the Vickers context. He has proposed recommendations in the report that you may have been reading since yesterday. These are independent proposals but, to be quite clear, I consider that they will constitute the basis of the Commission's work on this subject. We have opened a public consultation via the internet on the Liikanen report which will last for six weeks. Then we will analyse the submissions and conclusions of the work. Mr Liikanen has left the Commission to deal with the calibration of his recommendations. I have got my colleagues currently working on it in the Commission. Before next summer anyway, we will come out with some legislative proposals, very probably, with a view to having clear separation of tasks and risks in the banking sector. I wanted to say that we have been very attentive to other views offered. We have been checking the Liikanen report conclusions and we feel that they are very much compatible with the conclusions of the Vickers report. That is what I can say today on the substance. If I were to simplify the Liikanen conclusions —although everyone will need to read it very carefully and draw conclusions for themselves —I might just say the following. First, on the Volcker method, Paul Volcker is quite clearly proposing that banks are prohibited from carrying out certain activities. Vickers is proposing separating—hiving off structurally—investment activities from other activities. Liikanen is proposing a third way, that is, a legal ring-fencing of certain activities carrying speculative risk. There will be thresholds built in. There will be a big role for the national supervisor, who will have to look at the real risk levels in particular banks. The Liikanen approach has not been too doctrinaire; he has been looking at the strengths and weaknesses of Vickers and Volcker and he has taken into account the realities of the banking sector in Europe. It is a very important sector, as you know. Our economies are financed to a large extent by the banks, so we want to preserve the diversity of the banking sector because the diversity is one of the reasons for its stability. This area has not yet been the subject of legislation, but we will be building on the useful basis of the Liikanen report.

Regarding all of the other texts set out in the table, I hope that we can conclude most of these texts with a definitive vote before the end of next year. The financial markets—the players, businesses—need stability soon. They need to know what is expected of them. They need to know the regulatory framework, which is currently in transition. These are revolutionary times. It is time for matters to calm down and stabilise and let the economy take off again.

I am now open to listen to your questions.

The Chairman: Commissioner Barnier, thank you very much for that introduction and the very useful table. I find that there are certain elements in it where we have already issued reports, which we hope will help you in your deliberations. We are very pressed today. As you may know, we have to go to Lille in order to return home to London tonight because of the strike. We will be leaving in about 15 minutes. I wonder whether you could reflect on the timetable and all that you want to do in terms of the banking union, the RRD and so forth. You also mentioned the supervisory framework, which will be so important for the ECB. I am going to ask Baroness Prosser to ask a short question.

Q98 Baroness Prosser: I was slightly taken by surprise. You spoke, Commissioner, in your introductory comments on the supervisory framework about the need for a single rulebook for all 27 countries. A number of witnesses with whom we have spoken during the past few days have said similar things. But of course not all of the institutions are the same. Some are massive national institutions and some are small. Can you tell us your thinking on how such a single rulebook would be able to differentiate in terms of its impact—its intensity of rigour—in looking at those different kinds of institutions?

Michel Barnier (*Translation):* Thank you, Baroness Prosser. It is an important question you have asked. I have talked about the importance of the banking sector for the economy; 75% of firms are financed by banks. Let's look at Basel III and the CRD IV texts. We in Europe apply these rules to 8,000 banks. The Americans apply Basel III to 30 banks, the Canadians to six. We are applying all these rules to our very diversified, wide banking sector. In the legislative process in the context of Basel III I was very flexible in this field. There needs to be flexibility to incorporate national concerns and sensitivities, as long as we do not have 27 totally different pieces of national banking legislation; we want similarities in prudential legislation. We have wanted to have a degree of flexibility, taking into account national sensitivities. Now, your question really involves the liberty offered to the national supervisor. There will be quite a large degree of flexibility and pragmatism, to take into account the diversity of the systems in the different countries. The texts will have such flexibility. The national supervisor will have quite a degree of discretion and, with this, we will be able to meet the challenges of combining homogeneity and diversity.

Q99 Lord Marlesford: Commissioner, there is one thing that the markets and taxpayers are concerned about. To what extent, in your view, does the European Central Bank have a moral hazard obligation to see that those who have bought government borrowing from countries within the euro area will underwrite that borrowing in the event of the need for a default?

Michel Barnier *(Translation)*: Thank you, Lord Marlesford. This subject is of course linked to other policy areas—the monetary role, for example, of the central banks. They have a role to ensure monetary stability. Olli Rehn, who has currency and the economy in his portfolio, used the expression "moral hazard" which has always struck me. A lot of people in the banking sector use this concept. They seem to hint that there has been a lot of hazard around (and not much by the way of moral). Anyway, my problem is this: I have the job of helping the taxpayers by a preventative approach. I am a preventative person. In the field of environmental protection, for example, preventing the damage is better than clearing it up afterwards, and if you get it right and prepare in advance it costs you less money at the end of the day. So I want to cut the link between sovereign debt and the banking sector. For this, we need to have this toolbox on resolution. The British Treasury supported this. All this is about working together. I have worked with the Treasury quite a lot on the resolution of banks, and all this is to my mind to reduce the risk of moral hazard and reduce the risk of the taxpayer having to pay at the end of the day. There needs to be a toolbox and a common resolution framework in each European country; and the UK will also have one. Sweden and Germany already have theirs. The idea is that each transnational bank or systemically important bank would be obliged to have a resolution plan. Each bank will think in advance, preventatively, on its own orderly resolution following bankruptcy. Weighty decisions need to be taken such as on management change; prohibition of certain banking activities; prohibition on paying out dividends; the issue of bail-in, calling for money from the outside; and the use of the resolution fund. This is to prevent taxpayers being called to pay at the end of the day. The European Central Bank as the single supervisor in the eurozone will ensure that each transnational and systemically important bank will have the necessary toolbox at its disposal for a rainy day.

Q100 Lord Kerr of Kinlochard: My question is about architecture because we tried to be architects together some time ago. It is about the architecture in respect of member states whose currency is not the euro but who wish to be in the banking union. I am not talking about the United Kingdom, but about member states not in the euro who wish to be in the banking union. As I understand the proposal for the additions to the structure and role of the central bank, the supervisory board would not take the final decision. The final decision would be taken by the Governing Council of the central bank. How do you sell that as a concept to member states in that category of not using the euro but wishing to be in the banking union, and how are these decisions as they affect their banks appealable? What is the court of appeal when the ECB orders the closure of a bank in a country that does not use the euro?

Michel Barnier (*Translation):* Thank you, my Lord. I would just like to say, Chairman, that I have a lot of respect for Lord Kerr; we worked together for quite a long time. We dealt with institutional issues together seven or eight years ago; it is nice to see you back, my Lord. The Banking Union architecture is a complex issue. I am working on the basis of a decision of the heads of state and government of 29 June at the European Council. They decided that there should be integrated supervision in the eurozone because of the particularly strong solidarity and interdependence stemming from having the Euro as a common currency. The eurozone must work efficiently. I have heard British leaders say that it is in UK interests as well that the eurozone should become stable and should function well, because of course we are closely linked: for example you export a lot to the euro area. There are countries, which are not yet in the eurozone and would like, because of the structure of their banking sector, to be involved in the SSM, and to be supervised in the context of the single supervisory structure. I am currently going with my services through the various texts governing the functioning of the ECB. We have gone as far as we could with our proposal. We have tried to say: if a country wants to come under the single supervisory umbrella without being a eurozone member, it can do it on a voluntary basis, accepting that its banks would be supervised by way of the single supervisory mechanism. Those countries would be round the table, would have access to all information and would participate in the decision-making process. There was one thing that I was not able to put down in writing, because of legal obstacles. That is that such a country would have the right to vote on the same footing as the eurozone members. I could not get that into the text. I think, though, in the context of how the ECB's internal regulations govern its work, that there is a degree of flexibility so that we might be able to improve this proposal. I myself would be prepared to support a proposal which might lead to enhancing the capacity of those countries. So, Lord Kerr, we are working on this issue. The ECB is working on this issue. At the end of the day, from a formal point of view, it is the Governing Council of the ECB that ultimately decides. However, we would like to see all members subject to the single supervision having the same rights.

Q101 Lord Hamilton of Epsom: My question is about the RRD and about how realistic is the Commission's desire to reach agreement on this package before the end of the year. The UK Government have said that they will resist any pressure to proceed with undue haste.

Michel Barnier *(Translation:)* We are talking about the resolution system, are we not?

Lord Hamilton of Epsom: Yes.

Michel Barnier *(Translation):* I am sure that you have access to reliable information, but I was not aware that the UK Government was resistant to this. The Bank of England supported our view. We shared the same understanding that we would have a co-ordinated coherent resolution system in each country. I worked a lot with the Bank of England on this. We have not actually set it in tablets of stone that we have to get a decision on this by 31 December 2012. I hope that it is possible, and Parliament and the Council are working to achieve it. On deposit guarantees, those texts have already been discussed for some time—a year and a half. We will need these two mechanisms to protect and guarantee deposits, and have resolution rules in place in every country, in a coherent way so that the system can function well across 27 countries. Discussions are moving forward. I have not heard the UK authorities being so resistant; I have not heard that they wanted to block the vote on the text. It will be a qualified majority text. I hope that the UK Government continues to support the decision. I would be disappointed if it did not. I have tried to take into account the opinions of the Bank of England when I did my work—I have really tried.

The Chairman: We will have the Minister before us before we conclude our investigation.

Q102 Lord Flight: Commissioner Barnier, my question is about the UK. The UK Government have made it clear that they are being supportive of the banking union for the eurozone because it is necessary to sustain the currency, but at the same time making it clear that the UK itself will not want to take part in the fundamental elements as it is outside the eurozone. My questions are, first: how realistic is it of the UK Government to argue that Britain's non-participation will not adversely affect London's position both internationally and as the leading financial centre in Europe? Secondly, you started off with the point that you wanted to make a single rulebook for all 27 members. The banking union is being led by the move to put the ECB in the position of key regulator of banks. Do you envisage the UK joining in with that, because that is not what the UK wants to do?

Michel Barnier *(Translation):* Thank you, Lord Flight. We propose a system open in principle to all countries—those who are eurozone members and those who are not. The whole thing would be on a voluntary basis; people can opt in to the supervisory system and get a seat around the table. If certain countries do not want to be involved, and I have understood that includes the UK, there is a place where there will be a co-ordination activity of national supervisors, with their own powers. It is the European Banking Authority—that is the forum. It is based in London, and it is a very important forum. That is where technical standards are elaborated, and where there is an opportunity to exchange views if there is disagreement. The single European supervisor in the eurozone, the UK supervisor or the Swedish supervisor can get their heads together and have a dialogue; it is flexible. Any member of the 10 can opt in to the supervisory mechanism, and if somebody wants to stay out—if they think that it is not in their national interests—they would still use the single supervisory handbook and they will have a forum of discussion and arbitration. The EBA will keep the last word, Lord Flight. If there is a disagreement, a dispute for example between the ECB and the Bank of England, there will be a 'complain-or-explain' arbitration procedure in the EBA. If that is enough—if a solution can be reached—fine, but if not the EBA can impose its decision, even by addressing it directly to a bank in France or Germany or anywhere in the eurozone. It is important to be aware of this. My view is that the UK feels that the eurozone should work well and that it would be good for Britain and good for UK exports and financial services in particular. It is in our general interests in Europe to have the biggest financial centre in the world. A strong City is good not only for Britain but for Europe, and we realise that it is in our interests. We have to find the right methodology within the EBA so that we can get a balance in the relationships between the non-supervised non-euro countries and institutions, and those that are supervised and are in the euro. We will have to work on the nuts and bolts of that but I am prepared in the spirit of compromise, to pursue that work. The second question was on the single rulebook, I think. Could you remind me of the second question please?

Lord Flight: I think that you really have answered it, Commissioner Barnier, because it was in the context of your saying that you wanted a single approach for all 27 members.

Michel Barnier: What is important to understand is that there is a real difference in what is in this table as far as regulation is concerned for the provision of one single rulebook.

Translation: Regulation and supervision are different. Supervision involves an integrated application in a direct fashion of the framework, which is the same for everybody. There is just one set of regulations. In the eurozone, the single supervisor will be able to ensure that the same requirements are being implemented uniformly across the board in every bank. The risks incurred by a bank can be investigated more directly. In the eurozone, if you have a bank in trouble it can have a severe knock-on effect. You can see that already.

The Chairman: Mr Vice-President, we have passed a fascinating albeit short half hour. We have learnt much, including about you—vous n'êtes pas seulement un architecte financier mais aussi un ecologiste financier. We hope that we can continue to work with you. We hope that we can send a supplementary letter for some of those items that we were unable to reach, but we will review and listen to you very hard indeed. In the meantime, we are very grateful for your time. Should you be in London, you will always be most welcome before the Committee should you wish to expand further on these important issues.

Michel Barnier: Lord Harrison, thank you very much for your time and for your visit.

Translation: Please do consider that I am, like you, a politician. I was a senator in France as well. I was a member of the National Assembly; I was an MP in France. We work with colleagues who are competent and are committed to the European general interest. I know that the UK is very committed to the internal market, not just in the field of financial services but in every area of the economy. That is the other leg of my portfolio, the internal market. Today, the Commission adopted the Single Market Act II, second stage, with dozens of very concrete proposals to get the internal market working better and to prevent its fragmentation. I have enjoyed the support of the British Government here. We have delivered 47 proposals. This morning we decided to add 12 more, broken down subject by subject to iron out the points where there was noted unfair competition and fragmentation in the functioning of the internal market. The internal market is not the whole economy, but it is its foundation. To use figurative language, if your floorboards are wobbly and there are cracks appearing, that is not very good. If you build on it, it is not going to work. All initiatives coming from the public and private sector, if they are on a splintered floor, they are not going to work.

I have also proposed something that the UK Government is supportive of, which is the European patent. We have been waiting for this for 35 years—35 years! Obtaining a patent is 10 times as expensive in Europe as it is in the US. If there is one patent for the whole single market, the innovative efforts of many industries will be more efficient. We have also proposed a text on e-authentification—on security of electronic signatures. It is the key to developing e-commerce. You can save billions of euros avoiding red tape, bureaucracy and paperwork if more transactions can be done faster. So we are attentive to the internal market. I know that the UK is a fan of the internal market.

I look forward, Lord Chairman, to coming back to London and seeing you again soon if you will have me.

The Chairman: You are very welcome. Thank you very much indeed.

Georg Boomgaarden, German Ambassador to the UK—Oral evidence (QQ 172–194)

Evidence Session No. 11 *Heard in Public* *Questions 172 - 194*

TUESDAY 23 OCTOBER 2012

10.30 am

Members present

Lord Harrison (Chairman)
Viscount Brookeborough
Lord Dear
Lord Hamilton of Epsom
Lord Jordan
Lord Marlesford
Baroness Prosser
Lord Vallance of Tummel

Examination of Witness

Georg Boomgaarden, German Ambassador to the UK

Q172 The Chairman: Once again, it is a very warm pleasure to welcome you, Herr Boomgaarden, to our Committee. We are very grateful to you for making yourself available this morning. I will ask the initial questions, but I understand that you want to make an opening contribution. I am sure that you are familiar with our practices, but I remind you that we will make a record of this conversation and send you the transcript. We would be grateful if you would correct it, or add to and embellish it. If you have any further thoughts, please provide those to the Committee, which is moving towards a resolution in trying to provide something useful in the form of a report not only for our own Government but in time, we hope, for the Commission.

Georg Boomgaarden: Members of the Committee, thank you for giving me the opportunity again to elaborate on the German position on the ongoing reform of the EU banking sector. First, I state my appreciation for the work of the House of Lords. It is extremely important that understanding is very close, and that no misunderstandings come up. The profound expertise of this House is something for which I always envy Britain. The subject of banking reform and so-called banking union is very pertinent. At the same time, many things are still in flux. Sometimes I do not know whether my papers, which are from yesterday, are still valid today. I must ask you to bear with me if not all my answers are as concise as you hoped, because some things are still under debate. Before going into detail, I will outline some key issues, and then we can have questions and answers.

First, we want to break the vicious circle between banks and sovereigns. We have seen sovereigns bailing out banks, banks pressing sovereigns and so on. The banking union is a fundamental part of the overall stabilisation efforts in the euro area, but it is not a substitute for fiscal union. Rather, the two will have to go together and, in turn, only true fiscal union will complete the monetary union.

Secondly, the first step of a banking union will be the creation of a euro area banking supervisory body built around the ECB. There were a lot of debates over whether it should be the ECB, the EBA or whatever. The so-called single supervisory mechanism has to be successfully established and working effectively before any direct recapitalisation of banks in the euro area by the ESM can take place. The ESM can capitalise today, but it must do so through the states. For it to go directly to the banks would need the banking union supervisory mechanism to be established and in place. Additional and appropriate institution-specific, sector-specific or economy-wide conditions will be applied, which were agreed in the euro area summit in June 2012 and reconfirmed in the recent summit.

Thirdly, the single market is one of the great accomplishments of European integration. Yesterday at the embassy, a historian gave us a lecture. This happens once a year. He talked about Britain and Europe from 1973. He stressed how much the single market is also the creation of ideas that Margaret Thatcher had, and how much of an imprint Britain made on the Union—something that is still very valid. We think that Germany and Britain have a common interest in ensuring that the functioning of the single market is not impaired by the banking union and by specific euro area policies. We want to keep the integrity of the single market in place. Therefore, we need mechanisms to ensure that countries that are not participating in the banking union or in other policies relating to the euro area retain adequate influence on the development of the single market. We take that seriously. Conversely, it is also important, and also taken seriously, that non-euro area members take a constructive approach, so that the monumental task of stabilising the monetary union can be accomplished. Thank you for your attention. I look forward to your questions.

Q173 The Chairman: Herr Boomgaarden, I must say that your emphasis on the integrity of the single market is music to the ears of this Committee—and, I am sure, to Her Majesty's Government. Looking at some of the other testing questions that you raise, which flow from the 18th and 19th Council, was Germany satisfied with the outcome and the recognition of the division between the fiscal and banking union and the sequence of steps for achieving the kind of goals that are commonly held within the eurozone?

Georg Boomgaarden: Absolutely right. It is very important to get the right sequence. As we said, and as the most recent summit confirmed, quality goes before speed. Speed is fine, but quality is more important. That means, first—this is part of the sequence—that we need a single rulebook. A single rulebook means that we need negotiations on how to implement Basel III. The capital requirements directive will do that. We need a deposit guarantee scheme directive. That means harmonisation of national policies, but does not mean a single, centralised instrument. We are not in favour of centralised credit lines between national intervention funds or deposit guarantee schemes. Then we need the recovery and resolution of credit institutions directive. A key element will be the creation of a common banking supervisory body. The view in Germany on this is that here we need to apply the principle of subsidiarity. Germany is a decentralised country and we see the future of Europe in decentralisation, not with a central body controlling everything. This means that we think that European supervision should concentrate on those banks that are necessarily seen as systemic risks at a European level. This means that we should as a rule keep smaller banks under the national supervisory authorities, although we know that sometimes smaller banks can be a systemic risk as well, and in such a case the ECB must of course have the right to take them under its supervision. Some of the Spanish cajas, for example, are certainly a systemic risk, even though they are smaller banks. So on the one hand we must not overload the supervisors, but on the other we must keep the workload manageable for the ECB, in correspondence with the size of its personnel body.

Q174 The Chairman: In the context of what you say—that it is preferable to get the final architecture right rather than to make haste and perhaps get the wrong kind of architecture—could you describe the differences between the view that Germany takes and perhaps the view that President Hollande takes? Sometimes in the press here those views are portrayed as complete opposites, but the position is much more nuanced than that. Given that the timetable is important as well, what subtleties might need to be resolved between the views of the French and yourselves?

Georg Boomgaarden: Before summits there is always a lot of speculation about different positions being incompatible. But in the end, meetings in Brussels are not meetings in court, where barristers attack each other and then go for a drink afterwards. Meetings in Brussels go for compromise. If you go in with different positions, you try to come out with a common position. This was what happened at the last summit. The timetable from June has been reconfirmed. The principle that quality is more important than speed has been reconfirmed. Now it has been agreed that January 2013—this is different from what the Commission thought at first—will not see the introduction of banking union as such. However, we want to have a common view by January 2013 on a legal framework. During 2013—this, too, is the result of the summit—the single supervisory mechanism should be put in place, at the earliest possible date but with the necessary quality. There are still some things that are not clear and have to be negotiated—for example, the direct recapitalisation of banks in the euro area. Recapitalisation through the states is already part of what the ESM can do. There were also debates between member states on whether all banks should automatically be under the supervision of the ECB. That would be a problem because some countries, including Germany, have a large number of banks, so one would be giving the ECB a task that it would just not be well prepared for. At the summit it was said that this should be done in a way that differentiates not according to size but according to systemic risk — only systemically relevant banks should be under ECB supervision. As to other banks and financial institutions the ECB should have the right to access and collect information which would allow it to take over supervision itself if deemed necessary. It was also said—we think that this is extremely important, and there were debates with France on it—that the independence of the ECB must be maintained. Between monetary policy on the one hand and supervisory policy on the other there must be a strict internal division line.

The Chairman: Let us explore some of those ideas.

Q175 Viscount Brookeborough: I think you have really answered much of my question, which was about the number of banks and at what level you would supervise them. However, would you say something about those countries that are outside the euro? You talked about a supervisory mechanism for those within the eurozone. What about those that are not in the eurozone? Will the supervisors have a natural bias, as their job is protecting the eurozone, and will this not be a problem for the other countries?

Georg Boomgaarden: It is just a fact of life that the dividing line on questions and definitions of where interests are is not just eurozone/non-eurozone. There are dividing lines, particularly north/south, inside the eurozone. There are also a lot of interests that we in Germany share with non-eurozone members that we may not share with those who are inside. So Eurozone membership will not be the most important dividing line. Germany, particularly at the summit, insisted that we need a mechanism, which of course must be well founded legally, guaranteeing absolutely the same participatory rights to eurozone members and those non-eurozone member states that want this. They should have full voting rights in a banking union. It is a choice, so it is not a "must"—but whoever wants to join in can do so, and we want to put all the legal possibilities in place so that there will be full and equal voting participation in the banking union for non-eurozone states.

Q176 Lord Jordan: I just wanted to hark back to something that you said: that supervision must be effective before recapitalisation. We would all agree with that. However, given the time that it will take to make it visibly effective, the politicians are not going to hold back on recapitalisation. They are almost rushing at the gate to make sure that they save some of the banks.

Georg Boomgaarden: I will say something that sounds a bit subtle. We draw a distinction between recapitalisation in general and direct recapitalisation. For example, we want to resolve the problems of the Spanish cajas. Private debt is a big problem in Spain, but public debt much less so. However, there is a problem with the smaller banking sector—the cajas in the different regions and so on. If we resolve this by recapitalisation through the Spanish state, Spain has the right to access the ESM. There is a debate in the country regarding this approach. If the state is doing this—the ESM is paying Spain and Spain is paying the banks—there will be strict formal conditions in the form of a state programme. There is a view—maybe an illusion—that if the recapitalisation funds go directly to the banks, conditionality could be largely avoided. Currently this is not the subject of any negotiation. Spain has not asked for such money up to now. It is handling the issue through its own budget and observes a very strict fiscal policy. However, I cannot imagine that any direct recapitalisation of the banks could happen without conditions. We had this in Germany when Commerzbank went under the umbrella of state protection. In Germany at that time, one condition was that the CEO had a limit of €500,000 for his income —which sounds very low. This was absolutely observed. The only way to get back to pre-crisis salary levels in the banking sector was to get away from the state umbrella and bring the bank into better shape again. The debate sometimes seems a bit artificial because we already have recapitalisation through states. Those countries that have accessed the ESM already have it. I cannot imagine that with direct bank recapitalisation there will not also be clear conditions. Some believe that direct capitalisation of banks could be easier if everything else (particularly an effective central banking supervision) were in place. For that, you would first need the single rulebook. The conditions must be known for everybody, because you need a level playing field; it should not be left to chance, with different conditions in different cases. We need the rulebook and the legal framework. With this in place, we will, indeed, have a second, different way to do things.

Q177 The Chairman: I will move on to 7.6 as the proposed legal basis for the supervision of the banks by the ECB. Are you broadly happy with that and do you see the landesbanks as coming under the supervision of the ECB? Are there any problems associated with doing that for the landesbanks?

Georg Boomgaarden: This is not a major problem. Banks all over Europe have already accepted that they will have a new supervisory body. Some are in fact looking forward to it because they see that it is better to have a level playing field to get rid of what we had during the past two or three years, which was a renationalisation of banking. This can re-Europeanise banks. Something that I hear often in the City, and which is very interesting to the City, is that if you have a single rulebook, it is certainly much easier to treat the whole area as one banking area. In the renationalisations of recent years, everybody retired to their own national territory, and that certainly was not good for the City or for any big banks. This is also true for the German banks. We had some reforms in the landesbank sector, which certainly prepared for this. The other thing is that, for example, the several thousand mutuals are certainly not systemic. Many of them are agrarian financing banks or things like that. They are very small. We think that the main problem that could come out there is that the ECB, separate from the monetary policy part, needs staff for supervision: it needs qualified people who can do the job. You cannot do this from one day to another by decree. You have to recruit people and give them a rulebook, and this takes time.

Q178 Lord Marlesford: You have made it so clear—and I am very much of your persuasion—that we must distinguish between the rulebook, in other words regulation, and supervision. The Commission largely fails to do this in what it proposes for banking union. It seems to me, following what you have said about the need for details of the rules of supervision to be clear, that we are really talking about the extent to which the ECB will have a role in supervising the supervisors, rather than going into direct supervision itself. You said a moment ago that the ECB must have the staff to do this. There is no way in which it can, on any envisaged timescale, recruit the people who will be needed to deal with supervision. The best that the Commission can do is to have a sound rulebook that applies to everyone under your single-market principle. Supervision in general has to be done locally anyway, because you cannot get close to a bank unless you are physically close to it.

Georg Boomgaarden: What you describe is more or less what we understand by the principle of subsidiarity. We think that the ECB should supervise banks, not only supervise the supervisors, because there are some systemic cases. They can recruit some highly qualified staff but they cannot control 6,000 banks. It is necessary that they supervise the supervisor in case the national supervisor fails; they can draw the case into the ECB if it is systemically relevant, which happens only in a small number of cases.

The other thing is that you very correctly said that we need to differentiate between supervision and regulation. We see a very big role for regulation in the EBA, which is here in London, as you know. The EBA should talk about the regulation. To be very clear, the EBA is an institution of the 27. It should work on the regulation and be included in the working out of the rulebook; it has a role there. The division between supervision and regulation has to be very clear-cut.

Q179 Lord Vallance of Tummel: May I move on to the role of the supervisory board within the ECB, starting with the legal position? As we understand it, only the governing council of the ECB has decision-making powers, which means that the supervisory board could only be advisory. Are you happy with that structure, or is there a risk of monetary policy taking precedence over banking supervision, or even being in conflict with it? Is there not at least a potential reputational risk to the monetary authority, coming across from the supervisory side?

Georg Boomgaarden: You are touching on exactly the point where we do not yet see how it will work in the future. This is not worked out in a way that would be good enough for implementation at this moment. I cannot go into much detail on, for example, how decisions will be made in a supervisory context; this has yet to be worked out. However, what we need in order to avoid the conflicts of interest that you have just mentioned, is strict governance inside the ECB that strictly separates supervision from monetary policy. This means that we need a special group for supervision; it cannot be the governing council of the ECB as it exists now because then we would have a conflict of interest and we would not be happy with that. Therefore, certainly for questions of banking supervision, we need a group of people that has the final say and is independent of the council of the ECB. It could be inside the ECB but not the governing council.

Q180 Lord Vallance of Tummel: I understand that this is a work in progress so we cannot take it too far, but may I pick up one point? We picked up a report that Germany has proposed an adjustment to voting weights on the supervisory board to reflect the relative size of banking sectors. One can see some rationale for that; is it a genuine proposal?

Georg Boomgaarden: There is no proposal on the table at this moment. Therefore, it is a bit difficult now to see where it is going. We saw the Commission propose something very similar to the voting rights in the Council, which may not be the best idea for a supervisory body. However, this is really a work in progress, as you said.

Q181 The Chairman: Could you explore the rationale for national supervisors and the ECB a little more? How do you think that will work? I recall that Mario Draghi, as ECB president, has talked about the system bedding down over the period until 2013. You have alluded to the fact that supervisors do not just come off the shelf, as it were; they have to be trained for the particular purposes that are required of them.

Georg Boomgarden: Yes, that is exactly what we said and it was a topic for the council. This is what is meant by the differentiated way of supervision. Differentiated also means that there has to be very close co-operation between the national supervisory body and the ECB. We think that it is important that, in the single supervisory mechanism, we also have the participation of the non-euro states, which means that it cannot be done through the governing council. The governing council is a body of euro member states, while this should be a body of all participating states. Those who participate in common banking supervision should be there with full voting rights and this should be done via a different decision making body.

We also think that this makes the harmonisation between the different national supervisors easier. In the conclusions of the council, it is mentioned that national Parliaments should have a say. The national supervisor is normally under national law; national Parliaments made these laws and may change them. They play a role in the whole harmonisation so we think that national Parliaments should also play a role in this.

Q182 Lord Marlesford: On this question of the practical methods of supervision by the ECB, I take the point that only the ECB can really supervise the euro area banks. Indeed, it would not be appropriate for the ECB to attempt to supervise non-euro area banks for obvious reasons. When you identify cases where a greater degree of supervision is needed—in other words, moving away from my point about supervising the supervisors—would you envisage the ECB putting people into banks? Half the time the management of banks do not succeed in preventing ghastly things happening inside their banks. The idea of it being done from Frankfurt in other countries outside the eurozone seems quite unrealistic. Do you envisage the ECB having a moving staff who will move into specific banks where there are worries?

Georg Boomgaarden: The details are part of the work that needs to be done before we make it official. It is something of a work in progress in that, so far, it is not clear how this will work. However, there is one thing: the banks themselves are already European and are not only within the eurozone. As we know most major European work across borders. If they want to work efficiently all over Europe and reverse the renationalisation that we saw recent years, they may be content having a supervisory body that they can address and which has the same view wherever they move in Europe. The supervisory staff will do this whenever a country wants to take part in this mechanism. If a country is not part of the mechanism, the European supervisor just has no competence for that and the national supervisor is the only one. At least the German banks and those in London will certainly agree that supervisors should work on the basis of a single rulebook. That means that the decision-making bodies must include everybody who wants to be a part of the mechanism. So all 27 can, if they want to, be part of it. You can lead a bank globally from Frankfurt. Today, a bank does not know national borders. The same is true of the supervisor. We cannot go into the future with only national supervisors if the banks are global. If they are systemic risk banks, we need common supervision. However, this is a limited number of cases; this cannot be generalised and is not for all non-systemic banks.

Q183 Lord Hamilton of Epsom: I believe there was a proposal that this should be done in stages. You would take the big banks—25 to 30 of them—first, then go to 200 banks and then to 6,000. Where does Germany stand on this?

Georg Boomgaarden: I think that this is off the table. To go to 6,000 just does not make sense. You would have a super-bureaucracy in the ECB that we just do not want. We want a lean, very highly qualified but small enough body to tackle the relevant systemic risk banks, but not to go into the 6,000 mutuals that are all over Europe unless there is a systemic risk. This can sometimes take place but would be an exception.

Q184 Lord Jordan: We have talked about some of the things that have almost been bypassed in this rush to get legislation. Accountability does not even seem to be an afterthought among some of those who are pushing this. We have heard from European MPs who have said, "The democratic control of the proposed supervision authority is questionable as it is built within the system of the ECB whose independence cannot be violated". We have heard from another source, perhaps more familiar to you. Wolfgang Schäuble questions whether the ECB can take on the role of the supervisor and the legal basis for the proposal, and has floated the idea of splitting the European Parliament to improve accountability. What is behind that? I fail even to understand what he means about splitting the European Parliament.

Georg Boomgaarden: In the first phase of the whole debate—maybe three or four months ago—Minister Schäuble in particular, but also others in Germany, were of the opinion that accountability was so important that there must never be a conflict of interest in the ECB. Maybe Germany was one of the very few that saw this problem. In the end, a big majority agreed that the ECB anyway should have a special body for executing the supervision.

Now we are on the way to doing this inside the ECB but with a separate supervisory body. This is a different view from before because previously there was a view that the ECB, as it exists, would do the supervision. Minister Schäuble only made clear that this was not guaranteeing accountability because, on the one hand, the ECB and monetary policies are independent and this independence should be left untouched. The accountability of an independent central bank comes from it having its rules and those rules being strictly supervised. However, within their rules and limited competencies, they are independent, and this should go on for the ECB. This was one of the problems that have been resolved by separating the structure for supervision inside the ECB.

However, the other point, of accountability generally, is very important. If you have a supervisory body and a single rulebook the point becomes political. Supervisory bodies do not enjoy the independence of the central bank. On this question, certainly, we need democratic legitimisation. For example, are supervision laws EU laws from Brussels or national laws? How they are harmonised is something that has to be decided by Parliaments. That is why at the summit we included the role of the national Parliaments. We do not have all the competences in the European Parliament. Since it is a harmonisation effort, national Parliaments play a big role. This is important because a supervisory body can eventually close down a bank or change its management. It could say, "This management is no longer apt to rule this bank". Such rules need a democratic basis; that is why the rulebook needs accountability.

Lord Jordan: It makes sense to see them as two distinct bodies doing different work, but to whom would the supervisory body be answerable? Would it be the ECB or Parliament? If it is one or the other, no one has yet said which it will be. This is a very crucial area.

Georg Boomgaarden: You could get to a kind of infinite regress if you always look to the supervisor of the supervisor. The problem here is mainly something that we know from our democracies—that is, the balance of powers. On the one hand, a clear rulebook may be typical of continental law. Here in Britain under common law you would be more flexible on that, but in continental law if you have a common rulebook you really are bound by it. Your manoeuvring space is close to zero; you have to stay within the rulebook. There is no flexibility in interpretation or in developing it and so on. If someone wants to develop the rulebook, it must be done through the legislative process.

Q185 Lord Vallance of Tummel: Could we move on to the role of the EBA in all this? It is clear that there needs to be a clear delineation of powers and responsibilities between the ECB and the EBA—between the supervisor and the regulator. Do you think that the proposed architecture gives that clarity?

Georg Boomgaarden: The separation between supervision in the ECB and regulation in the EBA is, I think, plausible and does what it should. As to exactly how this is done in the EBA, we had some proposals from the Commission on changing its procedures. We do not think that what the Commission proposes is already mature enough. There is no need to change the procedures in the EBA; the EBA as it is can do this work.

Q186 Lord Vallance of Tummel: Could you perhaps shed some light on whether the EBA's main relationship would be directly to the supervisory board in the ECB or to the council of the ECB?

Georg Boomgaarden: We still think that the EBA is in the hands of the members of the EBA; it is the member states who rule it. This also has to do with what I said about democratic legitimacy. These are decisions about making the rules, which needs democratic legitimacy. Supervising the observation of rules does not.

Q187 Lord Vallance of Tummel: That is not quite what I was driving at; perhaps I did not explain it clearly enough. There needs to be an ongoing day-to-day relationship between the rule-makers, in this case the EBA, and the main supervisory bodies. That relationship can take place either directly between the EBA and the supervisory board—the advisory committee—or with the council of the ECB. Which way do you think it would work?

Georg Boomgaarden: It is our view that the EBA should be independent in that sense. It must secure that the different supervisory bodies—the national bodies and the ECB special body for supervision—are applying the rules in the same way. This is the relationship. In that sense, it is a way of supervising the supervisor but only on how the rulebook is applied. The bodies are independent of each other so one is not dominating the other. Here we have the principle of "tell and comply". If the EBA feels that there is a difference in the application of commonly agreed rules, it has to make that public.

I am sure that if the EBA were to say, for example, that the supervisory bodies in Spain and Ireland did not conform and applied the rules in a different way, it would have to go public with that.

Q188 Lord Vallance of Tummel: I think you have answered my question on whether the EBA's role needs to be strengthened further. You have said that it should stay as it is now. Perhaps we could just touch on voting provisions. One of the things that came out of the recent council meeting was the statement that, "An acceptable and balanced solution is needed regarding changes to voting modalities and decisions under the European Banking Authority (EBA) Regulation, taking account of possible evolutions in participation in the SSM, that ensures non-discriminatory and effective decision-making within the Single Market". One of the concerns of the UK Government is that, under the arrangements for the SSM, they would be obliged to caucus before they took decisions or voted in the EBA. Do you think that is an acceptable and balanced solution?

Georg Boomgaarden: If that were the case, we would take that seriously but we do not really think that a caucus is mandatory. As I said at the beginning, we do not see that eurozone members have much more in common with each other than they do with non-eurozone countries. On banking supervision and so on, Germany, the Netherlands and Finland are often much closer to everything that you do here in the UK than they are to France, Spain or Italy. This idea that there should or could always be a caucus, with Britain coming along to the EBA and simply having to accept what the caucus had already decided may be a bit exaggerated. If things really went that way, it would be a problem; I absolutely accept that. We think that this is particularly true of anything that influences the integrity of the single market. If some integrate more, they certainly need more interaction—that is normal. On the other hand, we think that the single supervisory mechanism is open for everybody. Here we need good mechanisms in these bodies, which we think will be fully in place, making it attractive to non-euro member states to join in. In the EBA, every country has its vote and we need not change that. It is there and everybody takes part in it; the same should happen in the future. So, if there were a real danger of caucusing—of there being "ins" and "outs"—we would take that on but we do not think that it is really the case. Whenever we have a debate, the dividing lines on most questions are not between eurozone and non-eurozone member states.

Q189 Lord Dear: May I turn our attention to what happens when things go wrong, and the RRD—the recovery and resolution directive that is proposed? COM 280, the proposed directive, talks a lot about bail-in tools and minimum resolution tools. We are sure about what they mean but not too sure about how they would work. In particular, a view has been expressed to us in governmental circles that the UK Government have fears that any of those special management tools could carry some sort of risk. If they are deployed too early, you would simply accelerate the distressed nature of a bank by taking away confidence. There is a problem there that we all recognise. Regarding the asset-separation tools, we think that some of the benefits are unclear. It would be helpful if you could give us your view on the whole package of what happens when a bank begins to fail or show signs of being in a less than confident state.

Georg Boomgaarden: The recovery and resolution directive is, for Germany, an essential part of the harmonisation effort. At the same time, we are in favour of harmonisation but not in favour of a single resolution mechanism that is centralised on a European level. This is something that must be harmonised but stay within national competence.

We are not in favour of having credit lines between bank restructuring funds, which are obligatory, and things like that. The bail-in instrument could be a good idea. It is also mentioned in the Liikanen report and it could work. We do not yet have a full view on the Liikanen report, as you know, but there are points in it that are worth looking at and the bail-in instrument is one of them. It could be a useful instrument but there should primarily be a harmonisation of the regulation, not a kind of recovery and resolution mechanism set up and controlled by the Commission. We do not think that that would be appropriate at this stage.

Q190 Lord Dear: There is this thorny problem of when you go in. Do you go in too soon and accelerate the lack of confidence that may be becoming manifest, or do you draw back? I personally feel that it is a very difficult question to answer in theoretical terms; it is a judgment call. Do you agree with that?

Georg Boomgaarden: The main point is certainly that we have several necessities. You have the Vickers report and what the Government made out of it. We have Basel III and all this brings additional conditions for banks, for example on capital and so on. If banks cannot comply with that, they may have a confidence problem. The whole reform of the banking sector is based on restoring confidence, the trust which existed prior to 2008 and has been lost since. I would fully agree if you said that this was not an easy process. If you force things, this can sometimes be dangerous for confidence. It is the same when you force the introduction of Basel III. If you say that everyone must comply tomorrow, it may be dangerous for a sector that is fragile. However, we think that it has to be done—it is necessary. Most of the reforms are necessary but they must be done on a smooth path. It is part of what we call "quality before speed".

Q191 Lord Dear: Have you any thoughts about how the single resolution mechanism might affect member states that are not part of the banking union?

Georg Boomgaarden: As far as the common harmonisation of the project is concerned, we wish that everybody would be part of it. We should keep the single rulebook in a way that means it is not only open to everybody but—I would go a little further—attractive to everybody. That is why we have to talk to everybody. Certainly, it would be wonderful if it was attractive for Britain. That is why we should keep having a dialogue about what would be attractive, acceptable and feasible. Even if this is not the case, we should certainly do it in a way that is workable. That means that we have to include all member states in the debate about how far they want to integrate. In this sense, we need a mechanism just to debate this. I do not think that such a mechanism is already in place. If a country for example definitely does not want to be a part of a recovery and resolution directive, it may not be very attractive for others to be part of it. For example, what would the consequence be for the City of London? The consequence would be a different, more complicated and fragmented rulebook. Continental banks that are here would have to comply with a common European rulebook and a whole set of national rules.

Q192 Lord Jordan: You have started down this path. Obviously, our Government have said that in no way will we be part of this. You are not spelling out what might happen to countries such as Britain as a result of standing to one side. Do you believe that there is real reason for concern that countries such as Britain, and others that are not in the plan, will be marginalised in the longer term?

Georg Boomgaarden: Every country has to ask itself about the consequences of the strategy that it is following. I am not looking into the formulation of the British Government's strategy. That is something that the British Government itself can answer. I do not see it as a question of being marginal or not. Maybe it is a bit daring but I would even say that Britain is too big to be marginal, so I do not think that it will happen, even if there are such fears. The thing that each Government must look into—I cannot prejudice the decisions of the British Government here—is what is in their own interest. London is a place that I think will, for the time being and for some foreseeable future, be the financial centre for Europe, not just the financial centre for the UK. There is, then, a big interest in bringing conditions to the working of the financial sector that are attractive, first for London, second for Britain, and then for the continent and the member states of the eurozone. I regularly visit our banks here in the City. There is not one big German bank that is not represented in the City, not to mention a lot of smaller banks, hedge funds and so on. Sometimes the debate, particularly in the press, is about this big, big gap that calls itself the Channel, beyond which there is another world. However, that world is so intertwined with Britain, with so much in common, that on closer sight, the British Government will in the end come to the conclusion that there is an interest in being part of the common effort. Britain will always be a part of Europe in the sense that it is part of the single market. Britain will always be included in decisions that are made by the 27. As I said, the dividing line is not between eurozone and non-eurozone members.

Lord Jordan: If you follow through the implications of saying that the UK is too big to marginalise, other partners may then start to take steps to make sure that they are not marginalised.

Georg Boomgaarden: I cannot look into the plans of other governments; you may ask them directly.

Lord Jordan: What about other partners—other people in Europe?

Georg Boomgaarden: I think the other partners have a very strong will to go forward in this. We saw that monetary union was wanted by a large majority. I just came back from Spain. When there are big debates on European matters, it is about the fear that they may not be able to stay in; it is not about wanting to leave. There is a strong will to go on., Certainly, in the debate about the details of the legal framework, we look at its quality. Maybe there is sometimes the illusion that you could just introduce it by decree. This is not possible; these are very complex questions and one should not rush them. One should really do it in a well thought through way. However, the will to go forward is there, in Germany as well as in other member states of the euro area and beyond.

Q193 Baroness Prosser: Going back to when things might go wrong, may I ask you about the proposed directive for the deposit guarantee scheme? We understand that it is part of the Commission's longer-term proposals and will not be at the top of the agenda in January 2013. We have heard that it is not exactly flavourful for the German Government, who are not entirely convinced by this proposal. Could you tell us a bit about that? Also, how do you think banking union could be established without such a fallback scheme?

Georg Boomgaarden: The central topic, which is a kind of umbrella over all the debates between Germany and some other countries, such as Finland and the Netherlands—even non-euro states such as Poland, which is like-minded in this—is how you balance control and solidarity. These go hand in hand. You can have more solidarity if you have more control. If you have full control you can have full solidarity. If you do not, you have to make do with the instruments that you have now at your disposal.

We think that the deposit guarantee scheme directive runs in parallel with the recovery and resolution directive. Both have to be implemented quickly but on the premise that they must be intelligent, that they are comprehensive and that they are examined carefully before being implemented. We are not against a deposit guarantee scheme directive but we do not think that a centralised model is the right model. This has to do with the fact that control of assets and liabilities would not be balanced. If we found ourselves at another stage of integration it would be a different debate, but this is not the case today. We are not at this stage of integration and, at this stage, we should have national deposit guarantee schemes, which should be harmonised and hence similar in all member countries. But there should not be a centralised deposit guarantee scheme.

Baroness Prosser: That is almost the same answer that you gave on the recovery and resolution directive—to quote your words, "harmonised but within national competence". Are you confident that that could come about?

Georg Boomgaarden: Harmonisation has for decades been the principle of progressing in Europe. There is often a misunderstanding, and this includes Germany, that the EU level should make all the rules. Normally, it functioned, and functioned rather well, by just harmonising the things that had to be harmonised. For progressing in the European Union, this has always been a method that works. It never worked very easily; sometimes we needed council sessions until 5 am to reach a result. Sometimes you need compromise. Compromise is a form of fairness which means that everyone brings in something. Harmonisation sometimes leads to comical results—sometimes you want to cross sheep and goats—but it often works in the end. This may be the way to go. There are of course things that should be regulated on the EU level, as the Commission does with trade policy in the single market. That works and no one complains about the Commission's trade policy. However, we do not think that centralisation is always the right way.

Q194 The Chairman: Herr Boomgaarden, once again, you have been very helpful to the Committee and we are very grateful for your answers. I am sorry that we were not able to ask you about the Liikanen report, but if you were able to write to us about that it would be very helpful. Indeed, if any other points have arisen from today's exchanges, we would be most grateful to hear about them. If you could just look at and correct the transcript, we would again most grateful. In the mean time, on behalf of the Committee, I am most appreciative of your coming before us and speaking with such clarity on separating the sheep from the goats in this very difficult business. Many thanks.

Sharon Bowles, Member, European Parliament—Oral evidence (QQ 19–39)

Evidence Session No. 2. *Heard in Public.* *Questions 19 - 39*

MONDAY 1 OCTOBER 2012

4.45 pm

Members present

Lord Harrison (Chairman)
Lord Flight
Lord Hamilton of Epsom
Lord Jordan
Lord Kerr of Kinlochard
Lord Marlesford
Baroness Prosser

Examination of Witness

Sharon Bowles MEP, Chair, European Parliament Economic and Monetary Affairs (ECON) Committee

Q19 The Chairman: May I welcome Sharon Bowles, who is a familiar face to the Committee? Thanks very much for coming in. We had a session before when we heard from Sharon. It went very well. I have to tell you the usual stuff: we will be sending you a transcript of this and it would be very kind if you could look at it and correct it. As you know, we are doing this investigation of the banking union and the RRD and we would be grateful if you could help us. As a kick-off question, how do you define the banking union and what do you think the weaknesses are that it is trying to address?

Sharon Bowles MEP: Well, I think the problem is that it started off as one thing. It has already morphed into a second or third thing, and by the time it comes out the far end, it will be yet another beast. The history of it in my recollection is that first, when there were the slow bank runs that were happening in Spain, which it was feared would happen in Italy, Mario Monti suggested that there should be a common deposit insurance across the eurozone to stop the bank runs so that it did not matter which country your money was in. This quite rapidly transformed itself into the banking union with the idea of there being back-stops that applied across the whole of the EU. At that stage, it seemed to me that people suddenly thought that it was easier to get a banking union than fiscal union. I remember doing more than one speech saying that I did not think much of the idea because there was three times as much debt in the banks as in countries, so it should be three times as difficult. That is a rather simplistic way to put it. It then moved on so that it had limited back-stops by the ESM and there was an idea that the ECB should come in to be the supervisor. That idea of the ECB as supervisor found favour in the middle of the year when we were struggling away with capital requirements and looking at all the different variations in different countries, and the

Basel committee saying, "You will never comply because you have all these exemptions". They assumed that every bank uses every exemption not that the Italians use the Italian exemptions and the French use the French exemptions. The idea of the ECB smoothing this over looked attractive and it would make the banks stronger for the markets. That was also quite a good reason why people supported it and certainly why the UK and I thought that it was good that it added value, looking at it from the capital requirements side. As we know now, the proposals have come out without the deposit guarantee schemes because Germany would not have them. At the moment, they are without the back-stops, so all we are left with is the common supervisory mechanism. As we have looked at it in more detail in conjunction with how it might work, the independence of the ECB and what it means if you are not a eurozone country but want to join, it has become a lot more difficult to see our way through. I have got myself to the point of questioning whether one has gone into the negative side on the cost-benefit analysis in the sense of whether it disturbs the single market in any way. You have not got a proper banking union: you just have common supervision. Do you then have anything that is worth having? In the context of the UK, where we do not know where we sit in this thing, you cannot really go into it when you have a banking sector that is a third of Europe's banking sector without having a vote that is at least equal to the one that others have. There is a fiscal consequence of common supervision that I think some countries are in denial about at the moment. It is not really there in the sense of black and white. It is a bit like, if all banks suddenly start to fail, would you let them? It is the same as the euro problem replicated. There are so many other problems within it that we have got some way to go.

Q20 The Chairman: Can I tackle one problem that we think arises from the narrative that you have given to this evolution? Do you think that it is in any way, shape or form a realistic timetable?

Sharon Bowles MEP: No, I do not think that it is and that is pretty much the feeling both of Governments and in the Parliament. The original pressure for the timetable was this belief that, as soon as you got the ECB as the supervisor, it would release funds for direct recapitalisation of banks in Spain and so maybe you could hang on to the new year when that would happen. But pretty soon after the Council meeting it was made clear by Germany that that was not its understanding. Wolfgang Münchau has written a very good article today in the *FT* which to some extent says it all. Therefore, that option does not really exist. Schäuble has definitely said that it is a necessary but not sufficient condition. Various people have said that it does not make sense to hurry in and replicate mistakes of the kind that we now know were made in the construction of the euro by doing it too quickly. Ignoring the fiscal consequences is not sensible. If one looks to the fiscal consequences, one ends up thinking, "Will you have even the supervision aspect at all?" There has been so much trumpeting of it and it is very difficult in Brussels to get rid of something that has been trumpeted.

Q21 The Chairman: We, as a national Parliament, come to talk to you in the European Parliament and you have an important role in the democratic accountability side of this. Are you satisfied that that would operate in a fiscal and banking union? You have a co-decision-making role but I wonder how that would take place in practice.

Sharon Bowles MEP: The ECB part is not co-decision, that is just a Council decision, but the EBA is fully co-decision. Because of the need to adjust the voting mechanisms within the EBA, nobody is going to agree to the Council decision or the Council regulation until the EBA is sorted out. As we did with the economic governance package where some of it was a Council decision and some of it a co-decision, we could leverage off the co-decision in the sense that, until we have agreed that, we will not agree the other one. I suppose that they could do something sneaky in the voting, but I am not expecting that to be the case. In a sense, although the Parliament proclaims that it is annoyed that this is not being done on a genuine co-decision and single-market basis, the net effect is that we can force almost the same power over it as if we were in co-decision.

The Chairman: This is of great interest to Lord Kerr.

Q22 Lord Kerr of Kinlochard: Inside the EBA, as its role gets strengthened, how are decisions to be made? In the proposal, we see talk about a strong review of voting modalities. The proposal tells us that that is necessary to ensure that the outs are not left out. It does not tell us the opposite: that this is necessary to ensure that the outs are not over-weighted or over-dominant in decision taking. You might argue that if the ins have the co-ordinated ECB position it does not matter what the outs say. What is all this about the voting rules? Is the Parliament about to solve them?

Sharon Bowles MEP: Well, we will look at that, as will the Council. It may be that in this instance the Council is in a better position to sort it to the agreement of everybody because of the voting arrangements in the Council in terms of qualified majority voting. In the Parliament we use just a simple majority so it is very easy for the eurozone countries within Parliament to vote through what they want if they do not take notice of what happens to the outs. In general, because the Parliament's line is that we would much prefer something that was single-market and 27-based, I do not think that they will take that very self-centred eurozone line. I hope they will not but it is always a possibility. The proposals in the basic documents, that there is sort of reversed qualified majority that needs at least three from each camp in it, are not adequate. Various other proposals are around and I do not know which will come out. The idea of having a simple majority from each camp is one very good way that would be satisfactory while you have substantial numbers of ins and outs. It becomes very difficult if you get to the situation where most of the outs can be satisfied by the voting arrangements within the ECB side of things, which is what is now holding them back, so that most of the outs which will ultimately join the euro go in—or, if we look further ahead, they have joined the euro and are in. It is difficult because nobody is prepared to see the UK with what is tantamount to a veto. There is that long-term problem but we do not know whether it will be only a long-term problem or come upon us sooner if all or most of the outs go in. If it is just a long-term problem, it may be that we can run in some kind of co-existence for a while, before the ESAs reviews and everything else come round. Then, presumably, we would have to look at the situation again. At the moment, I find it very difficult to see the way through to a long-term solution that would work for the UK. We have long-term solutions that work for everybody else but at the moment I have to admit that for us it is looking pretty tricky.

Q23 Lord Kerr of Kinlochard: You do not see a magic solution coming perhaps because the Parliament, although prepared to accept that there is a clearly an enhanced supervisory role for the EBA, is uneasy about the role proposed for the ECB. Is that right?

Sharon Bowles MEP: There are lots of problems with the ECB as the supervisor. Rather ironically, that clause was put in to try and stop the ECB being the supervisor rather than to enable that, but we are now where we are. Strange things happen in negotiations. The independence of the ECB, and how far that extends, appears to be being challenged differently by different legal services. The ECB and the Commission maintain that the ECB´s independence will extend over the supervisory side as well, which would deprive the outs of any vote on any supervisory board that was constructed. I believe that the Council's legal services are advising that that is not the case, and that the treaty independence of the ECB would not extend to the activation of 127.6. That means that you could have a vote for the outs on the supervisory board, which is one of the lines being pursued in the Parliament. You are still stuck because, at the end, it is the Governing Council that would take the decision. We have been looking at constructions such as whether they can say only yes or no and cannot change the content of what comes up from the supervisory board. We then start revisiting all the arguments that we had with the Commission's position vis-à-vis ESAs and delegated acts, and whether you can bind the Commission. The same arguments seem to come along that you cannot bind the ECB. It is a bit messy. We are looking at whether there are constructs where somehow you can lasso the ECB in, but it is not just that. We are all thinking very hard but I cannot tell you the solutions yet. Quite a few in the Parliament think, 'Let us leave the ECB thing to one side because it is a big problem and see whether we can just do it around the EBA'. When I spoke to the head of the working group from the Council during the informal ECOFIN (in Cyprus), I asked about an appeal level. If someone has a banking licence withdrawn and the only appeal is to the ECJ, that is not a very happy situation. I would have thought that many eurozone member states might suddenly find their banks complaining to them about due process. You have to have an appeal level. Lots of other complications come in with the ECB, such as whether it is to be audited by more than just the normal European Court of Auditors. If it collects money from industry, I think it needs a full commercial audit. Then there are all the issues of separation of what it is doing on the monetary policy side from the supervision side. That has been explored in the UK vis-à-vis the Bank of England taking in the PRA but the monetary independence side is perhaps more tightly defined and more independent in the eurozone because the construct in the United Kingdom is different. So there are all these other problems. But if you go down the line of the EBA, then you run up against the Meroni case and what powers can be delegated. Some people are saying, 'Okay, let us just have a formal signing-off of the Commission on the top', but we all know that you cannot mandate the Commission to do that, so it could start interfering again. Anyway, if we tried to do that across the 27, and we wanted to join in, I think that we would potentially be in referendum land. Although that looks attractive from a single market point of view, it is still a problem unless there is some way that you can get it to work where the fiscal safeguard that is already in the EBA can be operated under a range of circumstances. I have not finished my thinking on that. We are all still stuck.

Q24 Lord Kerr of Kinlochard: We are a long way behind you. The arcane mysteries of the relationship between the supervisory board and the general council and voting rules hide a big political point. If the supreme supervisor of the European Union's banks was the ECB Governing Council, that would be a very hard sell in non-eurozone member countries, particularly the one with the biggest banking sector. It seems to me to be an impossible sell. If the Governing Council, on which there is no UK citizen, should decide, irrespective of whatever was produced by this funny animal, the supervisory board, with the representatives of the other member states, was able to say that it did not agree and did not want to do this, that would conceivably be more in the interests of the eurozone than of the single market. It seems to me to be unsellable. Is that right?

Sharon Bowles MEP: That is the problem and that is why, initially, as soon as the idea came along that we might get stability for it, the UK said that we would not be going into the banking union. But of course the way in which it potentially rocks the single market is a big problem. Even if we are not in it, we are not happily on the sidelines; we are still very greatly influenced by it. There are certain things that cannot be overridden to do with the single market, but we just do not know what is going to happen. Then we come back to the fact of the voting on the European Banking Authority. If the Council legal services are right about the fact that the supervision side of the ECB is not independent, you could have the situation that the EBA can actually overrule the ECB. At the moment, with the way that proposal is constructed, the outs have to comply but the ECB can ignore it if it wants to, which is of course unsatisfactory. If the ECB is in the same position that it can be overridden, never mind the balance of reputations and so forth, that evens things up. But you still come back to all the voting provisions within the EBA. As I said, in the short term, if you just say that voting is on a mechanism whereby to get a majority you have to have a majority of the ins and a majority of the outs, that works, as long as you have enough outs for it to be a significant body. As soon as the body of outs has dwindled for whatever reason, you are back to the problem that I previously outlined.

Q25 Baroness Prosser: You have covered quite a lot of the ground that I was thinking about apropos the supervisory council. If I understood you correctly, I think your view is that the Lisbon treaty provides sufficient cover for the establishment of such an arrangement and that there is a long way to go yet before a framework which would be suitable for everybody and with which people would be happy can be agreed. This envisaged that the arrangements would cover all banks of whatever size, shape and business model that they follow. We know that even if a small bank falls into difficulties that can cause a lot of trouble, but it is a bit unclear as to what the coverage would be.

Sharon Bowles MEP: The Commission proposal is that it should cover all banks. The idea of it being welcomed by the UK was on the basis that it would cover all banks and that we would get the stability. I keep referencing the UK, because I have thought about this in parallel with what has gone on in the UK; it ended up with 99% on exactly the same page through my independent thought processes. It remains a problem, largely because Germany does not want the savings banks in. There has been a huge uprising in Germany, with big full-page adverts in newspapers. The savings bank lobby from Germany is extremely strong. It has managed to get itself all kinds of special deals in just about all our legislation, one way and another, partly built around its mutual insurance guarantee schemes. Some of their exemptions are probably just about justified, but the extent and size of them is probably too large. That is my personal view. But they can be systemic because they have the same business model in the same way that the Caixas were systemic in Spain, so we really should be having them in. Germany is rather isolated on this, but it is being very vocal. At the end of the day, what good is this common supervision if you do not get the additional stabilisation that you need from back-stops?

Q26 Baroness Prosser: There is a lot of talking and thinking to be done if the timetable is going to stay on track?

Sharon Bowles MEP: I cannot see the timetable being realistic at all, and I never thought so. It is unwise to do something that is quite profound so quickly, but I also think that it is unwise to do something so profound just because you have the whip hand there, be it from the demands of the ECB, to suit its own ends because it wants the supervision, or from the needs of a member state because of market pressure. That is a harsh thing to have to say. On the majority of things I support the ECB and the notion that if it is going to engage in some of these additional operations there must be some strings somewhere. But maybe this was not the right string.

Q27 The Chairman: What might be a realistic timetable and what are the elements that might be tackled within a realistic timetable?

Sharon Bowles MEP: I really do not know is the answer to that. We have the outstanding deposit guarantee scheme, DGS2, where we have not reached agreement on the amount of ex ante funding because we needed to know how much of that could or could not be used in crisis resolution. So those are all still pending. It is going to be quite difficult to see our way to doing those all by the end of the year. The Commission keeps assuming that we can do it, but we have already got 10 things in trialogue at the moment. There is a physical limit to how many things you can have running at once, because you do not run trialogues in parallel since every group is entitled to be there and the smaller groups cannot have it. There is only one of me as well. For the majority of trialogues, I am exercising my prerogative to chair it rather than delegating it to a vice president.

Q28 Lord Marlesford: You have explained clearly the initial foundation on which the European banking union rests, particularly the back-stop and the common guarantee scheme. Given that there is now doubt about the legitimacy of the legislative cover for the supervisory role and that the timetable is clearly impossible, would it not be sensible for the European Parliament to tell the Commission to go back to the drawing board and start afresh rather than having all this expectation that something is coming out for action in 2013? Would it not be quite useful for the Commission to wait and see how the British Parliamentary Commission on Banking, which is expecting to publish a report at the end of this year, might fit in to dealing with the immediate problem? It seems that all that is left at the moment of this idea is the general furtherance of the internal market. It seems that the pressure with the timetable is totally unviable.

Sharon Bowles MEP: I agree with you that the timetable is unviable. From the discussions that were held in committee and in private, quite a lot of MEPs would like to send it back, but there is this pressure being brought to bear on the basis that this is what the markets have expected. In particular with regard to Spain and Ireland, they were expecting to be able to get some recapitalisation that did not go on their sovereign tab. With that pressure being brought to bear, and I know that it is being felt in the Council, too, they are thinking that they cannot really send it back. It could be a phased thing, in the sense that once there is the realisation that we are not going to meet this end of year timetable, people can say, "Well, then what?" It is not actually our way to send things back, because we have substantial powers of amendment. It is not like UK legislation, where it comes out and because you are trying to fit with only one country you know all about it and it can be 99% perfect. There is quite a lot of European legislation that might only be 50% perfect when it comes out of the Commission; I do not know what percentage it would be, but sometimes you almost reverse it. It might be interesting sometimes to look at the beginning and end. We are far more likely to go in for taking control and amending it ourselves to what we think that it should be, rather than letting the Commission, which we think has done a rotten job already, have another go. That is our attitude. It is tantamount to the same thing, but the co-legislators will revise it, not the Commission.

Q29 Lord Jordan: We came here with this task of looking at the present proposals for reform of the European banking system. It is as though we are trying to look at a maintenance system for a car that is being redesigned every single day. The Münchau article, as you rightly point out, was highly critical; you certainly felt that he was on the nail with many of his comments. Then listening to you in your introduction, I detected the same thing that he said, a pessimism that this thing is unravelling and a question over where it is going and what we are going to do. We can be helped most, I think, by drawing on your experience as to where in this unravelling you think it is going to go. We can spend a long time looking at a particular proposal that you in your mind have already decided is gone. It seems to me that this has come at the wrong time. The European economic crisis has brought the idea forward at the worst possible time to do such a thing, because the people looking at formulas are looking at the differing strengths of economies in the north and south of Europe and asking how on earth they can be fitted into a sensible structure. If they are going to fit them in, people will want so many assurances that it will make it unworkable.

It seems as though that is happening.

Sharon Bowles MEP: I think, as I said, that it will not be the same proposal at the end, so if you spend your time analysing the draft that has come from the Commission there will be huge changes at the end. I cannot tell you yet, because I cannot see my way through and I do not think that anybody else can. I can see a way through for some parts of it—I can see the way through for the EU minus the UK—but trying to find compatibility there is extremely difficult. Large parts of the EU actually want us in it or do not want a schism, which is good because, at times, relations have not been very pleasant and lots of people have been saying, "Well, we'd like to see the back of you". At the moment, we have managed to get ourselves into a place where we are genuinely searching for the answer, the same as everybody else is.

Although like others and the UK I welcome the idea from the point of view of stability, in the cold light of day it is a pretty bad idea at this point because without back-stops it does not really work anyway. When I was over in July, the IMF was very keen on the idea of a banking union because it is actually trying to push Europe towards the fiscal union as fast as possible. It said that the EU had to keep coming out with ideas like this every few months—a kind of distraction technique—or keep on doing things so that the pressure inexorably backed Germany up an alley. When I put it to them in those terms, chief economists look at me with alarm but that is probably where it is at.

Q30 Lord Flight: I thank you very much for your straightforward comments and I very much agree with what Lord Jordan said. On banking union, all I can see that might be possible is a common approach to banking regulation, but I want to know what has happened to RRD because part of what this was all about was to provide some mechanism to put up the money for failing banks. The British Government have been fairly critical of RRD and wonder whether the treaty base under which it is proposed can actually be used for that and whether its special manager tool might actually have the effect of removing confidence in a distressed bank. My basic point is: the money has got to come from Germany again and Germany has made it very clear that it is not going to put up any more money. Is RRD alive and, if so, where is it and what do you think might come forth here?

Sharon Bowles MEP: Again, it is the same as ever. We will look at it and see how we can amend it. It may well be that either us or the Council, or both of us, decide that some of the tools need modification or need to come out. There are problems as well in terms of instruments, especially if you rescue rather than go into resolution. You start to get legal uncertainties around what is happening. We are actually having some debate about some of these within the capital requirements directive as well. In the Parliament we decided that some of these things in very fundamental terms could actually be ceded into the capital requirements directive, just in case other things never came along. This is one of the arguments that we are having about the point of non-viability, so it is quite good to have a common set of rules operating across the whole of the EU. Look at what they have in the United States: there is a common set of rules for when a bank is no longer a going concern and certain things happen. It is when you get into the never-never, twilight land of "Are you going to keep it going or not?" that possibly we from the UK take a harsher line on this, because we had to peer over the abyss in a bigger way earlier than everybody else and therefore we have done more thinking about it.

Q31 The Chairman: If you take the special manager tool, for instance, are the UK Government right about that? Could that distress a bank even more?

Sharon Bowles MEP: Yes, but it may not stay.

Q32 Lord Flight: It has been put to me that the really big banking issue has not been addressed: that is the mechanism for settlement between the central banks of the eurozone, which is similar to the system that operates in the Federal Reserve but lacking in the disciplines. The main result of this is that the amounts of money which other central banks owe the Bundesbank have been ballooning to €700 billion or €800 billion. That is a mixture of balance-of-payments deficits and capital flight and that—although you will not read it in the newspaper—is what is driving Germany to a harder and harder line, particularly the Bundesbank, about money, because they know that they have this huge, growing and unavoidable debt burden building up here.

Sharon Bowles MEP: Yes. I cannot say anything other than that.

Q33 Lord Kerr of Kinlochard: If something had to be done by the end of the year, for facile reasons, do you think that the CRD4 plus the deposit guarantee proposal, which is after all from two years ago, could be brought to fruition by December?

Sharon Bowles MEP: I think the CRD4 can be, and that within it we can have a few elements of crisis resolution. I do not think that we can get DGS to completion until they know what is happening on crisis resolution, because they are trying to use the same fund and the Parliament's position is so very different from the Council's position there.

Q34 Lord Kerr of Kinlochard: If you keep everything interlocked and say that nothing can be done, as the Germans are not going to do it—

Sharon Bowles MEP: The CRD is not interlocked to it; it stands alone.

Q35 Lord Hamilton of Epsom: As you know, both Houses of Parliament are actually legislating over our own regulations at the moment. We have very much bought into the concept of Vickers and this idea that investment banks can somehow be ring-fenced, with Chinese walls and that sort of thing. Nigel Lawson has for some time now been saying that that is not enough and that we should go for Glass–Steagall. Interestingly enough, I think Ed Miliband is making a speech to that effect as we speak. Where do you stand on Glass–Steagall? Surely, it has the advantage of really making the separation that protects taxpayers from the more gambling-like activities of banks.

Sharon Bowles MEP: When I gave my input to Vickers, that is not the line that I took so I ought to be consistent, in the sense that we had problems with entirely retail banks and with entirely investment banks but taxpayers seemed to be on the hook for both of them. It seemed to me that you should start with how easily a bank could be resolved. I had already done quite a lot of work on this in the insurance concept text of Solvency II. I talked about escape modules and planes of severance, and I think I invented "living wills" for insurance—especially in the cross-border dimension, where we could not get it to work. I am a great fan of the living will idea and then I thought, "Well, once you've got the living will, whether or not you need to have ring-fences and other things should become apparent from how resolvable a particular type of bank structure is", because there are all kinds of different things going on. If you want to have a fixed-rate mortgage then you are going to have to have the derivative, so you are either going to go out and buy them or have them in-house, which is of course the argument being had at the moment vis-à-vis Vickers. I think that they have now gone back in-house, or inside the ring-fence. You cannot escape from the fact that these products are still going to be used, irrespective of whether you are ring-fenced or not.

My whole approach now is just to go for simplicity. I regret to say that Vickers—and the way it appears to be having to be dealt with—is getting more complex. The same is true with Volcker in the United States. We had the meeting here that Philippe Lamberts organised, at which I spoke, and we had lunch afterwards with the two Vs. I think they were both thinking that they had a nice idea that was getting spoilt by being made overly complex. We should go on a really big simplicity drive in every respect. Some would say that Glass-Steagall is therefore simple, but I am not sure that it produces an end result because you will still have to have each part of it so that you can resolve it—so that you know what you have to preserve. On the notion that you could just let a big investment bank go to the wall, we have not done anything that has changed since we discovered that that was not such a good idea with Lehmans.

I guess all the other things we are doing mean that the disaster, when it happens, would be smaller because we would not discover that there was a kind of giant slush account with derivatives and all kinds of other things in it, and that we did not know who the counterparties were, and so on. So it would be a smaller event, but it would still be an event. Across the board, there should be much greater simplicity so that everybody knows what is going on and you do not have nonsensical drivers like you did in JP Morgan when they were told to go and reduce their exposure. What do you do then? You buy more hedges. Irrespective of the fact that the trader did a bit too much, the basic principle of having ever deeper and ever more hedging is not providing us with simplicity. That is something that I am driving on quite a lot. I know that I have fellow travellers on this path but we probably have to do it internationally.

Q36 Lord Hamilton of Epsom: Let me leave you with a thought. I accept the consensus that Lehman Brothers was too big to fail and the collateral damage when it did was unbelievable. But then, on that basis, you should break up Lehman Brothers. If Goldman Sachs today is too big to fail, which I suspect it is, you should break up Goldman Sachs. I do not accept that these businesses have to be ginormous to be effective; I do not think that there is any viability in that at all. They can be broken up into component bits that are small enough to fail.

Sharon Bowles MEP: I am much happier with the idea that you break banks up because they are too big than chopping them into different types.

Q37 The Chairman: Two final questions. One is on whether you have a leak on Liikanen.

Sharon Bowles MEP: No.

Lord Marlesford: Sorry, I did not hear that first question.

The Chairman: It was about the Liikanen Group, which is reporting on reform of the banking sector. We are hoping that we will get something tomorrow on that. You have mentioned the UK a lot and set out some of your thoughts on running in parallel. I am trying to look at it from that angle as well as the EU angle. What do you think about the impact? Is the single market going to be overturned? I cannot understand that all this is going to happen without it having an impact on financial services, despite what we have heard from the UK Government.

Sharon Bowles MEP: It is very difficult, because as soon as you have a banking union in whatever form people will start thinking that we should have one for insurance and markets. Those voices have already been raised. With markets and insurance, you do not have the excuse that it should be done in the eurozone, either, because there is not the sovereign bank link in the same way as there is with banking. So then where are we at? That is an uncomfortable question, and it is one reason why it would be better to keep the banking union at the single market level. I have been honest with you, in that I cannot see my way through. I can see where I do not want to go and I can see the Catch 22 problem that I have explained between being excluded or isolated in the long term or medium term, on the one side, and something coming along that would mean a referendum that would come too soon for us. There is certainly no sense in having any kind of referendum while we are in the middle of a eurozone crisis, when we are trying to establish our relationship with the zone in crisis. So those are two places that I do not want to go, and I am trying to find the crack down the middle. So, too, I think, is the Treasury. The reason why I had to do some independent thinking on this was because I was in the front line, with Germans jumping on me while everybody was happily having a jubilee in the UK. So I had to sit down and have a deep think. As usual, I have got to roughly the same space. Some people think that a solution lies in the UK somehow applying financial legislation more flexibly; that is one way in which the thing works. The Swedes said that in the informal ECOFIN; Borg said that if we wanted a quick fix we could split the single market, as he put it, by saying that the outs should become more semi-detached from the regulation. He was not a proponent of that, and I do not believe that the rest of the EU would tolerate the UK being in that position with access to the single market. There is still the fundamental point that they think that we are responsible for the eurozone crisis, at least in part, because it was the financial crisis that caused the escalation of sovereign debt in many countries. We can leave Greece out of it, because it is a kind of special case. But that then caused the rocking in the eurozone, which we contaminated through the single market from the City. We have admitted that and gone around the world saying sorry for it, so they do not want to allow us to be on a looser rein and do it again, and that we have all got to be in it together. They also know that they have been foolish, if they would but admit it, as many of them do. They bought products that they did not understand, and banks were also culpable because they did not understand what they were getting into. We want to have a level playing field within the single market. The Parliament is very determined that this should be maintained, and my feeling is that that is very much still the majority view in Council.

Q38 Lord Flight: I am shocked to hear you say that these people are still so ill informed as to blame the UK for the crisis, because it is entirely clear that the eurozone crisis is the result of the inherent problems and weaknesses of the euro.

Sharon Bowles MEP: They are not saying that we are responsible for the flaws in the euro. They are saying that the financial crisis exposed those flaws in the euro, and made them more severe when they were exposed. There is no denying that there were flaws and that something might have happened anyway, but it is bigger and worse and more immediate.

Q39 Lord Marlesford: Do they not see that it started in the United States with the sub-prime loans in 2007?

Sharon Bowles MEP: We know that, and we have had lots of mea culpas for our light-touch regulation, which has a very negative effect.

The Chairman: Colleagues, let us conclude it there and thank Sharon, who always gives us food for thought, some spicier than others. As ever, will you look at the transcript and send it back to us, if you have further ideas?

I officially conclude the meeting.

British Bankers' Association (BBA)—Written evidence

What has the euro area crisis revealed about the weaknesses of the EU banking sector? In what ways do you believe that the EU banking sector needs to be reformed?

1. A great deal has been done over recent years to address the failings made apparent by the financial crisis. Unsustainable business models have adapted and a roadmap has been put in place which significantly strengthens the regulation and supervision of the EU banking sector. It is clear, however, that stresses remain and there is a feedback loop between weak sovereigns and weak banks which will not be addressed by a programme of prospective regulatory reform. In our view, it would appear that there are a number of issues which must be answered in response to the evident weaknesses in some sections of the EU banking sector:

   - a run on a retail bank must be prevented by ensuring that consumers have confidence in deposit guarantee schemes;
   - confidence must be restored that instruments are priced appropriately and that banks are correctly applying accounting standards and providing transparent disclosure;
   - a way must be found to strengthen the capital positions of those banks without the need to rely on the balance sheets of weak sovereigns or on national supervisors who are seen to have failed or to have been complicit in the failure of their banking systems; and
   - there must be a credible regime to resolve failed banks in an orderly manner.

Steps towards 'banking union' were set out in the Van Rompuy report *Towards a Genuine Economic and Monetary Union*. How would you define 'banking union' in the EU context? What is your assessment of the report's conclusions, and what will its impact be on existing proposals (such as CRD IV)? What are the key elements of such a banking union if it is to function effectively?

2. The combination of Economic and Monetary Union and freedom of movement under the Single Market has driven the banking sector within the Eurozone closer together leaving it particularly exposed to the cross-border spill over effects which arise from banking failures. When taken together with the weakness of some sovereigns in the Eurozone we acknowledge that there is a need to consider what steps can be taken to facilitate common decision making to address these issues. In terms of the likely impact on existing proposals, we believe that the discussion on banking union may delay negotiation of proposals designed to respond to the weaknesses identified by the financial crisis including CRD IV, the Recovery and Resolution Directive and Deposit Guarantee Scheme Directive. We are keen to see these proposals finalised.

The 28/29 June euro area summit statement said that when an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could recapitalise banks directly. What is your

assessment of this proposal? How likely is it that this would successfully stabilise the EU banking sector?

3. We observe that this point is interpreted differently by different parties. Some view the statement as implying that recapitalisation will take place once the legislation to introduce the SSM is given legal force whilst others see recapitalisation as occurring once the Single Supervisory Mechanism is operational. This is an important difference which will require resolution by the European Council. We note that in the past, uncertainty over when actions will take place has destabilised financial markets. We believe it will therefore be in the interest of all parties for there to be as great a degree of clarity as soon as possible.

4. In terms of the likely success of recapitalisation conduct via the ESM, this will largely depend on the assessment of potential losses and therefore the appropriateness of capital (and solvency) levels required. This can only be done through rigorous and extensive stress testing. The market must believe that the stress testing has been properly undertaken and consistently applied across jurisdictions.

In January 2012 European Commissioner Michel Barnier set up a high level expert group to explore possible ways to reform the structure of the EU banking sector, including consideration of structural reforms such as activity restrictions as applies under the Volcker Rule, size limits, and structural separation of retail deposit banks from investment banking. What is your assessment of such proposals for structural reforms? Which, if any, would help ensure the future health of the EU banking sector?

5. The high level expert group is due to report later this month and so the committee will have an opportunity of reviewing the recommendations actually made. In submitting views, we outlined the UK position on retail ring-fencing and explained that we considered that the distinction between Vickers and Volcker can be overstated since the Volcker rule is an add-on to pre-existing US requirements for retail and investment banking to be kept separate under a holding company structure. We also suggested that the US experience does not suggest that Volcker is any more easy to implement than Vickers and that the objective of limiting proprietary trading can be equally delivered through the Basel III capital regime. We can provide the committee with our response to the high level group's consultation if that would be helpful.

Banking supervision

The European Commission are expected to present proposals for a single European banking supervisory framework in September. What is the purpose of such a framework, and what key elements need to be included if it is to succeed? How likely is it that such a framework will be adopted?

6. The timetable for the adoption of the SSM looks to be very ambitious. It is not at all clear to us that the European authorities will be in a position to deliver the package in the timeframe.

What is the most appropriate division of responsibility between national and EU supervision under such a framework?

7. We believe that the Commission has identified a broadly appropriate and realistic division of responsibilities between the ECB and the national authorities but with the ECB retaining ultimate responsibility for those tasks which are not delegated to the national level.

In what way, if at all, should supervisory powers vary depending on the size and nature of banks?

8. Practicality argues in favour of a phased approach to the implementation of the SSM with the most significant groups coming within scope ahead of others. In principle, we believe that the SSM should ultimately extend to the full range of credit institutions within the SSM area but with the degree of direct oversight from the centre subject to proportionality. Such an arrangement will ensure that failings in smaller, regional institutions will not be overlooked. In this regard, it should be noted that the IMF has repeatedly used its Global Financial Stability Reports to warn of the risks posed by such sectors.

What powers and responsibilities is it appropriate for the ECB to possess in relation to regulation of the European banking sector, and in particular in relation to supervision of euro area banks? How should the ECB be held accountable for the exercise of such responsibilities?

9. We believe the Commission proposes a broadly appropriate set of powers and responsibilities for the ECB. We are somewhat concerned, however, by the proposals relating to administrative pecuniary sanctions under Article 15 of the Council Regulation. This grants the ECB the power to impose sanctions for failings with penalties of up to 10 per cent of total annual turnover to be applied at the consolidated group level of the ultimate parent undertaking.

10. Concentrating responsibility for supervision at the ECB whilst leaving responsibility for resolution with Member States will, however, no doubt give rise to considerable tension and may inhibit the operation of the new structure. Under the proposed model, the ECB is responsible for the supervision of institutions whilst they are going concerns and is charged with assessing whether or not an institution meets the conditions for resolution (see RRD Article 27 for definition). If it determines that a firm is no longer viable then it will be for the relevant national resolution authority to resolve the bank. In practice, we anticipate that the ECB and relevant supervisor would be required to come to a mutually agreed view on whether or not the trigger had been met but this may add delay and uncertainty to the process.

European Deposit Insurance schemes

What is your assessment of the Van Rompuy proposals for a European deposit insurance scheme for banks, to be overseen under the new European banking supervisory framework and with the ESM as a fiscal backstop? What is the purpose of the proposal and what will its likely impact be on the existing Deposit Guarantee Schemes Directive proposal? Is it likely to be effective? How likely is it that such proposals will be enacted?

11. The fact that the Commission stepped away from proposing a single guarantee scheme alongside its supervisory proposals testifies to the political and practical difficulties of developing such a scheme.

12. On a related matter, we are concerned by the proposals in the RRD that the DGS or Resolution Fund in one Member State may be obliged to provide funds to another Member State. We do not see this as appropriate given that:

    - It breaks the link between responsibility and liability;
    - It has the potential to act as an avenue for contagion across Member States; and
    - The text foresees a right to the provision of cross-border assistance at a point before ex ante and other national assistance have been drawn down.

The proposed Directive for bank recovery and resolution
What is your assessment of the proposed Directive (COM (2012) 280) establishing a framework for the recovery and resolution of credit institutions and investment firms? What will be the impact on these proposals of the steps towards banking union (including a resolution framework) as set out in the Van Rompuy report?

13. We welcome the proposed directive and believe it to be an important step towards the establishment of a regime under which the failure of a bank can be dealt with in an orderly manner. In our view, it is a vital counterpart to the measures designed to strengthen banks (such as CRD IV), those to strengthen supervision (such as the European System of Financial Supervision) and those to strengthen markets (such as MiFID).

14. In our assessment, the directive faithfully implements the Financial Stability Board's Key Attributes of Effective Resolution Regimes and looks to be largely in keeping with the developments undertaken in the UK in this area over recent years.

15. In terms of the impact of the banking union debate on the RRD, we are anxious that this does not distract from the imperative of agreeing and implementing the RRD as quickly as is practicable. Whilst the RRD was clearly prepared ahead of discussion of banking union we do not see it as incompatible and believe that steps can be taken to amend the framework – particularly around the measures concerned with the cooperation of authorities and the role of the EBA – to adapt to the proposed structure. Any such steps, however, must be taken in a manner to ensure that the RRD continues to set a framework for the EU27 as a whole.

What will be the impact of the Directive upon the European Banking Authority (EBA)? Are the new responsibilities proposed under the Directive for the EBA appropriate?

16. The EBA is granted a significant role in relation to promoting consistent implementation of the directive and in facilitating the supervision and resolution of groups.

17. We welcome the strong role afforded to the group-level authorities and acknowledge that the EBA should play a role in helping home and host authorities to come to a mutual decision on supervision, where a college is only EU-wide. However, we believe it is inappropriate for the EBA to involve itself on its own initiative in the running of supervisory colleges and that it should be for the home authority to refer a matter to the EBA for mediation. We also believe that some of the timescales foreseen for EBA mediation are unduly long and complex and could prove detrimental when a decision is required urgently.

18. However, we are less comfortable with the role foreseen for the EBA in resolution. For example, we are uncertain that the EBA has expertise in the area of resolution, as opposed to supervision. Given the requirements on national competent authorities for functional separation between supervisory decisions and those relating to resolution it begs the question whether this division should be replicated at the level of the EBA. If it is nevertheless decided to grant the EBA a role in coordinating resolution actions then we suggest there will be a need to consider the consequential changes to its structure and resources to enable it to perform the functions proposed.

19. As a final point, we note that there are a significant number of tasks to be delegated to the EBA. Care must be taken to ensure that policy decisions are not inappropriately delegated for decision at Level 2.

What is your assessment of the proposed 'bail-in' tool (Articles 37-38 and 41-50)?

20. We have long been supportive of the concept of bail-in within resolution and therefore welcome the RRD proposal for a broad statutory bail-in power which looks consistent with that envisaged by the Financial Stability Board's Key Attributes for Resolution Regimes.

21. In terms of the purpose of the bail-in tool, we accept that it should be used either to provide capital for a bridge-bank or, in exceptional circumstances, be used to recapitalise an institution following its entry to resolution. We are concerned, however, by the potential market reaction to the latter option, including the possibility that Resolution Authorities may view this option as a first resort rather than as one of a range of resolution tools, and as such could be tempted to use bail-in prior to the PONV. For this reason we believe it should be subject to very strict controls and requirements, such as the removal of the board of directors, not least as pre-bail-in write-down of capital will result in a significant change in ownership and control of the entity. The resolution authority must also be confident that there is the realistic prospect that bail-in will achieve the objectives of resolution (as specified by Article 26).

22. Given the consequences of bail-in for creditors, we believe that there should be a duty on the Resolution Authority (in the UK, the bank of England's Special Resolution Unit) to maintain a Code of Conduct identifying the circumstances in which each of the resolution tools might be used. HM Treasury is under a duty to maintain a similar code of conduct under the Banking Act 2009, prepared in collaboration with the industry *Banking Liaison Panel*. We see this as something which has increased the understanding and acceptance of the UK's Special

Resolution Regime and something which would add benefit if mirrored in the RRD.

23. As noted above, we are supportive of a broad statutory bail-in regime, under which bail-in may apply to any liability other than those where it is either not practicable or undesirable for reasons of financial stability to include. We mostly agree with the list of liabilities to be excluded from the bail-in power under the RRD. However, further thought must be given to the proposed exclusion of short-term liabilities. Whilst we can recognise that the intention is to minimise the impact on short-term funding markets, excluding short-term liabilities has a number of perverse effects, including:

    - it introduces an exemption which is not mirrored for the other resolution tools – it is therefore not clear what comfort a creditor would take from their exclusion from the bail-in regime if they were potentially in scope for the other tools;
    - it incentivises a move towards short-term funding which conflicts with other regulatory initiatives (such as the Basel III Liquidity Coverage Ratio) and necessitates the introduction of a minimum threshold to ensure that sufficient bail-inable liabilities are available, adding complexity and cost for supervisors and firms; and
    - it subordinates other senior creditors, altering the creditor hierarchy.

24. In our view, therefore, a one month exclusion is the least optimal solution and we encourage discussion over whether this should be removed altogether, or extended to 12 months (thus reducing the conflict with the LCR but increasing the subordination of senior creditors and incentivising the shift towards short-term funding).

25. We disagree with the RRD that it is appropriate to specify the minimum requirement of bail-in liabilities a firm should hold by reference to *total liabilities*. We suggest that this should be amended to place the resolution authority under a duty to ensure that each institution maintains a sufficient amount of bail-inable liabilities. Fundamentally, we believe that RWAs is the better measure as it would link the requirement to the basis on which the capital structure is calculated and mitigate any concerns that the requirement could unintentionally become a binding constraint, a point noted by the Government in their response to the ICB. In order to ensure that the quality of the assessments is sound, we believe that countries should not only be required to inform the EBA of the levels which have been determined (Article 39(6)).

26. In terms of the application of bail-in (Article 41(2)), we believe that this should not be such that it can restore 'market confidence' as is currently proposed. Given the information asymmetry at the time of bail-in, we believe that instead this should be about restoring 'clear solvency such that the lender of last resort can provide liquidity without putting taxpayer monies at risk'.

27. In terms of the sequence of loss absorption, we note that prior to bail-in of more senior liabilities, Article 52 (1b) proposes that the principal amount of relevant capital instruments is reduced to zero. While we agree that capital instruments should fully absorb losses before senior liabilities are bailed-in, we urge that this point is amended to make clear that capital instruments would

only be 100% written down if the loss (plus required recapitalization) exceeded equity and regulatory capital. If the loss was less than that, capital instruments should be written down sequentially, and only to the extent needed to absorb the losses.

What is your assessment of the following specific elements of the Commission's proposals, as set out in the Directive, in relation to:
(a) Recovery and resolution planning (Articles 5-12)?

28. Subject to the points below, we welcome the introduction of requirements for recovery and resolution planning, which in large part mirror measures adopted by the FSA under the Financial Services Act 2010 and initiatives from the Financial Stability Board.

(b) Group recovery and resolution and cross-border activity (including resolution colleges) (Articles 7-8, 11-12 and 80-83)?

29. We welcome the recognition that the arrangements proposed must be workable for internationally active groups and believe in principle that recovery and resolution is most effective when coordinated at the group level. The directive includes a number of important powers, such as the ability for the EU to recognise third country resolution proceedings and the option for third country authorities to participate in colleges.

30. There remains uncertainty, however, over whether it is intended that the EU requirements proposed supplement existing international arrangements where these are already in place, for example in relation to resolution planning where 24 groups are already subject to G20 Crisis Management Groups, or whether the proposed EU Resolution College will operate in parallel. Our strong preference would be to avoid duplication and that where an international arrangement exists this be deemed to meet the requirements of the directive. Doing otherwise risks duplication and uncertainty which could be destabilising during a crisis.

(c) Preventative powers (Articles 13 and 14)?

31. We acknowledge the importance of ensuring that groups are resolvable without assuming recourse to public financial support. We view the resolution planning as a collaborative dialogue between the firm and the resolution authority. We are somewhat concerned that the directive requires resolution authorities to make assumptions on the resolvability of firms without granting the firms the right to review and challenge the assumptions used. However, we view a dialogue between a firm and the resolution authority over its resolvability as preferable to the imposition of mandatory structural change which pays no regard to the circumstances of individual banks.

(d) Intra-group financial support (Articles 16-22)?

32. Our members do not generally view the proposed framework for intra-group financial support as something they would utilise and therefore do not oppose its inclusion in the directive on the understanding that the framework remains optional. That being said, it is not clear how the framework affects existing intra-

group arrangements in the ordinary course of business such as stand-by lines of credit, some longer-term facilities, clearing and settlement lines, etc.

(e) Early intervention measures, including the 'Special Manager' tool (Articles 23 and 24)?

33. It is important to distinguish clearly between recovery and resolution and to be cognizant of the differences when considering the way in which the various crisis management tools should be sequenced. We are concerned that a number of measures in the proposed directive blur this distinction but this is most apparent in regard to the early intervention powers.

34. Our members view the recovery phase as being firmly their domain, during which the shareholders through the board of directors remain responsible for the management of the group. A transfer of control away from management before the point of non-viability (PONV) risks disenfranchising shareholders and opens the supervisors up to moral hazard and criticism if disproportionate and premature action is taken. Once the PONV has been reached control passes to the resolution authority as it seeks to use the powers available to it to achieve the objectives of resolution. The process can therefore be considered as a continuum, stretching from going to gone concern with the supervisor employing a graduated approach, intensifying its supervisory engagement as the bank moves towards the point of failure. In terms of the powers envisaged by the proposed Directive, we believe this manifests itself as follows:

- The development and implementation of the recovery plan is a task for management, albeit under the oversight of the supervisor (Article 5);
- Deficiencies with the *recovery* plan or its potential implementation identified by the supervisor should not give rise to a requirement to alter strategy or change business structures (Article 6);
- The development of the resolution plan is a task for the Resolution Authority but with input from the firm (Article 9);
- Firms should have the right to review and challenge the assumptions on which Resolution Authorities have identified potential impediments to resolution before measures in response to those impediments are mandated (Article 15);
- Early intervention measures should not be utilized until such a point as one (or probably more) early warning signals have signaled the need for action (Article 23). The EBA can play a valuable role in promoting the convergence of supervisory practice in this area and ensuring that undue supervisory forbearance is not used to prevent problems from being dealt with;
- In terms of the early intervention measures themselves (Article 23), the majority are part of the existing supervisory tool kit. Others, however, look to us to be more like resolution tools which should not be utilized until the PONV has been reached. Specifically, the power to require an entity to 'plan' for debt restructuring (23.1(e)) could have serious consequences if creditors believe that failure to comply will result in resolution being triggered. However, the negotiations will take place without the explicit safeguards and procedural requirements that accompany similar actions within resolution. The power for the supervisor to contact potential purchasers to prepare for the resolution of the institution (23.1(g)) confuses the role and responsibilities of the supervisor and resolution authority and blurs the functional separation required by Article 3;

- We view the Special Manager power as a resolution not a recovery tool. Its use as a recovery tool risks signaling to the market that the firm is failing which will in all likelihood bring forward the point of failure and open the supervisor to moral hazard (Article 24);
- The trigger for resolution should be the PONV, which should be set as close as is possible to balance sheet insolvency to ensure that creditors' rights are not unduly impinged but also to ensure that it is still possible to meet the objectives of resolution (Article 27);
- The resolution tools, such as bail-in, must only be utilized once a firm is in resolution (Articles 31(2)) and not as the first/default option.

(f) The various resolution tools, including sale of business, bridge institution and asset separation (Articles 31-55)?

35. We are supportive of the proposed resolution tools.

(g) Cooperation with third country authorities (Articles 84-89)?

36. We are supportive of the proposed cooperation arrangements but would welcome clarity that the steps under Article 84 relating to the negotiation of agreements with third countries do not prevent Member States from negotiating bilateral agreements.

(h) The proposed system of financing arrangements (Articles 90-99)?

37. Our starting point is that the funding arrangements – as with the other aspects of the proposed Directive - must be developed in a manner which permits them to work in the context of the Single Market as a whole and we therefore believe that their consideration must be separated from the discussion around Banking Union for the Eurozone. This point notwithstanding, we can accept the development of resolution funds on the basis that there is recognition of the substantial synergies between DGS schemes and ex-post resolution funds and that the Commission framework permits Member States to utilise their DGS scheme to finance the use of resolution tools on an ex post basis. However, we believe that given the current economic environment the pre-fund must be developed over a period of at least 15 years, rather than the 10 currently proposed.

38. This support, however, is prefaced on the clear understanding that the purpose of resolution funds is tightly constrained and that they should be used only to provide funds to meet the immediate costs of resolution and should not absorb losses until shareholders and other providers of capital have been extinguished, when they should be bailed-in pari passu with other creditors subject to bail-in. In this context, it would be useful to clarify how this seniority would be ensured in practice. Further, it is important to recognise that resolution funds should not be viewed as sources of liquidity provision: Lender of Last Resort and other such normal central bank market liquidity provision facilities must remain for central banks.

39. We do have concerns, however, related to the calculation and use of the levy. Not least among these is the potential for the fund in one Member State to be

under an obligation to provide assistance to a fund in another Member State. As currently drawn, we do not believe this is appropriate given that:

- it breaks the link between responsibility and liability;
- it has the potential to act as an avenue for contagion across Member States; and
- the text foresees a right to the provision of cross-border assistance at a point before ex ante and other national assistance have been drawn down.

40. We are therefore unable to support this element of the proposal at this time. Once the pre-funded element of a Member State's Resolution Fund is exhausted it should raise finance (through a Government line or commercially) at no cost to taxpayers, with its surviving banks funding the interest costs and repaying the principal over time.

The impact on the UK

The Government have made clear that the UK will not take part in the fundamental elements of a banking union, and will neither be part of a common deposit guarantees nor come under the jurisdiction of a single European financial supervisor. What is your assessment of this position? How should the UK respond to these proposals?

41. Our starting point is that it is in the UK's interests for there to be a stable and consistent supervisory regime in the Euro area and that we recognise that monetary union gives rise to specific risks which may be mitigated by more coordinated decision-making. We are supportive of the steps the UK is taking to strengthen financial supervision and agree that there is logic in the UK remaining apart from the SSM at this time, given that it is being developed principally to respond to weaknesses which have arisen from EMU. We agree with the Government that the UK should not participate in a common deposit guarantee scheme which would break the link between responsibility and liability.

42. Given that we believe it is in the UK's interest for there to be a robust system of supervision within the Euro area, we would wish to encourage the Government to offer constructive support for the proposals and to identify ways in which it can be made to work effectively and efficiently in the context of the Single market, which in our view remains Europe's greatest asset.

What will be the implications of steps towards banking union for those countries, such as the UK, that stand apart? How realistic is the Government's argument that the UK's non-participation should not and need not adversely affect London's position as the leading financial centre in Europe, nor adversely affect the operation of the single market?

43. This is a complex matter which is of very great importance. Part of the answer will lie in the development of appropriate safeguards to ensure the equitable operation of bodies like the EBA but others will depend on the reality of how the ECB interprets its mandate and how its role evolves over time.

44. It should be clear that we believe that the Single Market is vital to meeting the requirements of customers and that fragmentation would have major

consequences in terms of the efficiency of the provision of capital to business. This means that there must be no divergence between requirements applicable to banks based in the Euro area and those from the wider EU. In our view, the Single Market has contributed to the success of London with a considerable portion of European banking activity taking place here and international firms opening regional offices in London to branch into the Single Market. Great care must be taken to ensure that there are no barriers – perceived or otherwise – which alter this position.

How do you assess the risk that, as elements of a banking union, including supervision, are addressed by a subset of its members, the Council's role in banking regulation will be undercut, with its legislative debates pre-empted and/or decisions pre-determined in discussion amongst banking union members?

45. We believe that this is a legitimate concern and one which is very difficult to resolve by way of procedural or statutory requirements. We welcome the fact that the Commission has acknowledged this issue in its communications and has sought to address concerns via amendments to the operation of the EBA. Whilst we are still assessing the technicalities of the changes to the EBA's decision-making powers, it is not altogether clear to us that these measures mitigate concerns over 'soft' coordination and, as such, will need to be the subject of considerable deliberation by the UK government and industry.

1 October 2012

Bruegel—Oral evidence (QQ 40–53)

Evidence Session No. 3. *Heard in Public.* *Questions 40 - 53*

TUESDAY 2 OCTOBER 2012

8.30 am

Members present

Lord Harrison (Chairman)
Lord Flight
Lord Hamilton of Epsom
Lord Jordan
Lord Kerr of Kinlochard
Lord Marlesford
Baroness Prosser

Examination of Witness

Jean Pisani-Ferry, Director, Bruegel

Q40 The Chairman: Colleagues, let me bring the meeting to order. I warmly welcome Monsieur Pisani-Ferry, who returns to us, having given evidence on an earlier occasion and having accommodated us at 8.30am. We are very grateful. You may know that we are interviewing a lot of Members of the European Parliament—we started yesterday—about the banking union and the recovery and resolution directive. Later today we are seeing Herman Van Rompuy, Monsieur Barnier and Mr Enria from the EBA, so it is particularly helpful to see you in advance of those meetings. First, could you say a little about yourself for those colleagues who have not met you before and then tell us whether you have a definition? Your colleague Monsieur Véron was on the television this morning; I cannot remember which channel. What do you believe is the outline of the proposed banking union in the first place? We are still finding that difficult to grasp.

Jean Pisani-Ferry: Thank you, Mr Chairman, for asking this simple question and for inviting me again. As you said, you proposed this question in the context of earlier stages in the crisis and I am back to discuss a possible solution. I am happy that you asked this broad question because my background is not in banking regulation; it is more on the macro side. I am happy to comment on it. The decision on 29 June by the Euro Area Summit to go in the direction of a banking union, starting with single supervision, is a watershed in the nature of the responses to the crisis. Before that, there was a period when the focus was on crisis-management mechanisms with the creation of the EFSF and then the ESM. There was debate about whether there should be assistance and bailing out, the question of resolution mechanisms for states et cetera, and the so-called firewall. All that came to an end more or less with the agreement on and the creation of the ESM. Then there was a second moment when the focus was on enforcing the pre-existing commitments to fiscal discipline. We had a whole package of legislation—the six-pack, the two-pack and then the treaty—but that was very much starting from the same model of the monetary union. It started from the assumption that the problems were with implementation—the enforcement of the disciplines, rather than the model itself. The move to banking union is recognition that there are systemic deficiencies in the architecture of the monetary union. This first sentence in the summit statement—that it is imperative to break the vicious circle between banks and sovereigns—is welcome recognition that there are problems of a different nature in the functioning of monetary union. It was really a surprise for the largest part of the professional observers who had researched monetary union to observe this extraordinary stop of capital flows from north to south Europe and this extraordinary reversal. If you look at the numbers, you will see that private capital outflows from countries such as Spain and Greece, for sure, Portugal, and to some extent Ireland and Italy, were the reversal of the previous inflows to a considerable extent, meaning that fragmentation of the euro area was in the making. You certainly know of examples of banks having customers on two sides of a border and lending to those customers on very different terms independently of any consideration of the riskiness of the lending to a particular customer. That is systemic. By having monetary union at the same time, you have no lender of last resort for sovereigns, so there was a debate about the role of the ECB. The answer was that it was not the role of the ECB to provide lending to a sovereign and to make sure that it would not lead to a situation in which it could not borrow more on terms that would keep it solvent. That is one thing. The second thing was that there should be no mutualisation of debt among sovereigns, and the third was national responsibility for banking systems, both in terms of supervision resolution and a fiscal back-stop—having to shoulder the burden of the banking crisis. That made sovereigns much more fragile and opened the way to this correlation between banking risk and sovereign risk that we have seen to an extraordinary extent. Obviously, these correlations can be seen everywhere. The experience with the banking crisis is that there is always a repercussion on the sovereign, but the degree of correlation between sovereign and banking indicators, like CDSs, is extraordinary in the cases of Spain and Italy. It is a distinctive feature of this euro crisis. It is a recognition of this fact.

Q41 The Chairman: Before we explore that very interesting line of thought and look more into the role of the ECB, the EBA and the RRD, what do you think about the timetable? Certainly, from Parliament, we had a large degree of scepticism. We also asked our European parliamentarians about the element of democracy and accountability in the process, because they are charged, along with the Council, with performing that task. Have you any thoughts on those two matters?

Jean Pisani-Ferry: The timetable is extremely ambitious in view of the complexity of creating the single supervisory mechanism, but also because it is only the first step towards banking union. Banking union is not single supervision. Single supervision by itself would not solve the problems that I have just discussed. It would require a combination of supervision, resolution and a fiscal backstop. So we are starting a discussion on supervision without sufficient clarity on the other combinants, which, from the viewpoint of their fiscal implications and their implications in terms of responsibility for banking crisis resolution—which can have major domestic consequences—is not quite there. So I agree with you that it is difficult to have this discussion on the first step of something very ambitious within a very short timetable. The reason for that, as we all know—to respond to the Spanish crisis, and the possibility of using the ESM to recapitalise banks directly—has been linked to the creation of the single supervisory mechanism. So I can understand the reason, but it makes things evidently very difficult because the two timetables have nothing to do with each other. The timetable on Spain has to be short; the timetable on responding to the systemic deficiency has to be a process that goes fast enough to ensure that, for markets, there is credibility in the process, but, certainly, it is not the same timetable as the one for Spain. We are back to this discussion, as you know, with all the ambiguities in recent weeks, about what could be done and at what point in time.

The Chairman: Just on the democracy point, do you think that that will be satisfactory? This really is such an important task that will be shouldered by the European Parliament.

Jean Pisani-Ferry: It all depends on the way in which it is organised. I would be more worried by what I said before; that is, the discussion focusing on one part without sufficient clarity on the other combinants.

Q42 Lord Marlesford: How could the Commission have confused, as you so clearly demonstrated to be the case, crisis resolution with structural reform and tried to force them both into the same timetable? I do not understand it.

Jean Pisani-Ferry: What do you mean by structural reform?

Lord Marlesford: Structural reform being the longer-term things that are needed in the banking union and crisis resolution being Spain and all the rest of it.

Jean Pisani-Ferry: I do not think that it is the Commission. There is a problem with the legacy assets and the degree of mutualisation for past crises. Basically, banking union is an insurance mechanism. Normally, if you change from one insurance system to another, you first go through a health check. You do not want to have an adverse selection through which you would take on all people with hidden illnesses. It is normal to say that the cost of recapitalising banks and addressing past failures should be shouldered by those who made the failures. If they were supervisory failures at national level, it is basically for nationals to pay for them—to the extent that they can, which is the whole difficulty. By taking on the cost of the banking crisis, they should not put their own solvency in jeopardy, which, in the end, would be another form of mutualisation through debt restructuring or sovereign restructuring, or through inflation if you wish—there are various ways in which you can mutualise the cost of a domestic banking crisis. So it is understandable if you say that you have to distinguish between the two and start from something that is as clear as possible. "As clear as possible" means that you define your responsibilities and then have a process of taking responsibility for the banks within the scope of single supervision. Then you deal with the legacy assets and you can inject capital provided you are sure that the supervision is adequately carried out by the new supervisor. So I understand the logic. It is simply that, in terms of the timetable of it, we are speaking of firefighting on one side and of longer-term architecture on the other.

Q43 Baroness Prosser: Two things, really. I am not sure that I have heard you say anything about the role of the Lisbon treaty and whether that confers sufficient rights and powers to transfer all this over to the ECB. Secondly, you have talked a bit about the varied timetable. Do you think that the supervisory powers should also be varied depending on the size of the banks and the nature of the institutions?

Jean Pisani-Ferry: The Lisbon treaty is a weak basis, because we know that it contains this article which does not say much. It clearly comes from recognition at the time of the Maastricht treaty that there was an issue that would need to be addressed at some later time, but it is a single subsection of an article so it is not much. It does provide a legal basis—I would not dispute that—but it does not provide the architecture, so it is building on something that is limited. On your second point, let us start from the analysis that the problem to be addressed is at core a fiscal problem and a problem of the risk for the sovereign of the cost of banking crisis. Let us take the case of Ireland as an indication. Perhaps it is an extreme example, but if you look at the distribution of the costs of banking crisis it is not so extreme—we have seen 40% of GDP in other countries. It indicates that that is at the core of the issue that you have to deal with. Certainly, this is not something that you can limit to the major systemic banks. There are two sets of logic behind the banking union. The first, which was the former logic of the Commission, was the single-market logic. Essentially, you make a case for banking union based on cross-border integration and there are a number of arguments to defend; for example, the idea that the banking union would be a complement to the single market. That was up until late in the spring the view of the Commission, but it was not the decision of the European summit, which adopted a different logic, that of the monetary union, which is the one I presented. So, by the first logic, you could say that banking union has to be limited to a subset of banks—the largest banks with cross-border operations and with systemic damage—but that would not address the fiscal problem that we are discussing. To address the fiscal problem, you need wider coverage. How large should it be? You know this number of 6,000 banks. If you look at the distribution of those banks by asset size, you see that 200 banks represent some 95% of total assets. So we are not speaking really of 6,000 banks. We are not speaking of 200; we are not speaking of 6,000; we are speaking of something in between. Here, clearly, in terms of information and not burdening the ECB with having to deal with very small institutions that are local by nature, a reasonable compromise needs to be found. That reasonable compromise has to be the ECB having the authority but being able somehow to delegate its authority. Here, an interesting model is provided by competition. We know that the Commission has overall authority in the case of cartels. National competition authorities working under the single legal framework are taking and implementing decisions on cartels at national level, but the Commission can at any time call in a case and re-examine it. That is a model that works and I think that competition authorities at national level and the Commission are both happy with it. It is the sort of model that we can take inspiration from.

Baroness Prosser: With some flexibility built in.

Jean Pisani-Ferry: Yes.

The Chairman: Lord Hamilton, are you looking at the ECB?

Q44 Lord Hamilton of Epsom: No, I am really following up on the banking union proposals and Lord Marlesford's point. I want to clarify it in my mind. As I understand it, the banking union proposals have now been reduced to supervision and regulations, but at the same time we are trying to handle the crisis. Surely, even if these proposals went through by the end of the year, they would have no effect on the banking crisis in Spain as it stands. They would not make any difference to Spain because we are talking about shutting the stable door on regulation and supervision. I do not understand how that would do anything to solve the short-term problem of the banking crisis in Spain.

The Chairman: I shall ask Lord Flight to come in because he was nodding away vigorously there.

Q45 Lord Flight: Absolutely. Going on from that, what is the hang-up as to whether Spanish banks should be bailed out directly versus via government? It still amounts to the money being found from the ESM. The model with Ireland was established to put it on the Government, so that the money lent had sovereign debt status. Today, I think there is a debate as to what is the better credit risk. Why is there this huge argument about whether the bailout of Spain should be direct or via government?

Jean Pisani-Ferry: Let me start with the Spanish situation. The fiscal situation there has deteriorated significantly recently. The economic outlook for this adjustment is a long-term one, to do with regaining competitiveness and rebuilding a growth model for the Spanish banks. We really do not know how much time it will take or what kind of implications it will have for tax revenues. We do not know the extent to which it will affect the solvency of private borrowers in general. It was, at core, a crisis of private borrowing. What is most worrying in the Spanish case is the external debt—not government but private debt.

Lord Flight: It is the same as Ireland but on a smaller scale.

Jean Pisani-Ferry: Yes. So the question is whether, by adding to that burden on the Government and keeping the potential costs of future banking troubles on the balance sheet of the Government as an implicit contingent liability, you risk keeping them in a situation where market access will be difficult. The cost of that will be too high so you risk driving the Spanish states to a situation of de facto insolvency. That was the whole purpose of having direct mutualisation. The legacy costs do not need to be mutualised as a matter of principle. Some of those legacy costs should be left to the Spanish state but the potential future costs should be shared. The problem that we have is that no one has proposed a workable formula for sharing the burden between the Spanish state and the Parliament. I think the IMF should provide that because the IMF is in charge of doing the debt sustainability analysis in all the countries. It is really the IMF's responsibility. The IMF should tell us what it thinks is reasonable as a formula. It is important in that formula to keep the incentive rate. Obviously, you should not give the signal that whatever you do will be neutralised, and therefore irresponsibility at a national level is something that you can encourage. So, for both the short and medium term, it is important to have a formula that addresses this risk and at the same time sets the incentive.

Lord Flight: Out of interest, is that not a comment that the way that Ireland was dealt with is therefore thought of as being slightly wrong? What you said implies that the way that Ireland was handled, with the ECB forcing it all on to the Government, has been reappraised as being not the right formula for a similar but larger problem in Spain.

Jean Pisani-Ferry: There is evidently a learning process at work. The two are linked through this question of under what conditions the ESM can lend to Spain. That is the connection between the shorter and medium-term conditions. I should like to go back to what you said at the beginning about supervision versus other dimensions. Supervision by itself, and limiting that supervision, would not only be insufficient but would create significant difficulties in the relationship between the national regulation authorities and the supervisory authorities at the European level. Let us assume that there is a common supervisor; that all the rest, such as resolution, is left at a national level by definition; and whatever else has to be paid in terms of the budgetary costs of the banking crisis. Then, assume that there is a supervisory failure. What will the national state say? They will say, "I am not going to pay for the mistakes that you have made. I am not going to use taxpayers' money. You—the ECB or the European institution—were responsible, so it is not possible to ask me to pay for your mistakes". Logically, there needs to be a degree of consistency between what is done in supervision, in resolution and on the fiscal backstop. I am not saying that there should be 100% consistency, for reasons of information and to do with the fact that any banking crisis resolution has connections to labour and bankruptcy laws and there is a national dimension. I also do not think that the old national competencies should be transferred to the European level or that all costs should be neutralised. That would give some wrong incentives. When I presented our paper on banking union to ECOFIN, the Dutch

Finance Minister was in favour of it—the Dutch are in favour of banking union—but said that it would give a free incentive to Parliaments to pass laws that would basically cut the debt burden of households at the expense of banks. If there is then a cost to be passed on to taxpayers, it will be the taxpayer at European, not national, level. So it is the whole issue of setting the right incentive in this process so that behaviour at national and European level is in line with the proper assessment of risk.

Q46 Lord Jordan: What is your assessment of the package of powers being given to the ECB? Do you think that those powers go too far, as some are already saying they do, or perhaps that they do not go far enough? The German Minister of Finance, Dr Schäuble, immediately blasted off and that, as you say, has already caused a revision from 6,000 to 200. Further, is there enough accountability in the proposals? The ECB will be one of the most powerful bodies in Europe. Some parliamentarians and Ministers are saying that there is not enough accountability and, worse still, the argument may be used to slow down the whole process by those who think they are being bounced into something that has nothing to do with accountability but will actually cost them a lot of money.

Jean Pisani-Ferry: In terms of the powers and the scope, I think that they are broadly appropriate. In terms of the banks, the fact that all banks are in principle covered, albeit that it is understood that they will be able to implement internally some division of labour between the national supervisor and the ECB, is appropriate. There is also the fact that it will cover the euro area with some possibility of variable geometries between some countries. That opens the whole question of a device for the non-euro area and how nations want to position themselves vis-à-vis the banking union. I think that that is right and, on the whole, I support the proposal.

One point that is clearly going to be difficult and needs to be looked at carefully is implementation. What will be the capacity of the ECB to make assessments? In practice, how many supervisors will we have in Frankfurt? That is being discussed, and we know how there can be fights that have nothing to do with first principles. None the less, this is very important for those involved, so it will have to be looked at carefully.

Accountability is one issue of major importance. I do not take lightly the criticism of those who say that the traditional model is of a central bank with a fairly limited mandate to look at price stability, and therefore there is a rationale for independence. That is a logical construct. By adding supervision, you are adding something of a different nature that requires, let us say, a different type of accountability. There is a different type of relationship with political authorities and Parliaments, which can complicate the matter. It is a problem that everybody is confronted with on the world scale. One of the lessons arising from the pensions crisis for the central banks is that they have to be given more responsibility for financial stability, which is different from the nature of their responsibilities for monetary policy. That is the situation for the Bank of England. It is probable that the protection that was given to the ECB by the treaty was extreme because of the fear that pressure on the ECB to inflate would be so strong that it needed to be protected to that degree. That does not square well with, and makes things more difficult for, an independent central bank, which is able to set out a tough monetary policy but is not protected to such a degree.

Q47 Lord Jordan: Are there any measures that you can think of that might reassure people on the question of accountability, given the present proposals?

Jean Pisani-Ferry: In terms of the governance structure of the supervisory part, there is a clear distinction between the two roles. Perhaps a more compact board for financial supervision would make a contribution. It is going to be a combination of a national supervisor and ECB board members, with the national supervisor being accountable at the national level. Because the ECB board members will have responsibilities for monetary policy, the degree to which they can be held accountable is limited by that trade-off. Perhaps having a board with appointed executives accountable and responsible for banking supervision, a few of whom would be from the ECB board, would be more helpful. It would add, let us say, a board committee structure to address the particular problem of the dual mandate of those who are also responsible for monetary policy.

The Chairman: Lord Kerr, would you take us on to the European Banking Authority?

Q48 Lord Kerr of Kinlochard: We are from London, but we believe in the single market. We have signed up to the Monti report and we would like to see a stronger single market. As we look at these dossiers, we worry about the integrity of the single market. If that is lost, everything is lost, so the stakes are high. As we look at this complicated structure, with a new role for the ECB and the EBA, we can see that the proposal from the Commission states that to reflect the ECB's responsibilities, representatives on the council of the EBA from competent authorities of participating eurozone member states shall co-ordinate and express, for matters falling to the competence of the ECB, "a common position". That seems to fly completely in the face of what the Commission said, correctly, about the importance of maintaining the integrity of the single market. Is this a circle that can be squared and, if so, how?

Jean Pisani-Ferry: I share the concern about the single market. There are two ways in which the euro area could create problems for the single market. One is to become itself a source of fragmentation, which is what we have seen. What we see in the euro area is not compatible with the survival of the single market. We have seen national supervisors telling their banks: "Do not lend across borders". We have considerable evidence of national supervisors preventing banks lending across borders. Pan-European banks are having to go through the ECB because they have a liquid position on one side of a border and are short of liquidity on the other side. They cannot channel, internally and within the same banking group, liquidity from one side of a border to the other; they have to go through the ECB. That is a total contradiction of the single market. Because of its own fragmentation, the euro area is currently in the process of destroying the single market. I think that is the main risk.

I cannot see Governments in struggling countries, watching their viable companies having to borrow at 200, 300 or 400 basis points higher than their competitors in Germany, allowing that to go on for long before they take measures to support their own companies. The risk in the short term is extremely high. I wanted to say that because we have to start with the risk we are dealing with at present.

There is the other risk of the euro area becoming a sort of caucus which, on single market issues, will always speak with one voice and thus put into a minority position those members of the EU who are not members of the euro area. I think that is the concern you are expressing. The answer has to be found in governance provisions that recognise the risk, either through representation in the EBA, which is being proposed, or through voting rules that recognise the importance of market issues and a majority that goes beyond the euro area, that means that the euro area is not able to come to a compromise with itself and, as a second step, to propose a compromise to other EU members.

So it is delicate, because you do not want to make decision-making in relation to the single market unworkable. You do not want to go back to unanimity but, at the same time, you want to find a solution that prevents the creation of a very asymmetric situation.

Q49 Lord Kerr of Kinlochard: Can I ask a more fundamental question? Do you think that the role that is being given to the ECB is appropriate to the ECB? My difficulty these days is that I cannot remember Jean-Claude Trichet ever bidding for this role, and I do not know that the ECB now, under Mario Draghi, is bidding for this role. It seems to me to be an uncomfortable mix, with the very important and difficult role that the central bank is carrying out, and the new structures inside the central bank that are described in these papers, including the supervisory board. In what sense is it supervisory? In reporting to the general council, it will have had four representatives of the general council on it. What voting rules will they use? Will the general council have the right to override the board? Yes, presumably, otherwise what would be the point of reporting to it? Is this a sensible construct? If I came to it completely afresh, I would say that this looks like much more of a role for a new institution than for an existing, crucially important, institution.

Jean Pisani-Ferry: Are you saying that there may be a case for giving the central bank supervisory powers in general, but that the particular structure of the ECB—

Lord Kerr of Kinlochard: I am saying both. I am saying that I am doubtful about whether it is a good idea in principle, and I am saying that in practice these arrangements look at best obscure.

Lord Flight: You are saying that the UK is returning because—

Jean Pisani-Ferry: It is true that we are adding complexity to something that is already complex and difficult by having to deal with this problem within an institution that has its own logic, abstracting from the fact that the legal basis is that provisions of the treaty make it possible to give supervisory powers to the ECB.

Lord Flight: As a matter of principle, the US model covers both monetary policy and supervision. The UK is returning to that model. Lord Kerr is saying strongly that he thinks that model is unwise in a European context.

Jean Pisani-Ferry: That is a question I was asking. There are two types of discussion there. One is whether, as a matter of principle, you want to give the two responsibilities to the same institution. I think the reason why there is a move in this direction is that a lesson drawn from the financial crisis was that financial stability matters have to be regarded as more important in the way that central banks approach their role both in terms of monetary policy and macroprudential instruments, and that there should be some sort of connection with the microprudential dimension. I think that there is a logic to that. It is not a fully tested model. You may be conscious that I have been hesitating between two different models for some time. There was a move in the other direction, best represented by the UK, actually.

Lord Flight: Exactly.

Q50 The Chairman: We are pressed for time. I was going to ask you whether you would reply at the end of the session, if you have further thoughts. It seems to me that Lord Kerr has raised some issues that you might want to reflect on, but I am anxious to deal further with at least two items. One is the relationship of the ECB to the European Banking Authority. I think that follows logically. Perhaps Lord Kerr would expand on that. I also wanted to ask you about Liikanen, whether you have had an opportunity to read what may have been published in that regard, and whether you have further thoughts on it.

Jean Pisani-Ferry: No.

The Chairman: That clears that one up, but do you want to pursue the EBA? I think it is important that we look at that.

Q51 Lord Kerr of Kinlochard: If you, Mr Pisani-Ferry, or those with whom you work, had thoughts on the correct structure for supervision, I know this Committee would be thrilled to hear or see them. It seems to me that we in the European Union chose to go down a particular course when we set up the EBA and the other two bodies. Some thought that maybe the Commission should be doing this job. The argument at the time was not that the ECB should be doing this job. We have set up this fledgling organisation that is very lightly staffed. We are now imposing another model and trying to run the two in parallel. I find it very hard to see the interaction between the two of them. When I said "a new institution", I meant the EBA. That is my worry about the architecture here. Apart from the general question about whether this architecture deals with the real issue, there is the particular question about whether this architecture would work. I am on the second one at the moment.

Jean Pisani-Ferry: Let us assume that the euro area would make a different choice. Let us abstract from the legal dimensions and assume that the euro area would create a supervisory institution distinct from the ECB. That would not make the problems of the EBA simpler; it would probably make them even more difficult because you would then have another euro area-specific institution behaving in the same way—the elephant in the room—whenever there is a discussion within the EBA. You would have two elephants in the room instead of one. If you have a banking union for the euro area, or for the euro area plus some others, and you try to keep the EBA active and acting according to its mandate, you will in effect create an imbalance.

Q52 Lord Flight: Where are we with the RRD directive, which slightly seems to repeat your other discussions? Secondly, as I understand it, this is about going forward in terms of providing bailout; it is certainly not dealing with legacy stuff. Thirdly, there have been some criticisms of its proposals, in particular of the special manager. The UK Government thought that this could worsen the problem of loss of confidence at a distressed bank.

Jean Pisani-Ferry: I think that that is a question to put to the Commission because my reading is that the strategy of the Commission has been to propose the supervisory mechanism. As regards resolution, it has had to wait and keep its proposal on the table, knowing that it is not fully consistent with the logic of the single supervisory mechanism and that at some point it will be asked to come back with other proposals, but this is coming from what we previously called the single-market budget. It could at the same time have proposed some amendments to it; it has not done so. There will be no problem with consistency issues here. The question is when and under what conditions it is ready to move.

Q53 The Chairman: You can be sure, Mr Pisani-Ferry, that when we return to the United Kingdom we shall have before us Government Ministers and we shall test them very hard about the effect of the UK's position and how the United Kingdom might be affected. From your perch, what do you see as the important things for the United Kingdom to think about, both within its path of being part and parcel of the European Union and to defend its very real interests in the City of London and so on?

Jean Pisani-Ferry: I have appreciated the position taken by the UK Government on this issue of banking union. Relatively early on a clear stance was taken that it is needed, that it has to be an ambitious and complete banking union—not a partial one for the reason that a partial one would not solve any of the problems which justify creating a banking union—and that it has to be done on the basis of the euro area logic. This contribution has been helpful to the debate. What we discussed in relation to the EBA is one aspect of a broader set of issues on the implications of having a banking union in the euro area and a single market with another financial centre that is a de facto financial centre of the EU. It will inevitably be a discussion with many dimensions, but again I think that once you get the principles right, it helps a lot in the discussions that will inevitably be complex.

The Chairman: We will send you a transcript of this exchange. We would be very grateful if you would look at it closely and correct it, if necessary. We would also be grateful for your further thoughts. I thought that our exchanges provoked some interesting debate. We would be very grateful to you for your responses to that to help us compile our ultimate response. Monsieur Pisani-Ferry, c'était un grand plaisir de vous rencontre encore une fois. Nous apprécions très chaleureusement votre presence aujourd'hui et votre aide sur ce dossier difficile. Merci bien. Thank you very much.

Building Societies Association—Written evidence

INTRODUCTION

1. The Building Societies Association (BSA) represents mutual lenders and deposit takers in the UK including all 47 UK building societies. Mutual lenders and deposit takers have total assets of over £375 billion and, together with their subsidiaries, hold residential mortgages of £245 billion, 20% of the total outstanding in the UK. They hold more than £250 billion of retail deposits, accounting for 22% of all such deposits in the UK. Mutual deposit takers account for 31% of cash ISA balances. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

General views

2. The BSA broadly supports the UK Government's position on the so-called "banking union". We reject – for the UK, and our members - both the single supervisory mechanism under the ECB, and any EU-wide pooling of either deposit guarantee schemes or resolution funds. So long as these measures are confined to the Eurozone, they are a matter for Eurozone countries, provided nothing is done that infringes the single market.

Banking reform, banking union and the Eurozone crisis

3. Serious weaknesses have emerged in the banking systems of some EU countries, notably Ireland and Spain. At the same time, many other EU countries appear to have avoided such problems. Apart from bank holdings of peripheral Eurozone sovereign debt, it is not clear that there are common weaknesses across the EU that require structural reform going beyond measures – such as CRD 4 and RRD – that are already in train. No doubt these matters will feature in the forthcoming report of the EU's own high-level expert group.

4. The BSA broadly supports the implementation of the ICB recommendations as proposed by the UK Government in its June White Paper, and more specifically in relation to building societies in the discussion document "The Future of Building Societies" in July. The Association's responses to both these documents are available[32]. The ICB recommendations were based on UK specificities, and they do not constitute a universal prescription that should necessarily be rolled out in the very different environments of other EU states.

Banking supervision

5. Prudential rules governing banking have been set at EU level for some time, and this has been taken further, with greater uniformity, in the current "CRD 4" package, where most of the prudential rules for banks take the form of a directly-applicable EU Regulation with no role for national implementation. Against that background, we do not consider that a single European supervisor is either necessary or desirable. Since the banking crisis, banking has become more national in character, with the fragmenting of some of the major cross border groups such as Fortis and Dexia. Some national supervisors, such as those in Spain and Ireland, may now look discredited by the serious weaknesses revealed in their banking systems, but that does not justify a centralisation of all supervision. This would be particularly unsuitable for smaller banks in any state,

[32] http://www.bsa.org.uk/policy/response/the_future_of_building_societies.htm

and represent a major denial of subsidiarity. The ECB moreover should have no competence outside the Eurozone, unless by voluntary agreement with a national supervisor.

Deposit insurance schemes

6. The BSA rejects UK involvement in any single deposit insurance scheme, as does the UK Government. Nor is the UK alone in rejecting this: on 25 July, the leader of the German committee of banking trade associations also categorically rejected exposing German banks and German savers to bailing out failed banks in weaker states[33].

Recovery and Resolution Directive (RRD)

7. The draft RRD proposal finally published by the Commission in July seems broadly sensible, and much of it is patterned on the UK's existing Special Resolution Regime. The BSA supports, in particular, the emphasis on proportionality in the requirements for recovery and resolution planning. One of the minor weaknesses of the UK regime was that this emphasis was missing in the legislation, and therefore in its initial implementation.

8. At a recent round-table in London, the European Parliament's rapporteur on the RRD, when asked about the interaction of the RRD and the "banking union", favoured rapid progress towards adoption and implementation of the RRD first, before assessing whether further measures, such as "banking union", were in fact needed. We support this sensible approach – unfortunately, the signals in Europe are in the opposite direction – that the "banking union" may distract attention from the completion of work on the RRD.

9. The BSA has consistently argued that the need for the bail-in tool arises for systemic banks only, therefore its impact should also be focused on systemic banks, and this view is supported by the conditions attaching to its use proposed in the RRD. Since systemic significance will not be constant over time, and the threshold too can vary according to the authorities' risk appetite, we recognise that a statutory framework for bail-in, with suitable safeguards, that theoretically applies to all deposit-takers, as proposed in the RRD, is probably necessary.

10. Of critical importance is that use of bail-in, and any required maintenance of a stock of liabilities that are capable of bail-in, is genuinely targeted on the most systemic banks. In that context, we draw attention to the criteria set out in Article 39 of the draft RRD for determining the minimum amount of liabilities eligible for bail in, which clearly (and correctly in our view) emphasise the size, business model, risk profile, and interconnectedness of the institution.

11. We have two criticisms of the proposed financing arrangements. First, as already outlined, we reject any obligation for a national resolution fund – which in the UK is likely to be the deposit part of the FSCS carrying out both the resolution fund and deposit guarantee functions – to lend money to the resolution funds of other member states. Second, Article 99 needs amendment so that, once retail depositor preference is enacted in the UK as proposed in the White Paper, the FSCS will have the same priority in the liquidation of a bank as the retail deposits in respect of which it is called on to contribute to a resolution.

Impact on the UK

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[33] "Denn deutsche Banken und Sparkassen und nicht zuletzt der deutsche Sparer dürfen nicht zur Rettung anderer europäischer Kreditinstitute herangezogen werden" Uwe Froehlich, 25 July 2012, http://www.die-deutsche-kreditwirtschaft.de/uploads/media/Statement_UweFroehlichDK-PK_250712.pdf

12. As outlined above, the BSA fully supports the UK Government's position in taking no part in any "banking union" and rejecting (for the UK) common deposit guarantees or a single European supervisor. We recognise that all these issues involve a balance of risks. The BSA's view is based on what we consider likely to be the best, or least bad, outcome for our members.

13. There is clearly some risk that the "banking union" might undermine London as a financial centre, or affect the single market, or lead to domination of EU-27 decision making by a Eurozone-plus caucus. There is also a risk that by staying apart from any pooling of deposit guarantees or resolution funds, there will be a greater burden on our members, through the FSCS, of compensating depositors, or financing resolution, in any future UK bank failure. Set against these is what we consider to be the much greater, and unacceptable risk, that our members could be called on to contribute to deposit compensation or bank resolution triggered by bank failures in any one or more of the other EU states.

1 October 2012

Professor Andrew Campbell, Professor of International Banking & Finance Law, School of Law, University of Leeds—Written evidence

List of Questions

1. *How would you define 'banking union' in the EU context, and what are its key elements? How likely is it that its package of proposals will, in the Commission's words, "place the banking sector on a more sound footing and restore confidence in the Euro as part of a longer term vision for economic and fiscal integration"?*
   - *How realistic, and how prudent, is the Commission's timetable for implementation, with its various proposals planned to enter into force on 1 January 2013? Is the Commission's proposed sequencing of steps towards achieving banking union workable?*
   - *Does the package of new proposals, taken together with changes to CRD4 and other reforms adopted in the aftermath of the financial crisis, adequately address the problems of moral hazard and 'too big to fail'? if not, what further steps are needed?*

   The term 'banking union' in the EU context is used to describe the situation where there would be a single banking supervisor, a pan-European deposit insurance scheme and a bank resolution framework. To describe it as a 'banking union' is not entirely accurate as the proposals stand at present but this may reflect a longer term aim. The Commission's timetable for implementation of the proposals is very ambitious indeed and unlikely to be achievable. The proposed sequencing of steps is workable but at a slower pace than envisioned by the Commission. There is certainly going to be political opposition from a number of Member States to some of what is contained in the proposals. It is not clear whether the package of new proposals does adequately address the twin problems of moral hazard and 'too big to fail'. The question of moral hazard is always contentious and it is invariably difficult to agree on a balance. The 'too big to fail' (or too important or interconnected etc) issue goes beyond the borders of the EU and although what is contained within the proposals will assist, what is really needed for the truly global banks is a global solution and not just a regional one.

2. *How realistic is the Commission's assertion that "the creation of the banking union must not compromise the unity and integrity of the single market"? Is this goal compatible with the Commission's argument that the single market and banking union are in fact mutually reinforcing processes?*

   The Commission's assertion is realistic although some may argue otherwise. This goal is, in my opinion, compatible with the argument that the single market and banking union are mutually reinforcing processes.

3. *The European Commission has presented proposals for a single European banking supervisory framework, under the ECB, as a key element of banking union. What is your overall assessment of the Commission's proposal? What are the necessary features of such a framework if it is to succeed?*

- *Does TFEU, Article 127(6) provide an adequate legal basis for the supervisory tasks proposed to be conferred on the ECB?*

The proposal is far reaching and while welcomed by some will be opposed by others. It is an ambitious project to create a single European banking supervisory framework but this would have to be a key element of the proposed banking union.

4. *The Commission proposes that the ECB will become responsible for supervising all banks within the banking union, regardless of their business model or size. Do you agree? In what way, if at all, should supervisory powers vary depending on the size and systemic importance of banks?*

I have some concerns about this. It is hard to see how this would work in practice across the entire banking union. I think much more thought has to go in to the question of how a single bank supervisor should be structured and how it would work in practice. This is a singularly important issue which requires a considerable amount of further work to be done before such a supervisor could come into being. It could be very costly if this is not designed and implemented effectively and efficiently. Great care is needed.

5. *What is your assessment of the proposed package of powers for the ECB? Are they appropriate, do they go too far, or do they not go far enough? Is the proposed division of responsibilities between the ECB and national supervisory authorities either appropriate or workable?*

The proposed package of powers is reasonably appropriate but there are potential problems in the division of responsibilities between the ECB and the national supervisory authorities.

6. *The Commission asserts that the ECB "will be subject to strong accountability provisions", including to the European Parliament and Council, "to ensure that it uses its supervisory powers in the most effective and proportionate way". Are these accountability provisions sufficient?*

I am not certain that the accountability provisions are sufficient.

7. *What risks, if any, to the UK and other non-participating Member States are posed by the proposals for the ECB to develop international relationships on supervision? In particular, is there a serious risk of the ECB becoming the dominant influence over European positions in international fora, with the effect of marginalising non-participating Member States? What is the likely impact on Member States who wish to participate but are not members of the eurozone?*
    - *Do you agree with the Commission that its proposals will provide an effective framework for cooperation between the ECB and national supervisors in Member States that have not adopted the euro?*

This is a difficult question. It is hard to see how the UK and other non-participating Member States would not be marginalised at least to some extent. It is not clear what the likely impact would be on Member States who wish to participate but are not members of the Eurozone.

8. *In the context of these proposals, the Commission has also published a proposal to amend the regulation establishing the European Banking Authority (EBA). What is your assessment of the proposals? President van Rompuy has argued that the proposals will ensure a "clear and workable interaction" between the EBA and the ECB. Is the delineation between the EBA and ECB's areas of responsibility both "clear and workable"?*
    - *Do you perceive a need for the EBA's role to be strengthened further, and if so, how?*

   The proposals go a long way towards ensuring a 'clear and workable interaction' between the EBA and the ECB. The delineation between the EBA and ECB's areas of responsibility appears to be quite 'clear and workable' but perhaps this needs further clarification.

9. *Are the proposals on adaptations of the voting procedures within the EBA adequate to ensure that its decision-making structures remain balanced and effective, and fully preserve the integrity of the single market?*

   I have not had the opportunity to study this in sufficient depth to answer.

10. *The Commission has also called for agreement by the end of 2012 on its proposal for a Directive on Deposit Guarantee Schemes. What is your assessment of these proposals, in the context of President Van Rompuy's call for a deposit insurance scheme for banks, to be overseen under the new supervisory framework, and with the ESM as a fiscal backstop? What is the purpose of the proposal and is it likely to be effective?*
    - *What are the likely implications of recent developments for these proposals?*
    - *How realistic is the Commission's timetable?*
    - *Is it feasible to conceive of a banking union without a centralised deposit protection scheme being established from the outset?*

    The Northern Rock crisis in the autumn of 2007 revealed several deficiencies in the deposit guarantee scheme in the UK. It has since been significantly reformed. Recent events in parts of southern Europe have demonstrated the fragility of depositor protection within the EU. It is extremely important that if reform takes place that is done so after proper consultation. What has been proposed in relation to a single deposit guarantee scheme needs to be clarified as in some places it is unclear exactly what is being proposed. It is also crucial that an effective system of bank supervision be in place before such a pan-European guarantee scheme is introduced. The idea of a pan-European deposit guarantee scheme is currently being widely discussed and has many supporters. However, there is also significant opposition. It seems therefore that the Commission's timetable is not very realistic. It is difficult, although not impossible, to conceive of a 'banking union' without centralised deposit protection from the outset.

11. *What is your assessment of the proposed Directive (COM (2012) 280) establishing a framework for the recovery and resolution of credit institutions and investment firms? What will be the impact of these proposals on the banking union proposals, and vice versa?*
    - *How realistic is the Commission's desire to reach agreement on this package before the end of 2012? How would you respond to the view of the UK*

Government that "we should resist any pressures to proceed with undue haste"?
- *What will be the impact of the Directive upon the European Banking Authority (EBA)? Are the new responsibilities proposed under the Directive for the EBA appropriate? How would you respond to the concerns expressed by the UK Government that the extension of the EBA's powers, in particular in relation to agreements with third countries, is disproportionate?*

The proposed Directive to establish a framework for the recovery and resolution of credit institutions and investment firms is a welcome development. The lack of such a framework has hindered cross-border bank insolvency resolution for far too long. It is worth noting here that the UK was at the forefront of introducing new legislation 2009 for the resolution of insolvent banks.

12. *What is your assessment of the proposed 'bail-in' tool, and the other proposed minimum resolution tools? What is their purpose, and will they be effective?*
    - *The UK Government have expressed concern that the Special Manager tool may result in a significant risk of a loss of confidence in a distressed bank, thereby speeding up an institution's failure. How would you respond?*
    - *The UK Government have also told us that the benefits of the proposed asset separation tool are unclear. How would you respond?*

This is an interesting topic which is the subject of considerable debate. The question of how effective 'bail-in' will be in practice is still to be answered. In principle the proposed tool is a worthwhile development but its practical effects are far from certain. The UK government is correct to express concerns about the Special Manager tool and the proposed asset separation tool. The first may indeed result in a significant risk of a loss of confidence in a distressed bank, thereby speeding up an institution's failure. However, this is far from certain and is something which requires further study. The benefits of the proposed asset separation tool are unclear and further clarification needs to be provided.

13. *In its Roadmap towards a Banking Union, the Commission states that it plans to publish a proposal for a single resolution mechanism to coordinate the application of resolution tools to banks within the banking union, whereby shareholders and creditors would bear the costs of resolution before any external funding is granted. What is your assessment of this proposal, and how will it relate to the Recovery and Resolution Directive?*

It is not entirely clear how this planned proposal will relate to the Recovery and Resolution Directive. Further clarification needs to be provided. In principle the idea that shareholders and creditors would bear the costs of resolution before any external funding is granted is one that has widespread support.

14. *The UK Government have made clear that the UK will not take part in the fundamental elements of a banking union. What will be the implications of steps towards banking union for those countries, such as the UK, that intend to stand apart? How in your view should the UK respond to these proposals?*

- *How realistic is the UK Government's argument that the UK's non-participation should not and need not adversely affect London's position as the leading financial centre in Europe?*
- *What are the potential implications for the UK of the suggestion that the EBA should develop a single supervisory handbook to complement the single rulebook? In particular, might this be a threat to 'judgment-led' supervision?*

This is a complicated and uncertain issue. The UK government has indeed made it clear that the UK will not take part in the fundamental elements of banking union. If the UK does not participate in the proposed banking union is it possible that London's position as Europe's (and perhaps the world's) leading financial centre will not be adversely affected? There are many different views on this. Frankfurt will undoubtedly be the leading financial centre within the banking union (this is, of course, on the assumption that Germany will be a part of the banking union) and it is difficult to imagine that it will not become stronger and therefore a more likely competitor to London in many respects. This is something which should be approached with great care and be widely discussed. There may, in fact, be many benefits for the UK in joining an EU banking union.

15. *How do you assess the risk that, as elements of a banking union, including supervision, are addressed by a subset of its members, the Council's role in banking regulation will be undercut, with its legislative debates pre-empted and/or decisions pre-determined in discussion amongst banking union members?*

I am not certain to exactly what extent that the Council's role will be undercut but this is a real possibility and a matter of some concern.

This response is provided in a purely personal capacity and does not represent any views which the University of Leeds may have on this subject.

12 October 2012

Centre for European Policy Studies—Oral evidence (QQ 54–70)

Evidence Session No. 4. *Heard in Public.* *Questions 54 - 70*

TUESDAY 2 OCTOBER 2012

9.40 am

Members present

Lord Harrison (Chairman)
Lord Flight
Lord Hamilton of Epsom
Lord Jordan
Lord Kerr of Kinlochard
Lord Marlesford
Baroness Prosser

Examination of Witness

Karel Lannoo, Chief Executive Officer, Centre for European Policy Studies

Q54 The Chairman: Colleagues, it is my great pleasure to welcome Karel Lannoo from the Centre for European Policy Studies. As you know, we are looking at the banking union, RRD, and so on. Later today, we are seeing Mr Enria from the EBA, Commissioner Barnier and Herman van Rompuy; so all that you can tell us now will be vital in those questions. As you may know, the House of Lords has this process of conversation which is recorded. We will send you the transcript and ask you to correct or improve it. We are very open for cheating. Before putting the first question, it would be useful if you would introduce yourself and say a little about the CPS.

Karel Lannoo: Good morning and thank you for inviting me. It is a pleasure to speak on this subject, which I have followed for a very long time—for more than 15 years. I have followed single market issues and single financial market issues since before the creation of the monetary union when there was intense debate about, for example, market financial supervision and why the ECB was in charge of only monetary policy and nothing else. It goes back to 1997-98. I know Article 127.6 very well because it was intensely debated 15 years ago, although among academics it was seen as the last option. That is why, for me, this issue is easy. The Centre for European Policy Studies, one of the oldest institutions in Brussels, was created in 1983. I think that we are also one of the largest. We employ more than 50 people and have a total budget of about €9 million. Essentially, we are private. We participate a lot in tenders for the EU, for EU institutions and frameworks for research. We have a large corporate sponsorship list: if you want to see it, I have the latest activities report here. At the back, there is a list of members who support us. We have one of your Members, Lord David Simon, on our board. He is sometimes very busy and not always able to attend our meetings but, of course, he is on several boards. I do not know whether he is still on the Volkswagen board, but he is on the Suez board which is fairly important.

Baroness Prosser: We will have to get him to buy the drinks the next time we see him.

Karel Lannoo: We are entirely independent. We do not take a position as a centre: we take a position for the researcher which works with us. We have established a strong reputation in the financial markets, which I often say in Brussels but I say also to people in the UK. We have 10 people working full time on European financial regulatory issues. I can hardly follow everything because so much is coming out all the time. We also have experts on capital market regulatory issues, credit market regulatory issues and prudential supervisory issues, including CRD4 and Solvency II. Apart from that, we closely follow the whole monetary policy macroeconomic debate, climate change and regulatory policies, as well as migration, institutional issues and foreign policy. However, our main focus is on economic policy.

Q55 The Chairman: That is really helpful. We think that there are something like 31 dossiers alive in this area, so we will interview you for all. However, today is about the banking union and the RRD. First, would you define what you think the proposal for the banking union is about? What is the problem that it is trying to deal with and what success might it have?

Karel Lannoo: I wrote an article, which is on our website, which was published before the Commission's proposals were issued. I have only a couple of copies but it can be freely downloaded from our website. First, I will try to define the banking union, which, to some extent, is missing from this debate. Anyhow, it is not that special. If you look at other federations, the United States, Canada and Australia have all got a banking union. Germany and Switzerland are also federations which have a banking union. You may say certain things—for example, subsidiarity cannot be applied. Let us say that that be done only at the highest level because if there is insufficient, for example, exchange of information or co-operation, it cannot work. This compares to other forms of financial supervision. You can compare prudential supervision to product supervision or conduct-of-business supervision where this argument cannot be made. We see the same in other jurisdictions; for example, Canada is the best example. It has a full, unified banking supervisory model. It has a basically disintegrated securities market supervisory model because security markets have never seen so far, let us say, the argument to have an integrated single supervisor. They have some co-operation now but until recently they did not have any co-operation. For banking, Canada is probably one of the only jurisdictions in the western world to have escaped the crisis. It has always had, and we need to have, centralised banking supervision but conduct-of-business and product supervision can remain local. That is how it works in Canada. As a result of Dodd-Frank, in the United States we see more central banking supervision even than there was before. It clearly says in Dodd-Frank that banks with a balance sheet of more than $50 billion have to be supervised by the Fed. An anomaly of the US situation is that there remains a form of national or state supervision as well. We saw that clearly when a New York state supervisor imposed a fine on Standard Chartered. It is not a federal jurisdiction. That is already extremely important in the European debate. I am in favour of a banking union. We need to ensure exchange of information and co-operation between supervisors, which did not work sufficiently before. We have seen clear examples even here in Belgium in the Fortis case. That was the best example, which was initially used by the Commission to have the supervisory authorities. An even better example is to say that we need a banking union because the supervisors between the

Netherlands, Luxemburg and Belgium were not exchanging information. Apparently, the model worked out as a result of the crisis was not sufficient. We need a single, sovereign entity to be in charge of supervision—in this case within the eurozone—because otherwise it will not work. The intermediate solution of EBA has shown that it did not have sufficient staff, clout or power to impose a solution on supervisors and member states because they did not necessarily exchange information. The best example recently was Spain. Spain, like Canada, has been saying, "We have the best supervisory model in the world"; that is, until a year ago. Spain had been saying that, but apparently it was far from sufficient. Of course, it had some dynamic provision in the system. It had some €100 billion additional provisions on bank balances to cover for the real estate bubble but it was insufficient. Some people said that it needs another €200 billion. The report which came out on Friday says that it should be another €60 billion. Some people question whether that is enough. Bringing us back to the definition of a banking union in an EU context, if we look at it in the old way we may presume that the EU to some extent is a federal model. That will be the biggest change because, so far, we have functioned using the home-host model; that is, we have the home country supervisor and then the host country helps by exchanging and giving information, and doing local supervision for the issues for which it is responsible. Within the eurozone, we will entirely skip that. When that is completed we will have only one home country, which will be the eurozone. The supervisors of eurozone countries will all sit around the table as part of the same country. They will have the same responsibilities and liabilities under one single umbrella—the ECB. From that moment on, liability will move to the ECB and will no longer be with the national supervisors.

Q56 The Chairman: There is a huge amount to explore there. One of the things that has perplexed us, even in the short time that we have been here, is how realistic the Commission's timetable is to achieve this. Have you a view on that, or an ideal timetable if we are to move relatively quickly?

Karel Lannoo: Anyhow, the timetable is not the Commission's; it is the Council's. The eurozone Council decided at the end of June that this has to be done by the end of the year. The Commission has now worked out its proposals and said that it should probably only be in extreme cases, for those banks that receive state aid—there are quite a lot of them—from 1 January next year, then for the systemically important banks from 1 July and then for all banks from 2014. So there is a gradual step-over into a eurozone model. For my part, that is not so much the issue. As I said at the beginning, the ECB has been following this very closely because of this article in 127.6. For example, if you type into Google to find what was, in the former denomination of the treaty, Article 105.6, you will find plenty of articles, written in the early 2000s. In 2001, Tommaso Padoa-Schioppa, a well-known former member of the executive board, said it is natural for a central bank to be involved in prudential supervision. At that time there was a battle between the Finance Ministers and the ECB. The Finance Ministers came out in 2002 with a press release or proceedings of the Council of Finance Ministers saying clearly that supervision has to be carried out, where accountability is and where taxpayers' money is meaning in the hands of the Finance Ministers, not with an unaccountable institution such as the European Central Bank. The ECB has in the meantime stayed silent but has always been ready to do that. If the executive board says it is now open to that, I think they would go with that. As I said, in an article I wrote that is on a website, I have called around a bit in the ECB and the ECB is fully prepared to do it. Why do I not see a problem with the words "very rapidly"? First, the ECB is prepared to do it and secondly, it is a prolongation of what the ECB has been doing in other areas, like for payment systems where it is co-operating with the national central banks and securities settlement systems with the new target 2 system. So, basically, it is allowing the information flow to come to the highest level and there is no reason for the national supervisory authorities—most of them, by the way, national central banks—to stop the information at the national level. That was clearly the case with Spain. At the time that we discussed the European Systemic Risk Board in 2009—not so long ago—Spain was not the only country that asked that the ECB should not be allowed information about individual banks, but only in aggregate form. There is clearly an article in the ESRB regulation of 2009 that makes you suspicious as to why that was. They said that it was to protect the competitive strength of their banking system, but if you look at it now, it seems to have been just the opposite. That is why I have a lot of sympathy for the ECB. If the ECB wants to continue to provide its liquidity-proving operations, it needs to have the information about national banking systems. Of course, you could say the negative element of that is that the ECB will become far too powerful and, apart from monetary policy and macroprudential supervision, will also be in charge of microprudential supervision. On top of that, there is also the problem of accountability, which you also address in your note. You ask how we will organise accountability for the supervisory side, which is not the monetary policy side.

Q57 Lord Flight: On the structure, I am not clear whether you see the central banks of the individual countries such as the Bundesbank becoming a German division of the ECB for this purpose, or the ECB setting up its own organisations on the ground in Spain and Germany to carry out the supervisory tasks.

Karel Lannoo: No, it is very simple. The ECB has the authority, functions and multinational, eurozone-wide groups to execute its powers—for example, in payment systems and securities settlement systems. It has started to do this for macroprudential supervision and will soon do it for microprudential supervision. Rather than having colleges of supervisors for eurozone-wide banks on which every sovereign supervisor sits, I expect people to say "I am no longer a sovereign supervisor. I sit on the top. We work together with all these eurozone supervisors and there is full exchange of information, but I am the entity to decide in the end".

Q58 Baroness Prosser: You have spoken in quite positive terms about all of this. You obviously feel that the history of it and its future is something that you want to promote. What do you think should be the particular features of the framework that would enable it to be successful? Some of the people we spoke to yesterday sounded rather more doubtful than yourself about the possibilities of this working in a very positive way. That is one question. Secondly, you talked about flexibility of the timing and the timetable. What do you think about flexibility in terms of the nature of the institutions, such as the size of the banks and banks with different structures, et cetera?

Karel Lannoo: On the first question, to make it work, the Commission—and, in the negotiation process, the Council and to a lesser extent the Parliament—will need to be extremely flexible to work out the accountability structure and to make a clear division between prudential supervision and monetary policy. Monetary policy and accountability are entirely different and that is agreed worldwide. We need to have an independent central bank for monetary policy. For prudential supervision, it is a different thing. What I miss so far in the Commission proposals is a clear structure for accountability. How will they do that? Accountability for supervising Bankia or a German bank, and the way you have to respond to the public, is entirely different to the way you do it for monetary policy. Monetary policy simply says, "Inflation is this, hence we do that". For prudential supervision, like in the case of Bankia, you have to address for example the role of subordinated debtholders and what to do with it. You have to be able to come before the public and explain what you have done, which may be much more time-consuming than explaining a monetary policy stance. On top of that, you may need to use taxpayers' money. The taxpayers' money in the case of the ECB will be the European Stability Mechanism, where you have no joint liability but every member state of the eurozone has its share in it. It can be used in ultimate circumstances to bail out banks, as it has now been decided for Spain. What about the flexibility of the timing and the nature of institutions to be supervised? I would not make any difference between large institutions and small ones. The manner of supervision should be exactly the same, meaning that you apply the CRD4, the Basel rules. Of course, the intensity will be entirely different. We know very well that not only extremely large banks had problems in this crisis, but also mid-sized banks. Look again at Spain and also your own country. The manner should be the same for all banks but, of course, a Deutsche Bank will be much more intensely supervised than a small Sparkasse in Germany. Even so, the information that the ECB has and the calculation of the capital adequacy should be exactly the same. There should also not be any way to say, "Look, we will only have the information of large banks, and therefore we will not have it for small banks". That is a debate we are having in Germany at the moment. Sparkassen, which have 45% of deposits in Germany, are saying that they should not be under the supervision of the ECB. That does not make sense to me. We have also seen in 2008 and 2009 that many of these smaller banks in Germany have made huge losses. If it comes to accountability, the ECB will be taken to be accountable yet without having the information. You cannot do it like that. You cannot have a two-tier system. It is already extremely confusing in the eyes of European citizens as to why this has not worked so far. We have been speaking about the single banking market for 20 years since 1992. What is not single today? Apparently, supervision was, after 20 years, far too divergent.

The Chairman: Before Lord Hamilton, would you pursue the point about accountability, Lord Jordan?

Q59 Lord Jordan: Yes, because the proposed package of powers you referred to is seen by many prominent people as going too far in creating too powerful an institution, they could be assuaged if they thought there was sufficient accountability. There is as much criticism about the lack of accountability as to the amount of power this new body seems to have. What are your views on whether it will be too powerful, as some people say, and how to restrain the exercise of powers of that nature?

Karel Lannoo: On whether it will be too powerful, that may be, but it is the institution which in the eurozone context has the most credit left. Again, as I said at the beginning, the Bank of England in your country has also received more powers, notwithstanding mistakes that were made in 2008-09. The Federal Reserve also has more powers, notwithstanding, to some extent, having caused the credit bubble in the period 2002, 2003 till 2007 by not acting. We know that it has received a lot of criticism but it also received more powers. Apparently, we have not found another solution, so what do we do now? Do we put it all under a single roof and make a structure by which there is sufficient control and sufficient testimony before the European Parliament and other bodies to explain what it is doing and then make a clear separation within the structure? I have proposed something in the paper to say that the president should be in charge of monetary policy and the vice-president—Vitor Constancio today—should be in charge of prudential supervision. The Commission has worked out something different—a kind of separate supervisory board. It would be useful to separate it person-wise so that there is clearly one person in charge of monetary policy issues and another in charge of prudential issues. That person should then have a board or a comity below him saying who is in charge of those matters. It would also make it clear to the public who is in charge. That is not how it has been worked out. I heard yesterday that Draghi wants to keep it all under his control, but that is because he comes from an Italian context, and it has always been the case in Italy. That is also why we should not be too confused about this move. The majority of the central banks in the eurozone are also prudential supervisors. Spain has probably not done it well but Italy has certainly not done it as badly as Spain.

Lord Jordan: But do you believe that the present proposals contain enough accountability?

Karel Lannoo: No. The Commission's proposal shows that it is a bit in there, but not sufficiently. The Commission should have been aware of this concern and should have tried to be more imaginative in its ideas. It should have proposed a clear schedule as with monetary policy with testimonies before the European Parliament every three months. There are many areas where there could have been more imagination but Article 127.6 is not a co-decision article, so the Parliament is not involved and the Commission can basically do what it wants. It is under the orders of the Council. The Commission in general looks at the member state when it makes proposals, not sufficiently at the European Parliament. That is my feeling over the past year on European Union-related issues.

Lord Jordan: Could that be changed with one or two proposals?

Karel Lannoo: It could be a matter of a few articles. The fact that the Parliament reacted immediately and so aggressively saying that it should be a co-decision just because of the changes to the EBA regulation means that the Parliament was not happy in how it had been treated in this proposal.

Q60 Lord Hamilton of Epsom: Can I just tease out the supervisory role and executive action? Let us grossly oversimplify that. The ECB comes to the conclusion that Bankia in Spain should be put into liquidation and I understand that that is the job of the Spanish central bank which refused to do it. How does that work out?

Karel Lannoo: That is why we have a federal structure. Who is in charge in the end? It will be the ECB. There was a controversy last week in a Spanish newspaper and also in one of your newspapers about a meeting of the three triple-A Finance Ministers in Helsinki. It said that first the bank will be restructured and then support would be provided. I have never understood that that was any different since it was agreed at the end of June until today. Has there been a debate in Germany about using ESM as a mutualisation of the debt? No. First, there is no joint liability in the ESM. On top of that, clearly we apply state aid rules. State aid rules means that there is, first, restructuring, a contribution by the state in question and bail-in, which is also a burden to debt holders. Basically, the Spanish Government and the Spanish authorities have been misguiding public opinion that it would be better at 100%. Apparently it has not yet been settled. I had a discussion with a colleague yesterday about the Oliver Wyman report. I do not think that Spain campaigned for 100%. Bankia has a loss of almost €24 billion. You have to have joint responsibility; you have to restructure the bank; and you have to split off some parts. That is why it is good that we have no structure as the ECB that will be clearly in charge and will have to intervene. Probably it will have to delay just to calm the sentiments in Spain, but it will have to take a decision and in the end liquidate parts. That is in the 28 June Eurozone Council decision on state aid rules. We have also learnt from the British context that we have not applied state aid rules sufficiently strictly—certainly in the beginning of the crisis. What we learnt from 2008, we do not have to repeat the same mistakes.

Q61 Lord Kerr of Kinlochard: You talked about the desirability of Draghi not being responsible for this dossier. You are not happy with the proposal for a supervisory board loosely linked to the governing council. How do you see the effect on the EBA? However the ECB positions are formed in the ECB Council, or by a subset of the ECB under a specific vice-president—the representatives from the competent authorities who sit in the EBA from Eurozone member states will in future be speaking to a common position, arrived at somehow in the ECB? What effect will that have on the EBA and the single market?

Karel Lannoo: First of all, I would never have changed this EBA regulation. The Commission has opened a can of worms and created more problems than it has solved. The Commission has said that it is not its responsibility but that of the Council. Technically, this was a mistake, even more so from a practical perspective. EBA's mediation power will no longer have any importance once ECB is in place. You know well that you never see the EBA mediating between the ECB and the Bank of England. In which other cases will it have a role? In a new member state? New member states are basically controlled by western European banks, so it remains probably for Sweden. There are not many cases where the EBA could have a role. It will be squeezed between two big regulators or supervisors. Even between the Swedish and the ECB supervisors, what could the EBA do with a staff of 50 or 60? I would never have thought of this. We have to accept that the EBA will essentially become a standard-setting authority. That is basically its role. According to the treaty, its role is in helping the Commission in standard setting. They are regulatory not supervisory tasks. Mediation is a supervisory task. It is a grey area but it is basically supervision, not regulation. Also, initially the Commission did not want to speak about the ECB. That is very interesting if we are to look at the memoranda published by the Commission at the end of June about the banking union. The word "ECB" is not in there and neither is Article 127.6. Barroso says that he is the initiator of this idea but he has never mentioned the ECB. The way I see it, initially we want to have a structure by which we save our baby—the EBA. But because of the Meroni doctrine there could be a problem with the EBA having supervisory powers. We have tried to circumvent them but in how we do it today the problem is cleared. We say that the EBA is an executive regulatory authority and that the ECB is a supervisory authority. That is the distinction: the ECB should not be a regulator; it is a supervisor. From that perspective it is also useful. I would leave it to a decision between Barroso and the Council, and eventually the European Parliament. That is also where this issue of accountability comes in. Why is the Parliament concerned? Parliament has more accountability in the EBA structure than the ECB structure. To return to your question, that is why a more imaginative solution of accountability for Parliament in the ECB structure would have been desirable, but I do not see it for the time being. Have I responded to your other question?

Q62 Lord Kerr of Kinlochard: You have more than responded, and I agree with what you said. If you take the proposal as it is and assume, as I suppose we must, that it will be pursued, how do you see new voting rules inside the EBA working over time? I find it very hard to see, because the idea of a double system, with each side having a bloc, works only if the blocs are of constant size. But if one bloc is seeking to shrink as fast as possible, the blocking power—a diminishing power—given to it seems to me likely to become highly unattractive to the majority. Therefore, it would seem to me to be unlikely to make sense as a proposal now and to work in practice over time if it were implemented now. How do you respond to that?

Karel Lannoo: Yes, but, again, if you start with the reason which I have just laid out—let us say that the EBA is essentially limited to regulatory issues—we were content to follow the Council structure for regulatory matters, even for secondary legislation. It should not be a matter of saying, "Look, the ECB has so much and the rest of the eurozone has so much". In the end, on regulatory issues, say, member states' votes are sovereign but not on supervisory issues. That is why I would have left it untouched.

Q63 Lord Kerr of Kinlochard: I understand, but we are where we are. The proposal is on the table. What sort of workable outcome can you see? I agree that it is not the right thing to be doing but nothing is going to be ideal. What is the best you can make of this mess?

Karel Lannoo: The way the Commission works, you could have some blocking minority or some way of taking into account dissenting opinions. On the other hand, you could say that even within the eurozone there can be a difference of view on regulatory issues. Germany may have a different view from that of France and feel that they should not be on one line. Of course, that will be less and less likely. But what is also important is that Article 127.6 has to be voted in unanimously. Why? Because it is related to monetary union. All those who are not part of monetary union within the EU have derogation. Essentially, from the Commission's perspective, the Commission should be legislating for the 27 or the 28, not for the 17, because basically all those with derogation will one day become members of the monetary union, which means that the legislative framework should be the same for all of them. There should not be any difference between the 17 and the 27. That is the assurance that the Commission has to give to the others, saying, "We'll continue to do the same for everybody because we have derogation, with the exception of two member states—the UK and Denmark—but essentially we'll do the same for every member state". That is probably why, for example, Barroso did not mention the ECB—because the Commission wanted to retain some powers as compared with the ECB and also the Commission acts for the Union, not for the 17. It has to make sure at all costs that there is no growing friction between the ins and the outs. Another thing is that the Commission has not sufficiently worked out the question of non-eurozone member states eventually opting into the ECB structure. For example, regarding the Poles, the Hungarians or the Danes opting in, it does not have anything to say about supervisory matters. It will have to be imaginative in working out a structure if the Hungarian supervisor becomes a member of the ECB supervision, because that of course would be extremely complex.

Q64 Lord Hamilton of Epsom: Looking back on the ESM, if you are suggesting that that would be the fund that would bail out banks under this system, is there a risk that it might run out of money and that we might reach a point where the Germans would say, "Hold on, we thought we'd pinned the amount of obligation that we had to doing this and now more money is being demanded from us?". The Germans have said that it has to go in front of their Parliament if there is going to be any increase in their contribution. Is it a worry for the Germans that constant calls will be made on the ESM to bail out banks right across Europe but it will run out and €500 billion will not be enough?

The Chairman: I know that Lord Flight is going to look at the recovery resolution in a minute but he wants to come in with an earlier point, perhaps on the back of Lord Hamilton.

Q65 Lord Flight: I think that you are saying that, under your model, the Commission can act under Article 127.6 and tell the ECB to get on with it. You are saying that you think the regulations should cover the whole EU but, first, I am not quite clear whether you are envisaging the ECB immediately supervising non-eurozone banks as well as eurozone banks, and, secondly, I still want to know what will happen to the central banks. I do not see the Bundesbank sitting by and being ignored. What task does it have left?

Karel Lannoo: First, on the ESM and whether it will run out of money, I think that that is a bit less likely today after the ECB's decision in early September because the ECB can buy bonds on the market. The problem would have been there if interest rates in Italy and Spain had risen to very high levels but this situation has come a bit more under control. Of course, we know that there is a huge debate in Germany about this but I see the ESM also as the resolution entity of the last resort. You know that the Commission proposal says that every member state needs to start a resolution fund. Of course, some member states have it. Spain had one but it has already been exhausted, or it is already indebted to the state, but others do not have one at all. In the meantime, we can use the ESM as a very last resort, but it is always the case that if you have to liquidate a bank you first have to try the private sector solution before you can look to the public sector solution. That is also part of the EU's state aid rules. However, my view on the whole recovery and resolution debate is that the Commission made this proposal on 7 June, which was already some weeks into the banking union debate. But mostly it was starting with a national resolution authority, and so far it has not made any attempt at addressing deposit guarantee systems. Apparently it was on the table but you can ask Monsieur Barnier about that this afternoon. It was on the table but was retracted at the last minute. I think that we could have far more funds and also be much more credible if we had at least a eurozone-wide deposit guarantee resolution fund funded by the private sector than if we had a diversity of national funds. We have to deal with the question of which banks pose the biggest threat—the 60 or 70 systemically important banks—but we have to act immediately. In case of crisis we have to sit down at the table today with all the resolution authorities and say, "Look guys, how much can you put in?" We have to have a whole weekend of discussions and then at opening time on the Monday we have to say, "Look, we have found an agreement". But it is far too late. That is the problem that we had with Fortis. In the case of emergencies, you have to be able to act extremely rapidly. For example, if you are going to have a Spanish or a Danish model, you need a combined deposit guarantee resolution fund which is entirely private, funded by the banks on a percentage of deposit guarantees or, say, a percentage of the size of the bank for the resolution trust. Today, you would have to start at over €100 billion and then grow it over time. The problem, however, is that some member states have pre-funded deposit guarantee schemes and others have post-funded schemes, so there is no single solution. As I said, the Commission has not dared to make any far-reaching proposal for the time being. You asked about the central banks and what is left in the way of powers. Basically, for me that is a non-issue. Supervision is a matter of co-operation between the ECB in an ESCB context and in a European system of super-central banks context. So the ECB is not acting alone. The supervision of German banks would essentially be arrived at under the German Bundesbank, which of course does so in co-operation with Bafin, or for France with the Commission Bancaire. Compared with the situation that we have today, there would be a big advantage if the Commission proposal put in place more European-wide or international colleges. It should get away from the home bias as regards supervision, where there was a French supervisor essentially supervising French banks and a German supervisor essentially supervising German banks. The Commission proposal should get rid of this and have a much more neutral and distant structure for supervising banks.

Q66 Lord Flight: So you are putting this ECB role on top of the existing central banks and not having it exercise it independently from Frankfurt?

Karel Lannoo: I quote from my article a sentence concerning the way the ECB is exercising the supervision. I cannot find it but it says that the ECB, in an ESCB context—there is a protocol of the ECB statute—basically carries out day-to-day tasks in co-operation with the central banks which are members of it. Basically, that has worked very well for 15 years.

Q67 Lord Flight: Let us take Spain. It is pretty clear that it will have to tell the central bank of Spain what to do with no messing about. The other question was about eurozone and non-eurozone members of the EU.

Karel Lannoo: There again, I would say that the Commission has not been sufficiently imaginative in doing something for the ones that want to be under the ECB but are not members of the eurozone, giving them something more to say. I see that at least two or three member states have said that they would like to be part of the ECB supervision, at least if that meant that they would have more of a say or at least if it meant that the structure for resolution and deposit guarantees was more unified. But that has not been met at the moment.

Q68 The Chairman: Before I ask Lord Marlesford to close our proceedings, do you have any thoughts on the recovery and resolution directive? The UK has particularly identified the special manager mechanism, which seems to be fraught with danger in as much that as soon as you appoint a special manager you embarrass the bank.

Lord Flight: The bank is dead. Once you appoint a special manager, who will trust that bank? They will know that it is dead.

The Chairman: If you could just tell us about the impact of the RRD on the banking union proposals. What is the relationship, if any, there?

Karel Lannoo: First of all, it is a good step that the Commission has made this proposal after two or three years of consultation. It took quite some time and should have been there before. I said already that it was already overtaken by events—by the eurozone banking union. But it is very good that, at least, we will have a common structure in place to say from which point onwards there is a banking problem, what should be done by the supervisors and what are the means to act. We did not have anything sufficiently comparable in the EU so far. Every member state was acting alone. That is why it is very useful that we have a structure now in place, like there is in the United States, for prompt, early and corrective action. Once the capital level falls below that, we act and so on. However, there are some things that I still find fairly weak. The weighted risk ratios have been referred to—the risk weighted asset ratio of Basel 1. The Commission's proposals on CRD4, there is no leverage ratio. For these kinds of situations, you need to have a clear leverage ratio. In the case of Dexia but also in the case of some other banks, a risk weighted ratio blurs the picture. You do not see exactly how much capital a bank has. Then there is the issue of who then has the powers to intervene. The Commission has essentially left it to each member state to appoint an authority, but what do you do with multinational banks? The home-host issue there could become extremely sensitive. It was already sensitive in 2008-09. The financial crisis does not really overcome that in this proposal the way I see it. Also, there are certain issues which have not been adequately addressed, such as shareholder rights, which have not been harmonised at European level. It is extremely difficult. It may also, as you have pointed out in the Lords, have links to tax issues. What do you do then? Tax is a unanimity matter at European level. Yes, it is a very good first attempt. We need to have something similar, but the Commission could go further.

Q69 Lord Marlesford: I want to ask you about the impact on the UK. You said right at the beginning that the ECB is ready to fulfil its supervisory role. When you said “ready”, did you mean willing or equipped? Frankly, I know you have been referring to the continuing role of the national central banks, but it is very hard to see that they can in anything like the timescale envisaged equip themselves to be able to supervise. In Britain, we are in the process, probably, of moving the supervision of banks from the Financial Services Authority back to the Bank of England. The need to be close to what you are supervising and really understand it seems to be paramount. The FSA, if it has failed—and in many ways it has—has done so because of box-ticking. Box-ticking is not really the way of getting inside it. The phrase we used sometimes in the old days of the Bank of England was “the Governor’s eyebrows”. If the Governor raised his eyebrows, that was the end of the discussion. Everyone conformed at once. The British Government have decided that they will not join the banking union itself and they do not believe that that will adversely affect the position of the City of London. I would like to know whether you think that it is reasonable to assume that on the other basis that London is one of the three world financial centres. The rest of the EU does not have a world financial centre—the three being London, New York and Hong Kong. The City of London is different. Would you like to comment on those points?

Karel Lannoo: First of all, on the ECB’s readiness to exercise supervision, as I said already, it has been waiting since 2001. Also in the debate on EBA in 2008 and 2009, the ECB was already insisting on more powers and was not been given them by the Commission and the member states. It is not a matter of only being ready. It has been waiting for the necessary resources.

Lord Marlesford: It has the resources.

Karel Lannoo: It also has a prudential supervision department, which is as big as EBA or bigger. On top of that, there is a director-general and below that several directors and several heads of unit so it is a large department.

Q70 Lord Marlesford: Wait a moment. Frankly, if you have not had powers, you are hardly likely to have the people in position to exercise powers that you have not had. Otherwise, what have they all been doing? They may have some people concerned with supervision, but we are talking now about a new role and we need some time to get people actively to carry out that role.

Karel Lannoo: Yes, I know, but this new role, as I said several times, will be carried out within the structure of all the other tasks that they have. Take liquidity providing operations. If you have to check collateral, a bank takes liquidity from the ECB at ECB level. This bank says, “I have collateral there and there and there”. The authorities within the national central banks have to check in many different places, but effectively this is the case. Something similar will now be put in place for supervision. They will say, “I have the powers but you have to check there and there and there what has been done”, but under one single set of rules. For example, for liquidity-providing operations, we have seen so far, like with the Bank of England, what has been acceptable as collateral has been expanded, but that has functioned fairly well. We have one set of rules for what is collateral within the eurozone. Now we have said, “We will do the same: we will have one set of rules for how you supervise the banks”. One of the things that had not been supervised or harmonised sufficiently was accounting rules. You could not compare accounts sufficiently even after international accounting standards and after so many harmonising rules from Brussels because every bank supervisory authority does it in a different way. There it can take over some work that EBA has done in its COREP and FINREP proposals to make sure that this is now comparable. But EBA did not have sufficient powers to say, "This is level 2 capital and this is superannuated debt". There is an authority that effectively has the authority to say what something is and how it will be interpreted. Not like the EBA saying, "This is what this is", and the Bank of Spain says, "I could not care less about what you are saying". That was very often the case until today. I understand the UK situation to a certain extent. The benefit for the UK of having the ECB in charge is that you have a clear structure. You do not have, for example like Deutsche Bank or the other French banks that are active in the City, to deal with many different national regulators; you have one clear interface. On the other side of the Atlantic, your interface is the Fed, mostly, and on this side it is the ECB. It will facilitate communication enormously. The only thing I have my doubts about is whether the UK is still committed to the single rulebook. I heard Mark Hoban, who was here on 9 July, say very clearly, "We need proportional regulation and minimum standards", and I was entirely confused. On this issue of derogation, we can have a functioning banking union only if we have almost the same rules for everyone. Of course, there must also be some degree of implementing powers for EBA or whatever, but they should be the same rules. There can be no difference. This exercise will be extremely important for the UK, a country that supports competition.

The Chairman: Karel Lannoo, I know that the clarity of your answers to the questions that the Committee has put to you has impressed my colleagues. Occasionally, you have done a very fine job of raising our eyebrows and helping us think a little bit about some of these issues. We are most grateful to you for coming. We will, as I intimated before, send you the transcript. If you have anything to correct—or add because you have further thoughts that might be useful to the Committee—please do. Thank you, too, for the information that you brought along today. It has been a stimulating and enjoyable session for us.

Karel Lannoo: Thanks a lot: it was a pleasure. I will leave this book here, which is to do with the Liikanen report. It is commentary but if you would like more it can be found on our website.

Centre for European Reform and Open Europe—Oral evidence (QQ 195–208)

Evidence Session No. 12 *Heard in Public* *Questions 195 - 208*

TUESDAY 23 OCTOBER 2012

11.30 am

Members present

Lord Harrison (Chairman)
Viscount Brookeborough
Lord Dear
Lord Hamilton of Epsom
Lord Jordan
Lord Marlesford
Baroness Prosser
Lord Vallance of Tummel

Examination of Witnesses

Mats Persson, Director, Open Europe, and **Philip Whyte**, Senior Research Fellow, Centre for European Reform

Q195 The Chairman: Colleagues, let us resume. It is my great pleasure to welcome Philip Whyte, who is a senior researcher at the Centre for European Reform. Thank you very much with coming to help us with the banking union and the recovery and resolution directive. We also have a familiar face in Mats Persson: he almost has an Oyster card to this Committee, so regular are his visits here. We are grateful to you both for coming. Perhaps Mr Whyte has picked up that we make a transcript of this exchange of views, which we pass back to you. Please correct that and if you can furnish us with additional material, we would be most grateful as we are now in the closing stages of this report and it would help in our deliberations. Perhaps I could ask Mr Persson, as a starter, whether you could help us to define the banking union as proposed and concerning the timetable. Is the sequence of events, as proposed within the Commission and Van Rompuy's papers, achievable?

Mats Persson: I wish I could be more helpful on those questions than I can but I do not think that anyone knows the exact answers, and that is Europe's problem. If you look at the definition of a banking union, the basic idea is reasonably straightforward. You have two steps: first, a single supervisor, which will be the ECB; second, a joint backstop for Europe's banks involving a resolution structure and a deposit guarantee scheme, which will be subject to some sort of cross-border liabilities. It will mean either one banking system being liable for another country's banking system or taxpayers in one country underwriting a banking system in another. You can see why that second step is so controversial, which I am sure we will get into in more detail. That, I would say, is the basic two-step definition.

It has been rightly noted by people from across the political spectrum in several different EU countries that the timeline, as originally envisioned, is hopelessly optimistic. The idea that this will be in place on 1 January next year is silly. After last week's EU summit, it is quite clear that that is not going to happen. The question is: when will the first step be in place? The truth is that we do not know. It might be at some point after the German elections, if we are lucky, or even later. I do not think that it will be in the first half of 2013, so the timeframe is very optimistic and has been so from the start. That is even before we start to discuss the second step of the banking union, which is the joint backstop.

In terms of the sequencing, which I am sure we will discuss in more detail and to which the German ambassador alluded towards the end of his remarks, it is clear that oversight should come before solidarity. It will be oversight and supervision first, then cash later. That is the effective German sequencing, both when it comes to fiscal union and to banking union. I do not think that is negotiable. It is what is going to have to happen but is problematic for all kinds of reasons, because it would not have the resolution and supervision at the same level at once. It would be a mismatch between resolution and supervision but for political reasons that sequencing, for better or worse, has to take place.

The Chairman: Do you share that pessimism, Mr Whyte?

Philip Whyte: Yes, and in some respects I am even more pessimistic. Let me explain why. It seems to me that there are four elements to a banking union: common supervision, a common fiscal backstop, common deposit protection and a common resolution regime. Sitting at the back and listening to the German ambassador, what really struck me was that if that is what you understand by a banking union then Germany does not believe in one. It believes, and has just about conceded, that you can transfer responsibility for supervising systemic banks, particularly in the eurozone. However, it does not believe in a common deposit protection scheme or a common resolution authority, or in having a common fiscal backstop to the eurozone. The question then is: is Germany going to get its way or, as has been the case to some extent for the past two years, is it going to have to give way on some of these issues over an extended timescale? Certainly, in terms of setting up supervisory responsibility for eurozone banks the timescale being mentioned is hopelessly optimistic. You could have some elements of it emerging during next year but if we think that this is part of the solution to, say, the Spanish banking crisis at the moment then that is pie in the sky. There is no desire whatever at the moment, certainly in Germany, to use ESM or the embryonic banking union as a way to resolve the Spanish banking problem.

The Chairman: The integrity of the single market is very important to this country and it was interesting that the German ambassador spoke about that very early on. Is that achievable under the proposals?

Mats Persson: On the first proposal, yes. There are clear risks involved in having fragmentation of the single market, particularly if the ECB starts to enter into single market territory and the line is not clearly defined. Intellectually, however, it is a quite confusing proposal from the Commission. It talks about the banking union as a way to supervise systemic risks and being the tool for macroprudential supervision; at the same time, it also seems to suggest that it is a way to deepen the single market. That confusion is perhaps semantic at the moment but it could create problems down the road, so there needs to be much clearer intellectual and practical division in these proposals between where the single market ends and where supervision starts. One is about macroprudential supervision; the other is about trade-facilitating regulation. Those are two separate things. The Commission needs to be clear in its proposal and in its language when talking about it.

Philip Whyte: I would say two things. First, on the vision of the banking union, it seems that Germany's vision is compatible with Britain's continued membership of the EU and therefore the single market. That is partly because it does not require a bunch of functions to be federalised and transferred from national level to eurozone level, so that sits quite well with Britain's vision of things. On the other hand, I am not sure that Germany's vision of things is compatible with either the survival, or at any rate the good functioning, of the eurozone. So long as you have all these functions carried out at national level—resolution, deposit protection and so on and so forth—you will continue to have an unstable relationship between states and banks in part of the currency zone.

The Chairman: This is a bit of a sideways question but when we were taking evidence in Brussels recently, the Liikanen report was published—indeed, Mr Liikanen has been in the Palace of Westminster recently. How does that help or otherwise what is proposed here?

Philip Whyte: I am still thinking through the consequences of this issue but you can probably think of three scenarios. The first scenario is one of broad correspondence in which the EU implements Liikanen in a way that does not really require any change to Vickers. The second is one of conflict, in which the EU implements Liikanen in a way that requires us to change Vickers. The third is a form of co-existence, but that will perhaps subject certain cross-border banks in the UK to two different ring-fences.

The Chairman: But it is nearer to Vickers than to Paul Volcker.

Mats Persson: Yes, and there are a lot of overlaps between the two. A lot of the ideas in Liikanen are familiar to anyone who has been involved in the debate about how to stabilise the UK banking system. We quite like some of the ideas in the Liikanen report: the ideas about a bail-in, where you would subject shareholders to losses, and that you pay some executives in bailed debt so that they are the first in line to take losses, rather than taxpayers. All these ideas are quite attractive in principle. Intellectually, there is some conflict between the two yet they are quite consistent, broadly speaking. Whether Liikanen is implementable is a wholly different matter. It is about whether you can actually implement some of the quite sensible proposals in Liikanen rather than whether there will be conflict with Vickers at this point, at least.

Q196 Viscount Brookeborough: We all agree that a supervisory framework is a very important part of this. The European Commission has presented proposals for the single European banking supervisory framework as being a key element. The Commission proposed that it will become responsible for all banks, regardless of their size or model. Do you agree with that approach and in what way do you think it should deal with the banks that have a more systemic importance?

Philip Whyte: I am happy to go first. As you say, in the original proposal the Commission wanted total coverage and ran up against a number of member states, in particular Germany, which wanted a relatively narrow coverage for perhaps 25 systemic banks. What we have is some sort of compromise. It is still not quite clear to me how the cake will be sliced in the end—a cake in which the European Central Bank has ultimate responsibility but in which day-to-day supervision will be carried out for the vast majority of banks across the eurozone by national authorities.

The question is: on which side of the fence will the German Landesbanken and all the Spanish cajas fall? The problem I foresee is that we have seen quite a lot of regulatory forbearance. These institutions in Germany and Spain have strong links to local politicians and are important elements of the local credit system, and politicians are very reluctant to have a European authority take responsibility for them. I am not quite sure on which side of the fence those sorts of institutions are going to fall. My problem is that if those institutions remain under the purview of national authorities, we will continue to see what we have seen for the past three or four years: policies of forbearance driven by local political considerations.

Viscount Brookeborough: But the Commission believes and argues that recent experience has shown that the small banks can have a very big effect when they go wrong. How is one going to decide which category those would have fallen into? If it looks as if it is going wrong, who is going to admit that it is and have oversight over it?

Philip Whyte: If you look at the European banking system, the 200 largest banks in the eurozone account for about 95% of total banking assets. When you are talking about the eurozone banking system, well over 5,500 of them are real tiddlers. You could close them down and it would probably not cause a systemic crisis if they ran into trouble. I suspect that, in time, you could have a system where the ECB is responsible on a day-to-day level for something approaching the 200 largest banks in the eurozone and national authorities are responsible for the rest.

Viscount Brookeborough: So you would really have a two-tier system.

Philip Whyte: Yes, exactly.

Mats Persson: I agree with a lot of that. Practically, the ECB cannot manage all 6,000 banks. It is a very small organisation, so there will have to be an element of outsourcing with some sort of ultimate responsibility resting with the ECB. But it is quite right, in principle, that while the largest banks are by far the most important to keep an eye on—at least initially—the political tension arising from regional savings banks needs to be dealt with sooner or later. There has to be a clear division of labour between the ECB and national supervisors. If a situation arises around a caja, for example, does the ECB have final responsibility? The EU is years away from solving that tension. However, will member states also agree to give up so much control over their major banks? That is a big issue as well. When it comes to it, will France really allow the ECB to take effective control over its three large banks if, heaven forbid, it ever came to that? So on the small banks, yes, but even before we get to a position where we can talk about them we have to clear up what kind of control the ECB will have over the big banks, which is an open question.

Q197 Lord Marlesford: When we went recently to Brussels, I, at any rate, felt that there were two big defects in the thinking of the Commission. One was that it was not clear on the crucial distinction between setting the rules—the regulatory function—and supervision. Secondly, it had not begun to work out the nuts and bolts of how that supervision would work, which was revealed by the fact that it proposed that the banking union should come into force on 1 January 2013. Obviously, to a large extent it will be a matter of supervising the supervisors rather than doing the supervision. What do you feel about the draft rules laid out so far for the ECB? Are they clear and comprehensive yet? Will they result in it picking up things which it is extremely difficult even for the managements of banks to pick up, especially when doing it remotely? Would you like to comment on that?

Mats Persson: I agree with you. There are a huge number of issues in these proposals that need to be addressed and a huge number of questions that need to be answered. Fundamentally, there is no guarantee that the ECB will do a better job of supervising banks than the national supervisors did; also, the proposal does not deal with another big issue involving the ECB. That is the reliance of a huge range of eurozone banks on cheap ECB liquidity to stay afloat. That fundamental problem is strengthening the link between the sovereign and the banks, not loosening it. The initial proposals provide very few answers and a lot of questions.

The Chairman: Mr Whyte, do you share the countervailing view that Mr Persson has there?

Philip Whyte: Yes, to a large extent. It seems that the haste in all these ambitious timetables that everyone seems to want to work to is really governed by the Spanish problem, rather than an attempt to deal with that separately and come up with an arrangement that works. The problem is that even a year or 18 months down the line, if discussions over banking union have become an excuse for not addressing the Spanish problem and allowing it to fester, those discussions will have been positively counterproductive. When it comes to the details of all this, the broad blueprint is that you have national authorities being responsible for things such as the conduct of business and money laundering and, to go back to what I was saying before, probably supervising on a day-to-day basis the vast majority of small banks. The ECB will then in time assume responsibility for directly supervising whatever number of larger banks in the eurozone that we are talking about. Even under that system, you can see all sorts of conflicts emerging between the national authorities and the ECB, particularly going back to the example that I gave about regulatory forbearance. The ECB may have fewer qualms about closing down, say, an insolvent German Landesbank, than the German authorities necessarily will have.

Q198 Lord Jordan: We keep coming across the problems that the relationship between the proposed supervisory body and the ECB may pose. The supervisory body will be under the control of the ECB. One of the first questions is: is there a danger that under this institutional arrangement supervision will be subordinated to the monetary policy function at the ECB, and that it will think that more important? In Brussels and with witnesses that we have seen, the question of accountability has also been raised. The supervisory board ought to have separate accountability—to Parliament in particular, we were told by MEPs. What are your views on this? We are creating a very powerful body, so powerful that it may believe that everything about supervision is its job and that no one else must touch it. That is a dangerous step.

Mats Persson: Yes, I am very concerned about that and I have a lot of sympathy with the Germans on this one. The sole reason why this is the case is that in order to comply with the treaty article under which the ECB, as a single supervisor, was founded it will have to be set up like this. You may otherwise have to move towards treaty change and, for a whole range of reasons, EU leaders want to avoid that—partly because of the stuff that is taking place in this Parliament. That is the rationale behind it, not any economic or political or other reason that will help the division between supervision and monetary policy.

There are several risks in this and you highlighted most of them. However, to emphasise it a bit more, the ECB will be in charge of all these different things: the OMT, which is the programme allowing the ECB to buy short-term debt from Governments; the LTRO, which is the cheap liquidity provision for banks; interest-rate setting; and collateral demands on banks in order to access liquidity. In addition, it will be the ultimate voice in the supervisory structure of eurozone banks. It is unheard of to have a supranational organisation with those kinds of powers but without any clear accountability mechanism, so clearly that creates problems.

Secondly, the conflict of interest is there as well. You could see a situation in the current economic climate in which the ECB, for example, wanted to loosen monetary policy and spray the continent with liquidity in order to get borrowing going both to Governments and to small businesses. You can see the temptation for the same governing council to also loosen the supervision structure—for example, with capital requirements—in order to reinforce that kind of lending capacity or provide another incentive for banks to start to lend. If you are sitting in Berlin, that is a nightmare because if you have a supervision structure being loosened, they may like that in the short term but it creates all kinds of long-term problems for the ECB's independence. That conflict of interest is very problematic and it can work the other way round, in using monetary policy to enforce supervision. To be honest, the worrying part is that there is no clear way out of it at the moment without a treaty change. That links to my final point, about accountability.

Clearly, the supervision structure needs to be accountable to something whereas monetary policy should be independent. At the moment, that is not working either. The supervision part of it will not be accountable to anyone in particular because the ECB is independent. That needs to change as well, but again it is very difficult to see how that can happen without a fundamental rewriting of the ECB statute.

Philip Whyte: Going back first to the structure—the relationship between the supervisory board and the ECB governing council—that is not so much an attempt to subordinate supervision to monetary policy as an attempt to square the circle, in that you might have certain non-eurozone member states deciding to join the banking union and therefore having to be part of some sort of body that is helping to formulate policy. The structure at the moment is that the ECB governing council will take the decisions based on advice that this supervisory board might give to it. The question is whether the pre-ins or the eurozone-outs, whatever you want to call them, that decide to join this single supervisory mechanism are happy with such a subordinate role. When you listen to the Swedes, the Poles and the Hungarians it is pretty clear that they think it pretty unsatisfactory. As far as they are concerned, it does not really help to address their problem. Although they understand that they are not part of the eurozone, if they are to join the banking union they clearly want to have some sort of active decision-making.

The arguments for greater democratic accountability are pretty compelling. As Mats said, the ECB will potentially have a huge expansion of powers. It is pretty clear that an institution of that nature should be accountable to legislative bodies. The European Parliament is probably going to fight very hard over the course of the next year to make sure that the ECB has some lines of democratic accountability to it. One question that strikes me is: if individual member states are to continue to be responsible for bailing out banks—rather than, say, a European fund—should the ECB be responsible to national Parliaments as well as to the European Parliament? The other thing that strikes me is that this will have big implications for the UK because a lot of eurozone member states are very reluctant to have the European Central Bank accountable to British MEPs. After all, Britain is going to be part of neither the banking union nor the eurozone. I have heard a number of French and Germans say that this is intolerable and that British MEPs should not be part of those discussions.

Q199 Lord Jordan: The Commission thinks that its proposals will provide an effective framework of co-operation between the ECB and the national supervisors in countries such as Britain that are not part of the euro. Do you agree with it, and would there be advantages in having a cross-border banking group headquartered in the UK as a sort of sop?

Philip Whyte: It is an interesting question. Sweden, Finland and the eurozone are currently involved in a discussion about who would supervise the Swedish bank Nordea in the particular scenario that we are describing. Nordea is headquartered in Sweden but it is a large bank in the Nordic area and, I think, the largest lender in Finland. The ECB is essentially saying, "We think this is an institution that we should ultimately be responsible for supervising", while the Swedes, who are not yet sure whether they will be joining the banking union, are saying, "Sorry, but we're not having this". Certainly there is a danger of having arguments about competence creep, with the European Central Bank trying to take responsibility for supervising banks that some of the "outs" say that it has no business doing. The other thing, which I touched on previously, is just how the "outs" are represented in the single supervisory mechanism if they decide to join it.

Mats Persson: This is a big question, obviously. On Sweden and some of the other "outs", I would say that Sweden is interesting. It is not only that Sweden is divided over the fundamental question of whether to take part in more eurozone integration; it has also done its homework when it comes to its banking system. It has capital requirements that are higher than the EU norm, as it had a situation in the early 1990s that forced it to do things differently. In order for Sweden to join, not only does it need to have a stronger say in the ECB supervision structure. I think it also needs to have carve-outs for issues such as capital requirements because it cannot be that the ECB imposes lower capital requirements on Nordea, and potentially on some other banks, than what the Swedish Government have pushed for. So if you are a non-eurozone country, you need both a clear structure for influencing decisions on the supervisory side of the ECB and, probably, carve-outs. I can envision that in order for Sweden to join, for example, it would have a similar arrangement to that which exists around the fiscal treaty: that only a certain part of this package applies to you until you join the euro. That could be a potential compromise but at the moment it is not a particularly attractive prospect for Sweden and some of the others to join.

Britain is in a slightly different position because the Bank of England, when it takes over macroprudential supervision from the FSA, will supervise 36% of the EU's wholesale finance markets. I think the Committee may have been touching on that in the previous session. If you are the ECB and you ignore that then you are pretty stupid, to be honest—sorry, but that is what you are. Of course, the Bank of England and the ECB have to negotiate with each other as equal partners. In that sense, the banking union as currently constructed is less of an issue for the City of London than for a country such as Sweden, precisely because of its size and therefore its clout.

Therefore, the key issue to look at here is whether the Bank of England and the ECB can develop a good, solid working relationship. If they can, the gap between the single market and the banking union can remain very narrow, which would be a good thing. However, there are two risks in terms of firms being based in London and using it as their entry point to the single market. I think I touched on these risks before. One is that the 17 start to write the rules for all 27 member states, using an inbuilt majority at the EBA and in the EU's voting structure. The other is that the ECB starts to demand that banks, financial firms and others be based inside the eurozone in order to do business there. Of course, the worrying precedent here is the ECB's demand that City-based clearing houses be based inside the eurozone in order to be allowed to clear derivatives contracts in euros. If that becomes the practice, the nature of the City of

London as an entry point to the single market may be brought into question and there might be more of an incentive for firms to relocate inside the eurozone. However, precisely because both those risks are still unknown, you can work with this. The UK needs to put into place some of the safeguards that we and others have proposed.

Q200 Lord Vallance of Tummel: Perhaps we can move on to the role of the EBA. Quite clearly, for all this to work there has to be a clear and workable interaction—I think that was President Van Rompuy's phrase—between the ECB and the EBA. Do you think that the current proposals on the table will achieve that?

Philip Whyte: I will take that. On paper, it is a workable arrangement. The EBA continues to do what it has been doing for the past couple of years, which is to develop the single supervisory rulebook, mediate between supervisory authorities and so on and so forth. The question is how that works in practice. As Mats has just said, the big danger is the elephant in the room: the ECB and how it interacts with the EBA. If the ECB becomes a single bloc that dominates and becomes an inbuilt caucus inside the EBA, there is potentially a big problem because effectively the UK will be subject to rules over which it has had almost no influence.

Q201 Lord Vallance of Tummel: When we were talking to the German ambassador a moment ago, we touched on a proposal that seemed to have emanated from Germany at one point: that at least in the context of the ECB, and perhaps the supervisory board, votes should be weighted according to the proportion of the financial markets in Europe. Does that have any virtue for you, both in terms of the supervisory board and the ECB, and perhaps for the EBA?

Mats Persson: Britain could potentially have 36% of the voting weight, up from 8.4% now, so I think London would take that if you have a strict weighting according to the share of wholesale finance markets. I do not think that would fly at the EBA, precisely for that reason: effectively, Britain would have a permanent blocking minority at the EBA. I am sure that some people here would love that but I do not think that the Germans or some other countries would be too keen on it. It is certainly an interesting proposal, which I am sure the Germans are quite keen on regarding the ECB but not so keen on for the EBA.

However, there are other ways to solve the EBA issue and avoid eurozone caucusing. We proposed in a report last December the principle of a double qualified majority, where you would have one vote among the eurozone bloc and a separate vote among the non-eurozone bloc and that in order for a proposal to pass, it would need a qualified majority among both blocs. That could balance the European Banking Authority and serve as a template for how to reconcile further eurozone integration in financial services and banking with the EU single market, which remains the property of all 27 member states. Those are the kinds of proposals that we have to look at.

Q202 Lord Vallance of Tummel: Perhaps I may ask a slightly different question. We have talked about relationships between the EBA and the ECB but there is another star in the constellation, which is the European Systemic Risk Board. If the ECB is going to be doing macroprudential regulation and looking right across the financial markets, how do you think the relationship will develop with the ESRB?

Mats Persson: I am perplexed about this. To me, it seems that the ESRB will become superfluous. I do not see the need for it if you have macroprudential supervision, with stronger kinds of mechanisms around it already resting with the ECB. Why would you need the ESRB?

Q203 Lord Vallance of Tummel: Does that not bring us back to the single market again? As you said, 37% of the wholesale market is here in the UK but the ECB will have no direct interest in that.

Mats Persson: Well, the ESRB can be a good forum. At the moment, it does not really have any firm decision-making powers. The ESRB is, for want of better words, a talking shop. It can issue recommendations and monitor systemic risk, but it cannot really do anything. It can be a useful forum for discussions between national supervisors but it will never be able actively to protect the integrity of the single market through decisions.

Lord Vallance of Tummel: Does it need its back strengthened?

Mats Persson: What do you mean? I am sure that it does, but—

Lord Vallance of Tummel: As part of the new architecture, in looking at which you have to look at the strength of the EBA and how that operates versus this big new body, the ECB. Perhaps one also needs to look at the strength and responsibilities of the ESRB at the same time.

Mats Persson: For it to be strengthened?

Lord Vallance of Tummel: That is right.

Mats Persson: That is an interesting idea, which could also serve as a counterweight to the ECB's inherent incentive to look out for the interests of the eurozone.

Q204 The Chairman: Mr Whyte, is the ESRB a white elephant in the room?

Philip Whyte: I had not really thought about this. Thinking about it now, it strikes me that—certainly from Britain's perspective—the potential problems with the ESRB are smaller than they are with the EBA. Given Britain's status as an international financial centre, you would have to be really quite stupid to set up a macroprudential function that did not take a strong interest in what was happening in the City of London. On macroprudential, I think that the UK would always be a serious interlocutor with the ECB, and those two would be primus inter pares within the European system, whereas on the EBA I fear that there is a danger of British marginalisation.

Mats Persson: But the ESRB could be a good forum for the ECB and the Bank of England to talk. If they needed the ESRB to do that, I would be really worried but it could still be an incentive for them to get together and have regular meetings and chats.

Lord Dear: Mr Whyte, I know that you were at the back of this room when we were taking evidence from the German ambassador a moment ago. Mr Persson, I am not sure whether you were present as well.

Mats Persson: I was here for the latter part.

Q205 Lord Dear: In which case, this will be fairly common ground to you having heard my question and his answer about the RRD—the bail-in tools, the minimum resolution tools, the special manager tools and all of that architecture which is proposed to be going in when a bank gets into trouble. I wondered whether you had any views on that, particularly set against the UK Government's expressed concerns that, for example, special manager tools might well result in an increased and accelerating loss of confidence—"Be careful how you use them" and that sort of thing—and about the benefits or disbenefits of proposed asset separation tools. Regarding the big tool chest that is being proposed, which could or would be deployed if banks began to show signs of struggling, the UK Government have a declared view. They are lukewarm, to put it mildly, and I am not sure whether the rest of Europe seems much more in tune with it. What do you think?

Philip Whyte: The specific details of the recovery and resolution directive and how it differs from the regime which we have established in the UK are slightly beyond my level of competence. The basic principle of bailing in banks' creditors is, philosophically, the right one. I do not know anyone who really disagrees with that. As you say, the question is how this sort of instrument will work in a crisis. As we know, these things often work very differently in a crisis than in peacetime. It is probably also true of the British system that there is almost a counterproductive element to it: just by triggering the bail-in instrument, you make matters worse rather than better. That applies as much to the British system as to the European system. My final point is that the recovery and resolution directive, to go back to my very first remark, is still embedded in the old system of the pre-banking union world, in which these sorts of things happen at national level rather than at federal or eurozone level. Again, listening to the German Ambassador, it was very striking that he talked about keeping this whole process at national level rather than transferring it to the eurozone level. If you are talking about the stability of the eurozone, that is not really good enough.

Mats Persson: I do not have much to add. It is quite difficult to second-guess the market perception in a crisis situation. That is not going to be easy. This is the usual discussion about how exactly you inject market confidence in that kind of crisis situation. That is very difficult to predict with any degree of certainty. In general, the recovery and resolution directive has some positive elements to it such as the use of bail-ins, which I mentioned before and which Philip mentioned. However, it is a fundamentally different proposal to the one which some envisage now, where you have cross-border liabilities as part of the resolution scheme, so in one sense this proposal is already dated.

Q206 The Chairman: Before I invite Baroness Prosser to ask our last question, could you touch on the proposed deposit guarantee scheme? Is that an essential element in a banking union?

Philip Whyte: That is a tricky one. The United States has a common deposit protection scheme and a common resolution scheme, both administered by the FDIC. I suspect that a deposit protection scheme is necessary for a stable currency union but that it is probably not sufficient. Even if you implemented a common deposit protection scheme, you would not necessarily be eliminating redenomination risks. Take the Greek problem, which is that people are worried about Greece leaving the eurozone and therefore take money out of their Greek banks and stick it in a German bank. Unless a deposit guarantee scheme guarantees the euro value of all deposits, regardless of whether a member state stays in the eurozone, you have not really dealt with the problem of redenomination risks and have not therefore dealt with the potential to have runs on banks in countries with weak sovereigns.

Lord Marlesford: Perhaps I may follow that up. Much of this brings up another dimension which has not been much discussed, in the whole argument about the moral hazard obligation of the European Central Bank to bail out or underwrite, or to deal with depositors and all the rest of it that moral hazard ultimately means—and they are all too aware of this—that Germany is the lender of last resort. All of this will reinforce that obligation of the European Central Bank. They are setting up a system which they will say is going to get this thing right. I asked Commissioner Barnier about the moral obligation of the ECB under the present rules and he did not answer. He said, "Oh, we hear a lot about morality and not about hazards". I said, "What about moral hazards"?

My real point is that there is possibly going to be a new dimension of liability on the ECB as a result of all this.

The Chairman: Before Mr Persson comments on that, I think that Lord Dear wanted to ask a supplementary.

Q207 Lord Dear: It is only a very quick comment on the back of my original question. You might remember that we put this question to the German ambassador. If we move to a single resolution mechanism, what about the states that are not part of the banking union? How would it affect them and how would they sit within, to use the word again, architecture of a different shape?

Mats Persson: In principle, they do not necessarily have to be affected fundamentally by the resolution structure itself; they are just not part of it. The Bank of England has already opted out of Target2, for example, so it is not part of that structure, which clearly links to lending across borders. You can be part of the same market but not be part of the resolution fund. The more pronounced risk is the knock-on effect that it could have on the incentive for the eurozone to take a common position in various other areas, rather than the direct effect. For example, with a common resolution scheme you would have more of an incentive to have perfect harmonisation within the single market because, for obvious reasons, the Germans will insist on perfectly harmonised capital requirements to avoid Spanish banks free-riding on German taxpayers. So you will have more of an incentive to pursue further harmonisation within the single market, which could have a spillover effect on regulation with Britain, for example, having a very limited ability to block regulations that it disagrees with. It is the knock-on effect rather than the direct effect that is interesting to look at.

Lord Marlesford: Could either of them comment on my point?

The Chairman: Yes, after Baroness Prosser tables her question I will ask Mr Whyte to respond to all that.

Q208 Baroness Prosser: Both of you have already talked quite a lot about the impact on the United Kingdom. The comment that there is nattering going on in Europe about British MEPs making decisions about these matters when the UK has decided to remain outside is, I thought, a bit like the European version of the East Lothian question. If it goes on as long as the East Lothian question has, I suggest we will never find an answer to it. The UK is determined to stay outside, as we know, but the banking system is global. We had evidence last week from two major British banks that operate right across Europe. They did not seem to be too fussed about banking union or the supervisory mechanisms that we talked about, et cetera. That is the first thing I would like you to comment on. Secondly, how realistic is it for the United Kingdom Government to determine that the City of London will remain the most important financial centre if we stay outside this whole edifice?

The Chairman: In answering Baroness Prosser, if there is anything else you wish to respond to on which you have not had the opportunity, please do.

Mats Persson: What was your first question again, Baroness Prosser?

Baroness Prosser: That this is a global system and that if the United Kingdom decides to stay outside, the representatives of the people who are going to be supervised are not really anxious about that. I would like you to comment first on that and, secondly, on the status of the City of London in the future.

Philip Whyte: There are a few things. We have spoken about the institutional difficulties and what you called the East Lothian question, but was it not rather the West Lothian question?

Baroness Prosser: Maybe it was. Yes, you are right, it is West Lothian.

Philip Whyte: All those things will be difficult enough but they are even harder for the UK, for a number of reasons. Firstly, although this has a slightly populist element in a lot of European countries the way they think about the matter is, nevertheless, that the financial crisis happened because of Anglo-Saxon capitalism. They think Anglo-Saxon capitalism needs to be tamed. Secondly, they resent the fact that the EU's largest financial centre is outside the eurozone, so a lot of them will want to repatriate euro-denominated business—particularly if we have an increasingly semi-detached role inside the EU. Thirdly, I think that Eurosceptic rhetoric in the UK has gone down quite badly in the rest of Europe. The talk of exploiting the eurozone crisis to get a better deal for Britain has been seen as incredibly hostile rhetoric elsewhere in Europe. Finally, there is a growing perception across Europe that the UK is on its way out of the EU, so why bend over backwards to accommodate the UK if we are? For all those reasons, this is a really difficult issue for the UK.

What it means for London as a financial centre, I do not know. There are two schools of thought: one is that if we break free of Europe—some Eurosceptic MPs have called it the rotting corpse of Europe—we will then be free to concentrate on the global market, particularly the fast-growing emerging markets. But I think that we will probably subject ourselves to protectionist measures on the part of the eurozone. They will make sure that euro-denominated business has to take place in the eurozone. The other is about whether we really will be a more open country to the rest of the world, which I would question. Anyone who thinks that should take a look at the *Economist* magazine's headline this week about immigration. Britain outside the EU would be more closed to immigration than it is as an EU member.

Mats Persson: To deal with Lord Marlesford's question first, he put his finger on a very important point about the ECB. If all of these things happen and you have a resolution structure and a deposit guarantee scheme in place, in order for them to work they will both have to have a direct credit line to the ECB. That would implicate the ECB further, all of which is pointing to the ECB becoming the eurozone's lender of last resort. That is precisely what the Germans do not want, so for that reason there are a lot of negotiations still to come on those issues. However, the role of the ECB is becoming extremely important; it will increasingly define the future shape and size of the eurozone.

On Britain in Europe, the ever so controversial question which we cannot avoid, I echo a lot of Philip's points although I would not necessarily put them in such stark terms. Fundamentally, Britain needs a new set of membership terms if it wants to remain inside the EU. That is the only way to reconcile British EU membership with UK public opinion. The banking union, as I said before, will be a template for how that can be achieved and there are a lot of pragmatic solutions in between the quite apocalyptic scenario that Philip painted and the status quo. If you have something on the EBA as a start, that would be a good way to create some goodwill. I think that the British Government have made some mistakes in terms of their tone towards other EU countries, in particular when lecturing the Germans to press ahead with a severe form of eurozone fiscal and banking union that Britain itself, interestingly, wants absolutely nothing to do with. But, fundamentally, Britain and the rest of Europe have to work with each other. That is particularly true on banking union because of my previous point: you cannot ignore Britain because the City of London accounts for such a huge share of the EU's financial services sector. Pushing it offshore by, for example, requiring more euro-denominated business to be inside the eurozone is not in the interests of either the eurozone or Britain when it comes to it. I think both parties realise that.

Secondly, both parties also realise that Britain cannot take part in a banking union, not only because of domestic political reasons but because if the banking union is taken to its logical end-point then German taxpayers will effectively have to underwrite the City of London. If I were Angela Merkel, I would not be looking forward to explaining that to German taxpayers—that in addition to underwriting Greece, Spain and Italy they will have to underwrite greedy bankers in London. Politically, on both sides, it is not possible and I think everyone realises that. Because of that, if you leave out the rhetoric and hyperventilating on both sides and the highly exercised politicians, it will come down to negotiations. Those negotiations will, in the end, produce a compromise that everyone can live with. That, at least, is my hope and my attempt to be optimistic.

The Chairman: Philip Whyte and Mats Persson, with great clarity and expertise you have answered all and sundry of the questions we have thrown at you. You showed particular erudition about East Lothian. We are very grateful to you for coming before us today and helping us with our inquiry. We will send a transcript of the conversation. Please correct that and if, as you go out of the room, you have further thoughts which you think would benefit the Committee, please communicate them to us. But at the end of this heavy Tuesday morning, it is my great pleasure on behalf of the Committee to thank you both very much indeed.

John Chapman—Written evidence

General

1. Thank you for inviting me to give evidence. My comments relate to the first and last sections of your paper - "Banking reform, banking union and the euro area crisis", and "The impact on the UK".

2. Official discussion of the euro crisis invariably focuses on debt problems. Sadly, there is little official discussion of the fanning up of such problems by the hedge fund/investment bank (HFIB) community.

The euro area crisis – causes, scale and the hedge fund/investment bank (HFIB) community

3. The crisis may be depicted as resulting from "irresponsibilities", e.g. property bubbles or over-generous pensions, of countries like Greece, Ireland, Spain and Portugal. The resulting debts of banks and sovereign debts became inextricably linked, with cross-border links leading to financial contagion.

4. But debts of weaker Eurozone countries had risen as much through the major US/UK-instigated 2007/09 financial crisis, as through national "irresponsibilities".

5. Moreover, until gamblers of the HFIB community turned their attention to Eurozone countries in 2010, debts of banks or sovereign debts in eurozone countries had not been a significant issue. Even then the Eurozone countries did not stand out; the Economist Intelligence Unit commented that the position of euro area looked no worse than that of the US and UK. But, unlike the US and UK, individual euro countries did not have central banks to escape a debt crisis by "printing money".

6. As pointed out recently by two Italian academics :-
"It was the financial crisis that spurred the sovereign debt crisis, and not vice versa: speculation has turned small differences in fundamentals into huge financial gaps. Before the financial crisis, the spread (between the Bund and long-term Italian and Spanish debt) was almost non-existent and the resilience of the euro was not challenged by the markets" (Learnado Becchetti and Giancarlo Marini of University of Rome Tor Vergata in the Financial Times (FT) of 24 August).

7. The attacks of the HFIB community on banks and sovereign bonds in Eurozone countries, and the euro, often through the gambling mechanism Credit Default Swaps, have been reported typically as:-

- "Traders' targets: Portugal and Spain" (Wall Street Journal of 27/11/10)
- "Hedge funds seek rich pickings from Greek crisis" (FT of 22/6/11)
- "US hedge funds bet against Italian banks" (FT of 10/7/11); "US hedge funds short Italian bonds" (FT of 11/7/11)
- "European banks face short-sellers' fire" (FT of 9/8/11)
- "Hedge funds bets against euro hit record" (FT of 4/5/12)
- "Bets on platinum's fall is anti-euro wager" (FT of 9/8/12)

8. The EU Commission estimate that over 4.5 trillion euros of taxpayers' money is being used to rescue banks in the EU ("A roadmap towards banking union", 12/9/12) – a sum resulting in part, and maybe in large part, from attacks by the speculators of the HFIB community.

Banking union as a fortress against speculators

9. Formally, banking union is an important step in breaking the links and vicious circle of bank debt and sovereign debt, and the cross-border spill-over effects in the event of bank crises. In reality, banking union amounts in today's inadequate fences being replaced by a fortress to repel speculators. But whether such a fortress will be strong enough to rebuff concerted onslaughts by speculators is uncertain.

Taking the fight to the speculators

10. Hedge fund speculators, and their investment bank working partners, now dominate market activity. Shorting, gambling against public companies, alone accounts for some 30% of market activity on the London and New York exchanges.

11. But the rise from nowhere to market dominance by the speculators of the HFIB community must be the most adverse commercial and economic happening of the last 30 years. As already argued in "Phasing out hedge funds", my paper in Public Policy Research of 2010, hedge funds have multiple and unfair trading advantages, are available to the rich but not the man in the street, menace companies through short selling, have pay rewards that pollute earnings generally, and hedge funds create or abet others in hugely damaging financial crises. In addition, as I have shown in "Hedge funds gains are other funds' losses" (Financial Times 9/4/2012), hedge funds out-performance has probably resulted in losses averaging $100 billion a year for other funds.

12. Instead of attempting to defeat the HFIB speculators mainly through a banking union, the EU should confront the HFIB community with more resolve than it has shown through the timid Alternative Investment Fund Managers (AIFM) directive. Short selling – betting against companies - is vital to the success of the HFIB community; it is also immoral, and a powerful deterrent to the risk-taking necessary for economic growth. It should be heavily taxed, with the overall aim of phasing out hedge funds.

The UK and London as a financial centre

13. A banking union without the UK must dilute the position of the UK in the EU, and, prima facie, weaken the position of London as a financial centre. As reported in "Bankers downbeat on the future of the City" (Financial Times of 24/9/12), "Eurozone pressures add to the air of gloom".

14. The City of London today provides perhaps the sharpest contrast between eurozone and UK aspirations. Whereas eurozone countries, to their great credit, have withstood countless attacks from the HFIB speculators, the UK has not been under similar attack. Indeed it has provided a haven for the largely American hedge fund owners and managers and investment banks. The HFIB community has used today's largely American-run City of London as an extension of Wall Street, from which attacks on the Eurozone can be more easily launched

15. Banking Union then poses the UK with a dilemma. If the UK stays out of banking union, both the position of the UK in the EU and the position of London as a financial centre are likely to suffer. Perversely, perhaps the only way the City could retain its leading position would be by becoming even more "American", and increasing its support for the "undesirable" HFIB community – developments at odds with Eurozone countries.

16. Eurozone banking union could then force the UK to take a hard look at the benefits and costs of today's City of London:-

- In his July 2012 report on "UK equity markets and long-term decision making", Professor Kay acknowledged that short-termism – inadequate investment for the future – is a problem in UK equity markets; the long-standing contention that the City harms rather than helps UK public companies appears justified;
- An FT article (30/7/12) on "London's precarious position" indicated that "As the City faces reputational fall-out and harsher regulation following recent scandals, rivals look set to reap rewards";
- The "take-over" of the City of London by the HFIB community appears as a strongly negative development; (in his report Professor Kay commented that "The norms of behaviour in the City of London were significantly affected by the pre-eminent role established by US investment banks");
- The reported suggestion (Guardian, 21/9/12) by ex-hedge fund chief Lord Fink, that London should become a tax haven for millionaires, is another "low" for the City's reputation.
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Summary of main points

17. The Eurozone debt crisis, and its high costs, stem in significant part from attacks by the speculators of the hedge fund/investment bank community.

18. Banking union may be an inadequate fortress against the HFIB speculators. The EU should take the fight to the speculators by phasing out hedge funds through a penal tax on short selling.

19. The proposed banking union, and its implicit curbs on the London-backed HFIB speculators, presents the UK with a dilemma. There should be a full investigation of the activities of the City, and their benefits and costs for the UK.

26 September 2012

John Chown—Written evidence

Introduction

1. There are two closely related questions underlying this Inquiry: what reforms are now needed to banking systems generally, and more specifically our own, and how will measures taken to deal with Euro area problems impact and conflict with United Kingdom policy? The latter is addressed by questions 1 and 14-16. At this stage, I am just submitting some general thoughts and will be happy to expand, in writing or orally, on specific issues and as matters develop.

2. Being neither a banker nor a regulator, I have not (yet) looked in detail at the European Commission proposals but have no conflicts of interest. For the time being, I leave the details to others but set out some general principles. I strongly support free market and banking activities, while opposing some practices and the promotion of them by lobbyists, and as a "critical euro-enthusiast" I long regarded the form chosen for the euro as a disaster waiting to happen. This, precipitated by the general crisis, has come earlier and proved more damaging than I had expected.

3. We cannot and must not legislate against risk: a healthy and prosperous economy needs risk-takers, and ours in particular must have flexible competitive financial services responding to new opportunities and challenges. They should suffer the minimum regulation consistent with facing up to and addressing mis-selling, conflicts of interest, and inappropriate self-dealing, of which there is a very long history. The financial crisis has uncovered many such, but even if these are dealt with others will be invented.

THE EU ASPECTS

4. Question 1 asks **"**What has the euro area crisis revealed about the EU banking sector? How can we protect ourselves against the measure which might be taken?" The "banking crisis" precipitated a potential `sovereign' problem, at least in some countries within the euro zone. The two are now closely inter-connected. The determination of the ECB and the Commission to "save the euro" inevitably includes proposals to centralise bank regulation and provisions for bank bailouts within the zone, and recent initiatives, assume that the rules will apply across the EU.

Last year, I gave evidence to the Committee on the Financial Transactions Tax[34] and was pleased with the resulting report. The same issues apply here, although we do not have protection of the "unanimity" provisions of Article 113 on non- tax measures which may be used as an alternative means of attacking our favoured approach. There are two ways, not mutually exclusive, to protect ourselves.

- We should, alongside our domestic deliberations, make detailed and <u>constructive</u> comments on the EU proposals. We cannot hope to block them but should <u>helpfully</u> draw attention to difficulties their solutions may be creating. We also need to liaise with other EU members, as it is already clear that there is a wide divergence of views even between the core countries.

[34] "Time to Bin the Tobin Tax", John Chown, The Centre for Policy Studies, Pointmaker, April, 2012.

- Given that the Eurozone members may want to use an "enhanced cooperation" procedure we also need to protect ourselves and other "outs" from the effects of the measures.

6. Markets responded with guarded enthusiasm to recent proposals, which may be enough to preserve the euro in more or less its present form but it will still leave the long term problems. It is possible, but perhaps unlikely, that the time so bought would be used to tackle these. At what price will this be achieved? Would the Germans and others offer indefinite finance? Would the members be forced into a rushed Fiscal, or even Federal, Union without a proper political structure, and would the real victim be democracy?

7. A full Federal Union would need a new Treaty which would take years. Meanwhile, we have to consider various possible short-term outcomes. The aim of keeping all the present members in the euro zone would be the most difficult from our point of view, and an attempt to bring the whole of the Eurozone into an "ever closer" structure including banking union would probably seek to push through regulations applying to the whole of the EU by qualified majority.

8. From this specific point of view, it might be simpler if a smaller group of members under the leadership of Germany were to form a smaller eurozone with transfer capabilities, proper central sanctions on government expenditure and a Central Bank capable of being a lender of last resort. Those staying outside would divide into three categories: Greece and others who would leave the eurozone, devalue and probably default; the "opt out" countries, notably ourselves, Denmark and Sweden, would clearly not join; and those members of the EU who are committed to future membership who will have to decide their own policies.

9. Germany could even unilaterally revert to its own currency, issued under the control of the Bundesbank leaving other countries either to follow them or not. This would raise complex questions but might make the one before the Committee less urgent. The same would also apply if there were to be a very messy break-up of the euro zone.

10. Any inner group wouldn't want outsiders having an equal say in their relevant discussions and in any case for them the unanimity rule on tax policy would not work. The non-members, including the UK, would need to negotiate considerably less interference, particularly in financial regulation and employment policy in case these could be abused by the fiscal union group to force us to share their uncompetitive practices. Given the distrust of Anglo Saxon capitalism in various quarters, we will need superb, constructive (not dismissive) diplomacy, backed up by first class advice on the legal and monetary and economic aspects from those unconnected with any lobby or interest group. It would be politically unwise to see this as an opportunity to "bring back powers from Brussels".

11. At the EU level, we do need to ensure that banks are not assumed to be "too big to fail" – and must ensure that Member States (like US ones) are assumed to have their own credit ratings and be capable of default.

BANK REFORM

13. This current crisis is like others, based on a bubble leading to irrational exuberance, excessive risk-taking and a sharp rise in debt which inevitably caused a crash.

Malpractices created during the boom only became obvious when the bubble burst and the scale of debt based on worthless assets was enough to wipe out the capital of the largest banks, without the regulators, the rating agencies or the banks themselves having noticed. The steps taken to rescue their banking systems turned these into a sovereign debt one.

14. Mis-selling by financial institutions to corporate customers and institutional investors has a long history: my front row experience of major financial transactions as an international tax adviser revealed many practices which, to say the least, were less than fair to the interest of the clients. This did not destroy my faith as an economist in efficient and flexible capital markets but brought home to me the need for intelligent regulation – and the danger of regulatory capture.

15. My article for Central Banking (November 2009) explained that it was very important for those (i.e. the readership) to be concerned with how the banks made their money and not just leave it to regulators. If the profits were being made by risky self-trading or exploiting conflicts of interest they would not last. The problem for regulators of course is that if they check the boom they will be blamed for the spoiling the party rather than praised for preventing a disaster. There are two components of this. "Better regulation" does also concern those whose job it is to ensure fair trading is one approach and a main theme of the EU proposals. "Self trading", more obviously risky is being addressed in two ways: one is to ensure that banks are not "too big to fail" and another is to "ring fence" investment and commercial banking.

16. Clearly, we must discourage the banks from excessive risk taking involving depositors' money enabling systemically-important firms to fail will not help if the problem is that very many banks, large and small, are pursuing the same misguided policies. Seldom does a single major failure create a systemic risk. But it can, and on this occasion did, do just that with a simultaneous disaster hitting many banks worldwide. The point too is that the normal pattern of bubbles – irrational exuberance followed by a financial crisis – was in this case amplified by activities which involved either one or both of the examples of malpractice covered in this article. Banks were behaving as typical "Keynesian Sound Bankers."[35]

17. One main conflict of interest is that bank managements have become accustomed to extracting a large slice of the gross earnings of salaries and bonuses encouraging activities which bring in short-term returns (immediate bonuses) and high risk (downside effectively borne by shareholders or even the government.)

18. One present proposal assumes that `ring fencing' rules would apply to big banks across the EU. Something like this is needed more generally and is, of course, being proposed within the United Kingdom on banks generally. The rules should provide that self-trading and investment banking activities are held within a separate company without any loans or implied guarantees from the associated depositor-taking bank. Another approach (more prone to regulatory capture) would treat any assets involved in this way as having a very high risk rating. Hedge funds are available for those who choose to invest in risky finance.

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[35] "A sound" banker alas! is not one who foresees danger and avoids it, ,but one who, when he is ruined, is ruined in a conventional and orthodox way along with his fellows, so that no one can really blame him." Keynes, "The Consequences to the Banks of the Collapse of Money Values" in "Essays in Persuasion", 1933.

19. It is suggested that we should separate retail and investment banking but we do not go as far as the "John Kay" proposal effectively bringing back the Trustee Savings Banks. These and the Building Societies offered an excellent but limited service, but ordinary deposit banks must be allowed, and indeed encouraged, to take reasonable risks on loans to commercial customers, and to offer these customers honest hedging facilities and possibly to accept equity stakes when appropriate.

20. I have a specialist interest in financial derivatives and a strong one in the way in which public offerings are made. I mention these briefly in the next two paragraphs but can expand.

21. When financial derivatives were first introduced, I was a strong supporter believing (at first) that these were an efficient market method of spreading risk. Instead, I was horrified to discover that financial intermediaries were making huge profits by selling complex products to people who did not understand what they were buying. At first, intermediaries were simply misleading their clients, but during the recent period of irrational exuberance it seems they began misleading themselves.

22. Big Bang and the end of a commission cartel reduced intermediary profits in the secondary market but players responded by substantially increasing their cut out of Initial Public Offerings notoriously including the huge take out of the major UK privatisations by procedures actually in breach of Stock Exchange rules. A recent paper[36] was intended to prevent a repeat when bank shares are resold.

23. One should never waste a crisis and the current one could have been an opportunity for sensible and constructive reforms. Instead of that, there is huge evidence[37], particularly in the United States, of successful lobbying and regulatory capture.

3 October 2012

[36] "No to Underwriting: How the Coalition can avoid being ripped off", John Chown. Pamphlet for Centre for Policy Studies, August 2011.

[37] Simon Johnson and James Kwak, "13 Bankers: The Wall Street Takeover and the Next Financial Meltdown", Pantheon, 2010.

City of London Corporation—Written evidence

Submitted by the Office of the City Remembrancer

Introduction

1. The City Corporation welcomes the opportunity to contribute to the Committee's inquiry into reform of the EU banking sector. The Corporation's work on financial regulation and tax matters is informed by the International Regulatory Strategy Group (comprising senior representatives from a variety of industry sectors including investment banking, asset management, insurance, legal and accountancy services, exchanges and market infrastructure). Its role includes identifying strategic level issues where a cross-sectoral position can add value to the expression of views from particular sectors.

2. The Single Market is Europe's most valuable asset. The UK's priority must be to oppose policies that could lead to the fragmentation of the Single Market. Harmful measures include efforts to compel the clearing of euro-denominated trades within the eurozone and the partial introduction of a financial transaction tax. This UK-based activity therefore needs to remain competitive if Britain is to continue both to attract international business and to prosper in global markets.

3. The Commission proposal to make the ECB the single supervisor in the Eurozone is clearly a necessary step to save the euro and should provide much needed stability for the Eurozone and will benefit the whole EU. However implementation will not be easy and the Single Market and the European banking industry should not be jeopardised as a result of a desire to solve a different problem.

4. There some important aspects that should be considered by UK policymakers. The UK, for example, must ensure that it works to avoid affecting location decisions by major firms – or that it damages the single market. In order to help the EU compete internationally, it should be simple for companies to do business outside its borders and vice versa. Overly stringent 'third-country' rules threaten the ability of the financial services sector to support growth EU growth, as well as threatening one of the Union's most competitive exports.

The UK as an EU centre

5. The whole of Europe benefits considerably from the presence of large financial centres. In presenting the benefits of this situation, the financial sector based in the UK cannot be treated as distinct from Europe. The EU and UK's financial markets are intrinsically linked and both benefit from their relationship with the other. They are governed by a common overarching regulatory structure, and depend on each other to remain competitive.

6. London's reputation as a major financial centre is based to a significant extent on its international nature. It is populated by international institutions, 249 of the 325 banks located in London at the end of March 2009 come from outside the UK. Many non-European financial services firms locate their European headquarters in London to access both the international market and the EU's

Single Market based on the knowledge that the same regulatory system exists across the entire of the EU and that they can access European markets freely from London.

7. Moreover, many non-UK European banks such as Deutsche Bank and BNP Paribas locate in London to access the markets in which London has accrued specialities from financial and legal services to marine industry services. Many non-UK EU firms choose to list on the London Stock Exchange in order to access the capital on offer there, directly channelling capital to European businesses from London.

Importance of the Single Market

8. The integrity of the Single Market across the whole of the European Union must be protected and completed. This is not about 'protecting' any specific financial centre; rather it is about ensuring a level playing field so that the EU's many world-leading financial services sectors may continue to be internationally competitive. Fragmentation of the Single Market in financial services could drastically reduce the efficiency of the Single Market and European businesses' access to capital.

9. London's position as the most prominent international financial centre in the world would be put at risk by an imperfect Single Market in financial services in which rules and access differed by level of membership of the EU. This could also damage the interest of euro area headquartered firms.

Banking Union Proposals

10. In the interests of the European financial services industry and the consumers it serves, Eurozone members must carefully consider their differences on aspects of the Banking Union without prejudicing the position of Member States that choose not to join.

11. Those negotiating on the Banking Union's operations should focus on ensuring European-wide financial stability through increased integration and avoid structures that might endanger economic recovery and growth by limiting access to financing for firms and individuals. A stable and uniform regulatory environment therefore enforces the role of the EU as a globally attractive market place, which ensures that the industry can continue to create jobs and support growth.

12. Rather than front-running positions on the Banking Union, the UK may be better served by actively engaging with proposals in European Council working groups. It may be the case that the UK would benefit from various elements of the Banking Union being disaggregated and taken forward as separate initiatives. The Banking Union would be less politically sensitive if the advantages and disadvantages of different components were argued individually, rather than packaged as one initiative that would require a single definitive response from Member States. This approach could also be considered to be more appropriate given that some parts of the Banking Union, such as the deposit guarantee scheme, have been under discussion for a number of years

13. When dealing with third-country participants to EU financial services markets, protecting consumers is important. However regulations that restrict third-country access at the level of wholesale markets through exacting equivalency or reciprocity requirements risks damaging the EU's international financial services competitiveness. Moreover, EU financial services firms use many third-country firms to provide ancillary services. Too stringent equivalence rules could threaten this relationship and increase costs whilst impairing service provision, efficiency and competitiveness.

26 October 2012

European Banking Authority (EBA)—Oral evidence (QQ 82–96)

Evidence Session No. 6. *Heard in Public.* *Questions 82 - 96*

TUESDAY 2 OCTOBER 2012

11.50 am

Members present

Lord Harrison (Chairman)
Lord Flight
Lord Hamilton of Epsom
Lord Jordan
Lord Kerr of Kinlochard
Lord Marlesford
Baroness Prosser

Examination of Witness

Andrea Enria, Chairman, European Banking Authority (EBA)

Q82 The Chairman: Signor Enria, welcome once again to the Committee. I was pleased to be able to talk to you in the corridor for a moment. We have seen you before about the new supervisory framework, and you were very helpful to us in talking about the new EBA when we were forming our 2011 report. I think you know what we do in the Committee. A record is made of our conversation, which is then sent to you for correction and improvement if you have any good ideas that come to you later. You know that our major task is to look at the banking union and the recovery and resolution directive, and the crucial role of the EBA in that. We would like very much to test these issues with you. Thank you for taking the time to see us during your busy day of meetings here in Brussels. In starting, perhaps I could ask you what ideas you have formed about the definition of a banking union that has been proposed and is now before us. Also, do you have any thoughts about the timetable? Even in the short time that we have been here, we have noted that many of our other witnesses are alarmed at the speed with which it is desired to bring the banking union into force, given that it is such an important item.

Andrea Enria: Thank you very much. It is an honour to address the distinguished members of this Committee. It was a pleasure to come and share some of my views with you last time and I enjoyed reading your report. It is again a pleasure to come before you with some personal views on the banking union. It is clear to everybody, I hope, that a banking union is now badly needed to keep the currency union in place. We realise that we cannot have a currency union without a banking union because money, for the most part, is made in commercial banking. You cannot have a currency union without having a mechanism to ensure the stability of the banks that issue such a large part of the currency. Money aggregates are mainly made by bank deposits and, unfortunately, over the past year we have seen how increasing concerns about the euro and the integrity of the currency were bringing about a flight in deposits. This involved wholesale deposits across the euro countries, first in Greece and, in some cases, in Spain, as well as retail deposits to some extent. When you reach this point, you need to take action, because the alternative would be the break-up of the currency union. The point I should like to make is that the imperfection of the institutional architecture of the euro was bringing about instability in deposits and a dangerous interconnection between the banks and their sovereigns. Since August last year, we have seen that the ability of banks to tap into the funding markets, and even the price at which banks could fund themselves in the markets, is increasingly being determined by the country in which their headquarters are situated rather than by their balance sheets. This has generated a major interruption in the flow of funding to the economies of some countries and in a segmentation across the nations of the single market. Currency and banking union is an important step to take in trying to repair the institutional architecture. I tend to agree with the Commission that, while the ideal set-up would be an overall, comprehensive restructuring of the whole safety net of banking supervision, deposit guarantee schemes, resolution funds and mechanisms, it is important to try to proceed as quickly as possible in order to address the major harm that has been done to banking markets in the euro area and to the single market as a whole. What the Commission has proposed is, in my view, a sensible way forward. It proposes to go forward with the centralisation of supervisory responsibilities, following the decision of the Eurogroup in June. The proposals will now go through the usual process under Article 127(6) of the treaty, thus transferring tasks to the ECB. There may have been other possibilities, but I understand that, so as not to prolong the process, this is the easiest way forward. I agree in terms of the speed. A few weeks ago I witnessed debates at the informal ECOFIN council table. This is a major change to the institutional architecture which of course touches on a lot of very delicate issues. At the same time, I tend to think that we should not lose the sense of urgency needed to act fast in order to repair the problem. Let me stress again that the euro area funding markets have been broken since August last year. This means that if it were not for the long-term refinancing operations of the ECB in December of last year and February this year, banks would not have been able to roll over approximately €800 billion of funding that they had going to maturity in the first half of the 2012. This would have meant a major credit crunch. The funding markets have not yet been repaired. The access, pricing and cost of funding for euro area banks are still difficult, and the only way to repair that is to disconnect the banks from their sovereigns and make them more, let us say, capable of coming back to the markets. The banking union project is a key element of the pathway to restoring viability in the banking sector. So, while I have some comments to make about the Commission's proposals, I am very supportive of them. It is important to come to political agreement on the package, and the sooner the better, so the Commission is wise to try to achieve such an agreement by the end of the year. The practical implementation of the process could then take a bit more time, but it is important to lock in political agreement as soon as possible.

Q83 The Chairman: You have highlighted one element of that yourself. The Commission has said that banking union should be introduced without queering the pitch of the integrity of the single market. You have alerted us, in a very useful paper that you have written, to the possibility of a polarisation within the single market of those inside and outside the euro, which might be exacerbated by the banking union.

Andrea Enria: In a sense, if the banking union is realised as the Commission is proposing, we will have a peculiar separation between the technical rule-making responsibilities, which will be with the European Banking Authority and will have a single-market jurisdiction of the EU 27—soon to be 28—and the conduct of day-to-day supervision, which will be euro-area-wide for the 17 countries in the euro area and national for the other member states. This would generate a rather complex institutional set-up. In my view, there would be an absolute need for the euro countries and the ECB to move in to a setting in which they have exactly the same rules and exactly the same supervisory methodologies and approaches. They will have to apply this stuff in the same way to all the banks active and headquartered in the euro area. So there will be a great push for a much stronger, much more uniform regulatory and supervisory environment in the euro area. Now, in my view, this could be both an opportunity and a risk for the single market as a whole. It could be an opportunity because, of course, if we move to a more integrated regulatory and supervisory framework for the single market as a whole, we could have a much stronger glue keeping together all the actors in the single market and, we hope, much stronger rules and stronger supervisory practices for repairing the weaknesses that have been highlighted by the crisis. However, the risk is that, if this move to a more integrated regulatory and supervisory environment does not occur, we might have a much more unified regulatory and supervisory set-up in the euro area and discretions and national variations in the other countries, which could indeed be a force for division within the single market. The point that I have been making at the European Parliament, which you kindly recalled, and behind closed doors to the ECOFIN council, is that we need a much stronger commitment to a greater harmonisation of rules in the single market if we want to keep things together.

Q84 The Chairman: That brings me to my final question in this opening exchange. Many of my colleagues will not have met you when you came before, but we would love to learn from you how you are getting on with the single rulebook. Of course, the situation has changed in that you are now tasked with producing a single supervisory book or framework as an allied task. I wonder whether you would set the two together and report to us how that is going.

Andrea Enria: Without doubt, there is progress on the single rulebook. We have already issued some draft regulatory standards for endorsement by the Commission—recently, for instance, in the area of capital requirements for central counterparties. We have already completed full consultation on a number of standards that will be released once the capital requirements directive regulation is finally approved by the Council and the Parliament. More than 40 standards are in the pipeline, so it has been quite an effort on our part. We are making progress. Most of these standards are focused on capital and aimed at returning a much more uniform and consistent definition of capital for banks in the single market. Having said that, I must say sincerely that I am also a little disappointed by developments on the single rulebook in the past year or so. In a sense, we, as the EBA, have made a major effort to achieve greater consistency in key regulatory definitions but, unfortunately, the commitment at the political tables—the tables of the Council and the Parliament—has not always been completely supportive of these efforts. Sometimes we have seen the desire from member states to maintain some degree of flexibility in the definition of certain capital instruments and discretions at the national level, which in my view could hamper the strength and consistency of these definitions. Let me try to be concrete, because otherwise it seems a sort of abstract discussion. We have made an exercise. We collected data from the banks that were in our recapitalisation exercise and the effort to raise capital at European banks that we put forward; we will publish a report tomorrow. We aggregated the balance sheets of all the 71 banks in the exercise, generating a sort of average European bank, and then we calculated the capital requirements with the most and least restrictive approaches that we have seen across countries. The difference between the two is 300 basis points—3%—which is huge. If you consider that the minimum capital requirement now is still 2%, it is a huge difference. It means that, today, market participants are comparing data that are not comparable. The disclosure is that investors use in their investment choices a portrayal of the banks' situation that is not really comparable across the single market. In my view, this is major damage for the single market. As supervisors, with the Basel III implementation we have a unique opportunity to enforce a definition that is in line with the international standard, the same for all banks across the European Union, and a strong one. Unfortunately, I think that we are not there yet. This is my point on the single rulebook. On the single handbook, it is a point that I strongly support personally. Even if you have the same rules, today the national authorities have rather different machinery: different black boxes that then translate these different rules into supervisory practices which might lead, even when the rules are the same, to rather different supervisory outcomes. The point is that, after the crisis, we have a unique opportunity to define the best supervisory practices and push for convergence towards them across the single market. To make something that might seem abstract more concrete, my model would be what was done in the US in the late 1970s, when they had a debate that is very similar to the one we are having now in Europe about merging all the agencies into a single agency or keeping some degree of decentralisation in different banking agencies. They eventually chose to maintain those differences. They had the control of the currency, the Fed and the federal deposit insurance corporations; they are different agencies. But they set up a process for having a common manual for the supervisors, so that when supervisors from all the agencies went to examine the banks, they had in their bags basically the same methodologies to assess the risks and take corrective action where needed. I think that we should move in exactly the same direction.

Q85 Lord Hamilton of Epsom: When it comes to the City of London, as you know the United Kingdom has decided to opt out of the banking union. What is your forecast? Will it adversely affect the City of London as a serious financial centre? Is it going to be possible for EU countries to transfer many of the movements in euros to other European cities? How about the future of the EBA itself? Will that stay in London?

Andrea Enria: That is difficult to answer. In a sense, the crisis has shown the difficulty of having a system whereby there is common monetary support to the banks, and different supervision, rules and fiscal back-stops. These things cannot stay together; you need more consistency between those levels. We have two ways of doing that. One way, which I advocated in my previous remarks, is to move towards much greater consistency, so that you create a regulatory and supervisory environment much more based on consistency across countries and co-operation and trust between authorities. In this setting, an international financial centre like London and the City can of course maintain an important role. Another setting that is unfortunately emerging in recent market developments to some extent is one where you bring a much more abrupt alignment between the fiscal back-stop and the supervision and constraints on the banks' business, so that banks are now being pushed in many European countries—maybe in all European countries—to de-risk abroad and concentrate their business in supporting the domestic economy and sovereign. This is generating segmentation in the market and renationalisation of financial activities. If this is the setting that is going to emerge in coming years, international financial activities will be damaged. Already cross-border financial activities are being significantly reduced; the cross-border interbank market has disappeared and the cross-border wholesale business is not there any more. In a setting like this, of course, the City in my view will suffer to some extent. As a European supervisor, I was surprised to discover that 80% of the money market funding of European banks in euros occurred in London and that a large part of the funding was provided by US banks. That was the amount of international business that we had until now, and that is now retrenching very significantly. Either we can restore the environment of co-operation, trust and regulatory harmonisation that could support cross-border business on a safer level, or we risk having a sort of renationalisation of financial activity.

Q86 Lord Hamilton of Epsom: On the subject of de-risking, the leader of the Labour Party is putting forward the idea of Glass-Steagall, which is getting quite a lot of cross-party support. Where do you stand on that? Do you think that it has merits in terms of de-risking investment banks?

Andrea Enria: I am sorry if I start from a bit far away on this, but I started my professional career as a supervisor in Italy in a moment when there were a lot of structural barriers in the Italian banking market, barriers of geographies and regions and barriers between products. That produced massive inefficiencies and a concentration of risk that eventually generated the crisis. So in principle I am not the strongest supporter of structural regulations, but the crisis has brought my beliefs to a test. I have come to the conclusion that there is a key issue of ensuring that large and complex financial institutions might be resolved, put out of the market and wound down without the need for taxpayers' money to bail them out. I think that, in this process, it is probably important that some segregation of activities is enforced from a regulatory viewpoint, because that would make the resolution of the bank easier. We have seen that when all the activities are intertwined it is much more difficult for regulators and resolution authorities to resolve the bank and ensure a smooth exit from the market. So I am becoming supportive of this proposal to have some segregation of these activities. On the European level right now, the committee chaired by Erkki Liikanen, the governor of the Bank of Finland, will present the results of its work. I expect that there will be some proposals to move in that direction. We should test those proposals before moving to the outright separation between the two parts of the business. If you manage to keep them under the same umbrella but make them effectively separable in a crisis, that will go quite a long way to pursue the public interest that we care about.

Q87 Lord Flight: You made the very important point that about 80% of the €700 billion of international deposits that have ebbed away have come through London. The link between bank and sovereign is obvious, but the real constraint on international deposits is not sovereign but currency and the concern that economies will leave the euro. You cannot restore the flow of money until you get rid of that concern; it is not just a concern about the banks or even the sovereign creditors themselves.

Andrea Enria: I completely agree with you. We need to put the redenomination risk off the table absolutely in the euro area. If that is not the case, the whole currency and banking activities will remain profoundly impaired. I think that this process of repair needs several actions. To be honest, we went to the European authorities, to the Commission, Council and Parliament, as early as September last year, saying that there was a need for a three-pronged strategy to deal with these issues. The first was to strengthen banks' capital, because there was a problem with banks' funding and you need to have stronger banks to allow them to fund themselves and keep financing the economy. That was something that needed to be done, and we think that we have done it. We will publish the report tomorrow and testify to more than €200 billion strengthening banks' capital in the past month. The second strategy was to repair bank funding and detach the funding of the banks from the sovereign. Our proposal was to have a European-wide funding guarantee on the banks. That was not politically accepted at the time but, in a sense, the ECB provision of liquidity and the banking union should move in that direction. The third strategy was, as you correctly point out, to have significant action on the sovereign side to make sure that sovereign risk and currency risk within the euro area were contained and, if possible, eliminated. I must acknowledge that many steps have been taken in this direction. The fiscal compact has made a more credible process for all the sovereigns to be on a fiscal responsibility path, and there is much tighter control by European institutions now on the fiscal position of member states, which to some extent implies some shared responsibility. In the moment when you control the budget of member states in this way, you also share responsibility if something goes wrong. The decision of the ECB to move to outright monetary transactions recently is also helping to address the issue, but probably more steps will be needed going forward to reassure markets that the risk of a break-up in the currency is completely off the agenda.

Q88 Lord Kerr of Kinlochard: We need to home in on the area where you are the world authority. We need to ask you what the rationale is for the delineation of responsibility set out in this package of proposals between the ECB and the EBA, whether you envisage that the relationship would work effectively, and whether the proposals to amend the regulations in respect of voting rules are necessary and would work to protect the integrity of the single market.

Andrea Enria: Thank you for the question. In an ideal world, which is not the world we live in, I would prefer that the regulatory and supervisory responsibilities were more causally matched as a jurisdiction and as an institutional set-up. I understand that because of the political choices of the member states we have to live with a set-up in which there will remain a distinction between the single market and the single currency in the European Union. In this setting, what needs to be done and what points in the package might need adjustment going forward? As I mentioned before, the most important thing is to have a strong commitment to a set of high-quality, truly common rules in the single market. This is what can keep the two things together. The ECB will have its own rule-making powers to fill the room for discretion left in European legislation. If too much room for discretion is left in European legislation, the ECB will fill it in one way, the UK authorities may fill it in another way, and the Swedish authorities in another. Then, honestly, the risk is that the ECB role on the single rulebook going forward will be quite difficult. You will have different rulebooks moving in different directions and there will be little that we can do to keep things together. So my strongest claim is to push for more uniformity. I must also pay tribute to the UK position in negotiations on the CRD4/CRR on banking reform. I think the UK has strongly asked for flexibility in setting the level of the ratios but has also pushed for having the same definitions of key regulatory aggregates. While the first has been achieved, the second goal, which was also my goal, has not been achieved. That, in my view, is the most important point. If you look at the organisation of several national supervisory authorities, they usually have a policy department doing rule-making, supervisory methodologies and analysis of risks for the market as a whole. Then you have the line supervisors' departments, which do the day-to-day supervision of each bank. In my view, we could construct a set-up in which the EBA could be the policy body for the single market and then the ECB, the Bank of England, PRA and the others are the day-to-day supervisors of banks, but this would require a strong commitment to bring the rules under the umbrella of the EBA. On the voting point, I understand the concerns raised by the UK representatives. I must say that when I saw the proposal by the Commission I thought it was sensible. I thought it difficult to depart from the Council voting mechanism for rule-making, which envisaged qualified majority under the treaty. But I understand the position raised by the UK, which says that if the euro area authorities are requested to co-ordinate their position at the EBA table and, in a few years' time with the Lisbon treaty, the voting mechanism leads to the steady state solution, the euro area will have a built-in qualified majority. I understand that then the decision-making is imbalanced and there needs to be some action of repair taken. My concern is that if we keep moving in the direction of strengthening the majority needed to make sure that the euro area does not have a built-in majority, we come very close to a unanimity rule. That would definitely impair the decision-making mechanism at the EBA table. That is my main concern. So going forward my suggestion to you—it is a very personal suggestion and one that I am sure my board would not agree with—is to move more towards technical panels, proposing and adopting the rules and then having member states that can oppose those rules through some sort of qualified majority with very high thresholds. I say that because if you look, for instance, at the way this is done in relation to accounting standards, one can criticise the outcome but the process works very well. At the international level, you have the International Accounting Standards Board, which is composed of independent, technical and professional experts, drafting the accounting rules for the world at large which are now adopted in more than 120 countries. You have a governance structure on top of that which allows the different regions and geographies to intervene if the process is not correct. We should probably disentangle a bit from the idea that good regulations and technical rules in Europe can be done only through national bargaining.

Q89 The Chairman: Have you written down a proposal for that kind of set-up? Is that a bit difficult for you to do?

Andrea Enria: It is.

Lord Kerr of Kinlochard: Just a little supplementary question on what you have said—and if you do not want to go down this road, I will understand. Then I have one other question to ask. The supplementary question: is it not likely that your own colleagues in the ECB will co-ordinate positions among the eurozone member states on precisely the details of rulebook standardisation which is your business and the business of the EBA? Is there not a risk that, over time, your functions will be hollowed out by the duplication that would be inherent in that? Secondly, and unlike that one this is a really friendly question, do you think that the EBA should be given a greater role in stress testing? And do you think that the roles that the EBA already has require a bit more resourcing for operation? I have been reading what you said in ECON the other day. I thought you were extremely modest when you said that, "it remains difficult for us to fulfil our tasks under such stringent resource constraints. While the amount of staff envisaged in the steady state situation, to be reached around 2015, is still commensurate to our tasks, there is an urgent need to accelerate the process". I think you meant that there is an urgent need for short-term additional resources. That is the friendly question to match the difficult one.

Andrea Enria: To start with the unfriendly question, this is a bit difficult but I want to be as honest and outspoken as I can be. The risk I see is that the ECB and eventually also the other countries not participating in the euro could have a common interest to maintain the rules at the EBA table as at high a level and as full of discretion as possible. I will explain what I mean. There is a risk, as has been the case in the past and to some extent still now, that the authorities that are competent for supervision avoid being bound by rules defined at our table and prefer to tailor those rules to their own supervisory practices at their own tables. If the UK and the ECB support the Bank of England and the ECB disagree on a rule, the easiest way to settle the disagreement would be to keep our rules such that they are an umbrella for all the possible outcomes. That would not damage the UK authorities or the ECB. The ECB would then go back home, decide some rules at the ECB table and the Bank of England would go back to its home and decide its rules in London. The two sets of rules would be different and we would provide a sort of overarching umbrella which had no teeth. This is the highest risk for the EBA, and through it for financial stability of the Union as a whole, in many ways. I do not really see the other risk. I am sure that you could avoid a situation—it will be avoided in the voting mechanism—in which one jurisdiction can impose their rules on another. That would be unfair and eventually will not be part of the final outcome. But the other risk that I was outlining would be much more difficult to contain. It is a risk we have faced all the time in the past years. If there is no agreement between two positions, you fudge the wording and prepare standards that allow for different practices to survive without really producing true convergence. That is the risk there. On your second question, on the stress-testing and the resource, I have been quite honest with the Commission, the ECB and with the Council in saying that the present set-up on stress-testing does not work well. We are given a very light responsibility. The legislation says "initiating and co-ordinating" stress tests.

The Chairman: Did you say "light"?

Andrea Enria: The point is that we do not have the legal responsibility for and the legal task of conducting stress testing, so the final responsibility for the data and the quality of the results rests with the national authorities. If we are not convinced, as we have not been convinced in the past in some cases, that some of the data are reliable enough, we do not have the tools actually to intervene. We did a serious peer review process last year and strengthened the results of the stress tests quite a lot, but if the data we are given do not provide a reliable picture of the situation in a bank, there is a limit to what we can do. So my request to the Commission has been that we should move in one of two directions. We recognise that the stress test is a supervisory task which needs to be conducted by the competent day-to-day supervisory authorities. We can take the EBA out of it and put it in the hands of the ECB or the Bank of England, making it their responsibility, with us providing the tea and biscuits for our discussion of the results with the national authorities. However, we would not put our reputation at stake on those results because they are driven by them. Otherwise, if the legislators want to keep this responsibility with the EBA, they should strengthen our hand and give us the ability to call in the banks or, if necessary, to send in examiners to check the results. We will then have the responsibility to check them and our reputation will be at stake. That is my position. Being in the middle is too uncomfortable for us. I think that, honestly, last year we did a very serious job with the stress test, but we have seen our reputation falter because of Dexia failing a few weeks after its test. Bankia then disclosed huge losses a few months after our recapitalisation exercise. We need to find an instrument that works.

Q90 The Chairman: The second part of Lord Kerr's friendly question was about resources, which we discussed as part of our 2011 report on the EBA. Is the situation acute now? However, I suppose they depend partly on what you might become.

Andrea Enria: I like to quote the contact that I had with the acting chairman of the Federal Deposit Insurance Corporation in the US, Martin Gruenberg. He told me what he said to a hearing in front of the US Congress. The FDIC has been given the responsibility for resolving large and complex financial institutions in the US. It wants to be a credible body and to show that it is serious about doing this job. Within three months the corporation put 200 people together in one unit doing only this work. After 18 and now 20 months of the existence of the three authorities, we are around that figure. So, honestly, in terms of resources, I wonder whether we are serious about it. My answer at the moment is no, because we have too little in the way of resources. I must pay tribute to the national authorities which are helping us. They are seconding people, which is good for us and, I hope, good for the national authorities in terms of mixing cultures and experience, but we are very understaffed.

The Chairman: You have been very frank with us. I have other colleagues who would like to put forward some of the allied questions. However, I want to exhaust those questions which, as Lord Kerr has characterised, are really essential because you are the person who can respond to us about what the EBA might do and what it can contribute. Are there any further questions about the EBA itself?

Q91 Baroness Prosser: Mr Enria has spoken to us in detail about the supervisory structure as he sees it, but I want to look at one aspect that he has not touched on. Mr Enria, do you envisage that the structure you have described to us, its rules and practices, will cover banks of all sizes and types? We heard from one of our witnesses yesterday that there is quite a campaign, for example, for the savings banks to be excluded. What is your view of how that would work?

Andrea Enria: My personal view is that it is essential that banks of all sizes are included in the new institutional set-up. Why is that? If in Greece you now had a set of banks being supervised by European authorities and with a European safety net, and another set of banks under national supervision and a national safety net, in a moment of distress you would have flights of deposits from one set of banks to the other. Instead of creating more stability, you would destabilise the system. The responsibility needs to be maintained at the same level. This does not mean that you need to apply exactly the same rules and supervisory practices to the two sets of banks. I acknowledge that when you supervise a savings bank, you might have a more decentralised arrangement and you may have to tailor the requirements in accordance with the specific nature of the bank. For instance, let us take as an example the recovery and resolution plans. It is clear that you cannot ask a small co-operative or savings bank to produce a stack of documents on how it would break up in anticipation of a crisis—what type of business it would dismantle and so on. That is a different type of business so you can have much lighter rules for it than those which would apply to Deutsche Bank, HSBC or Barclays. You can tailor the rules for the complexity of the entity, but in my view the rules should still be in place.

The Chairman: In our last few minutes I will ask Lord Marlesford to pursue his question which follows up on that put by Lord Flight. We will then hear from Lord Hamilton, followed by Lord Jordan if he wants to speak. Finally, I would like Lord Flight to put our last question.

Q92 Lord Marlesford: My question follows your reply to Lord Flight about the currency risk and what you said in your paper about taking redenomination risk off the table. Do you feel that saving the euro is more important than necessarily saving the current structure and composition of the euro area; and that, by attempting to do the latter, which has been attempted for many months now, you could imperil the former?

Andrea Enria: I honestly think that, to take the redenomination risk off the table, it would be important to avoid exit of any country from the currency. The construction in the beginning was that adhesion to the single currency was irreversible. Of course, you can always leave the Union and there are processes for doing that, but I have been personally concerned about the idea that some countries can at a certain point try to push others out. That goes against the very nature of the European construction, which was built to bring the member states together, and would carry more risks than advantages.

Of course, this requires a lot of effort from all parties in terms of fiscal discipline and adherence to the common rules and, probably, stronger responsibilities for the European Commission, other European institutions and the ECB. That may be more painful but it is the more stable way forward. If some countries now leave the euro, the probability of default or exit by other countries would start to be factored in and the euro would quickly move from a single currency to a stronger fixed exchange rate mechanism.

Q93 Lord Hamilton of Epsom: You have mentioned Bankia. The decision may be taken to wrap up Bankia altogether. What is your view about moral hazard here? There seem to be three people in the firing line: the European taxpayer, the Spanish taxpayer and the depositors. How do you share out that liability when you wrap up a bank like Bankia?

Andrea Enria: If I look backwards, I have to say that there have been two mistakes in the management of the crisis in Europe. The first has been the idea that everything had to be done at the national level, which has meant in some cases that countries' budgets were not strong enough to do the task. In relation to that, the second mistake has been that sometimes the restructuring actions have been too timid. Because the budgets were too weak, too little capital has been injected, too little restructuring has been done and too little exit from the market has been done so far. Eventually we need to come to a situation in which, as you correctly say, we identify ways to apportion the cost while finding the least cost solution. Sometimes, keeping a bank afloat is not the best possible solution for taxpayers and the stakeholders of the bank themselves. We need to distinguish between the legacy issue and the future set-up. In the future set-up, I think that the US has constructed something strong. We should learn from that. There, they can wind down even large and complex banks. These banks are passed to a sort of bridge entity and all the creditors of those banks—first the shareholders, of course, then the holders of hybrid instruments and, eventually, the secured debt holders—suffer haircuts to their claims which allow restoration of capital to the new entity, putting it on a sound basis. That is the way forward. As to the resolution of the banks now under stress, I think we should find a balance between imposing losses—on existing shareholders, for sure, but, to some extent, also on existing debt holders—and imposing a serious downsizing of the activities of those banks, so that we also minimise the need to use European taxpayers' money.

Q94 Lord Jordan: I am a great eyebrow reader, Chairman, so I will not ask the detailed question that I was going to. Mr Enria, you have tended to put a positive note on the potential of the proposals. Quite a number of people think that they are too much, too fast, and that, with the present lack of accountability, they have no chance to remedy what is going on. What is your best bet on the outcome of those two views: the positive and negative?

Andrea Enria: As you correctly mentioned, I tend to disagree with the idea that we need much longer to get this right. When you are in a crisis, policy makers need to get their act together and deal with the issue on the table fast. There is also the risk of getting it wrong, but it is important to give it our best shot to fix the situation. I very much agree, however, with the point that you raised and which the European Parliament is raising: that you need to set the new institutional framework on the basis of sound democratic accountability. That is vital for the new mechanism to work properly. I am sure that the Parliament will push for that. Personally, as a European citizen—although also as a supervisor who is grilled by the European Parliament—I would like my colleagues at the ECB also to be grilled. Joking aside, I think that it is important that there is strong democratic accountability. Honestly, I think that eventually in the euro area, if they move to a new set-up, they need also in the longer term to fix the issue of resolution and the deposit guarantee scheme in a more co-ordinated fashion. Eventually, there needs to be parliamentary control of the use made of European taxpayers' money. It cannot be only the Council or closed circles of civil servants who oversee the process. There needs to be stronger accountability for how taxpayers' money is used—although, as I say, I hope that that will not be the case any more.

Q95 Lord Flight: Can I ask you about the resolution directive? A number of the individuals whom we have met have suggested that it is unlikely to be continued with—that it was floating an idea. More particularly, what do you think will be the impact of the banking union proposals and how would you respond to concerns expressed by the UK Government that the extension of the EBA's powers—in particular, to agreements through third countries—is disproportionate?

Andrea Enria: First, I genuinely hope that the issue is not just an idea to float but is a serious attempt to reform. As I said, I think that the US has progressed further than the European Union in repairing their financial system exactly because they have been quicker and more serious in enacting reforms. We should now address that issue quickly. The Commission's proposals are a step in the right direction. In many areas, they are exactly in line with the recommendation of the Financial Stability Board and best practices have been defined in the international setting on crisis resolution. Indeed, banking union will require, at least in some areas, that the framework become more ambitious. The Commission's proposal has perhaps not been bold enough in the area of financing of resolution. Basically, it has left it to national authorities. Now that we are moving towards banking union, it is important that there are stronger steps in the euro area towards a common resolution mechanism—maybe also a common resolution authority. That is recognised. The communication of the Commission says that clearly, so I think that it will move in that direction, but other aspects of the directive need to be approved and implemented soon. For instance, a crucial point for me is the idea of bail-in—the fact that creditors can be suffering haircuts on their claims. We need to clarify those proposals as soon as possible. Every investor I meet—in London and everywhere else—tells me that no one is now putting money to finance European banks because of the uncertainty on how that money will be treated. We need to produce that piece of legislation fast enough to repair bank funding. On the tasks of the EBA, I think that in this area, as in others, it makes sense to have a single entry point to establish agreements with third countries on how cross-border resolution can be managed. A lot of European financial institutions have establishments outside the European Union—and the other way round, of course; a lot of US or Asian institutions have establishments in different countries in the European Union. I understand the concerns raised by the UK Government, at least in the sense that it is difficult for us as a European agency to impose on a member state the enforcement of resolution actions which might not be compatible with a national legal environment. I understand that there is a tension between the need for co-operation and the legal setup, but I hope that harmonisation will be produced by the resolution directive, these concerns can be alleviated and we can work together with the national authorities to set up the good agreements with third countries to ensure that cross-border resolution can be achieved in a corporate fashion.

Q96 The Chairman: In concluding this very profitable session, would you like to impart anything else to the committee that you think would be valuable in our discussion and the construction of our report?

(Private evidence was taken at this point in the meeting)

The Chairman: We enormously value not only that insight, which was private to us, but the other insights which you have given with great clarity and which have given us great food for thought. You mentioned that in your public role and also as a European citizen your sitting before the European Parliament and getting grilled. This is the second time that you have come before us to get grilled. Perhaps I may say what an enjoyable experience it is and I hope that you will always be able to return to us for further grilling.

European Central Bank (ECB)—Oral evidence (QQ 149–171)

Evidence Session No. 10 *Heard in Public* *Questions 149 - 171*

MONDAY 22 OCTOBER 2012

2.05 pm

Members present

Lord Harrison (Chairman)
Lord Dear
Lord Flight
Lord Hamilton of Epsom
Baroness Hooper
Baroness Maddock
Baroness Prosser
Lord Vallance of Tummel

Examination of Witnesses

Vitor Constâncio, Vice-President, European Central Bank

Q149 The Chairman: Good afternoon or bom dia, Vice-President Constâncio. My name is Lyndon Harrison and I chair this Committee on economic and financial matters in the European Union. We are doing this report on the banking union and the recovery and resolution directive. We are most grateful for your coming before us today to explore some of the items that we have already alighted upon when we visited Brussels and met President Herman Van Rompuy, President Andrea Enria of the EBA (European Banking Authority) and Michel Barnier (European Commissioner on Internal Markets and Services). We are taking witnesses here in London and you are most a welcome addition to that cause. When we have finished today's deliberations, we will send you a transcript of what we have discussed. We would be very grateful if you could check that and send to the Committee any additional information that you have. We hope to report in about in a month's time for the European Council. I wondered whether you wanted to say any opening words and to introduce yourself. As an opening question, are you able to define what you think banking union means in practical terms for the ECB?

Vitor Constâncio: First, let me say that it is a pleasure for me to be here. I thank you for inviting me and for having this idea of hearing many opinions before you finalise your report. Of course, the concept of banking union is something for which different people can have different definitions. Nevertheless it is now more or less official, because it is already stated in documents that it comprises three main elements: first, supervision, then resolution of financial institutions and then deposit insurance. One could add some other elements to a full concept. For instance, one could have it that in talking about supervision we should include not only what is considered microsupervision but macrosupervision. We could also have it so that a fully fledged banking union in Europe would include direct capitalisation of banks, in some cases from European funds. In the present context that would be an instrument fully to separate banks from sovereigns which, as you know, is a reason for concern and one of the motivations to start the whole project—this new chapter of European integration.

The Chairman: That ability to fund banks directly may come about when the ESM is in place but we have a few steps to go before that happens.

Vitor Constâncio: Yes, I am just talking in general terms about the components of what will presumably be the full banking union concept in the future.

Q150 The Chairman: From where you are sitting, if these three items are put in place are you able to make a judgment on whether that will bring some stability and confidence back to the banking system?

Vitor Constâncio: Yes, I should say so, and even if they are implemented gradually and not immediately—those three together—the decision of the summit was to start with putting supervision in place, because in any case that would be an absolute condition for starting, for instance, the direct capitalisation of banks by European funds. I presume that after that resolution, later there would be deposit insurance. My own opinion about this is that deposit insurance can wait some more time; it can come at the end. What is important to ensure financial stability is effective supervision that can detect early on what problems are emerging in different banking sectors, which, as we know, prior to the crisis created a lot of imbalances in several countries, putting into jeopardy the stability of the euro area as a whole. So for that purpose, effective supervision is necessary and, as we all know, there is normally a local and national bias in conducting supervision. Even in the US, a recent study showed that there is such a bias when it compared supervision by regional and federal authorities. To eliminate this local bias, it is important to ensure stability in the euro area and to have a solid banking sector that cannot create problems for the sovereigns but can also resist if the sovereign is weak in its public finance.

The second element to ensure this, after supervision, is of course resolution because in many cases—in particular, regarding cross-border banks—it is important to be able to resolve banks that attain a point of non-viability. Indeed, I think personally that what is most necessary in the steps towards banking union is to have resolution for the big cross-border banks in Europe. Most of the banks can continue to be resolved at national level, so not all have to be transferred to the European level. The same is also true for supervision, which I am sure we will talk about later on.

Q151 The Chairman: Yes. Between whiles, do you think that this package of proposals and what we are intending to do in making changes to Basel III and CRD4 will overcome the problem of moral hazard or having banks which are "too big to fail"?

Vitor Constâncio: If you include in that the approval of the directive on resolution and crisis management, because that is the central piece for the purpose of dealing with the so-called "too big to fail" banks. Yes, we have welcomed the draft proposal of the Commission on the resolution of financial institutions and the attempt to harmonise the national laws in that matter, which is of course the purpose of the directive. By the way, the directive follows very closely the so-called key attributes of resolution regimes that have been approved by the G20 in Cannes, and by the Financial Stability Board before that. This is an international effort that goes beyond the EU. The key attributes that were approved in that context were respected in the Commission's draft. We see that as an important step but it is of course not enough for banking union, because for big cross-border banks we really need the European level to be there.

Q152 Lord Hamilton of Epsom: Mr Vice-President, I would very much like to ask about the timescale. As you know, the initial timescale proposed was extremely tight for the end of the year. To what degree was that related to Spain? If Spain asked for a bailout tomorrow, do you have sufficient powers for the ECB to go in and buy Spanish bonds on the secondary market and is there enough ability to recapitalise Spanish banks if these proposals have not gone through?

Vitor Constâncio: As regards our own programme of authorised monetary transactions, yes, we have the powers to decide that on the conditions that we have defined very clearly and strictly. On those conditions, it was a decision of the governing council of the ECB. That is totally separate from any question about banking union in all its elements. Regarding direct capitalisation, as was already decided in June, that was linked by the summit with effective European supervision being in place for direct capitalisation to happen. It was clear that it would not be ready at the beginning of next year, as desirable as that would be.

Now, as you know, as a result of the very recent summit there is an agreement, which we have also welcomed, that the regulation activating Article 127(6) of the treaty will be approved at the beginning of the year and will enter into force more or less immediately after its approval, so that the start of effective supervision in the field will happen only at the beginning of 2014. The entering into force is important because it will allow the single supervisory mechanism to prepare itself to discharge the mandate and to improve guidelines and manuals for supervision for all the national supervisors, which will have their own important role in the system, and so on. Then it will start in January 2014; at the same time, the CRD4 and the associated regulation will also start to be operational, which is a good coincidence. This timetable clearly resulted from the recent summit and it is a reasonable timetable. Of course, it delays until the beginning of 2014 any operation to directly capitalise banks in any country, which means that Spain or any other country that has to capitalise banks meanwhile has to do that with their own contribution—even if, as is the case with Spain and other countries, there are funds that are granted to the country as a loan to be able to buy itself those capitalisations.

Q153 Lord Flight: Mr Vice-President, what is the ECB's position on the Commission's rather broad proposals for a single European banking supervisory framework? What do you think is required for the concept to succeed? Do you feel that TFEU Article 127(6) provides an adequate legal basis for the supervisory tasks proposed? More practically, I think you have referred to the ECB being largely responsible for the larger banks as a systemic risk, but the Commission's proposals are for the ECB to become responsible for supervising all banks within the banking system. The point has been made that small banks have sometimes started banking crises. Is the ECB going to open supervisory offices all over the eurozone? How is its role going to interact with central banks' responsibilities?

Vitor Constâncio: Thank you for the question. I referred to the large, systemic cross-border banks in connection with resolution. Now, on supervision we broadly agree with the proposal of the Commission. We think that it respects the main principles that we have defined for the ECB to fulfil that role. Those were: first, that the mechanisms should be strongly and clearly defined as the intention of going in the direction of a banking union; also, that it should be effective in the sense of giving to the ECB the powers to do the job without compromising in any way its own reputation. That is achieved because from the start we have been in favour, from a legal point of view, of the ECB being given legal authority over all the banks. Although this is a system that one could say will in many ways be federal—meaning applying and very much using the principle of subsidiarity, which of course belongs to a federal concept—the centre will directly supervise the more significant banks. Mostly, that is those which are big enough and have cross-border activity in Europe. For the others, there will be decentralisation to national supervisors.

However, the fact that the ECB will have authority over all the banks implies two very important things. First, the national supervisors will act in accordance with guidelines and manuals for supervisory practices that will be approved at the centre. The centre will have the right to monitor how these are applied and implemented and to organise peer reviews and so on. That concept is very important. The second crucial consequence of having authority over all the banks is that it will allow the ECB—the centre—to call in banks, either individually or in groups, that require more direct and close attention for the precise reason that you mentioned: that we have seen in the crisis that some groups of banks, and in some cases small banks, have been responsible for creating the financial instability. If the national supervisor does not deal adequately with those cases then, by having the legal authority, we can interfere and start directly supervising those banks to take the appropriate measures. To have that authority over all the banks is essential to try to eliminate or at least mitigate the national bias in conducting supervision. That is crucial; it is one reason to have this new step into deeper integration.

However, it will be very decentralised in its day-to-day operation because, as I said, initially we will deal directly only with the big banks. This can evolve in the future but having the legal responsibility means that, at the same time, we will have to follow all the banking sectors to detect any early signs of potential problems. We will also follow many individual banks that are of importance at national level. We will do that from a distance just by looking at the indicators, but we will do it to detect any potential problems. That will be our responsibility and that is why it is important to have these... (inaudible).

The Chairman: We missed the last bit but I am going to invite Baroness Hooper to ask the next question.

Q154 Baroness Hooper: Good afternoon. My interest is in the relationship with the national supervisors but first I would like to ask for your views on the proposed package of powers for the ECB. You have already touched on this to some extent, but do you think that the proposals go far enough from the ECB's point of view?

Vitor Constâncio: Yes, we think they do. As you know, the article of the treaty says that the ECB can be given specific tasks on supervision, so it is not just in the broad concept that it is approved and given to the ECB. Article 4 of the proposal presented by the Commission lists the powers that would be given to the ECB, and we think they are indeed enough for us to ensure effective supervision.

Q155 Baroness Hooper: Thank you, but obviously we wish from a national point of view to be as helpful as possible—as helpful as necessary. I would be very interested to know the rationale for the proposed division of responsibilities between the ECB and national supervisory authorities. and how you feel that the relationship under the proposed regulation will work in practice.

Vitor Constâncio: First, the main division of labour is, let us say, between the banks that the centre directly supervises and all the other banks, which will in practice be supervised day-to-day by national supervisors. That means, for instance, that if we take just the big banking groups which have significant cross-border activity, we are talking about something between 25 and 30 banks—no more. There are about 6,000 banks in the euro area alone and almost 8,000 in the EU as a whole, so you can see that the main division is then that the centre will directly supervise the 25-odd banks or banking groups and that all the rest will be done by the national supervisors under the guidance, umbrella monitoring and definition of practices by the centre.

The second point is the following: the centre is not an abstract concept. At the centre, there will be the advisory board created by the resolution—and the supervisory board is composed precisely of the heads of supervision in each country that participates in the mechanism. All those heads of supervision will be seated around the table, preparing and taking the decisions that are given to the centre, so the centre is not an abstraction. The heads of supervision are national authorities, which will be there at the table approving the harmonisation of practices, standards of supervision and so on. That is another element in the division of functions that you referred to.

The relationship will then be very much influenced by this joint work being done by the supervisory board, which has all the heads of supervision. But of course, in order to be able in an effective way to discharge its responsibility the ECB—the centre—can have the power, to which the proposal refers, to give instructions to national supervisors in certain cases.

There is, I would say, no ambiguity in the system but a very extensive use of decentralisation and subsidiarity. It could not be otherwise; we could not have here in Frankfurt thousands of supervisors or open delegations from each country that will participate in the mechanism. That is not the concept.

The Chairman: Before we go back to the supervisory board, I invite Baroness Maddock to ask a question.

Q156 Baroness Maddock: Good afternoon. The Commission has asserted: “The creation of the banking union must not compromise the unity and integrity of the single market”. I wonder whether you think that this goal is compatible with the Commission’s argument that the single market and banking union are in fact mutually reinforcing processes.

Vitor Constâncio: Yes, I agree with that view, for the following reason: the single market is basically about rules and the implementation of those rules in all 27 member countries. That process is not touched by the creation of a single supervisory mechanism—not at all—because all the European legislation will come from the Commission to the 27. Meanwhile the EBA, as the banking authority, will be fully in its role as the approving authority for technical standards and secondary legislation, which will have to be applied in the 27 countries by all supervisors. In that respect, the single supervisory mechanism will just be another supervisor—the same as any other that exists—in the sense that it has to comply fully with European legislation emanating either from the Commission or from the EBA. The EBA will retain its role as the entity responsible for ensuring that all the European legislation is applied in the same way in all member countries and by all supervisors. That role of the EBA is maintained and has to be respected by all supervisors. The emergence or appearance of a new supervisor that in some ways substitutes for several supervisors does not change at all the concept of the single market or the entities that have a legal responsibility to ensure that all the principles of the single market are respected.

Q157 Lord Vallance of Tummel: Mr Vice-President, I would like to come to the way in which this new role of supervision will be handled within the bank itself. As you mentioned earlier, the proposal is that there will be a supervisory board to deal with these new tasks, although ultimate responsibility for decision-making would apparently remain with the governing council. There is an article in the *Financial Times* suggesting that the EU Council's top legal adviser has advised that under the existing treaties, at any rate, it would be impossible to give a bank supervision board within the ECB any formal decision-making powers. Is that the reason for this two-tier approach within the ECB—in other words, with the first tier being a supervisory board that would be no more than advisory and with the governing council taking decisions?

Vitor Constâncio: I am not sure that this will be the solution that emerged from the recent summit. Nothing much was said in public about the compromise that was reached. I am not undermining the version that was published by the media about this question, as it was discussed among lawyers. There was certainly debate and some different views—as is normal among lawyers and economists, of course—but that does not matter. In the end, that is just a process and in the summit last week there was the approval of a compromise to overcome those problems. The exact terms of the compromise now have to be translated by the lawyers, which means that the proposal presented by the Commission will be amended in that part. That is because the idea is to reinforce as much as possible the separation between monetary policy and supervision within the ECB, which means going to the extreme possible in reducing the role of the governing council as regards supervision.

The treaty, of course, talks about the ECB and the governing council is the deciding body of the ECB. But the supervisory board will have to have a very important role in taking the decisions, in particular if the decision of member states is to make possible a more balanced participation of countries that do not belong to the euro area by joining the supervisory mechanism. The summit itself found the guidelines and the orientation; it is for the lawyers now to draft the final version, allowing that all these problems can indeed be solved.

Q158 Lord Vallance of Tummel: Vice-President, from your own professional point of view, given your experience would you not prefer to have supervision completely independent from monetary policy?

Vitor Constâncio: Not really, no. The governing council of the ECB approved in 2001 a document about the advantages of giving the responsibilities of supervision to central banks, so it is not a new position. I was then already a member of the governing council, although that was then in my capacity as a national governor, but that document was approved in 2001. We have remained faithful to that view that central banks have many very important reasons to be involved in supervision.

If anything, the recent crisis reinforced all those arguments. It is not by chance but as the result of the lessons learnt in the crisis that there is now a sort of global tendency to shift supervision again towards central banks. Apparently, this is going to happen in the UK. As you know, it was announced and decided by the Government. It has happened in the US, where the Fed received under Dodd-Frank many more competencies regarding supervision, in particular over significant institutions. It is happening everywhere, the reason being that nowadays it is no longer really possible to distinguish the microsupervision of individual institutions from what is going on in the financial sector as a whole. It may be the case—as it was in many ways during the crisis—that when looking at individual institutions everything seems to be all right, yet the system as a whole is creating the source of huge imbalances. This overall view about the financial sector is something that the central banks really have the vocation to be very much aware of. There is a big gain in joining these two views of prudential supervision and central banks are better prepared to do so than other institutions. There are, clearly, very important synergies in this respect; I would say that that is the main reason why we see this trend in the world. Central banks have information directly from what is going on in the money markets and financial markets in a way that other institutions do not.

Of course, there are risks; there are no perfect solutions anywhere on anything. There are two main risks for central banks resulting from taking the responsibilities also for supervision. The main one, as I see it, is in potential reputation risks. Supervision is a very delicate thing and supervisors cannot see everything that is going on in an institution; that is impossible. By definition, we live in a system where significant margins of decision-making are fully decentralised to the private sector so, yes, there are risks of reputation. There are also some underlying potential conflicts between the objectives of monetary policy and those of supervision. I think this second potential problem is very much exaggerated, for two reasons.

First, it is clear that in many cases central banks have as their mandate in monetary policy a clearly defined mandate in the law—this is so in our case—in the sense of a hierarchical mandate. Price stability comes first; that is clear, and the main reputation of the institution is dependent on achieving that priority goal. Then, of course, whatever its mandate no central bank would compromise on monetary policy because it is told that one or two institutions required some treatment. No central bank would do that and if we are then talking about a general problem of the banking sector as a whole, since the 19th century no central bank ignores its role of providing liquidity in a financial crisis. It has been done in the UK, in particular since the 19th century. That happens in a financial crisis, regardless of the central bank having supervision or not. It happened in this crisis. All central banks did it because at that moment of financial crisis and the lack of liquidity in the system as a whole, there is no risk of inflation. Precisely, the financial crisis creates the recessionary conditions implying that there is no inflation risk. This conflict, which is mentioned many times, is really exaggerated as no central banks will compromise the main role that they have in our economies: to care for price stability.

Q159 Lord Vallance of Tummel: Thank you, Vice-President. Can I bring you back to a point that you made earlier, regarding how the new mechanism works for member states that wish to participate in it but are, at least to date, not members of the eurozone? Although non-euro member states will be able to opt in to the new arrangements, they will not enjoy voting rights in the new supervisory arrangement. Does this make sense to you?

Vitor Constâncio: As I hinted before, that is something that will be changed after the recent summit. I cannot tell you exactly how it will be done because it is not yet drafted but the political decision was taken at the summit to change it, so I think that we will very soon have details of the new arrangements for the governance of the single supervisory mechanism. The particular situation that you mentioned will certainly be changed.

The Chairman: We hope that that new arrangement will afford the greatest transparency for decision-making. Baroness Prosser?

Q160 Baroness Prosser: Thank you very much and good afternoon. This brings us neatly on to the question of accountability. You have talked about the decision-making structures within the European Banking Authority and the European Central Bank, but the Commission itself has asserted that the ECB "will be subject to strong accountability provisions", including to the European Parliament and the Council. In its words, it has introduced that "to ensure that it uses its supervisory powers in the most effective and proportionate way". How will you respond to those who will argue that if the ECB is to take on such significant new supervisory responsibilities, its accountability mechanisms must be made more robust? What do you think the ECB will do to ensure that it provides the public accountability that is expected of bank supervisors?

Vitor Constâncio: The type of accountability that the ECB will have to respect in its role as a supervisor in the single supervisory mechanism will be of the same type that national supervisors have nowadays in their own countries. It will not be very much different in that respect, which means that the appearances, reports and explanations given to the European Parliament and the European Council will have to happen more regularly and openly than has been the case with monetary policy. That is stronger accountability than was mentioned in the Commission's proposal in that respect.

In monetary policy, the central bank is fully independent. We issue explanations and have a press conference on the day that we take decisions, so the President of the ECB goes at least quarterly to the European Parliament. All that exists, but being totally independent in that matter of monetary policy of course implies that, legally, the degree of explanation can be more condensed than in the case of supervision, where accountability in terms of regular meetings and testimonies to the Parliament and the European Council means that we will have to be totally open about the decisions that are taken. This will be the same type of accountability that already exists in member countries regarding their national supervisors.

Baroness Prosser: You talked earlier about conflicts between the objectives of supervision and monetary policy. I think you were arguing that you did not think there was such a conflict, but this is a whole new process and much more detailed. You just implied that reporting may be as detailed or may be a little less, depending on who is reporting, if I understood you correctly.

Vitor Constâncio: No, the separation of monetary policy from supervision entails many aspects. One has to do with governance, which I already talked about, but there are more. Also, internally we will have different business areas dealing with monetary policy and supervision. We will have different meetings and bodies because the supervisory board will deal only with supervisory matters, while the governing council deals with monetary policy. The firewalls that will exist inside the institution will be respected on separation and the separation will also exist in terms of external accountability, in the sense that different sessions, reports and hearings will deal with monetary policy on one side and supervision on the other. There will be that total separation.

On the possible conflict that some mention, I tried to explain my view: that in the end, in practice, no central bank will compromise its role in monetary policy because of a supervisory role. As I have said, if there is a general problem of financial instability and collapse—or the possibility of a collapse of the banking sector—then the central bank, even if it does not supervise, will have to deal with that situation. That has been the rule since, historically, there were central banks. Historically, the main reason they were created was to deal with this sort of financial stability. At the time, there was no concept of monetary policy being an instrument to control inflation but the central bank has to do that in a crisis, without risking inflation, because in such a crisis the economy becomes weaker and there are no inflationary pressures. I tried to explain why these things are compatible—in particular, as is the case with the ECB, when there is a clear legal and hierarchical mandate. The division and separation go through many aspects and the lines of accountability will then be very clear and separated.

Q161 The Chairman: Do you ever learn anything from the European Parliament, when you and Mr Mario Draghi go before it, about the work that you are doing. Do they inform you? Do you see things differently as a result of your engagement with the European Parliament?

Vitor Constâncio: Yes, that engagement has been very extensive over the years. As you know, the President in particular goes there regularly. This interaction has consequences, as for instance was the case in the discussion of all this European legislation regarding the creation of the EBA and the European Systemic Risk Board. On all that, this interaction with the Parliament led to new compromises and understandings. I think that the same will happen in this case. It has not yet started in full because there is still no proposal by the Council but it will happen during the trialogue and, yes, we already have contacts with the European Parliament and the Commission about all this.

Q162 Viscount Brookeborough: Good afternoon, Mr Vice-President. Before I ask our question, can I ask you just a little about what you have described comfortably as the staged response to a crisis developing, of seeing the early signs of it and the supervisors therefore being able to do something at that stage and going on to resolution? Do you really think, taking the current crisis and its origins, that you will see the early signs?

Vitor Constâncio: Yes.

Q163 Viscount Brookeborough: Secondly, at one stage you mentioned monitoring. Supervisors, by nature of their definition, are bound to want to interfere to a greater extent than an observer. Do you not think that there would be an inclination for them to interfere at too early a stage, if indeed they can see the early signs? Can we see those anyway?

Vitor Constâncio: Yes, I think everyone has learnt lessons from the last crisis. It was already clear from other crises in history that financial crises are normally associated with a big increase in credit growth and in the leveraging of financial institutions. Those signs were clear for quite a while, although part of those increases in leveraging and credit growth were not fully seen because they were done in what has been called the shadow banking part of the financial sector. It is true that, all over the world, regulators were not fully aware of what was going on in this shadow banking sector. It added a lot to the increase in financing and leverage in the system. Those lessons have been learned and all the effort that has since been developed internationally by the Financial Stability Board and the G20 is to devise regulations that will deal with all these aspects of the financial sector, including the shadow banking sector. That is a work stream of the Financial Stability Board, which will present proposals to the G20 next year.

The Basel committee also introduced the new concept of imposing not only a capital ratio but a leverage ratio on banks—considering not risk-weighted assets but assets as such. There are new prudential ratios and methods, and lessons have been learned so that everyone is much better equipped to detect signs of financial imbalances being built into the system. The other element being developed is the lesson that the interconnectedness of financial institutions has increased enormously. Pure contagion effects can really accelerate and aggravate a financial crisis, so methods to detect this interconnectedness and analyse its consequences—and the measures to mitigate it—are also being developed. These aspects have improved a lot.

We know from history that authorities have tried many times to fight the previous battle and then new elements appear. We are all aware of that but with the broad view of monitoring and controlling the overall leverage of the system we can be more effective, even if new instruments are developed by the financial institutions. I think we can do that. There is always the question you raised, of whether one might intervene too early. It is a judgment call; internationally, authorities—in particular the Bank for International Settlements in Basel—started to talk about the risks very early on: in 2002, 2003 and 2004.

Other institutions also issued some warnings, perhaps not strongly enough, but there was a reluctance to interfere because the idea at the time was that the financial sector was very efficient, so that risk was being disseminated and the system was more robust. In the end, we saw that that was not the case and we learned a lesson about that. The financial sector is not totally self-correcting, as some thought before. It can generate crises that have real effects and are very significant. It can be a source of real fluctuations in the economy but now I think we will be much more aware of those possibilities. So there is a judgment call but we are better prepared to intervene in time, and the limits on capital and leverage will deal with some of the main risks.

Q164 Lord Vallance of Tummel: We come to the roles of and relationships between the ECB and the EBA, which need to be absolutely clear and workable if all these arrangements are to go. The Commission has published a proposal to amend the regulation establishing the EBA with that in mind. These relationships are inherently asymmetrical in that the EBA covers the whole of the European Union, whereas the ECB does not. Do you believe that the Commission's proposals will achieve clarity and effectiveness, or do you believe that the EBA's role needs to be strengthened further for that to come about? If so, how?

Vitor Constâncio: As I mentioned, the Commission's proposal fully respects the division of responsibilities between the EBA and any supervisor, including the ECB, in that it is clear that it is for the EBA to approve secondary regulation. No supervisor can change what has been called the single rulebook for the single market for the 27—the single supervisory mechanism. The ECB cannot pass new regulations; it is clear that it is for the Commission and the EBA to do that. That line is very well defined. It is for the EBA to monitor that all supervisors implement correctly the European legislation on supervision. We, as one supervisor among many, will have to be as much subject to that monitoring as any other. That is also very clear in the proposals. Therefore, in terms of the respective roles, there is no ambiguity in the proposals of the Commission—none whatever.

The EBA retains its powers, which are already stated in legislation, in its role as a mediator in case of conflict between two different supervisors. This includes the possibility of having a binding mediation between two supervisors. We should be subject to the same procedure of mediation as any other supervisor. As a conclusion, the Commission proposals fully respect the roles of both entities with regard to the single market for the 27 and the implementation of the single rulebook.

Q165 Lord Vallance of Tummel: The UK Government have pointed out that, as the ECB is an EU institution, it cannot legally be bound by EBA decisions on such aspects as binding mediation. Perhaps the new arrangements are not ambiguous but is it not a strange asymmetry that other national authorities and supervisory bodies are bound by the EBA but the ECB is not?

Vitor Constâncio: We accept that we will be bound in the same way as any other supervisor. We make a distinction between our role in monetary policy, where we are fully independent according to the treaty, and this new role of banking supervision.

The regulation is approved unanimously by the 27 under the terms of Article 127 and defines the specific tasks and role of the ECB in the matter of supervision. That is not to be confused with monetary policy and our full independence there. These are two separate things because Article 127 refers precisely to the fact that these new responsibilities can be given by a Council regulation. This means that in the treaty itself the role of supervision is not defined as an objective within the role of the ECB. It must be given by a new regulation and this new regulation can legally define the terms that give those supervisory tasks to the ECB.

Q166 Lord Vallance of Tummel: Can we move on to voting procedures, where there is another element of asymmetry? The UK Government have argued that, since the ECB regulation specifies that the ECB shall now "coordinate and express a common position of representatives from competent authorities of the participating Member States", that effectively means that participating member states will be required to caucus. If that is the case, it risks ECB domination of EBA decision-making. No matter what the de jure position may be, de facto you may very well find that the ECB dominates the setting of the regulations as well as the application of the supervision.

Vitor Constâncio: I agree that the second question that you now raise is different from the first. On the first, as I said, I see no asymmetry and no problem in overcoming any ambiguity that could exist in the draft that was presented. I am sure that, if there is any ambiguity, it will be corrected in the final version. That is the first possible asymmetry that you mentioned.

The second is the concern that it is more justified. If one were to be totally formal, one would say that given that a monetary union of 17 member countries already exists, the logic of monetary union by itself should, in principle, on many occasions lead the 17 countries to hold the same views about what the EBA does. This sort of convergence of views or interests could very well happen now when there is no supervisory mechanism. That problem is a general consequence of there being a monetary union inside the 27. However, it is not really a problem that we, as the ECB, feel that we have to take a position on, make recommendations on or whatever. We see that it is not our role to do so in respect of the problem that was raised by the UK in particular. It is something that we expect to be solved. I understand the concern, so if some reinforcement of the protection for minorities were to be introduced into the voting procedures of the EBA, we would have no objection. As I said, it is not something with which we have engaged with great interest because we feel that this is a problem for the member states to address and, we hope, to solve in the appropriate way.

Q167 Lord Vallance of Tummel: May I ask you about another relationship? How do you foresee the relationship between the ECB, with its macroprudential supervisory role, and the European Systemic Risk Board, the ESRB? How will that work?

Vitor Constâncio: As you know, the ESRB is for the 27 and can issue only warnings and recommendations. Legislation gave no instruments to the ESRB. It will continue to do its job in analysing financial stability in the 27 and to issue warnings and recommendations. Presumably it will issue—it has done so—recommendations to any particular supervisor or group of supervisors. So it can issue recommendations for the single supervisory mechanism in the same way as to any other supervisor. As it was conceived—it is now in legislation—the ESRB can continue to have a role in the system of European supervision.

As you know, it is also foreseen in the legislation itself that in 2014 there will be a review of any revision that was approved to the legislation. We will see how this will happen. I should also say that this reflection could be influenced by the number of countries that, in the end, will join the single supervisory mechanism.

Q168 Lord Vallance of Tummel: Given your unique perspective on what is going on in most of the banking system, do you see there being strong communication between you and the ESRB in future?

Vitor Constâncio: Yes, that already exists, as you know. According to the present legislation, the ECB was given the role of providing the ESRB with all analytical, statistical and logistical support, and we have done so. We have the whole business area of financial stability, in which we have already worked a lot on all aspects of macroprudential policies, developing the instruments to analyse risks in the financial sector and individual institutions of all 27 countries. We collaborated closely with the EBA when it conducted stress tests on the banks of the EU. We have also provided analytical support to the EBA and the ESRB. We will continue to do so in the future for the interest of that interaction and because it is in the legislation of the ESRB itself.

Q169 Lord Dear: Thank you for your continued time this afternoon. It would help us to turn our attention to the RRD, the recovery and resolution directive. In particular, we would like to get a feel for your assessment of that. For the record, the Commission has brought forward a proposed directive, COM 280, to establish a framework for the recovery and resolution of credit institutions that are in trouble, particularly a proposed bail-in tool and some more minimum resolution tools. It would help us if you could give a view on the purpose of those tools and how they will be effective, and a comment on the fact that our Government have expressed concern that the special manager tool might result in a significant risk, in that it would speed up an institution's failure. I do not know whether you would agree with that. Could you give us a view on it?

Vitor Constâncio: My view will be based on the early opinion that the ECB issued when the Commission published so-called communications about the issue. We are yet to approve our formal opinion on the draft directive. We are about to approve it but it is still not fully done. So what I say here will be more an expression of my own opinion than an institutional view, although I will be careful enough. I assume that the views that we have developed in the ECB will in the end be approved by the governing council.

We broadly welcome and agree with the approach taken by the Commission. We think it is necessary to harmonise more national legislation on the resolution of financial institutions. Europe is bound to do so as a result of the international commitments that were made in the G20. The FSB (Financial Stability Board) and the G20 in Cannes approved the key attributes of resolution laws and the intention of the G20 is precisely to harmonise national laws internationally in a better way to facilitate the process of resolving international, cross-border institutions. By presenting this draft directive, the Commission is mostly fulfilling the European commitment to having this approach approved within the G20. That includes bail-in tools. They are part of the key attributes of a good resolution regime.

In our opinion we expressed the view that besides the general bail-in tool that is in the draft directive, for big banks we could also have bail-in instruments that could be issued as such to the market, and even impose a minimum of such instruments that the big institutions would have to have. That would facilitate the process of dealing with "too big to fail" institutions. However, what is in the directive is just a general approach to bail-in tools, as they are generally mentioned in the key attributes approved by the G20. It is an important tool and I do not think it will create the problem that you mention.

We just have to compare with a sort of role model in the area of the resolution of banks—that is, the US institutions, particularly the FDIC (Federal Deposit Insurance Corporation). The FDIC, the deposit, insurance and resolution authority in the United States, has been given by law the same type of powers as are contemplated in the Commission's draft directive. It has early intervention powers and can immediately take over a financial institution that has triggered the indicators that show that it is about to have problems or has attained the point of non-viability. When the FDIC decides to do that, it has full powers to resolve the institution totally by creating bridge banks, separating a good bank from a bad bank, appointing managers to the institution and selling or merging the institution. All that has happened in the US during a weekend. Since 2008, the FDIC has resolved more than 400 banks without any great turbulence. It was a smooth process. In the US, the FDIC has very wide powers of overruling normal rights, including those of shareholders, as they exist in law, in the name of needing to deal with the potential failure of a financial institution. That has economic and social externalities which imply that the failure of a financial institution bears no comparison whatever with the failure of any type of non-financial institution. This is fully recognised in American legislation.

Many in Europe would like, if possible, a sort of European FDIC. That is not on the table right now. What is on the table is a draft directive of the Commission that intends to harmonise national laws. These are principles for national laws, national resolution authorities and national entities to implement. It is not yet the creation of any sort of European resolution.

We think that, because of the specific nature of financial institutions, the way to deal with those that are in trouble must be different from that for any other firms. It is important that the authorities have these wide powers to resolve institutions. The principle of dealing with "too big to fail" institutions is the same. The crisis has shown that, when there is a crisis, the taxpayer can be called on to put forward money in a big way. The way to avoid that is to have resolution regimes that allow the burdening of the interests of shareholders and creditors to reduce the amount of taxpayers' money needed to resolve financial institutions. Resolution must be very clearly distinguished from the bail-out of institutions. The draft directive and the possible future European resolution authorities are for resolution—to protect taxpayers as far as possible from having to save banks.

Bail-out is about saving banks. If countries and Governments want to save banks, that is their own responsibility, which is different from resolution. They will have to find the capital to recapitalise their banks. These are the sort of instruments that are necessary to mitigate—to reduce as much as possible—the resolution of financial institutions in a crisis.

Q170 The Chairman: Mr Vice-President, you have given us an hour and 20 minutes of your time. My concluding question is simply: if the United Kingdom abstains or stays on the sidelines when this is happening, how much more difficult will it be for you and your colleagues at the ECB to perform the tasks that you have been charged with?

Vitor Constâncio: The difference is not really significant. What do we have now? We already have many UK financial institutions that have a significant presence in other EU member countries, either with branches or subsidiaries. Nowadays, that is dealt with by the national supervisors. Some UK banks have very sizeable subsidiaries in other member countries. When it is a subsidiary, it is supervised by the national supervisor.

In principle, there is at least one such subsidiary that is so important that it may fulfil the conditions to be one of the institutions that will be supervised directly by the ECB. There will be no change. Nowadays, it is supervised by a national supervisor.

Then, for the institutions that have branches, colleges of supervisors have already been created. These meet regularly with the management of such institutions to discuss the problems of such institutions and the group as a whole, and to try to co-ordinate, understand and exchange information about the situation of the institution in all the countries where it has a presence. These colleges of supervisors are important instruments. The EBA also has an important role in these colleges of supervisors—all that will continue. One more supervisor will join these colleges and that will be the ECB. That is the difference. These entities are already very important instruments for co-ordinating intervention and the exchange of information among the relevant supervisors.

The Chairman: As promised, I will conclude the matter there. I apologise to some of my colleagues for not having been able to reach the questions about the credit guarantee scheme, the Liikanen report and some other aspects of the United Kingdom's role in all this.

Vitor Constâncio: I could be very brief.

Q171 The Chairman: If you are able to talk about the deposit guarantee scheme, I would be very grateful.

Vitor Constâncio: As I said, I think that the deposit insurance scheme will come later, not in the very near future. There are of course concerns that, in the present crisis situation, it could entail significant potential commitments by member states, so it will have to wait. As I said, it is not as vital as having the main elements of banking union, which are supervision and resolution. I accept the notion that deposit insurance will come when other elements of fiscal integration have progressed.

Regarding the Liikanen group, I think it is an intelligent compromise between the so-called Vickers proposals and the Volcker rule. It is somewhere between both approaches to some of the problems of institutions that, although funded by depositors from the general public, have embarked on proprietary trading and other, riskier activities that put deposits at risk and force the authorities to intervene. It is an intelligent compromise. I do not know whether the Commission will pick it up and transform it into a proposal; we will have to wait. So the ECB does not yet have an opinion on the issue. We have broadly welcomed the proposal but have not yet expressed a view. Personally, I think it is a good basis on which to deal with the problem of proprietary trading.

The Chairman: Vice-President Constâncio, I will send you a transcript of our exchange this morning and ask you to correct that. If you have further ideas, please communicate them to us, especially on some of those items that we did not tackle in depth. We are most grateful that you found time for an hour and a half's conversation with the Committee. Not only do we thank you, but any time that you are in London and would like to see us formally or informally, we would be very pleased to receive you here in the House of Lords. In the mean time, obrigado and thank you very much.

Euro Working Group—Oral evidence (QQ 71–81)

Evidence Session No. 5. *Heard in Public.* *Questions 71 - 81*

TUESDAY 2 OCTOBER 2012

10.35 am

Members present

Lord Harrison (Chairman)
Lord Flight
Lord Hamilton of Epsom
Lord Jordan
Lord Kerr of Kinlochard
Lord Marlesford
Baroness Prosser

Examination of Witness

Thomas Wieser, Chairman, Euro Working Group

Q71 The Chairman: Mr Wieser, you will be pleased to learn that you are our third witnesses out of about eight today, so I hope that you do not see the Committee begin to wilt. We are most grateful to you for coming in. We are doing a report on the banking union and the RRD. We are seeing quite a number of people; later on, we are seeing Monsieur Barnier, Monsieur Enria from the EBA and Monsieur Van Rompuy, so anything you can tell us now to inspire questions for them would be very helpful. I will ensure that we send the transcript of this conversation to you. We would be grateful if you could correct that but also feel free to add to it if there are further thoughts, as you always have when you leave a room and ask yourself why you did not say something. The Committee would find it particularly useful if you could just say a bit more about your chairmanship of the Euro Working Group and how you feed into the work of Jean-Claude Juncker, and so on. That would be a very nice lead-in before I put the first question.

Thomas Wieser: Thanks very much for inviting me. Of course, you could easily have met Monsieur Enria in London. You will be hearing all that you can hear and need to hear from Monsieur Barnier and Monsieur Van Rompuy later today. By way of introduction, I have got a dual job: to chair the Economic and Financial Committee and the Euro Working Group, which have overlapping compositions. The Euro Working Group is composed of the colleagues of the 17 euro area member states, and the EFC of the 27 member states. The EFC prepares ECOFIN decisions and the Euro Working Group prepares euro group discussions, and the two overlap significantly. There is of course a division of labour between COREPER, and the permanent representatives, and our groupings. For example, I will be having lunch today with COREPER to discuss exactly what each of us is doing to make sure that there is no underlap or overlap. In a slightly abbreviated form, I would say that COREPER is responsible for legislative matters and we are responsible for economic policy co-operation and co-ordination issues. We prepare the political decisions. The easier path these days is definitely to chair the Economic and Financial Committee, as you can well imagine, whereas in preparing discussions of the euro group I have learnt a lot of Greek, Spanish and even Gaelic in recent years. The latter is not true—but I am starting to learn Slovenian.

The Chairman: Given that you bestride the world of the 17 and the world of the 27, a number of questions will arise about the interface of the two. Could you in any way, shape or form define this banking union that is proposed? Do you feel that you understand its architecture?

Thomas Wieser: We are in a peculiar phase because there are a couple of distinctly separate pillars that are closely interconnected. It is like that nice building in Kuala Lumpur, with 110 floors, but I am not quite sure which floor we are at.

The Chairman: It is my deepest nightmare, that particular building.

Thomas Wieser: It is an interesting place. We have the so-called four presidents paper, which is a very important pillar. When I started writing little papers for Jean-Claude Juncker on this issue, the title of the first draft was *Putting the E into EMU*. Then I discussed it with a friend of mine, who asked me where the "U" had gone. So I then titled it, *Putting the U back into EMU*, but he said, "But it has never been in", so I took out the word "back". So now the paper is called *Putting the E and U into EMU*. That is exactly what led us into the whole discussion of banking union. We have a Council working group that is working on the legislative proposal of the Commission on the single supervisory mechanism. I understand that the British pronounce "supervisory" differently; I am always confused, because it is not my mother language. Those things are closely related but they are being dealt with by a Council working group and by heads of state or government. I am somewhat in between those people, looking left and right and not knowing quite where to look. Of course, the two overlap enormously. My understanding of the architecture is that the recent crisis has shown some of the enormous differences between a true monetary union and a single unified market on the one hand and a truly federal state, such as the United States, on the other hand. In a different incarnation, I have been part of these discussions about trying to save banks from collapsing. I have a comedian routine to explain how that happened. The CEO of a bank goes to the Finance Minister and says, "Please can I have a little money". The Minister says, "Why a little? Have a lot. Look at what the Americans are doing". He says, "No, no, no. Just give me a little money, because if you give me too much then Almunia in Brussels will turn up and say that he has to change his business model and sell his subsidiaries in Portugal, Romania, the UK or what have you. The Finance Minister says, "Ah, okay, I understand. I will give you a little money". "And, incidentally, it should not be core tier 1 equity but low-quality capital". The Minister says, "What's that?" The CEO says, "Ah, you don't understand. We are a Caxia or a Caisse d'Epargne or a Sparkasse or something else. If you take an equity stake in our bank, in five years' time you can sell it on the stock exchange and the Americans, Germans or Russians will buy it and that will be the end of our nice, cosy business model". "Ah", says the Finance Minister, "I understand. A little money and low-quality capital". This went on in very many member states, so we have a total failure of collective action here. If you look, on the other hand, at what the Americans were doing, they told the banking industry, "You're going to take a hell of a lot of money, we're going to swamp you, and you're going to write down odious, dubious and whatever claims, and that is it. It will be a clean slate". I never heard the phrase "distortion of competition" on the other side of the

Atlantic. Are we so much more stupid than the Americans? I do not believe so. But it is inherent in the fact that we have 27 or 17 different supervisors, depending on how you look at it. Also in your country banking is regarded as the industrial policy darling of the past 10 years. Most of you are over 40 and you will remember the times when the UK had Vauxhall, the steel and car and IT industries. For every country I have different examples. In Luxembourg I remind them of the ARBED steel business, which they ran into the ground in the 1980s. It was an industrial policy failure, and now we are witnessing a protection of the financial service industry from intra-European competition and competition rules by giving them too little too late and that of a measly quality. Had we had a single European supervisor three or four years ago, this would not have happened, because the CEO would have gone to that supervisor and the guy would have said, "You are going to be treated exactly like the 50 others. You are going to get a lot of money and write off all these claims against—take your pick—Holland, private households, Spain, real estate developers, and so on". And I would probably not be sitting here and you would probably not be in Brussels today. But there is a flaw to my argument

Q72 The Chairman: You describe that very well. Is the proposed banking union one that will bring about that golden state of affairs? We have heard a lot of criticism in the short time that we have been here about the unrealistic nature of the proposed timetable.

Thomas Wieser: First, I will pre-empt the flaw in my argument that you were too polite to point out. What I have said would call for a European supervisor for the 27. There are quite a number of good—and other—reasons for proposing a single, supervisory mechanism for the 17-plus others who might wish to join in. Indeed, there is a rationale for that, because, within a currency union, you have at least one degree of freedom less to adapt and adjust in case of a banking crisis. So you can easily also make the point whereby it needs to be among the 17, not among the 27. Now, on the criticism of the time plan, it is, of course, very ambitious. I personally do not believe that we will see a single supervisor on 1 January 2013, let alone have it functioning, and let alone with anyone in a position to write a paper saying that it has been functioning and supervising well. It is a bit like St Franciscus—or was it the other one?—who said, "Please, dear God, make me chaste, but not yet". St Augustine. It is a target. If it moves by half a year, it moves by half a year.

Q73 Lord Hamilton of Epsom: I am interested by your parallel of big money coming in; this is, of course, precisely what we have done in Britain post-crisis. The result is that we effectively have three nationalised banks in London. How are you going to avoid that if the same role is going to be played by the ECB? It prints vast amounts of money. I think that it logically then has to take a stake in the business. It must have some exit route. Presumably, in return for the bailout, it will end up with a very large equity stake in these banks, and then you are going to have a mass nationalisation of banks across Europe.

Thomas Wieser: An interesting point. On point No. 1, the ECB would be the supervisor, but it will obviously not be the provider of capital. In the UK, the money came from the Treasury and the supervisor was the FSA. The ECB will never take a stake.

Lord Hamilton of Epsom: So who will?

Thomas Wieser: I would suppose that it would be the ESM. Secondly, with the financial crisis that we see now, I hope and believe that it is a less-than-once-in-a-generation financial crisis. Over the next 10 years, we will be more occupied with reducing government stakes in banks that are now government-owned than in taking any new stakes. Thirdly, if you look at the proposals on resolution, bailouts should become even more the exception in future crises than they are today. You could argue that they were not the exception in the crisis of the past three years; they appeared to be more of a rule. As we complete banking union within the euro area and as we complete the design of financial sector regulation and supervision for the 27, there will be the proposals on deposit guarantee schemes and resolution mechanisms. All three taken together would imply that resolution mechanisms that cost money will be the true exception. There is a slight misunderstanding, I believe, in the media about the difference between recapitalisation and resolution. Member States have put enormous amounts of money into recapitalisation. Under the proposals, the ESM would presumably be the resolution mechanism, which is winding down a defunct bank. It would still need to be Governments who put up the money to recapitalise the banks, but that poses a very interesting question of a more constitutional nature: can you force a Government to recapitalise a bank if they have had no say in the decisions leading to the recapitalisation? I think that it is totally clear in everyone's mind that there needs to be a certain parallelism in the decision-making and shaping, and the financial consequences, no matter whether they are done at the national level or at a supra-national level. That is the really interesting question, but the volumes involved in resolution are considerably smaller than the volumes involved in recapitalisation.

Q74 Lord Kerr of Kinlochard: Two questions arise directly from what you have said. In answer to Lord Hamilton's question, you said that you presumed that it would be the ESM that would take an equity stake. There is nothing that I recall in the ESM text that talks of the ESM as shareholder. The ESM, I thought, was an IMF—a funder. It put in money; it did not take a stake. However, I might have misunderstood you. A second question: on recapitalisation—your last point—I strongly agree with what you say. Surely what is missing in these texts is any mechanism for the person who has acted on the bank to explain to the taxpayer of the member state, who will be paying for the consequences of his action, why it has had to happen and why it is the right amount of money and the right solution? In other words, accountability is not here.

Thomas Wieser: I said that this was my presumption, but it is the presumption of many people that the ESM will be functioning as the resolution mechanism. This is where we are—the stage of presumption. Since there is no single supervisor, and since we do not have any agreement on resolution, there unfortunately can be no agreement yet—indeed, no proposal—on who would be functioning as the resolution mechanism. If those assumptions turn out to be correct in the coming months, I presume that, in the case of resolution, you first have to take an equity stake in a bank if you then wind it down. However, the large-volume transfers of capital required to recapitalise banks would, as a rule, come from the sovereigns concerned. There is one exception. We go back to the euro area summit of end of June. Under certain circumstances, the ESM can directly recapitalise banks in programme countries. This has given rise to the noisy arguments following the publication of a German-Dutch-Finnish paper. Many things were written in that, but the main thing that stuck with the media and policy analysts was the treatment of legacy costs. We have a variety of sources of capital for the potential recapitalisation of banks, some of which are connected with the setting up and functioning of a single supervisory mechanism. Then we have the separate but related issue of the resolution mechanisms, and I would presume that before you wind down the bank, you have to take an equity stake to be able to do so. The question on democratic control and accountability has two different levels. One is the general accountability of a supervisor to an elected Parliament, and there I would suppose that the European Parliament would play an important role.

Lord Kerr of Kinlochard: That is not clear yet.

Thomas Wieser: I used the conditional—it "would play".

Lord Kerr of Kinlochard: But that is not proposed at the moment.

Thomas Wieser: Not at the moment; that is correct. We have had a meeting with eminent persons from the European Parliament, and they made their position eminently clear. Then there is the other aspect of accountability for financial consequences of recapitalisation. All I can say here is that everybody is conscious of the issue. It needs to be solved in a manner that is in accordance with member states' constitutions, so one simply will have to find a way to deal with this issue and to bring decisions and their financial consequences on to the same level of responsibility.

The Chairman: Before I bring in Lord Flight I have to go to Lord Jordan, just to polish off the point about accountability.

Q75 Lord Jordan: The accountability question becomes heightened if I take your big money proposal, which would certainly avert a crisis but also seems to be a recipe for everlasting bonuses and very little responsibility for the institution concerned. That then makes some say that an ECB that is capable of doing the sort of things that you want really would be too powerful. A lot of important people are saying just that, which then harks back to how we make it more accountable because, as Lord Kerr said, under the present proposals there is insufficient accountability. How can that be dealt with—I will not say at a stroke—with perhaps one or two significant measures?

Thomas Wieser: There are very many underlying questions in the short question that you posed. First and foremost: if you bail out banks, what are the consequences in terms of salaries, bonuses and all of that? This is something that you would naively think it would be extremely easy to deal with, especially if you are the owner of a bank as a Government. This has not been the case, which shows that owners exert damn little influence over some of the institutions that they appear to own but do not necessarily control. That shows that if one so desires, one would have to have a more horizontal approach to these issues. I have not heard that much about the G20 initiatives, which started out with great bravado, in recent months. On the issue of the power of the ECB, yes, again, the ECB will never be a direct or indirect owner of any bank. Its power will increase. I am not a friend of central banks being supervisors and never have been. It is a second-best solution. Pragmatically speaking, I think we all are in agreement that this is the best way forward: in the best of all possible worlds, we would be setting up a distinctly separate and different institution. What conclusion do I draw from that? That the firewalls between the ECB and what I hope is an "as separate as possible" supervisor are as tall, thick and impenetrable—is that the English word? These foreign languages are difficult—as possible.

The Chairman: That is really helpful. I think that Lord Kerr will want to pursue that point later but, Lord Marlesford, you had a follow-up point.

Q76 Lord Marlesford: It was really only on the accountability point and the European Parliament. Presumably, the European Parliament would be looking for accountability from the ESM, if it takes stakes, and not from the ECB as a supervisor. Or would it like both?

Thomas Wieser: The ESM is an intergovernmental mechanism, distinctly separate from the EU treaties. It is even domiciled in Luxembourg, but that is by coincidence. I would see no possibility at this stage of the European Parliament exerting any control over the ESM. It is rather the 17 national Parliaments that control the ESM, but not in the manner that there is an in toto control thereof. There is probably only the democratic accountability of the individual representatives of the member states within the ESM. Therefore, the accountability of the ESM rests and ends with the board of governors. The ECB, as a single supervisor under the treaty and with a legal base in the treaty—which many people would be able to discuss for weeks on end, I suppose—needs democratic accountability under European rules. That is where the European Parliament comes in, because the ECB cannot be accountable to 17, 18, 25 or 27 different Parliaments. It has to be accountable to one body, I would say, for its everyday actions. This is separate and distinct from the accountability of an individual supervisory action with financial consequences, but for its everyday operations I would actually favour having the European Parliament as the body to which it is accountable.

Lord Marlesford: At the moment, the ECB is responsible to the Council of Ministers of the 17, is it not?

Thomas Wieser: The ECB is independent and we therefore have no actual policy linkage between the Council of Ministers and the ECB, but we have a standing reporting by the president of the ECB within the European Parliament. However, that has nothing to do with accountability but has something to do with the interaction of the institutions.

Q77 Lord Flight: I think that we can all see the vision of one having to put in an EU equivalent of the Federal Reserve system, but how do we get to that? It is very clear that the ECB takes charge of supervision but if it is to deliver through the existing central banks of Europe then you have all the attitudes, habits and power bases of those central banks. I really cannot envisage the people working for the Bundesbank doing what the ECB tells them; they will do it their way. Nor do I believe is it envisaged that the ECB would set up its own on-the-ground operations in these countries, which would be the only way that it could become a Federal Reserve regulatory body, so I see a clash between the practical issues and the vision. My second point is that I could understand it dealing with future bank resolution but it will not want to deal with legacy. The immediate issue is, clearly, sorting out Spain's problems, which are grave and worsening and where there is not a solution yet. How is that going to be solved?

Thomas Wieser: So the question before the question was: should the single supervisor—I hate to call it the ECB—be responsible for supervising all 6,000 banks or just a subset? My response to that is: where did the crisis really start? Did it start with Deutsche Bank?

Lord Flight: In America.

Thomas Wieser: Ah but we imported it—in the UK, with Northern Rock. Then many people said, "Ah, it is an Anglo-Saxon malaise", but then it crossed the Channel and struck IKB. Nobody knows IKB, but from there it went on to the "Sparkassen" in Austria. We do not even know the names of these provincial little thingamajigs in Austria, and other countries, an exception being Hypo Real Estate. The crisis in Europe was with the smaller institutions, as a rule. There is a good case that you have got to supervise all banks but, quite obviously, you cannot directly supervise them all, so by an act of delegation you will empower the other supervisors—not the central banks—who in many cases happen to be the central banks but in quite a number of other cases are not. You will delegate to them the actual day-to-day supervision while ensuring that central tasks or questions are either done from Frankfurt, if it is in Frankfurt, or by way of supervising the supervisors with common rulebooks, handbooks and so on and so forth. That will also help to solve some of the problems of accountability when decisions with financial consequences are to be taken. Nobody is proposing that the ECB supervises all 6,000. The danger is rather the opposite: that you will have many people proposing that the ECB supervises only those who are—

Lord Flight: Too big to fail.

Thomas Wieser: Yes, exactly. That would be my answer. On the legacy assets, my view is quite clear but not universally or largely shared. If you want to recapitalise a bank, and there is direct bank recapitalisation, you want to make sure, first, that the losses are covered by somebody. If, in mid-2013, somebody was going to directly recapitalise a Spanish bank, I am quite certain that it should not be the European taxpayer picking up the tab for losses that are the result of bad risk management and possibly bad supervision from 2002 to 2012. If, in 2020, a Spanish bank were to be directly recapitalised, who is going to bear the losses? The official answer, which is not so stupid, would be, first, let us look at resolution. We therefore look at bail-in, and the issue of covering losses possibly does not arise. Then, you have the sequencing of private capital, government capital and then, only as a last resort, other public money. Once direct supervision has been working for a number of years, quite obviously you could not ask the local Government to come in and cover the losses. It is more a matter of what we do between 1 July 2013 and when the system is up and running. I suppose it is the case, as with any other takeover, that if you as a person buy a Spanish bank now, you will agree a price with FROB, but you also want to make sure that for a period of two or three years you have a comfort clause in your contract that states that if unexpected losses emerge after change of control—you have a taxative list and so on—then the Spanish sovereign and FROB would still have to cover those losses.

Lord Flight: The worry now is that if you loan it on to the Spanish Government, as was done in Ireland, you render the Spanish Government insolvent and basically uncreditworthy for ages. So there is a significant body saying—and we have heard them—that you cannot put it on to the Spanish Government. It is going to have to be done collectively.

Thomas Wieser: If you look at the results of Oliver Wyman, you will see that out of the, let us call it, €60 billion there is an expectation that a number of the banks will be able to be recapitalised from private sources. Here we are talking about covering not losses but recapitalisation costs. The actual recap measures are considerably lower because private sources will also play a role. In reality—we talk about the banking recapitalisation overburdening Spain—Spanish GDP is close to €1 trillion, so the whole recap exercise will cost them, or the ESM when it takes over, 4% or 5% of Spanish GDP. This is not even a straw that would break any Spanish camel's back.

Q78 Baroness Prosser: I wanted to ask about the Lisbon treaty, which I do not think you mentioned at all. To what extent do you think Article 127.6 of the treaty may give a legal basis for the work that is going on?

Thomas Wieser: Unfortunately, I am neither a lawyer nor a legal expert, otherwise I would probably be doing something more intelligent for my livelihood.

Baroness Prosser: More financially rewarding maybe, but not necessarily more intelligent.

Thomas Wieser: It would be less interesting. All our legal experts have assured us that Article 127.6 is the only coat-hanger in town. When I flip through the treaty, it appears indeed to be the case. It is a pity.

The Chairman: A man who is knowledgeable about coat-hangers—Lord Kerr.

Q79 Lord Kerr of Kinlochard: I want to take our witness into an area where he is absolutely not willing to go, because he began with that brilliant and elegant explanation of the distinction between the role of the Euro Working Group and that of COREPER. I remember well similar distinctions being drawn, unsuccessfully, by me between the role of COREPER, when I chaired it, and the work of the monetary committee—

Thomas Wieser: Which was chaired by Sir Nigel Wicks.

Lord Kerr of Kinlochard: Many years ago. I would like to ask about the EBA regulation and the proposals to amend it. Our witness will undoubtedly tell us that it is nothing to do with him, that it is a single market measure for COREPER and the Council. Nevertheless, let us ask him whether he thinks that it is worth doing. Is the amendment of the EBA regulation necessary, desirable and feasible?

Thomas Wieser: I have no direct responsibility for many of the things I have been talking about. I am here as the amateur mechanic or something. There was a very interesting discussion at the informal ECOFIN in Nicosia in mid-September. Not many major points were addressed, but one was about the timelines, which everyone said were utterly stupid, unrealistic and so on. I think that everyone was in agreement anyway, so it was a fight over nothing. It was not even a fight. The second issue was the relationship between the ins and the outs, crystallising in what happens within the EBA. Question No. 1 is: does one have to change the voting rules within the EBA? I believe that not only the Chancellor of the Exchequer but the Swedish Finance Minister made very intelligent and eloquent exposés of why this will be necessary, and there was no contentious discussion over that. Everyone in the end said, "Of course we need to change it". Is there agreement on how to change it? No—but mainly because the discussion has not even started. But the principle, as laid out by the UK, Sweden and others—a concern that the 17 supervisors of the euro area would be co-ordinated, ex ante, by the ECB and would therefore vote en bloc in London—is something that everyone admits should not and could not happen. So the voting procedures will change in order to give a vote that is representative of the multitude of opinions among the 27. Are there other issues that one would need to change in the EBA regulation? I do not think that there is anything completely central that you need to change there.

Lord Kerr of Kinlochard: In a way, you are changing the role of the EBA, are you not, if you are putting it in the box marked "supervision"? Here we have an organisation that exists for discussion among regulators being asked to take on, implicitly, a role in supervision. Is the EBA credible as a supervisor in future?

Thomas Wieser: I do not completely share your analysis of the distinction between regulators and supervisors, which the general public always confuses. They sometimes call the supervisors regulators, but I grew up believing that the regulator was the Government. This is no longer true under the Lamfalussy process because level 3 instruments are a regulatory device designed and developed by supervisors. So this distinction has become blurred and therefore the EBA is a chapeau over 27 supervisors, largely to the extent that they perform regulatory functions, but also, to a non-negligible extent, supervisory actions—for example, conducting stress tests, which is something that a regulator would never be concerned with. I believe that, both in the regulatory field and the supervisory field, there need to be changes in how decisions are arrived at—level 3 legislation, technical legislation. One wants to ensure, au minimum, that this is done in a completely harmonised way for those member states that are members of the single supervisory mechanism. The UK would possibly want to join on a case-by-case basis. This is a decision where it may want to deviate. So that is something which you need to enable. Will you need to change, for example, the co-ordination of stress tests? There, I believe that we have largely an identical approach among the 27, under the chapeau of the EBA—but Andrea Enria knows much more about these things than I do. That is where you would possibly want to have changes in how decisions are arrived at, but the actual work that the EBA is doing there is anyway quite harmonised. Developing a single rulebook is on the verge between regulation and supervision. So all this goes to show that the EBA is in reality doing both, and in the design of the single supervisory mechanism one has to take account of what the EBA is doing, not vice versa. You do not want to parachute things from the EBA into the single supervisor.

Q80 The Chairman: Two final questions. Where are we up to regarding the recovery and resolution directive, and what anyway is its relationship to the banking union?

Thomas Wieser: These are things that Barnier and others are much more qualified to talk about than me. However, it is very interesting if we talk about banking union. The single supervisory mechanism is not banking union. It needs to be complemented by a number of things. We have got the issue of deposit guarantee schemes, about which we have not said anything so far. The resolution mechanism issue needs to be considered. When you have all these in place, the question is: who is responsible in which manner for the contingent liabilities of such a system? If you have a true banking union—a real banking union—then you probably have joint and several liability for contingent liabilities incurred by a deposit guarantee scheme or the resolution mechanism, in extremis. Then you are with at least two of your toes within fiscal union. I would make that distinction. What we are talking about now is a supervisory mechanism. If it were complemented by a couple of other legislative Acts, then it moves towards a banking union, but the whole discussion of fiscal union, economic union, et cetera, is something that—

The Chairman: The deposit guarantee scheme is in extremis, is it? Is it an essential part, or important part of the directive?

Thomas Wieser: I am in a minority of one in this town on the importance of deposit guarantee schemes. For now, I think it is necessary and sufficient to have a harmonised approach on deposit guarantee schemes along the lines that the Commission has laid out in its proposal. Many people say, "But for a functioning banking union, you need one single deposit guarantee scheme for the whole area". I disagree. I think that deposit guarantee schemes are vastly overdone in their economic policy importance. They are extremely important as psychological devices for depositors; it is important to know that there is something there—that if something happens, somebody will take care of you. As soon as something happens, they are blown away by the wind, and the Government behind them needs to step in. That is also why I am not such a believer in this religious debate about ex ante or ex post financing. It simply does not matter. But I am the only one in town who says so.

The Chairman: You may feel yourself unfit to answer the next question, but we would love you to do so.

Thomas Wieser: I have probably been unfit to answer all questions.

Q81 Lord Hamilton of Epsom: Either by accident or design, our own financial regulation measures are going through both Houses of Parliament at the moment. Have you had visibility of that? Do you feel that, at the end of the day, the United Kingdom is going to be ahead of the EU or behind it in terms of the stringency of this regulation? I would very much like to know your opinion because the Labour leader, Ed Miliband—although I have not been able to confirm it—said yesterday that he believed in Glass-Steagall as a way of dealing with banks. What are your views on Glass-Steagall? There is a lot of cross-party support for it, particularly in our House. Do you think there are merits in splitting investment banks from the clearing banks?

Thomas Wieser: On your first question I am even more unqualified than for answering the other question. I follow the debate via the *Financial Times*, but I am not quite sure if it is reporting faithfully, either on the euro area or the City. As far as the Volcker rule, the Liikanen report or Glass-Steagall are concerned, we will have a different world of finance anyway, as we emerge from the crisis, with consequences for potential growth all over Europe, and indeed in all mature economies of the world, that people have not yet completely realised. All of our economies were living on debt. Some economies were living on public debt, others on household debt and others on corporate debt. But if you look at all internationally available statistics, the western economies—no, the OECD, because I include Japan—and indeed, all mature industrial economies have not come to terms and to grips with globalisation. Politicians have been unwilling to let the population know that globalisation may possibly be positive overall for an economy, but has negative consequences for income distribution—the bottom 10, 20 or 30% of income distribution. That is why, especially in the Catholic economies, the Governments indebted themselves in order to hide the consequences from the population in a passive manner. In the Protestant economies, one usually went via private debt, but the end result is all the same. They pulled wool over the population's eyes, with the exception of resource-rich economies such as Norway, Canada and Australia. So we will have to deleverage; and the art of deleveraging is difficult. It is like the kid's balloon—there is too much air in it. We will have to let the air out carefully, because if you do it too fast, you know what happens. I will not say that. The result will be that potential output in our economies over the next 10 years will be very subdued. That, in itself, leads to a totally different role for the financial sector in our economy than it has had for the past 10 or 15 years. Apart from that, anything that leads to better risk management is to be supported. If it is to be the separation of investment banking from other activities or if it is to be higher capital ratios or liquidity ratios, or whatever, one should not become too dogmatic on the means to try to concentrate on the end, which is to de-risk banking. I believe that within the European Union, there should be a largely uniform approach to de-risking the banking sector, because we are too closely interconnected to be able to avoid arbitrage behaviour.

The Chairman: Thomas Wieser, I shall regret to my dying day not hearing your articulate eloquence in speaking of these high financial matters in Gaelic. What I do know is that the Committee has enjoyed your articulacy and clarity of thought at the end of this morning, and we particularly like to hear from the last man in town who holds certain beliefs that sometimes become the currency with which we deal. We are most grateful to you. I remind you that we will send you the transcript. Please update it if you need to, but in the meantime we give you our sincere thanks.

Thomas Wieser: Thank you very much. I was quite nervous when thinking about this—being in the presence of the former president of COREPER put me on my toes.

The Chairman: Thanks ever so much.

HM Treasury—Written evidence

1. There is a wealth of evidence showing that a systemic financial crisis can have a clear impact on public finances, and the Euro area has been seriously affected by the current instability in the financial sector. The Government welcomes the Committee's inquiry into the reform of the EU banking sector and I hope this letter will assist the Committee in its deliberations.

2. As the Committee has acknowledged, various work on banking reform is being progressed by different bodies. While much of this work is still at an early stage, there have been a number of important developments since the Committee's call for evidence. At the June European Council, the four Presidents of the Council, Commission, ECB and Eurogroup were tasked with producing a specific and time-bound road map for the achievement of a genuine Economic and Monetary Union. The UK is fully engaged in this process and is awaiting the Presidents' interim report in October 2012.

3. At the same time, Euro area Heads of State or Government agreed that the European Stability Mechanism (ESM) could have the possibility to recapitalise banks directly, but only once a single supervisor for Euro area banks is in place. The relevant sovereign would still be subject to appropriate conditionality, including compliance with State aid rules. Euro area finance ministers agreed that the technical discussions on the future ESM direct bank recapitalisation will start this autumn.

4. Only once the full technical details of the proposal are known will we be able to make an assessment. The ESM Treaty is an intergovernmental agreement between Euro area Member States only. The UK will neither participate in, nor contribute to the mechanism, but was involved in the work to finalise its features along with the other 'euro outs'.

5. In early 2012, European Commissioner Michel Barnier set up a high level expert group to consider whether there is a need for structural reforms to the EU banking sector. The Government believes that the introduction of well-designed structural reform will significantly reduce the perceived implicit guarantee to the EU and UK banking sector, and is committed to taking forward the recommendations of the Independent Committee on Banking. These reforms are intended to address what the Chancellor has called the British Dilemma – of preserving stability while maintaining a world-leading financial services sector. Any reforms taken forward at a European level will need to reflect the specific circumstances of individual countries' banking systems. In this respect the Government looks forward to the important contribution of the Liikanen group to this issue.

6. Lastly, on 12 September 2012 the Commission adopted proposals for two Regulations concerning a Single Supervisory Mechanism for the Euro area, accompanied by a Communication setting out the Commission's position that such a mechanism is an important first step to establishing a Eurozone Banking Union and indicating the further measures that are envisaged. The policy analysis on these proposals is ongoing, and as negotiations are now live I'm sure the Committee will

appreciate that at this stage I am unable to comment in detail on the Government's negotiation objectives.[38]

7. However, to assist the Committee I have attached a copy of the Explanatory Memorandum and associated Impact Assessment that we are submitting today, setting out our overall position on the proposed Regulations and the Commission's Communication on Banking Union as a whole.

The Key Elements of Banking Union

8. As the Prime Minister and Chancellor have said, the proposals on Banking Union are coming forward to address specific issues in the Eurozone, and are a natural extension to a fiscal and monetary union, rather than the single market. Addressing financial stability in the Euro area, including by placing the banking sectors within the Eurozone on a more sound footing and ensuring that common backstops exist is important, bearing in mind the interdependency between banking systems in a single currency and macroeconomic imbalances within a monetary union, and can only be addressed through measures aimed at strengthening supervision and sharing of burdens in that union. The Single Supervisory Mechanism has been proposed with this in mind and we have welcomed this approach.

9. The Commission's Communication outlined a roadmap towards Banking Union, focusing on the establishment of a Single Supervisory Mechanism led by the European Central Bank as a first step. Future anticipated steps include a single resolution mechanism to 'govern the resolution of banks and coordinate in particular the application of resolution tools to banks within the banking union', and a call to finalise existing legislative proposals on Deposit Guarantee Schemes, capital requirements and the recovery and resolution of banks and investment firms.

10. As the Chancellor has noted, while Banking Union is being designed for the Euro area, this level of integration in the Eurozone could have profound implications for the operation on the single market. As Banking Union is implemented, it is critical that the legislation reflects the need to preserve the unity and integrity of the single market.

The Single Supervisory Mechanism

11. Under the Commission's proposal, the ECB would perform a significant number of supervisory tasks in relation to credit institutions established in the Eurozone (and those Member States who choose to enter into a close cooperation arrangements), with a focus on the larger and more complex cross-border banks. As the single currency's central bank, the ECB is an appropriate organisation to take on the central supervisory role for Euro area banks and this arrangement is fully consistent with the TFEU (Article 127(6) TFEU provides the legal base for the conferral of specified supervisory tasks on the ECB). It will be important for its success that the ECB performs its supervisory tasks in a way that is proportionate, effective and efficient, with decision-making independent of the performance of its price stability and macro-prudential tasks and with sound accountability mechanisms.

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38 ECB Regulation: http://ec.europa.eu/internal_market/finances/docs/committees/reform/20120912-com-2012-511_en.pdf EBA Regulation: http://ec.europa.eu/internal_market/finances/docs/committees/reform/20120912-com-2012-512_en.pdf Commission Communication: http://ec.europa.eu/internal_market/finances/docs/committees/reform/20120912-com-2012-510_en.pdf

12. It will also be particularly important from the perspective of all Member States that do not use the Euro, including the UK, that there is strong institutional balance in the Single Supervisory Mechanism. This is to ensure that, as Member States participating in Banking Union move towards being supervised by the ECB, the Euro area does not have a de facto veto or collective say over issues that should rightly be decided between all members of the single market. We have voiced these concerns alongside other Member States outside the Eurozone, and will prioritise the establishment of balanced governance for the Banking Union that provides for fair representation of non-Eurozone interests in all relevant forums.

13. More detail on our assessment of the Commission's proposals is included in the Explanatory Memorandum. The Government has consistently argued that Banking Union can make an important contribution towards a stable single currency, and we see no reason why a well-designed model that reflects the needs of both the Euro area and those outside the Eurozone cannot be implemented.

14. The Committee's call for evidence raises the question of whether the UK will be marginalised as a Banking Union in the Euro area is taken forward. The Government is clear that this will not be the case. A Euro area Banking Union will not change the fundamental Treaty freedoms that underpin the single market. It is also in the interests of all 27 Member States that the new regulatory arrangements do not interfere with the functioning of an integrated single financial market across the entire EU. It is strongly in the UK's interest for the EU economy to succeed and we will continue to play a constructive role in negotiations on the Single Supervisory Mechanism and other elements of Banking Union.

15. We will also continue to work closely with the Commission, other Member States and the European Parliament on financial services regulation that is appropriate for all members of the EU. For example, we are seeking to agree common rules on restructuring failed banks, shared principles on how to protect depositors and high minimum standards for capital that banks across the EU should hold. We also continue to strongly support the case for effective European Supervisory Authorities (including the European Banking Authority) in fulfilling its role as a coordinator of national supervisors, which will include the ECB in future.

Future Elements of Banking Union

16. Alongside the two Regulations, the Commission Communication on a road map towards a Banking Union sets out the Commission's intentions to bring forward proposals for further elements of Banking Union, these include a proposal for a single resolution mechanism. Again, bearing in mind this is part of a package of measures to strengthen the Banking Union, these measures should be aimed only at participating Member States.

17. The other dossiers referred to in the Commission's Communication are currently under negotiation and are at different stages of the legislative process. The Government will continue to be closely involved in negotiations on these dossiers.

Recovery and Resolution Directive

18. The Committee has asked a number of questions relating to the Recovery and Resolution Directive, where negotiations are more advanced[39].

19. As you are aware, the Government is broadly supportive of the Commission's proposal on a Bank Recovery and Resolution Directive. In the Explanatory Memorandum on the proposal of June 2012, my predecessor, Mark Hoban MP, set out the Government's approach to the Directive, including an evaluation of the proposal. Further to this his letter of August 2012, I responded to some further detailed questions asked by Lord Boswell. Both these documents (which are annexed to this letter for ease) provide responses to some of your questions (namely, responses to questions 10 to 12 and 13(e) which can be found in the letter of August 2012 to Lord Boswell, and a response to question 13(h) covered in the EM). Turning to your outstanding points not covered in the above mentioned documents, namely questions 13 ((a)-(d) & (f)-(g)).

20. The Government is supportive of the planning and preventative measures, such as recovery and resolution plans and the powers to identify and remove barriers to resolvability (i.e. the preventative powers). The proposed provisions on these plans are broadly in line with the UK's domestic regime and emerging international practice. They form the key foundations of an effective recovery and resolution regime. The Government also welcomes a requirement for there to be recovery and resolution plans for cross-border banking groups as part of a broader effort to improve cooperation and coordination pre-crisis and in the event of a cross-border failure in Europe.

21. The Government is also supportive of the proposed range of resolution tools. In the UK, the Banking Act 2009 already provides the Bank of England with the sale of business and bridge institution tools. In the 2012 Banking Reform White Paper, we have committed to introducing a bail-in tool[40]. We have consulted on draft legislation which extends the resolution framework for Banks to investment firms, parent undertakings of those investment firms and deposit-taking institutions and central counter parties. The same consultation also looks more broadly at whether a regime is needed for other (non-CCP) financial market infrastructure (such as exchanges and payment systems) and insurers, for which the case is less clear cut. The consultation closed on 24 September, and the Government is considering the responses.

22. While the Government supports a positive role for European Banking Authority in the Recovery and Resolution Directive, in particular as a standard setter and an assessor of best practice, we are concerned with certain proposed provisions that significantly extend the remit of the EBA, for example, such that the EBA would be responsible for determining whether third country resolution proceedings should be recognised in the EU (Article 85).

23. In such areas national resolution authorities, rather than the EBA, should remain responsible due to the potential impact of such proceedings on the interests of local depositors, creditors and shareholders of the institution under resolution. In

[39] http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/COM_2012_280_en.pdf
[40] http://www.hm-treasury.gov.uk/d/whitepaper_banking_reform_140512.pdf

addition, these provisions are arguably inconsistent with the fundamental principle of the EBA Regulation that the decisions of the EBA should not impinge on the fiscal responsibilities of Member States and of the principle established in the Meroni case that a delegation of powers to an EU agency which *"... involves a discretionary power, implying a wider margin of discretion which may, according to the use of which is made of it, make possible the execution of actual economic policy"* is impermissible. Furthermore, the proposed EBA binding mediation role during a group resolution, as part of their role in the resolution college, is highly likely to limit, and may delay, national authorities' flexibility in using the resolution tools effectively.

24. In terms of the resolution college membership (Article 80), given the potential impact on Member States, particularly those that are host to a significant number of branches, including the UK, the Government believes that host authorities should also be members of the resolution college. This would mirror the approach followed in supervisory colleges.

25. More broadly, we are not convinced about the merits of the intra-group financial support provision (Articles 16 to 22) and remain concerned that if triggered it may increase contagion risks within the group, leading to its failure.

26. The Government is already voicing some of these concerns during Council Working Groups that have been taking place since July.

27. I look forward to discussing these issues with the Committee further.

4 October 2012

HM Treasury—Oral evidence (QQ 209–237)

Evidence Session No. 12 *Heard in Public* *Questions 209 - 237*

TUESDAY 30 OCTOBER 2012

10.30 am

Members present

Lord Harrison (Chairman)
Viscount Brookeborough
Lord Dear
Lord Flight
Lord Hamilton of Epsom
Baroness Hooper
Lord Jordan
Lord Kerr of Kinlochard
Baroness Maddock
Lord Marlesford
Baroness Prosser
Lord Vallance of Tummel

Examination of Witnesses

Rt Hon Greg Clark MP, Financial Secretary to the Treasury, and **Nikhil Rathi**, Director, Financial Services and Market Regulations, HM Treasury

Q209 The Chairman: Minister, it is my great pleasure to welcome you to our Committee this morning. We hope to have as flourishing an exchange with you as we had in the past with Mark Hoban, your predecessor. I would be grateful if you could introduce your colleague when you first speak. I remind you that in the House of Lords we take a transcript of the exchange, which we will send to you for correction. We also ask people to add any afterthoughts or further information that will be useful to us in this our concluding witness session on banking union and the recovery and resolution directive. I will ask you whether you have any opening words, but I would be grateful if you could do all those things. I will remind you at the end.

Rt Hon Greg Clark MP: It is a great pleasure to be here. I hope that this will be the first of many occasions when we will be together and I look forward to your advice. My colleague Nikhil Rathi is, I think, known to you. He is a senior official on the EU working group on banking union, so he spends many waking hours in Brussels working on the detail. I thought it would be useful, since I know that you have also spent time in Brussels, to have a first-hand account of where we are, especially on some of the detail. You will also appreciate that as I am only a few weeks into the job, Nikhil Rathi has some of the technical detail that I know you will be interested in.

This is an unusual session in two senses. First, of course, the topics into which you are inquiring are still very much under negotiation, so I know you will understand that there will be certain areas where it would be injurious to our negotiating position to set out entirely our current views. However, I will try to be as candid as I can. Secondly, I have always taken a strong view that the benefit of scrutiny, the expertise around this table and the expert witnesses that you have consulted should be available to inform decisions by Ministers in these negotiations, rather than simply a matter of ex-post scrutiny.

If there is a way, perhaps informally, with the members of the Committee, before you publish your report, which I understand takes some time, while these negotiations are live, I would be very keen to have your steer so that you can help us in the negotiations. It might therefore be actively fruitful rather than simply an exercise in scrutiny pure and simple, though that is a very important role. With that, I look forward to your questions.

The Chairman: I regard that as a very helpful comment, which we will think about. Our intention is to publish the report the day before the European Council, but in order to make sure that we are able to influence you, and perhaps a wider circle, we are thinking of publishing a letter of emerging conclusions. If you wanted to meet some of us informally, perhaps afterwards, we will think about that. However, I am very grateful for your comment about having a good level of engagement between you and us as a commenting Committee.

What do you do in terms of defining the banking union? Do you think that the proposal as it stands has the ambition of trying to calm matters and get us into a steady state. Using Nikhil Rathi, whom we also welcome here, perhaps you could report to us from the 18 October meeting, and describe where we are up to.

Rt Hon Greg Clark MP: Certainly. On this question of banking union, whether it is in capital letters or not—and I have seen the evidence you have taken from others—we know that so far no single concept is totally accepted across the institutions. Its purpose is very clear, which is to say that it is very important to stabilise and to inject some prospects for future prosperity into the eurozone. A number of elements can advance that, in our view. Seeing the ECB as a supervisor for the banks of the euro area is one thing. However, in our view, as you know, the fiscal side of that is important, too. It is important to be able to have the ability to have a mutualised system of deposit insurance, and to be able to reassure investors and to stabilise the system. As you know, the discussions on the way have linked it to the ability in the future to have the possibility of a direct recapitalisation of banks in the eurozone. These are elements, therefore, that come together for the purpose of stabilising what has been a very unstable and turbulent situation within the eurozone. Nikhil, do you want to add to the current state of the negotiations, without breaching whatever vows you are expected to swear in these discussions?

Nikhi Rathil: The European Council set the objective of agreeing a legislative framework by the end of December, which in practice means by the next European Council. Of course, with these things there are many different interpretations as to what a "legislative framework" means. Different member states on different sides of the argument, who want to go at different paces, interpret it in different ways, but there is certainly a real impetus to try to make as rapid progress as possible over the next two months.

The European Council also signalled quite clearly that they saw the ECB as taking on direct supervision of large systemic banks, and having a somewhat more modified role in relation to other banks. That more modified role is also something that is subject to considerable discussion.

The other key part for us, in the opening Council conclusions, was the language on the integrity of the internal market and the interaction with the European Banking Authority, which we will come to. At this stage, therefore, there is a lot of intensity in the negotiations. It is quite heavy going—slow progress is being made—because there are a lot of technical issues. The next milestone will be the ECOFIN meeting in November, at which I believe further political guidance will be sought.

Q210 The Chairman: Minister, do you think that the ambition to hold to this very tight timetable is first of all achievable, especially when you include the single supervisory mechanism, and do you think that it is desirable?

Rt Hon Greg Clark MP: This is something on which I would seek your views, because I know that you have considered this question in detail. My view, and the Government's, is that if you regard the problem as being, as I described, the doubts and lack of confidence in the eurozone, then that is a current problem, and you need to move at pace to deal with it. As I said at the beginning, of course there are different elements to it, and the initial measure—the single supervisory mechanism—is first in the queue, as it were. That is likely to come up for discussion and possibly agreement at the end of the year. But even that sets a process in train. If adopted, it would take until 2013 for it to be implemented through the legislation in the different member states. It seems to me that to set out the structure and the framework by the end of the year, and then to implement that aspect of it over the next 12 months, is achievable. Going back to the purpose of it, we need to bear in mind the reason that we are engaged in this discussion in the first place.

Q211 Baroness Maddock: The Commission has asserted that, "The creation of the banking union must not compromise the unity and integrity of the single market". I wonder how realistic you think this is, given that the Commission also argues that the single market and banking union are in fact mutually reinforcing processes.

Rt Hon Greg Clark MP: They are different and it is important that we establish very clearly that they are different measures. The banking union is about providing stability to the eurozone banks. The single market in which we compete and operate has to continue; we must continue to have unfettered access to that. Part of our purpose in scrutinising and debating these measures is to make sure that that is not compromised.

Baroness Maddock: How do you think that will affect us in the United Kingdom, given our view on the banking union, and where we want to be?

Rt Hon Greg Clark MP: We have, in the Bank of England, a supervisory authority that serves the purpose for which it is proposed to create a supervisory authority in the eurozone. We think it works well and this Committee will know that there is legislation to strengthen it further. However, we have to guard against any suggestion that there would be less than full access to the single market through the adoption of the banking union proposals.

Q212 Lord Kerr of Kinlochard: May I press you on that for a moment, Minister? If you take things like capital adequacy, CRD4, deposit guarantees, common resolution arrangements and deposit protection, these are all, looking at it from one end of the spectrum, ways of deepening the single market. They are logical extensions of the great banking directives that started in the 1980s. If you look at them from the other end, they are urgently necessary to support the eurozone. They are now put together under the rubric “banking union”. The Prime Minister tells us that banking union is very important to the eurozone but nothing to do with us. How do we square that circle? If these are the pillars of the single market in financial services, but we say that we are going to stand aloof from them, how then do we protect the integrity of the single market?

Rt Hon Greg Clark MP: In terms of the components, there are various aspects that we do not want to participate in, such as the single supervisory mechanism. However if you take, for example, CRD4 and bail-in, far from standing aloof we are driving those dossiers towards maintaining the rigour we think is necessary in all our interests. It is not a monolithic set of proposals. There are some things where we share a strong common interest and we will continue to advance them. People on the Basel Committee recognise that we are playing a key role in maintaining a consistent approach.

Nikhil Rathi: To add to what the Minister said, we will be fully part of a number of the proposals he talked about: CRD4, the deposit guarantee scheme directive and the recovery and resolution directive. They will constitute a single rulebook that underpins the single market and the UK will be bound by them. We will not participate in the single supervisory mechanism or the areas which involve mutualisation of fiscal risk, because with common supervision goes fiscal risk.

Q213 Lord Marlesford: When we went to Brussels, I felt there was a good deal of confusion of thought between regulation and supervision. They are actually extremely separate. Regulation—in other words having rules in a rulebook which have to implemented and monitored—will presumably remain the function of the EBA, which happens to be in Britain. On supervision, when we were there they did not really seem to have got under starter’s orders even in defining what they wanted to legislate. So I find it a little curious that they are going to be able to produce legislation by the end of the year, even though it will take months and months to get anywhere. They talked about what a lot of banks there were—6,000 banks—and whether the supervision should be done on all of them or just the big banks or the vulnerable banks, which begs a question of course. I would like your view on the fundamental question of the extent to which it is a matter of ECB supervision of the banks or ECB supervision of the supervisors and then intervening directly as and when necessary. One of the lessons one knows about bank supervision is that, unless you are extremely close to the bank, the chances are that you cannot supervise it. The disasters of 2007-08 were largely the failure of the managements themselves to supervise the banks. So if the idea is that it can be done by the ECB remotely from Frankfurt, or even with having people around the place, the question is whether they have the capacity. How many people do they have? They do not seem to have thought of any of this. They hardly appear to be under starter’s orders. Would you like to comment?

Rt Hon Greg Clark MP: I noticed that you asked that question in Brussels during your hearings and you make a very important point. Sometimes the words supervision and regulation are used interchangeably. The supervisory mechanism, at least when it affects all the banks within the eurozone, will have some of the character of supervising the supervisors. It has to be that way, at least initially. I do not think that that means that it is not a valuable start to recognise the ultimate role of the ECB in verifying the processes and the soundness of the national authorities and, as it gears up over time, to make adjustments over which banks and which systems require more muscular supervision from the centre than others. The way that I would expect and hope that these powers would be interpreted is absolutely as you described it.

Q214 Lord Hamilton of Epsom: If the ECB does get this supervisory role, are you not concerned about democratic accountability? If, to take a rather extreme example, it comes to the conclusion that a caja in Spain is completely unviable and pulls the plug on it, will there not be a great tendency for both nationally and locally elected representatives in Spain to distance themselves from this decision and say, "This is all done by the ECB; these awful people in Frankfurt decided to shut this thing down and put large numbers of people on the street"?

Rt Hon Greg Clark MP: It is a very important and profound concern, which needs to be addressed. In this country it is clear that the Bank of England and, ultimately, the Chancellor of the Exchequer, is accountable to your House and to the House of Commons and has to answer to scrutiny. It will be important to look at the methods of accountability, to make sure that the tensions which are clearly there are anticipated and that there are some solutions.

Q215 Lord Jordan: We are talking about the ECB, an institution that will be one of the most powerful in Europe. Knowing that, the Commission has said there will be strong accountability to ensure that it acts in an effective and proportionate way. Are the accountability provisions that you are aware of sufficient? Do you envisage a conflict between its role as a fully accountable bank supervisor and an independent monetary authority? Most important of all, would it not be in the UK Government's interest to press for maximum accountability to the European Parliament so someone at least will have the power to start pulling this institution back? The UK Government will clearly not be able to.

Rt Hon Greg Clark MP: Thanks, Lord Jordan. In terms of the potential conflict or tension between the different roles of the ECB, part of the proposed ECB regulation takes steps to prevent the contamination of the supervisory and monetary policy functions. There are two aspects. One is to provide for a separate objective for the discharge of the ECB supervisory function. The second is to impose requirements to ensure that the tasks are performed separately. So that is envisaged structurally. As I said in my earlier reply, when you are taking decisions that affect populations in different member states, you have to think very carefully about accountability. I might ask Nikhil, who is fresh from the discussions, to say whether he can give a flavour of some of the solutions that are finding favour.

Nikhil Rathil: This is one of the big issues in the discussions. I would say that there is quite a strong feeling in the room that the current proposal does not go far enough on accountability. That is certainly something that the European Parliament will feed in. I would pick out three things in particular which I think need more work before this is concluded. First, there is no internal appeals mechanism in the ECB, so a firm has no way of asking the ECB to reconsider a decision. Secondly, the legal process for challenge is very complicated. The only legal redress a firm has is to go to the European Court of Justice. That can typically take two years-plus, and if your bank is about to be closed down, that does not really help you. So there is an issue about the speed with which you can get legal redress. The third point, which Lord Hamilton drew on, is: who is in charge in a crisis when the issues of democratic accountability are at their most profound? There is a gap in the current proposal as it stands as to how that would work. That needs working on.

Q216 Lord Jordan: On my point about Parliament itself, the UK Government are hardly flavour of the month in Europe. Do you not think that you would gain a lot of brownie points by backing stronger powers for the European Parliament, in particular to be able to hold the ECB to account?

Rt Hon Greg Clark MP: I recognise the case that you make. It is part of the discussions. For my own part, given that we will not be part of the ECB, one has to be careful not to lay down arrangements that are not going to apply to this country. There is always a sensitivity about that as well, as you know—about the UK making demands to which it will not be subject. For my part, I regard accountability to Parliaments, national and European, as a very important mechanism with which to build confidence in the decisions that are taken.

The Chairman: Before I bring in Lord Flight, do you meet our British MEPs?

Rt Hon Greg Clark MP: I do indeed. In, fact, when you were taking your evidence in Brussels, I was there on the same day, meeting some of the same people that you had met—Sharon Bowles and various others. They were not just our own MEPs, but MEPs from across the different member states. In fact, I was speaking late last night to one of our MEPs, which gave me some feel for how debates were going in the Parliament on some of these issues. I had better not embarrass her by giving her name. But I think that it is very important that the institutions that exist to represent people in this country should talk to each other and should not simply operate in silence.

The Chairman: Please feel free to divulge any name you wish to!

Q217 Lord Flight: Part of what I want to focus on has already been raised. It is wrapping up what your assessment is of the proposed ECB package of powers. First, it seems that there is a strong UK hand here, in that the proposed arrangements read very much like the twin-peak PRA that will be the superior supervisor, leaving the central banks to be the FCA and deal with all the consumer-type stuff. I see a UK hand here. The objective is, in a sense, better regulation—a clear recognition that some places regulate better than others and others may not be particularly good—and to bring the whole lot up to a decent standard. But then we are slap-bang into the issues raised, which are power, accountability and judicial review. Has the ECB got enough power? What do you think? There is enough criticism of what is coming in the PRA here, in terms of the Governor of the Bank of England having too much power, while on a pan-European basis it is really a dictator coming. Look at how Ireland totally resents the ECB package forced on it two or three years ago, even before we had any of this. Pulling that all together, do you think that the package of powers will work? Do you think that they are about right? As a follow-on from that, for non-eurozone members who may want to participate, we were promised on 18 October some proposals to change the voting rights relevant to non-eurozone members. Do you know anything more about that and what is likely to be forthcoming?

Rt Hon Greg Clark MP: In terms of the powers of the ECB and whether they are muscular enough, ultimately it is for the eurozone to decide how the functions should be allocated between the ECB and national competent authorities, just as we are having a debate in this country on the conclusions of the Vickers report as to what is the best split between the conduct of business and the prudential regulation. Those discussions will need to take place. What I would say is that since the ECB for these matters would be, in effect, a single competent national authority, my own view is that it should only have the powers that a competent national authority should have. We have our own arrangements and I think there is a rule of thumb that they should be replicated. We would have some concern if the ECB were to acquire greater powers than our own regulator has. The voting rights and the modalities, as they are called, are live issues in the negotiations, as you know. It goes back to the point about our ability to access the single market. We know that the ECB has an obligation to co-ordinate the position of its members. So we need to ensure that those members of the EBA who are not members of the eurozone cannot be disadvantaged. There is some recognition of this. I went to ECOFIN in October and it is by no means only the United Kingdom—other member states expressed the view very strongly and forcefully that the Commission's proposals were not adequate to that task. M. Barnier, whom you have met, recognised that they had further to go on this. There are live discussions. Nikhil, do you want to give some insight into where those discussions are?

Nikhil Rathi: I think there are three voting questions that are very sensitive in the negotiations. First, there is the question about the rights of non-eurozone member states that opt in, and whether they get a vote or not. It has become clear in the discussions that the treaty prohibits their having a vote on the ECB governing council. It is very clear that that is eurozone member states only; only the ECB governing council can take legally binding decisions as regards supervision. The solution that has been examined is whether the supervisory board that advises the governing council and drafts the decisions that the governing council takes can have a broader composition and can facilitate broader voting for countries that opt in. But they will not have a vote on the decision-making body, if any non-eurozone member states opt in. That is one of the voting questions. The second voting question is that within the ECB supervisory board, is it one member, one vote, or is it based on some qualifying majority? The larger eurozone member states are arguing for greater recognition of the size of their financial sector; the smaller countries want one member, one vote. That will be a very live discussion. The third issue is how this interacts with the European Banking Authority—I know there are some questions later in the evidence on this—where there is an ongoing debate about whether the Commission has got the balance of proposals right. I think there is an understanding, as reflected in the conclusions of the European Council conclusions, that we have still some way to go to make sure that non-participants' interests are properly taken account of.

Q218 Lord Flight: Finally, what are the implications of the ECB's powers for existing home/host regulators? Will the Bundesbank be happy to just become a consumer regulator? That seems a bit unlikely.

Rt Hon Greg Clark MP: We do not think that there should be any change in the arrangements. That is certainly the intention in the negotiations. I do not know whether you think that we are making good progress there.

Nikhil Rathi: Within the single supervision mechanism, the concept of home/host disappears. The countries that participate all become a home member state, effectively, or a home supervisor. That is the intention behind it. On the interaction between the ECB and non-participating member states, it is not envisaged that the home/host balance shifts.

Q219 Baroness Maddock: You indicated that other non-eurozone countries have similar concerns to ours. Can you elaborate a little on that, as to who they are and how helpful it is?

Rt Hon Greg Clark MP: At the October Council, and in fact in Cyprus before that, there was some dissatisfaction expressed by, for example, the Poles, the Swedes and the Hungarians that the potential for the ECB, through the eurozone members, to dominate the EBA was unsatisfactory. There was some concern at the October ECOFIN that not enough progress had been made between the informal ECOFIN in Cyprus and that October meeting. Nikhil is fresh from those negotiations and can say whether there has been a palpable acceleration of those discussions. There was a sense that it was treading water and not really moving. I detect from the briefing that I have seen that that is now being approached with a little more urgency.

Nikhil Rathi: These issues are now being much more intensively debated, I will say that much.

Q220 The Chairman: Adumbrating Lady Maddock's point, in much of the correspondence we have had with you, not just on this subject but others, the Committee is anxious to learn who our allies are. Do you feel, almost de rigeur, that you could let us know who they are when we write to you on these matters?

Pursuing that point, in reply to Lord Flight you said that it was of course up to the eurozone countries to decide these matters, as in the case of banking union. However, the Prime Minister has repeatedly said that it is in the UK's interest to secure a good outcome and the prosperity arising from that. Bearing in mind Lord Jordan's point that we may not be flavour of the month in Brussels, how do you finesse that when it is clearly in the UK's interests to have a good outcome about the design of the banking union, without being seen as experts who have come from overseas and who are not part and parcel of the group?

Rt Hon Greg Clark MP: It is an excellent point. It is as much about tone and demeanour as the proposals. First, it is undoubtedly in the interests of the United Kingdom and the City of London that the eurozone recovers its prosperity, both in terms of the market for our exports and, when it is well functioning, the volume of financial transactions in which we are of course the major participants. It is unambiguously in our interests. I have been surprised in some of my discussions in Europe by how sceptical some of our partners are that we should take such a positive view. Sometimes one detects an expectation that we would somehow prefer to see a eurozone that was not succeeding. I have said to everyone I have met in Brussels that that is absolutely not the case. It is strongly in our interests for it to be prosperous.

I will drop you a line and tell you which other member states have been supportive. The reason for mentioning it is that it makes a wider point. Sometimes these things are reduced to the UK digging its heels in and holding things up—and where our national interest is threatened, of course we will. However, it has not come to that. When we have had discussions about these banking union proposals, there have been other member states which have had very similar concerns. It is by no means a kind of UK contra mundum position. It has been a generally accepted problem, and it is as desirable as you imply to work with like-minded colleagues to express these views.

The Chairman: I am sure that is right—to adopt the right tone when you talk to colleagues.

Q221 Baroness Hooper: The Government have always stressed that the governance and decision-making arrangements should be transparent, free of conflicts of interest and capable of delivering effective, fair and timely decisions. Following on from your last reply, clearly it should not be too difficult to get support for those broad principles. Within the arrangements that we have been discussing about the establishment of a supervisory board and its relationship with the governing council—and the risk of supervision being subordinated to the monetary policy function, which we have already touched on—can you spell out the legal implications of the proposals in terms of compatibility with the treaty?

Rt Hon Greg Clark MP: My understanding is that the drafting of the regulation explicitly expresses the different role in terms of supervision and the monetary policy aspects of the banks' work. It is designed to do that. Nikhil, I am sure, has the legal base in mind.

Nikhil Rathi: The legal base is Article 127(6). We do not see any incompatibility with the treaty here, because the treaty specifically envisaged the possibility of these tasks being conferred upon the ECB. Clearly, the design of the scheme needs to be resilient to protect monetary policy independence. For our part, we do not see any problems on that score in what the Commission has proposed. Other member states have different views, but that is our position. It is also worth bearing in mind that one of the reasons that we are proposing to transfer supervision to the Bank of England is to try and generate some synergies—analytical and in implementation of policy—with the monetary policy function. That is also some of the thinking behind transferring some of these powers to the ECB: there was a gap between monetary policy and supervisors during the crisis and this should help remedy that.

Q222 Lord Hamilton of Epsom: I want to talk about the relationship, when it comes to national supervisors, between the ECB and those people who are not within the eurozone. Are you happy that this has all been designed in a way that means that co-operation will take place? Should there be a headquarters of the cross-border banking group in the United Kingdom? What are the advantages and disadvantages of that?

Rt Hon Greg Clark MP: It is very important that the institutions of the single market should continue to have the role that they have—to promote common standards and the technical aspects that they were set up to do. London is a good place for that work to be located, for obvious reasons. It is important to maintain the distinction between the ECB and the existing institutions. I am not sure that there is much pressure the other way on that. Are you detecting that, Nikhil?

Nikhil Rathi: It is worth bearing in mind that financial services is probably the most integrated and harmonised area of the single market, where the rules are probably tighter than in energy or other parts. So we have a very strong single rulebook, and that should not change. It would be to the advantage of UK-headquartered firms, first, to have a stabilisation of the eurozone and, secondly, to have perhaps a more streamlined process for running their operations in the eurozone.

Q223 Lord Hamilton of Epsom: Can I just bring in a separate thing, which is not part of these questions? Are you not concerned that one of the problems about any regulation of financial services, national as well as European, is that it is always behind the curve? You are talking about highly intelligent people with all the technology that is available, and they are constantly developing new ways of trading and new products. Inevitably, any bureaucracy is lagging in its process all the time. I was listening to an economist last night, who said that perhaps we should treat financial products in the same way that we treat drugs: you have to have approval for a financial product before it is put on the market, rather than saying, "Do what the hell you like unless it is illegal", which is the way that we operate now.

Rt Hon Greg Clark MP: Well, Lord Hamilton, you make a very sound point. It is a reflection on how regulation failed in the past crisis. The head designate of the FCA has characterised the regulatory regime that we are changing as "regulating through the rear-view mirror". There is some force behind that. The changes that we are making domestically, through the changes to the Bank of England, setting up the PRA and on the conduct of regulation, give more opportunity for inquiry, flexibility and, as it were, fleetness of foot on the part of the authorities, rather than having a very rigid process of data-driven collection that makes it quite difficult to exercise any discretion around that.

So I think that the point is well made. To deem everything illegal unless it is positively approved, I fear, might go a little too far the other way. Certainly, however, the point is well understood in this country. I think that, across the EU, we need to have a greater look forward to developing trends rather than simply to regulate for the past.

Q224 The Chairman: You might like to consult Nikhil afterwards. ESMA, in a way, has been developing the kind of role that Lord Hamilton was talking about in terms of proofing products that arrive early. I think that the government position is a little sceptical about ESMA. If that is one of the points that you pick up from this, it would very useful indeed.

Q225 Lord Kerr of Kinlochard: I would like to go back for a second to Mr Rathi's very helpful categorisation of three kinds of voting issues, and to consider the first one, where you, Mr Rathi, were talking about the rights of non-eurozone member states in respect of ECB supervision. We are talking now about the common supervisory mechanism- not "banking union" which is as long or short as a piece of string—simply the single supervisory mechanism. It is clear that the countries you mention, Minister—the Poles, Swedes and Hungarians—see themselves as members of, or associated in some way with, the single supervisory mechanism in a way that we do not, even though they do not in many cases see any link between that and mutualisation. It is clear that the EU is doing SSM first because Mrs Merkel says that it should, and she makes a link with mutualisation; that is very clear. But if you are a Swede or a Dane you do not necessarily do so. Why is our position different? Why do we say that any involvement in the SSM would mean mutualisation, so it is eurozone-only? Why are other non-eurozone member states conducting this negotiation about what rights they could secure inside the ECB or on the supervisory board attached to the ECB? Why did we decide before the negotiation started that we want no part of that?

Rt Hon Greg Clark MP: That is a very important set of issues. The one thing that distinguishes our position is that we are very clear that we are not going to join the euro, which of course is not the case for some.

Lord Kerr of Kinlochard: The Swedes are not going to joint the euro; at least, not for a long time. They had a referendum and decided that they would not do it.

Rt Hon Greg Clark MP: They are under a different obligation from us, of course. Another variable is the cross-ownership of banks. Some of the eurozone outs nevertheless have banks that are controlled by member states that are members of the eurozone. You are absolutely right that every country has a different perspective and comes from a different structural position on this. Ours is literally unique. We are not going to be part of the—

Lord Kerr of Kinlochard: How many states do you think will be involved in the single supervisory mechanism?

Rt Hon Greg Clark MP: That is a very good question, and it depends on the length of time and involves peering into the mind of the Governments of other national states, which is impossible at this stage. You are absolutely right to draw attention to the point that the institutional arrangements that are designed should not be thought of in, as it were, a sort of comparative static position—that it is for day one. There is going to be some dynamism to that. There will be non-eurozone countries who will decide to join the supervisory mechanism. There will be other countries that join the eurozone in the future. This is why questions of the voting structures are quite difficult and delicate. It is not just a question of taking the current Outs.

Q226 Lord Kerr of Kinlochard: Exactly. You detect correctly where I was going. You say in your helpful letter to us of October 26 that, "In respect of the EBA we wish to see changes to voting modalities that ensure that those member states outside the single supervisory mechanism cannot be systematically outvoted by those participating in the mechanism in the EBA". I see the desirability of that. I have difficulty with the proposal that has come from the Commission on how to do it. I also have a conceptual difficulty. I am not quite sure what proposal I would make if I were the Commission, to replace the one that they have made. For precisely the reason you give, it seems to me to be implausible that a majority of member states will be prepared to give a blocking minority vote to a group of a maximum of 10 and which is likely to get rather smaller. As you say, eurozone and SSM membership will not be coterminous—SSM membership will be somewhat larger; it depends on how these negotiations end. Only two member states, us and one other, have said that we will certainly not be In the eurozone ever. The rest are sort of "pre-Ins". It seems to me that to write in institutional, constitutional law a blocking minority for the Outs and pre-Ins is a very difficult task. I do not envy our negotiator. Given that people will assume that this group is bound to shrink over time, it could end up with the Brits alone having a blocking minority in the EBA on everything that the ECB 25 or 26 decide to do. That seems to me quite hard to negotiate. I was involved in some tricky negotiations, but I never had one as difficult as that.

Rt Hon Greg Clark MP: When I said at the beginning that we could benefit from the vast experience on this Committee, Lord Kerr is a case in point. It is difficult for exactly that reason. It is hard enough comparing two static states, but when you consider the potential changes and contemplate a potential, hypothetical end state, it shows how complex it is. However, I retain some optimism. We are clear that the draft regulations are inadequate. Even the Commission now accepts that there needs to be, as its members put it, a level playing field for all the nations involved. There are possible solutions here which concern binding mediation. These are live discussions, and I am conscious that I do not want to cut too much across the remit of our principal negotiator.

Q227 Lord Kerr of Kinlochard: It has to be said that quite a lot of our written evidence that has come from the City, and some of our oral evidence, is a little sceptical about whether there is a workable solution on this front. The BBA was very doubtful about the efficacy of the voting arrangements. The ABI suggested that it was difficult to conceive of any effective safeguards to deal with the situation that we are discussing.

I understand that you do not want to spell out where you think that this might go. But can you give us some sort of feel for it? Let me try you in a different way. One expert on the EBA from whom we took evidence—a real expert, unlike me—said that he feared that the solution might at the end of the day be that the EBA was gutted of real authority because decisions had to be taken at such a high level of generality in that the umbrella covered quite different supervisory systems and norms he thought it an implausible prospect that the EBA could be the forum for knock-down, drag-out fights between the Bank of England and the ECB. I find that very alarming. On my point about the single market, that would be another major blow to it. How do you think that this will play out? How is that risk to be avoided?

Rt Hon Greg Clark MP: Let me ask Nikhil, who is in these negotiations and is in a good position to judge what would be saying too much, and what would be reasonable to help you understand the state of play.

Nikhil Rathi: Thank you, Minister. It is quite important to look in detail at what the EBA does, and the mechanisms that underlie its decision making. Broadly speaking, there are two functions: first, EBA lawmaking and, secondly, EBA enforcement of rules. On the first, the most numerous decisions that the EBA makes are around development of binding technical standards, which are currently agreed by qualified majority. It is quite important to recognise that what the EBA does in that duty is to provide draft standards that are submitted to the Commission, and the Commission is the body that legally adopts those standards. So in the situation we have today, in which there is qualified majority voting, if there are two blocking minorities the rules do not stop being made. The Commission will simply listen to the differing views and then adopt the standards. I do not want to go into too many details, but that mechanism may also provide avenues for us to ensure that where a consensus of broad agreement cannot be reached, the rule-making does not stop but there is still a single market control process at the end which will take account of all interests. To date, as far as I am aware, there has been no situation in which the ESAs have not been able to reach a decision.

Q228 Lord Vallance of Tummel: There was an earlier German suggestion in the context of the ECB council, rather than the EBA, that votes should be accorded pro rata to the size of the national financial markets of the various countries involved. The German Ambassador told us last week that this did not seem to be on the table any longer, but there is a certain force there; there is an equity to it. Is that worth pursuing?

Rt Hon Greg Clark MP: I know that this was viewed unfavourably by some of the nations who would have been, as they would see it, disadvantaged by that. Whatever our view on that, and bearing in mind the Chairman's injunction not to go wilfully out of our way to upset other member states, that is not being actively pursued. It is resisted by those who would be disadvantaged. I assume that they have not changed their views since the European Council.

Q229 Lord Kerr of Kinlochard: I have one other point on the EBA, Minister, on symmetry. You have expressed concern that, because it is an EU institution, with its independence spelt out in the treaty, the ECB cannot legally be bound by EBA decisions on binding mediation, whereas our authorities can. That seems to me to be a real problem. How are you going to solve the asymmetry?

Rt Hon Greg Clark MP: It is a very big problem. The idea that the Bank of England could be mandated to operate in a certain way that the ECB legally could not is of great concern. Again, I know it is slightly tedious to say that these are under live negotiations. It is reasonable for you to reflect some of the possibilities, Nikhil?

Nikhil Rathi: Sure. It is recognised that this part of the proposal cannot stand, both in the Council and in the European Parliament. In both cases, this part of the proposal will be amended. There needs to be symmetry. There are two ways of doing that. You either subject everybody to the mechanism that the ECB is subject to, which is "comply or explain", or you find a legal mechanism of binding the ECB into EBA decisions. Our core concern is symmetry of treatment. If a legal solution can be found, and there is a lot of work going on to see if it can, then we would be open to it.

Q230 Lord Kerr of Kinlochard: That links back to your point on the first category of voting issues. If, while respecting the integrity and independence of the ECB and its council as the decision-taking authority, you build up the supervisory board alongside the ECB, if you create, without admitting it, a sort of division between the roles of the ECB in respect of monetary policy and in the respect of banking supervision, then the easier it will be for people to accept that, in the second capacity, it could be subject to binding mediation. Is that right?

Nikhil Rathi: In principle, yes. There are many different interpretations of the treaty and the extent to which the independence that is set out in different articles in the treaty will bind all activities of the ECB or just bind them as regards monetary policy. That is the legal debate that is under way at the moment.

Q231 Lord Marlesford: I am trying to decide or understand whether there really is a potential conflict in a rulebook which applies to the eurozone, for which the EBA is very much responsible, applying to the wider banking area of the EU. I can see that how things are handled—supervision and all that—are totally different, but is there a potential conflict with the actual rulebook? Or is it not possible to have a rulebook which, because it is aiming at the same thing, will cover both perfectly happily?

Rt Hon Greg Clark MP: The notion of a single rulebook supporting the single market is one that we cleave to.

The Chairman: My notion is that it would be applicable to the 27, but perhaps you could write to us on that point.

Q232 Lord Dear: I turn our attention to the RRD—the recovery and resolution directive. I am pretty sure that I am right in saying that it has in broad terms met with some support from government circles on the grounds, understandably, that it reduces reliance on support from the public and breaks that link between the banking crisis on the one hand and the sovereign crisis on the other. Can I first ask if you have any views on the timetable? It is obvious that the Commission has said that it wants to reach agreement before the end of this calendar year. We are almost up to that point now. You have in fact already alluded to this, but I wonder if you can help us with a little more detail. How did we get to the position where we are talking about getting there at the end of this year when we will patently not? What sort of timetable do you think will be put in place as an alternative?

How will your, or the Government's, view that we should press forward slowly—or not go ahead with undue haste—chime with the way in which the mechanism is being played out in Europe?

Rt Hon Greg Clark MP: As I said at the beginning, this is one of a number of elements that, together, will help give confidence to investors and taxpayers in the eurozone. Since we have a current crisis, we need to push ahead with it now. We have no problems with the timetable. It is right to have an ambitious timetable—having said which, my understanding is that the presidency is talking about a general approach by the end of the year. Then it would not be until 2015 before a directive came into force. The bail-in tool, which is something that we regard as central to it and absolutely important, will not be implemented until 2018. To keep up the pace and to embark on the initial stages of the process, but to reflect that there are several years before the detail is adopted and then enforced, seems to capture it about right.

Lord Dear: 2015 and 2018. Looking at the southern European economies in particular, is that almost fiddling while Rome burns? Will Rome have burned by the time we get to 2018?

Rt Hon Greg Clark MP: As you know, a lot of the changes that we are making, both in this country and at European level, are for the long term and are there to provide some substantial reassurance. We are conscious of Lord Hamilton's injunction not to regulate for the past, so this is about putting in mechanisms that are going to be robust for many years. Some of the shorter-term consequences of banking union, such as mutualisation, have a more directly positive prospective effect in terms of recapitalising banks. It is important to get this right and to begin the process. All of these things are a balance between legislation in haste and not having the degree of scrutiny and reflection that is needed.

Lord Dear: It is often said that hard cases make bad law, and I think that we would all agree with that. We should not be panicked into something premature with our eye cocked solidly on Portugal, Spain, Greece and perhaps Italy as well. How is all this going to play in with the way in which the EBA is having its powers altered?

Rt Hon Greg Clark MP: Again, Nikhil will update on discussions there. It is important to separate out the aspects of banking union from changes that are contemplated to the EBA.

Nikhil Rathi: I image that in the recovery and resolution directive there will be new areas where the EBA is invited to provide recommendations, guidelines and technical standards in the area of recovery planning and so on. To date that has been an unharmonised part of the single rulebook. Where we would have more questions would be where the EBA is being asked to get into day-to-day crisis management of banks. For our part, we would consider that to be, ultimately, the responsibility of the elected Government. When we had a failure of RBS, our view is that Parliament and members of the public would expect the Prime Minister and Chancellor of the day to be explaining the decision there, rather than the chairman of the EBA. That view is quite strongly held in a number of member states.

Q233 The Chairman: What is the latest state of play on the RRD? Where are we up to?

Nikhil Rathi: There are weekly working groups in the Council on this. It is touch and go whether the end-of-2012 deadline will be met.

Baroness Hooper: Where does the European Parliament come in on that?

Nikhil Rathi: The European Parliament is working intensively. As far as I am aware, it is not intending to vote on this during the course of 2012.

Q234 Lord Vallance of Tummel: Can we look further ahead, beyond the SSM? We have a proposed RRD, which covers the totality of the European Union. We have a proposed directive on deposit guarantee schemes, with the same coverage. Both are aimed at harmonising approaches across the union as a whole—"business as usual", if you like. You can argue as to timing and content. However, coming down the track in the context of the Commission's longer-term vision of the banking union with its more limited membership are the concepts of a single resolution mechanism, and of a common system of deposit protection. These will presumably be aimed at a uniform approach across the members of the EBU. How will those two systems or approaches of EU harmonisation for the totality of the union and uniformity in the EBU coexist? Is it not inevitable that there will be a momentum towards uniformity, and that there will be friction between the ins and the outs? The tyranny of the majority, if you like. Specifically, what would be the implications for a country like the UK which will not be in the EBU and unlikely to be willing to enter into any burden-sharing arrangements?

Rt Hon Greg Clark MP: The most important objective is to make sure that we have a mutualised system of deposit guarantees. It is important, as we have said, to build confidence in the European banking system. It is possible to have parallel ones. Nikhil, do you want to say what our colleagues are making of this?

Nikhil Rathi: It goes back to Lord Kerr's question a little earlier. It is our view that the banking union and common supervision will necessarily lead to mutualisation of fiscal risk. Ultimately the ECB and the supervisor, however good they are, will make mistakes. Everybody who is participating in that will be collectively responsible for it. So these mutualisation aspects, the mutualised deposit insurance and the resolution authority, are quite important parts of a comprehensive banking union. A priori, we see no real reason why a UK deposit insurance scheme which covers deposits in UK subsidiaries and UK banks cannot sit alongside a deposit insurance scheme in the eurozone. Similarly, on resolution, we will all have the same tools, and there will be a eurozone resolution authority dealing with those tools for banks under their purview. The Bank of England and the Treasury will be dealing with banks under our purview, with mechanisms to co-operate. We do not necessarily see an obvious tension. Of course, there could be disagreements, but not necessarily so.

Lord Vallance of Tummel: Not necessarily. But the momentum seems to be fairly straightforward, does it not? You have got the majority of the European Union moving in one direction, and us sitting to one side in another direction.

Nikhil Rathi: This is also the area that is most contentious. The common deposit insurance has actually been taken out of the Commission road map under German pressure. We would question whether that is sustainable in the banking union. These are the questions that go to the heart of the democratic debate, which is in a crisis situation. Will members of the public in any member state ultimately accept a decision by a technocrat in a European body, or will they expect their elected politicians to be the ones making decisions in a crisis?

We have always taken the view that, at least for the UK, elected politicians will need to be responsible when taxpayers' money is put at risk.

Lord Hamilton of Epsom: Can I just add that the advantage of the elected politician is that he explains the decision. If he is going to distance himself from it, you have got a big problem.

Q235 Lord Vallance of Tummel: Let us touch on Liikanen for a moment. What is your assessment of the conclusions of the Liikanen report? Specifically, are they consistent with Vickers?

Rt Hon Greg Clark MP: Yes, the Liikanen report, I think, came out when you were taking your evidence in Brussels; I was there with you that day, reading the voluminous report between meetings, like you. You will know that it states that it is broadly compatible with the Vickers proposals. It is out of the same stable. We are encouraged that Liikanen and his colleagues have reached similar conclusions to those of Vickers and his fellow members.

Lord Vallance of Tummel: But there will be differences in the fine tuning, no doubt. What happens if we go ahead with Vickers, or a variation on Vickers, and shortly afterwards we get a directive based on Liikanen? Is that just irritating, or is it likely to be substantive?

Rt Hon Greg Clark MP: I was interested and noted that, within the Liikanen report, he volunteered that it was compatible with Vickers. Obviously, we need to discuss the details and see how the Commission takes forward the Liikanen report. We have pre-legislative scrutiny of the future Banking Bill, and I am sure that this Committee will take an interest in the European aspects of that as well. There is time to iron out any of the wrinkles that might be there, but it is significant that the author himself chose to assert that these things were compatible.

Q236 The Chairman: Before I ask Lord Kerr to introduce the last—you will be pleased to hear—set of questions, can you reflect on the capacity, personnel and staff of the ECB in terms of the supervising that we are going to ask it to do? Also, in the case of the European Banking Authority—who we interviewed not only in the course of this inquiry but when we were reviewing the three new supervisory authorities—we found that there was a lack of capacity or personnel who might acquit all the tasks that the EBA has been increasingly asked to take on. Is it a worry that you share? Is the UK helping in any way, given the expertise we have here in London?

Rt Hon Greg Clark MP: I am very concerned not to lose Nikhil and his colleagues to European institutions; I need them here myself. As you will hear from Nikhil in a second, we of course help and participate very closely with the institutions. It goes back to a point that Lord Marlesford made earlier: this is not the sudden creation of a set of institutions that are divorced from and have no experience of and grounding in the supervisory authorities of the member states. Initially at least, the supervisory authorities and mechanisms will supervise the supervisors. It will be necessary to have some knowledge of what goes on in the member states and the institutions there, albeit subject to a different overall level of supervision. It is right to think of it not as the creation of new bodies that require a whole set of people to be magicked up from nowhere. You will need to have co-operation between the existing authorities, just as we are in this country with the reforms that we are making with the Prudential Regulation Authority and the Financial Conduct Authority. There is some transition into the two. In terms of day-to-day co-operation between officials on the road to this, Nikhil is in the perfect place to reflect on how he deals with his colleagues in other member states and institutions.

Nikhil Rathi: I think with regard the European supervisory authorities, the FSA in particular but also the Bank of England have been quite active in seeking to support secondments of their experts into those agencies. As those agencies' staff grows, I would expect that to continue. One challenge as the ESA review progresses is to ensure that the ESAs are genuinely independent from the Commission, so that when you second experts, they are genuinely doing expert work, not just to be overruled at a later point.

On the ECB, we have a huge amount of respect for the ECB. It will have the capability to perform these tasks. One should bear in mind that 11 of the 17 central banks in the governing council already perform microprudential supervision. They have in their network a fairly deep pool of expertise to draw on. Now, obviously, there is an operational question as to how they go about developing their supervision over 2013. We would think that they should be able to deliver on their tasks.

Q237 Lord Kerr of Kinlochard: We talked, Minister, about the fact that the membership of the single supervisory mechanism will not be coterminous with the eurozone. I do not want to press you on the UK negotiating position, for the reasons that you gave, but it would be very helpful for our report if you could write to us describing the positions of the other non-eurozone member states. We would find it useful to see them set out. Thinking of the risk to the UK, from the fact that that we are certainly not going to be in any of these elements of banking union, we on the Committee see three categories of risk. I will start with what is perhaps the least important: international negotiations about supervision. The ECB will clearly be a big new beast on this block. Will we therefore be proportionately less important in world debate?

Secondly, and to my mind much more serious, as the others—that is, the 17-plus—work together more closely, how will we avoid being regularly and repeatedly outvoted on single market financial services law in ECOFIN? The Commission of course will tell them that they cannot discuss it without the full Council present, but of course they will, over dinner. You cannot avoid that. They will turn up with their position informally agreed. What are you going to do about it? How do we avoid that? How big is that risk?

Thirdly, and this is much the most serious issue, we have a couple of cases in the ECJ now, I understand. I do not know the details, and it might be helpful if somebody could write to us with the details. There are a couple of cases where eurozone countries were, we thought, discriminating against UK entities, contrary to the laws of the single market, because the UK was not in the eurozone. I am sorry to be so vague, but if you could correct my vagueness on paper, that would be very helpful. What is the risk that that sort of thing will catch on? What is the risk that UK financial institutions based in London will lose out in one way or another, or be kept out of categories of business, such as clearing, inside the eurozone? What is the risk that non-UK financial institutions that currently base themselves in London will, thinking about that risk, decide to base themselves somewhere inside the eurozone? What was all that in the press about Chinese banks going off to Luxembourg? There are three risks: can you calibrate them for us?

Rt Hon Greg Clark MP: Yes. First, of course we will write setting out the different perspectives of some of the different member states, and indeed the cases currently before the ECJ. Let me give a general view first, and then comment on the detailed aspects. I do not think that we should get ourselves into a way of thinking that we are on the back foot, that we are a kind of benighted area of the European Union that is going to be done to rather than taking a leading role. A lot of this comes from demeanour and having a positive agenda. It is essential that this Government and their successors ought to do, on behalf of the United Kingdom—but in so doing, on behalf of the EU—those things in an international setting that are right for the competitiveness of this country, just as we have taken a decision which, domestically, is not without its controversy to say that we strongly believe that integration in the eurozone is the right thing for Europe and the members of the euro, and that this is in our interests. We should take a high-minded approach to these things.

I have had this job for six or seven weeks but, actually, looking at our presence in international fora—talking with IOSCO, for example—or our presence in discussions through the G20 and the Financial Stability Board, the strength, history and expertise that we have in this country are widely respected and we ought to be assertive about that. Sometimes, as you will know, influence and authority come not from structural mechanisms but through leading debates. We have done that in areas such as resisting the watering-down of Basel III, for example. We need to continue to do that and perhaps redouble it and ensure that we take that leading role.

When it comes to individual proposals for financial services regulation, we need to be adept and skilled at all the mechanisms that you developed skills in during your career to make sure that we get the best result. Banking union is not simply a negotiation that we participate in, get the best results and then retire and let it all operate. This is going to require week-by-week, month-by-month engagement on all the different measures that come up. There is no substitute for that. It will go on. The same is true when it comes to judicial action. We should be vigorous in making use of the ECJ to defend the position that we have in areas where we think that we might otherwise be disadvantaged. We should be active in defending our rights and, indeed, be as vigorous in the use of the ECJ as some of our rivals should be.

I come back to my earlier point. You met Commissioner Barnier in Brussels. I met him on the same day. Just as I was able truthfully to reflect to him that I strongly believed that it was in the interests of the United Kingdom for the eurozone to be prosperous, M. Barnier said to me—and I think he said to you—that there is a recognition that the scale and prestige of financial services in this country is good for Europe, too. We should not get ourselves into a position of always assuming that everything that comes forward is an attempt to write us out of the script. Nikhil, you might want to reflect on that.

Nikhil Rathi: I have nothing more to add to that.

The Chairman: On that note, I will say on behalf of the Committee thank you very much indeed. It is refreshing to hear a Minister defend the UK interests and correlate those with the European Union's interests. It may one day be that you return to this Committee and say that in defending the European Union you also defend the UK interests. Your little story about Michel Barnier reminds me of the occasion when George Bush Junior said, "You know, the trouble with the French is that they have no word for 'entrepreneurship'". But we have the phrase "entente cordiale", which clearly you have been trying to spread with advantage, I hope, to the United Kingdom in Brussels. We very much welcome your approach and attitude.

As I said, we will send you the transcript of this exchange. We would be very grateful for the homework that Nikhil Rathi is going to do on your behalf. We are most grateful to him for coming today and adding to this exchange, which has been very fruitful indeed. I go out on the note that you offered at the beginning of this exchange: you are seeking ways in which we can collaborate further as a Committee in coming to our views on banking union and the RRD, and pronouncing on them, so that we can work on a common cause. Minister, on behalf of the Committee, thank you very much indeed.

HM Treasury—Supplementary evidence

QQ 220, 237: The position of other Member states on the proposals, in particular the other non-Eurozone Member States

The Government has, from the start, been clear that the UK will not join the banking union. At the same time, we have supported the decision to allow the non-Eurozone Member States that might wish to participate the option to do so, and it is up to those Member States to decide whether they want to participate in banking union. Nevertheless, it is clear that those Member States that do not use the Euro have concerns – which we sympathise with – that opting in will ultimately not put them on the same legal footing as Euro Area members in relation to decision-making by the ECB when performing its supervisory tasks.

For example, Polish Finance Minister Rostowski stated in the Financial Times after the October European Council that the Commission's proposals would need to find a "balance between countries belonging to the Eurozone mechanism and those outside." At the same time, non-Eurozone Member States share our concerns that those Member States that do not participate should not be discriminated against in future. For example, Czech Finance Minster Kalousek has argued that the rights of non-participating Member States should be protected against the "Eurozone cartel".

We appreciate that the priorities of the Eurozone Member States will focus on the design of the Single Supervisory Mechanism given they are bound to participate. However, we find it encouraging that they have agreed that the treatment between participating and non-participating Member States should be symmetrical and, of course, all Member States agreed at the October European Council that a solution needed to be found to the issue of voting and decisions in the EBA.

QQ 223-4: Clarification on the role of ESMA in terms of the future-proofing of products

Under Article 9(2) of the European Securities and Markets Authority (ESMA) Regulation, the Authority is required to monitor new and existing financial activities, and may adopt guidelines and recommendations with a view to promoting the safety and soundness of markets and convergence of regulatory practice. Under Article 9(4), ESMA is also required to establish a Committee on financial innovation, which brings together all relevant competent national supervisory authorities, with a view to achieve a coordinated approach to regulatory and supervisory treatment of new or innovative financial activities and providing advice for the Authority to present to the European Parliament, the Council and the Commission.

The Committee raises the question about whether financial services products should be subject to a licensing regime, such as that for medicines. Such an approach would be likely to restrict competition and discourage innovation. In areas such as wholesale financial services, the time involved in an ESA assessing a product and then ruling it safe would tend to drive product development off-shore. In addition, the risks attached to a product depend not just on its features but also on correctly identifying the problem for

which it may offer a solution, and then marketing the product appropriately, ensuring that salesmen have a good understanding of its risks and benefits.
For these reasons it makes more sense to restrict the sale of a product (or in extreme cases ban it) rather than imposing a regime of pre-approval. Such powers are best deployed at the national level, since it is national supervisory authorities that will have the best knowledge of their markets. The ESAs have an important role both in sharing knowledge, in undertaking economic analysis of markets (this is one of their core tasks) and where this is necessary in facilitating co-operation, where for example the selling of services cross border creates risks in the country of reception.

Q 231: Further information on the application of the single rulebook

Lord Marlesford asked whether there is a potential conflict between rules that might be established for the Euro Area and a single rulebook designed in the interests of all Member States.

The Banking Union complicates the process of agreeing a single rule-book in two ways. First, the requirement on the members of the Banking Union to caucus creates a risk that the rules that are proposed by the European Banking Authority will have been drafted with the interests of the banking union in mind, not only the wider interests of the internal market.

Second, the Commission is proposing that there should be a single supervisory rule-book, sitting alongside the single European rule-book. This single supervisory rule-book would set out in law what supervisors had to do by way of supervision. There is an advantage to there being minimum standards of supervision across the EU that are legally enforceable. However, there is a risk that the requirement for minimum supervisory standards in the internal market will be conflated with the very different needs the ECB will have for a supervisory manual that controls what supervisors within the Banking Union have to do.

It will be a key priority of the UK to ensure that any single supervisory rule-book keeps to the key design principles of the single market. This will ensure that the Bank of England remains free to supervise banks in the way it sees fit.

Q 236: Further information on the question of the implication of the proposals for the capacity and staffing levels at the ECB and EBA

The ECB is a world class institution and can certainly have the capacity in place, provided adequate cooperation provisions are established so that it can work closely with those national competent authorities inside the Single Supervisory Mechanism.
The proposals will clearly result in an increase in the ECB's staff, although the precise increase will depend greatly on the distribution of responsibilities between the ECB and national supervisors. The ECB will need to determine this internally, and we would hope that they would continue to have access to the expertise available in existing national supervisory authorities, including through secondments.
The proposal is not expected to have an impact on the capacity and staffing level of the EBA, as the scope of the Authority's tasks has not been substantively changed by the EBA Regulation.

Q 237: Further information on the two cases before the ECJ

The Committee has asked for information on the two legal cases currently before the European Court of Justice. The UK has brought two cases before the General Court of the European Court of Justice in relation to the ECB's location policy for central counterparties (CCPs) that clear Euro-denominated business.

First Challenge: 15 September 2011

- The first case challenges the ECB's Oversight Policy Framework (July 2011) which updated the ECB's long standing location policy. This policy was updated to state that CCPs that clear Euro-denominated credit derivatives above certain thresholds (€5bn average daily net credit exposure or 5% of certain product categories) must "*be legally incorporated in the Euro area with full managerial and operational control and responsibility over all core functions, exercised from within the Euro area*." This would require CCPs located in the UK (and other non Euro and non-EU countries) with Euro-denominated business above those thresholds to relocate to the Euro area. A summary of the UK's challenge can be found in the *Official Journal of the European Union* (OJ) (19 November 2011).[41]

Second Challenge: 27 January 2012

- The second case challenges the ECB's Standards for the use of central counterparties in Eurosystem foreign reserve management operations [42] (18 November 2011). This includes the ECB Location Policy as one of its standards: '*Standard 4 Compliance with Eurosystem policies: CCPs should comply with relevant Eurosystem policies at all times. This includes compliance with the Eurosystem's location policy for non-Euro area CCPs with sizeable amounts of Euro-denominated business.'* This challenge is broadly consistent with the first case because there is a material risk that the ECB could use these Standards to continue to apply their location policy even if our original challenge was successful in removing the location policy from the ECB's Oversight Policy Framework above.

The UK has also launched a legal challenge against the Short Selling Regulation. This is not on a point of discrimination – rather this reflects legal concerns that a role granted to ESMA in this Regulation involves greater discretion in decision-taking than is permitted for an EU agency under EU law.

What will be the impact of the proposals for a Single Supervisory Mechanism (and further steps towards banking union) on the ESRB?

The creation of a Single Supervisory Mechanism will not have a significant impact on the European Systemic Risk Board (ESRB). The Commissions Regulation, which confers responsibility for prudential supervision of credit institutions to the European Central Bank (ECB), states that the, "ECB will carry out its tasks within the framework of the European System of Financial Supervision (ESFS) and will closely cooperate with the three European Supervisory Authorities."

The legislative proposals therefore provide an interface for the ECB to work with the bodies that comprise the EFSF. This includes the ESRB. Furthermore the ESRB will

[41] Case T-496/11: Action brought on 15 September 2011 — United Kingdom v ECB: http://eur-lex.Europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2011:340:0029:0030:EN:PDF
[42] http://www.ecb.Europa.eu/pub/pdf/other/standards201111en.pdf

continue to have a role in undertaking cross-sectoral analysis and once the ECB has been established as single supervisor for participating Member States, the ESRB will be able to issue recommendations to it, as it would for competent authorities in other Member States. In 2013, the Commission will be reviewing the ESRB as part of a wider review into the European System of Financial Supervisors.

I hope the Committee finds this supplementary information useful.

12 November 2012

HSBC—Written evidence

General comments: achieving financial stability in the European Union

There is an emerging official consensus that the long term solutions to the problems of stability in the Eurozone, and more widely in the European Union, can lie only in closer Fiscal and Political Union. At the same time, the direction of popular sentiment across the Union since the financial crisis is making the possibility of a parallel democratic consensus increasingly remote. For different reasons, populations in both the periphery states and the core states are less comfortable with the political trajectory of the Union. The rise of nationalistic sentiment will be exacerbated, not assuaged, by the prospect of such measures as fiscal transfers or the further subjugation of national sovereignty by Brussels. In the absence of strong political leadership the widening "democratic deficit" could threaten the Union, and the political purpose for which it was originally built, more deeply.

HSBC believes there is an alternative policy approach to achieving financial stability within the Union. The need for monetary discipline is well understood, and the role of the European Central Bank in respect of maintaining stable prices within the euro area is generally accepted. Fiscal discipline was recognised as a requirement at the inception of the euro, and the need for this has been reinforced by events, with the original Stability and Growth Pact effectively updated by a new Treaty. The third requirement is credit discipline.

There is a growing body of academic study which demonstrates that credit growth is a powerful predictor of financial crises[43]. But throughout the twentieth century, academic economists and central banks largely discounted the significance of bank credit. The notion that credit can, of itself, generate economic instability, although dating back to the work of Minsky in the 1970s, has only very recently begun to attract serious consideration. To those practitioners familiar with the day to day, granular, loan by loan, expansion of credit, this comes as a surprise.

Successful reform of the EU banking sector will require a reappraisal of long established assumptions about the nature of money and credit and their role in the economy. The evidence that past assumptions have been inadequate is in the events of the first decade of this Century – an unrestrained explosion of credit, or indebtedness, followed by a "credit crunch" and a subsequent prolonged period of credit starvation, paralleled by a range of official sector attempts to substitute the banks' role of credit formation. HSBC believes that current circumstances can be addressed through a focus on credit, and through sustainable, risk-based management of the expansion and contraction of credit supply. This is what we mean by "credit discipline", and as outlined in our response below, we believe this can be achieved through a macroprudential framework which connects macroeconomic analysis to prudential supervision, which operates at the level at which credit is formed. Credit discipline is explored in more detail in Annex 1.

Management of credit supply, to ensure that expansion is always supported by adequate capital, will create a fundamentally more stable financial system, and will complement the price stability that is achieved through monetary policy. It will also address precisely the

[43] See, for example, "Credit booms gone bust: Monetary Policy, Leverage Cycles and Financial Crises, 1870-2008", Schularick and Taylor, NBER, 2009, from which we have borrowed for this response.

tail risk for which banks hold capital, and which, as recounted above, powerfully predicts a financial crisis: that is the risk that at some point in the cycle, credit might expand beyond the capacity of the available capital to support it. When such tail risk manifests, the banks appear insolvent and require recapitalisation; and counterparty fear of insolvency leads to a liquidity crisis in wholesale markets. Nevertheless, even if this risk is specifically addressed by the policy framework, there will always be a possibility that a significant institution might fail, and work to facilitate orderly resolution in such circumstances is at least as important as developing a macroprudential framework to secure the steady-state stability of the financial system.

Q1- 4 Banking reform, banking union and the euro area crisis

Weaknesses and Reforms in EU Banking Sector

The issues which are affecting the EU banking sector are, in many respects, a consequence of the macro-economic conditions within the Eurozone. Over the decade since the creation of the euro, there has been (i) no material economic convergence among Eurozone states, (ii) a build-up of unsustainably large imbalances between the core Eurozone economies (including Germany, France, Benelux, Finland, Austria) and the periphery states (including Greece, Portugal, Ireland, Spain and Italy) and (iii) a sharp deterioration in the competitiveness (in both absolute and relative terms) of the periphery countries in contrast to core economies, most notably Germany.

The lack of a fiscal union to complement monetary union has limited the Eurozone's ability to tackle these imbalances. However, another key structural weakness in the design of the Eurozone was the lack of sufficient flexibility within many individual economies to adapt to an environment in which there was no possibility of individual adjustment of exchange rates, and in which interest rates are set centrally for the whole zone:

- The core economies account for almost two-thirds of Eurozone GDP and monetary policy is inevitably weighted towards them rather than the peripheral economies. At the same time, the economic cycles within the Eurozone are not synchronised, so for some countries at least, inappropriate measures may be applied, or measures which might otherwise mitigate a build-up of systemic risk are not available. The lack of flexibility to mitigate this situation has created issues.

- In the run-up to the crisis, an oversupply of credit, notably in peripheral Eurozone countries, led to an underpricing of risk. Economies were allowed to expand at a significant pace and governments 'bet' their fiscal policies and sovereign borrowing on those growth rates being sustainable. The inability to address the underlying imbalances through targeted monetary or exchange rate policy meant that the scope for adjustment in these economies was very limited.

- Furthermore, since the onset of the crisis, these issues have been exacerbated by the links between sovereigns and the banking sector as governments in some Eurozone states have become increasingly dependent on their domestic banks to absorb new debt issuance. For regulatory purposes, sovereign debt is still essentially classed as a "risk-free asset" (and considered an essential component of bank liquidity buffers), even as some sovereign spreads rise to unsustainable levels. For banks, buying such debt allows them to meet tougher

> liquidity requirements (and potentially gain political support), but the underlying sovereign weakness has consequences. In the end, it affects the ability to lend to the real economy, exacerbating any downward economic trend that has already led to weak public finances.

Essentially, policymakers tried to run the Eurozone in the belief that price stability (exchange and interest rates), achieved through a single currency and monetary discipline, was sufficient to ensure financial stability. But the ability of banks to expand the supply of money through lending undercuts this thesis. Against this background, a key reform for the Eurozone would be to restore discipline in the creation of credit through the establishment of national macroprudential authorities similar to the UK's Financial Policy Committee. These would have responsibility for ensuring that the expansion of credit supply to the economy remained stable and sustainable, making certain that capital requirements for exuberant asset classes are raised to protect against the effects of specific bubbles (so making such lending less attractive and/or ensuring there is sufficient capital should the bubble burst), and also reduced when there is excess caution in supply (which is a principal cause of damage to economic growth). Credit discipline would need to be exercised at the national level, but these national macroprudential authorities must be made subject to peer review by the European Systemic Risk Board (ESRB), to ensure that they are evaluating risk, and applying appropriate macroprudential tools, on a consistent basis.

National deployment of macroprudential tools, such as the adjustment of permitted capital buffers, would act as a safety valve, allowing national economies within the Eurozone to adjust to asymmetric economic circumstances and thus go some way towards compensating for the loss of independent interest and exchange rates. In summary, national macroprudential management of credit supply could compensate for the asymmetry inherent in centrally-set credit pricing, helping to ensure financial stability within the Eurozone without the need for political union, provided that fiscal discipline is also maintained nationally.

The ECB has previously recognised the importance of macro-prudential tools, and within any Banking Union these tools can be effectively integrated into the single supervisory framework. The ECB must, therefore, play a key role in the design and implementation of the national and European-wide macroprudential framework and tools, drawing on its extensive knowledge of credit conditions gained through the exercise of monetary policy.

Banking Union

Banking Union is part of wider moves towards greater economic and fiscal union within the Eurozone but immediately serves as a mechanism to break dependencies between national governments and banks. Direct investment in banks by the new European Stability Mechanism (ESM) should relieve direct pressures on stressed economies. This not unreasonably relies at a minimum on removing national-only supervision of beneficiaries to ensure that European monies are properly applied to banking reform, and do not sustain bad practices. Extending the goal of Banking Union to mutualising risks across the European banking system, rather than between governments (as effectively achieved through the ESM) may be a difficult step to achieve – international economic agreements of this kind have typically been the remit of the public rather than the private sector. But short term capital injections may well stop deposit flight from peripheral countries and, as we outlined above, if European supervision extends to macro-prudential policy, this may be sufficient to address some of the most significant longer term issues.

In terms of CRD IV, most of the measures contemplated will still need to be introduced in the long run to ensure that banks achieve more consistent and accurate calibration of risk, matched with appropriate capital, liquidity and funding. However, there will need to be technical changes to CRD IV to accommodate the new structure and, given its much broader perspective on matching the demand for equity and debt funding with supply across Europe, the ECB may seek to amend the implementation timetable, reducing the cliff which needs to be climbed and easing economic pressures.

The creation of a single supervisor could also renew pressure for maximum harmonisation of regulatory capital requirements across the EU and the application of a single rulebook. This may not be confined to the Eurozone, with implications for the UK which has consistently sought to be different or super-equivalent in a number of areas.

Structural Reform

A number of ideas have been put forward – notably those contained in the report of the Independent Commission on Banking (ICB) in the UK, the Volcker Rule being enacted as part of the Dodd-Frank reforms in the US, and most recently the report from the Liikanen Group. Whilst we understand the attractions of 'ring-fencing' from a political perspective, it is not clear that this is the most efficient mechanism for changing behaviours and reducing the public consequences of bank failure. Europe has many examples of banks that would be entirely or substantially inside a retail ring-fence (Spanish Cajas, Irish banks, Northern Rock) or predominantly wholesale (German landesbanks) that have failed and have been supported from public resources. On the Volcker Rule, we can see the attractions of prohibiting risky activities within banks which they do not need to do. Indeed, HSBC has not operated proprietary trading desks for some time and is winding down its private equity arms. But defining what constitute prohibited activities is difficult without risking encapsulating activities not the object of prohibition: for example, necessary market making to ensure liquidity in the market. Furthermore, the specific nature of the detailed US proposals and their extra-territoriality has created friction. Liikanen seeks to avoid this classificational problem by requiring all trading activities to be carried out within a separate subsidiary but introduces further definitional challenges, for example around permitted hedging activities.

In the UK, we believe that the majority of the benefits for financial stability from the Vickers proposals come from the improvements in loss-absorbency (which mirror international developments) – particularly if loss-absorbency is varied dynamically in response to fluctuations in risk levels – rather than from the ring-fencing of retail banking. However, HM Government has chosen not to identify the incremental benefits of the Vickers proposals taken in isolation, by comparison with the costs and benefits of the much wider package of internationally agreed regulatory reform. Ultimately, although we are committed to implementing the Vickers proposals as quickly as possible, we remain unconvinced that structural solutions based on separating retail banking from wholesale banking significantly reduce the probability of failure, or actually address the critical issue in bank failure – the risks which have been taken on and the ability to absorb the losses as and when they occur. This is common to all elements of banking, and will not be changed by separation, although the identity of those who will bear the cost of failure, in the first instance, may well be different. Ultimately, all losses fall to society through loss of future income, savings or pension entitlement.

If consideration is to be given to *ex ante* separation, to facilitate resolution, we have argued unsuccessfully that the priority should be geographic ring-fencing. The most complex technical and political issues in resolution are cross-border, given, in the case of the former, the interaction of different legal and regulatory regimes and, for the latter, the issues of stakeholders in one country paying for losses incurred in another. From a public policy perspective, geographical subsidiarisation also significantly dilutes any perception that the Government for the holding company jurisdiction may, in some way, be responsible for separately capitalised and regulated overseas operations and liable to send funds to support them. Overseas subsidiaries would clearly be the responsibility of the banking group as a whole for as long as it continued to have resources to support them and there would be no constraints on it doing so. However, in the event that these internal, private sector resources are not deployed, resolution becomes a local responsibility executed according to local rules with local application of costs. HM Treasury's White Paper provides a useful rationale in its discussion on primary loss-absorbing capacity (PLAC):

> *The Government does not consider it appropriate that UK-headquartered G-SIBs be required to hold either equity or debt components of PLAC (beyond international or local capital standards) against RWAs held by overseas operations that do not pose a risk to UK and/or EEA financial stability. Not only would this be disproportionate, but if the UK authorities were to impose such requirements, it may risk creating a perception that the UK holds or retains responsibility for providing bail-out financial support for such overseas operations. [Section 3.26]*

Q5-8 Banking supervision

As discussed above, without a single supervisory framework, it is difficult to justify the application of European funds to support failing banks; there would be a considerable risk that national regulators might continue to show forbearance to banks, extending the requirements from central funds and avoiding necessary reforms.

An effective single supervisory framework is a pre-requisite for progress in other areas such as cross-border resolution or deposit insurance and, for the reasons we have set out above, we will need to wait and see the degree to which these are necessary at the level of banks, or whether they can be kept at a Government level.

In terms of types of institutions covered and the extent to which non-Eurozone countries might join, we consider that all banks in the Eurozone, and other countries that apply to join a Banking Union, should be subject to the new supervisory mechanism, in line with the European Commission's proposal. In our view there is no logic to restricting Banking Union to the largest firms: collectively, smaller firms can have a material impact on national economies as a result of exposures to particular sectors (such as residential or commercial property, or trading books), geographic location (and resulting sovereign concentrations), and business model (with a consequent impact on funding and liquidity risks). Moreover, excluding smaller banks would complicate the operation of macroprudential policy, so making it more difficult to ensure a sustainable supply of credit to the economy and avoid crises.

We note that the European Commission's proposal would grant the ECB certain exclusive powers within the Eurozone, notably over prudential supervision of key risks that affect a bank's viability, but that national supervisors would support the ECB in undertaking these tasks. This would seem a pragmatic division of labour given policymakers' desire both to put in place the new supervisory framework quickly and ensure consistency of supervision, whilst recognising the substantial capacity that currently exists within national supervisors and which could not be created quickly within the ECB other than through secondments from national bodies.

Overall, we consider the range of powers that the Commission proposes for the ECB as broadly appropriate; however, we consider the proposed power for the ECB to impose fines of up to 10% of a bank's annual turnover and to apply this at the consolidated group level to be disproportionate. In HSBC's case, for example, the Eurozone accounts for a relatively small proportion of the group's assets and the group includes a number of large banking entities based outside the EU.

The accountability arrangements for the new supervisory framework will be the subject of much debate, particularly insofar as they relate to resolution of banks, which has the potential both to encroach on the rights of private investors, and to call on national taxpayers. It will be critical to get this right and to ensure appropriate accountability not just at the EU level but also at national level. In essence, a lender of last resort capacity at the ECB level approach when national resources are exhausted and where the integrity of the Eurozone financial system is at risk is appropriate but implies transfers from strong to weak countries and therefore requires clear accountabilities.

Q9 European Deposit Insurance schemes

As discussed, there are two stages to the Van Rompuy proposals. The first is to introduce a European supervisory framework, thereby unlocking the application of European monies for direct financial support of banks. This is a critical first step, hopefully addressing immediate vulnerabilities to deposit flight. Moving on to a more developed arrangement in which the burden of support (and potentially loss-sharing) is shifted from European Governments to banks is much more complex, both politically and administratively. If the supervisor steps are executed successfully, with the good application of macro-prudential policies and the support of monies from European governments, this may be a step to which the policymakers give a lower priority.

Deposit insurance contributions by banks to their national schemes are likely to rise in the short term once changes to EU rules currently being discussed, which would require pre-funding of deposit guarantee schemes, are concluded; and more substantial arrangements to prevent deposit flight may will need be considered over the medium term. But full mutualisation across the European banking industry without some form of Government intervention may be difficult to achieve.

We would suggest that, in the event of a bank failing, only when a national Deposit Guarantee Scheme (DGS) has been exhausted – including the capacity for this to be underwritten through further contributions from the local banking industry and the sovereign – should the EU assume liability. The EU could then take some funds from EU programmes such as the ESM or seek funds from other national DGSs. One question would then be the mechanism by which those Governments then chose to apply this to their local firms. The sovereign which has failed to support its own DGS would provide bonds to the EU to collateralise monies coming in but, given the circumstances, these bonds may default in part at some stage.

Admittedly, this gives rise to a contingent risk for non-defaulting countries but the consequences of deposit flight across the EU may make this worth doing, particularly given the real risks that this will actually be required.

However, underlying all of this, as the cost of providing deposit insurance is likely to rise in the future and to mitigate moral hazard, at least a component of such contributions should be related to a bank's risk profile (for example, as measured by metrics such as average Loan-to-Value ratio, Assets-to-Deposits ratio, Core Tier 1 capital ratio, reliance on wholesale funding).

Q10-13 The proposed Directive for bank recovery and resolution

We believe that the EU proposals on bank recovery and resolution, to be discussed by the Council and the European Parliament over the coming months, represent a good starting point. We are convinced that recovery and resolution plans will play a key role in increasing confidence, improving financial stability and ensuring a sustainable supply of credit to economies. They are the complement to effective macroprudential policy.

We support the bail-in of non-common equity capital at the point of non-viability (PoNV) as one of a suite of resolution tools, albeit an important one. However, an attempt to use bail-in as a recovery tool (i.e. before the last resort) would send a negative signal to markets, quickly precipitating *de facto* resolution – as would, we suspect, any precipitous instalment of a 'special manager' during the recovery phase. It will, therefore, be important that Resolution Authorities do not view bail-in as an 'easy option' which might be used prior to the PoNV – and it should therefore be subject to very strict controls and requirements. There may also need to be more clarity on the potential overlap between the PoNV decision by the Resolution Authority and the proposed ECB power to withdraw banking licences within the EU Banking Union proposal. Banks, public authorities and investors need to be clear about who is able to do what and under which conditions.

In terms of requiring banks to have sufficient external liabilities that could be bailed in within a resolution scenario, we believe that the current proposal strikes the right balance in providing sufficient loss absorbing capacity, while at the same time seeking to recognise and protect financial sector biodiversity, which aids systemic resilience. These liabilities should be a broad as possible, albeit excluding complex derivatives and certain other trading creditors. Our view is that it should include deposit guarantee schemes which otherwise may serve little purpose as bail-ins of other creditors would mean that the point at which their intervention was required would almost always be avoided.

It should not be forgotten that properly executed macroprudential policy will increase banks' loss absorbency precisely when it is needed – i.e. at times of increasing levels of risk in specific asset classes – and in the form, common equity, in which it is most useful. This has the potential to be more economically efficient than a requirement for banks to hold high levels of loss absorbency at all times, including cyclical periods of low endogenous risk and low economic activity.

HSBC operates as a series of separately capitalised banks, funded mainly from deposits (and so largely avoiding reliance on wholesale funding), regulated in their local jurisdiction and operating without inter-entity support or guarantees, albeit under a common brand, strategic direction and ownership. This structure is reflected in our resolution planning which does not envisage resolution of the Group as a single entity. Instead individual local authorities will be responsible for the resolution of bank(s) in their jurisdiction when the holding company no longer provides additional funds that are requested and required. It would be the responsibility of those national governments to ensure that they had a suitable resolution regime.

Since pools of both capital and liquidity are maintained at the local entity level, our structure presents significant and accepted additional costs to the Group but it presents the authorities with significant advantages in resolution. To offset this, we believe that it is appropriate that the regulatory framework should recognise these benefits and provide an incentive – a resolvability dividend – to promote these structures. In this light, we welcome the provision within the EU proposal to take into account individual factors including interconnectedness, business model and risk profile.

Q14-16 The impact on the UK

The UK's financial sector is the largest in Europe and has grown since the inception of the euro in 1999. However, to a certain extent its size is linked to London's role as a global financial centre and, in particular, as an entrepôt to the EU single market for non-European banks. We believe that it is appropriate for the UK to remain outside the Banking Union given that it is not part of the Eurozone, and that ultimate resolution authority in the UK remains with the Bank of England and HM Treasury, but the Government will need to consider the risks this presents to London's long-term attractiveness as a European base for foreign banks.

It will be important that the new structures include adequate safeguards for access to the single market in financial services across the whole of the EU. These will include a continuing role for the European Banking Authority (EBA) in setting EU-wide rules, with fair and appropriate arrangements for its governance; effective arrangements for supervisory cooperation, in particular with regard to banking groups with substantial operations both inside and outside the Eurozone; EU-wide access to market infrastructure; and continuing EU-wide arrangements to prevent deposit flight, whether through a European scheme or through an effective level of harmonisation of national schemes.

Some EU member states, including the UK, have expressed reservations on the proposed changes to the EBA's voting arrangements and the risk that technical rules underpinning the EU single market are dominated by the views of the ECB. Ensuring that the post-Banking Union governance arrangements for the EBA are perceived as fair by all member states is a legitimate concern, since it is in the interests of all supervisors, governments, banks and wider financial markets that the system of supervisory and regulatory cooperation operates smoothly.

There is also a risk that the ECB will seek to reaffirm its "location policy", which seeks to require that Central Clearing Counterparties (CCPs) with exposures over a certain threshold for one of the main euro-denominated products must be legally incorporated in the Eurozone with full managerial control and responsibility over core functions. This has been challenged by the UK government; and authorisation of CCPs will be mandated by the new European Market Infrastructure Regulation (EMIR), which includes a non-discrimination statement that effectively disallows the ECB location proposals.

There are good reasons to support the central role of London. Many banks will wish to clear their derivatives trades with a single CCP since this creates less legal risk, as only one insolvency regime applies. Mandatory local clearing of certain currency contracts could fragment the clearing market, make it more expensive and break netting arrangements. Reductions in multilateral netting could increase systemic risk and there would be less competition in certain contracts.

However, there are also reasons for the ECB to seek to have direct control over key elements of the financial infrastructure and we note that an ECB Executive Director reiterated the ECB's view on the location of CCPs as recently as June 2012. If the UK is seen to benefit from the Eurozone as a trading hub without sharing the burdens, this may become a political issue.

Longer term, if Banking Union in the Eurozone is successfully implemented, London is likely to see some reduction of its entrepôt role given the larger pool of capital at the ECB supporting the Eurozone financial system. To counter this, London needs to build its reputation for international supervision and regulatory competence to complement its undoubted legal system.

Annex 1

CREDIT DISCIPLINE AND A BANKING UNION

As Andrew Haldane, the Bank of England's Executive Director for Financial Stability, said in November of 2010: "Credit lies at the heart of crises". The fiscal crisis has arisen because oversupply of credit grew European economies to unsustainable levels, and governments "bet" their fiscal policies and sovereign borrowing on those levels being sustainable.
Credit discipline requires the risk-based management of credit supply to the economy at the systemic level. *It is as important as price management through monetary policy*. Historically, much of the policy discipline required for a stable European financial system has been absent, in the belief that price stability achieved through monetary discipline was alone sufficient to ensure "financial stability". "Bubbles", and their bursting, were seen by many theoreticians as a beneficial means of restoring an "equilibrium". As credit is "essentially unstable" – because banks expand credit supply in the act of lending – the impact of the financial system means that there can be no underlying equilibrium in the economy.

Credit cycles in Eurozone economies are *unlikely* to be synchronised. Credit discipline therefore must be exercised at the national level.

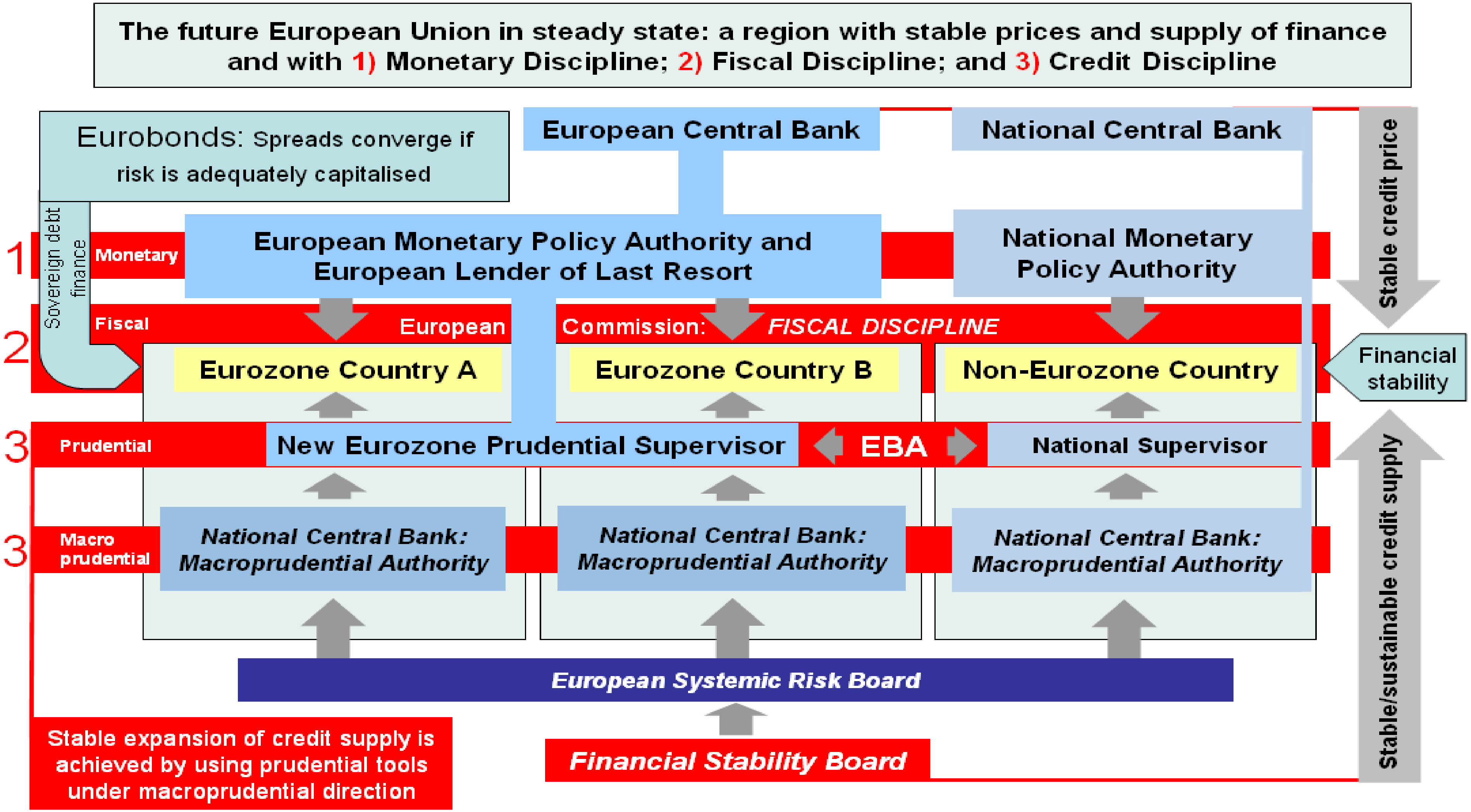
Eurozone national central banks will need to establish national macroprudential authorities to exercise credit discipline. They should be given responsibility for ensuring a stable and sustainable supply of credit to the economy, i.e. that the expansion of lending to the economy is supported by an appropriate level of capital, matching the level of systemic risk.

The chart on the next page sets out the relationship of the institutional structures and their responsibilities.

Although credit discipline must be exercised at the national level, the directions of the national macroprudential authorities should be subject to peer review by the ESRB, and ultimately the FSB; and implementation of microprudential measures in response by national supervisors, for the EU as a whole, could be subject to peer review by the EBA.

A critical feature of a Banking Union within the Eurozone will be a Eurozone prudential supervisor which reports to the ECB, i.e. with a relationship to the ECB similar to the relationship of the UK's proposed Prudential Regulation Authority to the Bank of England. Whilst carrying overall responsibility for implementation of microprudential measures within the Eurozone, the new Eurozone supervisor could in practise contract much of its work to national prudential supervisors.

With credit supply under proper risk management at the systemic level, the way would be open to enable the European Central Bank to act as European Lender of Last Resort. Appropriate management and capitalisation of risk across the Eurozone would also help to stabilise bond spreads, making eurobonds a feasible proposition.



The future European Union in steady state: a region with stable prices and supply of finance and with 1) Monetary Discipline; 2) Fiscal Discipline; and 3) Credit Discipline

International Centre for Financial Regulation (ICFR)—Written evidence

1. Founded in 2007, the ICFR is the only independent, not-for-profit research institution devoted to best practice in financial regulation around the world. The ICFR uses fact based research and roundtables to bring policymakers, industry participants and regulators together to discuss innovative solutions to regulatory issues. The views expressed in this paper are those of the institution.

I. European Banking Union: Why now?

There are a number of competing, but sometimes complementary, reasons why the European Union (EU) is pursuing banking union. At the heart of the matter is a decision over whether there should be more Europe, or less Europe.[44] The response from the European Commission and other institutions of the EU has so far been decisively in favour of more Europe. A useful way of separating out the issues driving banking union is into a 2x2 matrix covering short-term, long-term, EU-internal, and EU-external reasons:

	EU-Internal	EU-External
Short-term	Crisis response: preservation of the eurozone; political *quid pro quo* for European Stability Mechanism	Prevention of global economic meltdown
Long-term	More complete EMU; political federalisation; political *quid pro quo* for fiscal burden sharing	Place of EU in globalised world; creation of regional champions in globalised world

2. There are two fundamental tensions in the banking union plans: the first between the short term need for crisis response and longer-term aspirations for the Economic and Monetary Union (EMU), and the second between those members states who want faster progress toward a federal Europe and those who see the benefits of Europe largely as promoting free trade in goods and services across member states, while retaining as much national sovereignty as possible.

3. As the Vice President of the European Central Bank (ECB), Vitor Constâncio, highlighted in a recent speech: *"The decisions taken at the June Euro Area Summit are part of the long term reflections on the future of the Monetary Union, which are addressed by President Van Rompuy Report. They are also clearly motivated by the challenges that we face in addressing the ongoing crisis."*[45] The institutions of the EU will hope that they can balance these two. There are clear fault lines among member states, as evidenced by the publicly stated position of German finance minister, Wolfgang Schäuble, which has received support from Sweden, the Netherlands, and Poland, in contrast to the positions of ministers from France, Spain and Italy who appear to be pushing for others to agree to the existing ambitious timetable.

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[44] See Adair Turner, 'Financial risk and regulation: do we need more Europe or less?', 27 April 2012, available online at http://www.fsa.gov.uk/library/communication/speeches/2012/0427-at.shtml

[45] Vitor Constâncio, 'Towards a European Banking Union', 7 September 2012, available online at http://www.ecb.int/press/key/date/2012/html/sp120907.en.html

4. In addition, some see a united Europe as the best hope for a prosperous Europe, given the realities of globalisation. The President of the European Commission, José Manuel Barroso, used his State of the Union address on 12 September[46] to argue this case. Mr Barroso argued that "globalisation demands more European unity" which "demands more integration" which demands "more democracy, European democracy." The UK also has political choices to make within this context (see Section V, beginning at Paragraph 20). The UK would benefit from more clarity in its political attitudes towards this line of argumentation.

5. As noted above, there are also short term issues in play. While a more complete EMU has always been an aspiration of the Commission, the eurozone crisis has given the project an added impetus. Eurozone leaders made clear at their June summit that a precondition for the ESM to directly recapitalise eurozone banks is for the Single Supervisory Mechanism (SSM) to be in place for eurozone countries. The SSM involves ceding sovereignty to the ECB, which will be accountable to the European Parliament for its supervisory actions. This is part of the political *quid pro quo* for the fiscal burden sharing which the ESM involves. The German Finance Minister, Mr Schäuble, has however made clear that the SSM needs to be "fully effective", rather than simply in place, before the ESM can provide funds directly to banks, with the Dutch Finance Minister, Jan Kees de Jager, saying that the SSM would need to have a proven "track record" prior to ESM involvement.

II. What would a full banking union require and why?

6. For a full banking union to be able to act effectively in the face of deposit and currency runs, banking crises and systemic contagion, it would require: a single rulebook; a single supervisory mechanism; a single European level resolution authority with common funding; and a joint deposit guarantee scheme. The sequencing of these mechanisms as well as the breadth of their application can occur in many ways depending on the objective. At a minimum, it needs to apply across the entirety of a region using a single currency in order to constitute an effective crisis response plan. Wider compliance may be desirable for facilitating trade in services and 'level playing field' reasons, but is not strictly necessary for financial stability reasons.

7. Michel Barnier has said that "[The Commission's] ultimate aim is to stop using taxpayers' money to bail out banks." The way in which the Commission is attempting to achieve this is to encourage a more complete economic and monetary union, as well as a single financial market within the EU. Although in the decade before the financial crisis there was increasing financial integration, this has since been reversed. Banks have retreated within their national borders, and interbank markets have become impaired. In Europe's bank-dominated financial system, this has significant repercussions for the transmission of monetary policy and credit growth, and has also created a vicious circle between banks and their sovereigns. A banking union is perceived as one way to break this co-dependence. The way in which this is hoped to work is to improve supervisory consistency and cooperation, helping to restore trust in the stability of the financial system. For those who subscribe to this view, all EU banks should operate from the same rulebook, which should be applied in the same way by a single supervisor (operating through networks of national supervisors), with deposit guarantee

[46] José Manuel Barroso, 'State of the Union 2012 Address', 12 September 2012, available online at http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/12/596

systems funded at the EU level, and a single resolution authority with the power to bail-in banks' creditors in order to prevent the need for taxpayer bailouts.

III. Practicalities

8. There are significant political and practical frictions which sometimes become confused. An obvious and significant political issue relates to the ceding of sovereignty to a centralised supranational authority, which contrasts with the practical issue of resource deployment within the eventual structure. But the issue of whether the ECB should be responsible for supervising all eurozone banks, or just those that are systemically important (SIBs), straddles the division. It is a practical issue to the extent that it relates to the appropriate deployment of resources and the operational aspects of the SSM, but it is also clearly political in that it has consequences for the degree of sovereignty ceded to the ECB. The political and practical become confused wherever new powers increase fiscal burden sharing, notably in relation to the ESM, as well as in relation to deposit insurance and resolution. As a result, the full framework is not achievable in a single step, either politically or practically.

9. The Basel Committee's Core Principles for Effective Banking Supervision state that an effective supervisory system requires supervisors to conduct assessments "proportionate to their systemic importance" and deploy resources "on a proportionate basis."[47] As such, while supervisors should have the same suite of powers with respect to all banks under their purview, their attentions should vary depending on the size and nature of banks. The approach needed for supervising a systemically important bank is necessarily different from that needed for smaller institutions. It is clear that many smaller banks are concerned about potential intervention by the ECB using criteria designed for larger institutions.[48] The question should not be whether the SSM should cover all eurozone banks or just SIFIs, but rather how responsibilities should be divided between the ECB and national supervisors depending on the size and nature of the institution concerned. This would allow for a more fluid boundary than would be the case if ECB powers were limited to a subset of eurozone banks, and the latter could split the banking system even further. Concerns remain, however, that some members states want the ECB to supervise only SIFIs or major banks, so that local savings and cooperative banks can potentially be used for domestic public policy purposes.

10. Although the degree of operational centralisation of the SSM is not yet clear, early indications suggest that significant amounts of work would be delegated to national authorities, possibly amounting to "extensive decentralisation",[49] with the ECB only stepping in under "exceptional circumstances."[50] The financial crisis made clear that more work needs to be done to encourage cooperation between national supervisors, and a convergence of supervisory culture and practices may be one way to achieve this. It is hoped that this would improve under the aegis of the ECB, although this is one area in which practice does not

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47 Principle 8 and Principle 9, respectively, BCBS,'Core Principles for Effective Banking Supervision', September 2012, available online at http://www.bis.org/publ/bcbs230.pdf

48 See 'Smaller euro banks fear ECB scrutiny', Reuters, 17 September 2012, available online at http://uk.reuters.com/article/2012/09/17/uk-banks-europe-union-idUKBRE88G0NF20120917?feedType=RSS&feedName=businessNews

49 'EU's Barnier seeks compromise with Germany on bank supervision', Reuters, 20 September 2012, available online at http://uk.reuters.com/article/2012/09/20/uk-eurozone-barnier-germany-idUKBRE88J09R20120920?feedType=RSS&feedName=businessNews

50 Ewald Nowotny, Governor of the Austrian Central Bank and member of the ECB Governing Council quoted in 'ECB's Nowotny says don't rush bank supervision', Reuters, 17 September 2012, available online at http://uk.reuters.com/article/2012/09/17/uk-europe-banks-supervision-idUKBRE88G15G20120917

always conform to principle. In principle, the ECB will have the authority to enforce cooperation between national supervisors, as the ultimate decision making authority will move from the national to the supra-national level. However, the process of moving towards common understandings and efficient execution in crises will take time, and cooperation is likely to remain fragile for the foreseeable future. Establishing good working relationships between relevant stakeholders is every bit as important as having the right institutional framework.

11. It is crucial to separate out rules, supervision and enforcement. The EU is already on its way to having a single rulebook. The latest set of proposals relating to banking union are concerned with the consistent application of this rulebook, hence the emphasis on supervision and enforcement. Effective regulation is akin to a three-legged stool in this respect – it is stable only when all three legs do their job.

12. There are arguments both for and against converging supervisory practices. Fostering supervisory convergence has been an aim of many different stakeholders in the financial system, including both industry and regulators themselves. For instance, the Institute of International Finance (IIF) has argued that there should be a "more global approach to supervision" with "far greater cooperation, coordination, and information sharing in [supervisory colleges] and far greater cross-border convergence."[51] It must be noted that such convergence improves efficiencies and costs for large, global banks, increasing their competitive threat to small, local institutions. 'Over-convergence' it is sometimes argued, may actually increase systemic fragility, as when something goes wrong it is more likely to go wrong in all systems using the same supervisory approach. On the other hand, a lack of supervisory convergence can lead to conflicting requirements for cross-border institutions, as well as possibilities for regulatory arbitrage across borders. It is important to recognise, however, that national approaches also leave the door open to politically motivated regulatory forbearance, which can have cross-border externalities, as in the case of the eurozone.

13. There are various arguments for and against the inclusion of the central bank in supervision. For instance, central banks have a fundamental concern for financial stability, and locating supervisory functions within an institution which already has significant monitoring capabilities and expertise may allow synergies to be exploited. It also removes the need for an added layer of complexity in that the central bank does not need to coordinate with an external agency. On the other hand, it may lead to a reduction in diversity of supervisory perspectives. There is also the potential for 'mandate confusion' or the conflict of interest between monetary policy and supervisory function, as there is an incentive to use monetary policy to achieve prudential supervision objectives. There are also issues of reputational risk, as contemporary thinking on central banking holds central bank independence to be absolutely critical.

14. There is currently no consensus on the optimal division of responsibilities. Some countries have separate institutions for prudential supervision and monetary policy, while others house both in the central bank. There does not appear to be any clear-cut correlation between institutional structure and financial stability, let alone any suggestion of a causal link, and there is no internationally agreed best practice.

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[51] IIF, 'Achieving Effective Supervision: An Industry Perspective', July 2011, available online at http://www.iif.com/download.php?id=wulnswGYbyc=

15. Under current proposals, the EBA would retain its narrow remit of enhancing convergence, developing the single rulebook, and engaging in binding mediation. However, EU treaty states of the ECB that "it shall be independent in the exercise of its powers" and that "Union institutions, bodies, offices and agencies and the governments of Member States shall respect that independence."[52] The Treaty on the Functioning of the European Union (TFEU) and its associated Protocols suggest that the ECB cannot be instructed or bound by other EU institutions.[53] This would seem to suggest that the EBA cannot bind the ECB with its decisions. This issue has been raised in discussions between finance ministers, and suggests that the Commission's proposals may require more work. While the Commission's proposals state plainly that the ECB is not to take over the responsibilities of the EBA in terms of fostering supervisory convergence in the whole of the EU, the ECB does have the power to make regulations "to the extent necessary to implement the tasks"[54] which are conferred on it by the Treaty. The Commission text states that the ECB should exercise this power only where EBA guidelines "do not deal with certain aspects necessary for the proper exercise of the ECB's tasks or do not deal with them in sufficient detail." Whether in practice the EBA will retain its full role, or will in time become something of an appendix, is not clear from the current SSM proposals, and nor is it clear from the current proposed safeguards in terms of voting arrangements at the EBA.

16. More generally, as the ECB grows into its role, and in the eventuality that many of the non-eurozone EU27 opt into the SSM, the EBA may become redundant. Given the existing extraordinary complexity of EU decision-making and supervisory organs, there is a compelling argument for simplification wherever possible, both to avoid duplication of work and decision making, and to provide as much clarity as possible for the European public. Efforts to change EU frameworks without Treaty changes tend to lead to organisational complexity which limits both effectiveness and public understanding, delivering a sub-optimal response.

17. Regardless, there will need to be clear lines of accountability within the network structure. For instance, while the ECB will be held accountable to the European Parliament once a year, it is unclear how domestic supervisors will be held accountable, other than through a long chain. If the ECB were to take on "ultimate responsibility" for UK supervision, which institution would appoint the board for the domestic supervisory agency, and would this agency only be accountable to the European Parliament indirectly through the ECB? The accountability of the FSA to UK political institutions would need to be clarified.

18. Developing workable resolution regimes for banks is one of the most important elements of post-crisis reform, and central to overcoming the problem of 'too big to fail' financial institutions. The European Commission's proposed Directive for a harmonised resolution framework is broadly faithful to the Financial Stability Board's 'Key Attributes of Effective Resolution Regimes for Financial Institutions',[55] which sets out an international standard for resolution, and has been endorsed by the G20. However, while the Key Attributes represent significant progress, they do not go far enough to address cross-border failures, as

[52] 'Treaty on the Functioning of the European Union', Article 282(3), available online at http://www.ecb.int/ecb/legal/pdf/fxac08115enc_002.pdf
[53] Protocol No.4, Chapter III, Article 7, available online at http://www.ecb.int/ecb/legal/pdf/fxac08115enc_002.pdf
[54] TFEU, Article 132, available online at http://www.ecb.int/ecb/legal/pdf/fxac08115enc_002.pdf
[55] FSB, 'Key Attributes of Effectives Resolution Regimes for Financial Institutions', November 2011, available online at http://www.financialstabilityboard.org/publications/r_111104cc.pdf

they rely on non-binding institution-specific cooperation agreements. It has been recognised both by regulators and by industry that this is a shortcoming of the Key Attributes, but that at the time of writing there was insufficient political will to create more a binding cross-border framework. The creation of a single resolution authority in a European banking union could represent significant progress for overcoming this problem in the European context. There are many politically sensitive issues pertaining to this, not least of which is the issue of cross-border burden sharing. However, if a political consensus on robust resolution powers above the national level could be agreed, this would be a welcome development.

IV. What does this mean for the United Kingdom?

19. Host country supervision of eurozone subsidiaries will be taken on by the ECB. Thus, for any UK bank with a presence in, for instance, both Spain and Germany, the UK bank's supervisors may cooperate with the ECB, rather than with multiple sets of supervisors. Furthermore, for all eurozone banks with a presence in the UK, UK supervisors may cooperate with the ECB, rather than multiple eurozone supervisors or colleges of supervisors. This may allow certain synergies. Mervyn King, Governor of the Bank of England, recently said he "would welcome having as an opposite number the European Central Bank, with which we could talk about the capital and liquidity problems of major banks in Europe that [...] straddle the frontier between the euro area and ourselves."[56]

20. The impact on London as a financial centre depends significantly on the outcome of the eurozone crisis. Among other factors, the success of a financial centre is strongly related to the predictability of future policy movements in relation to regulation and taxation, and the stability of the business environment. Uncertainty stemming from the future of EU banking union may not adversely affect the UK's role as a leading financial centre if UK policy can become both more settled and consistent. There may be concerns that a European supervisor would be more interventionist and less predictable than a UK-based supervisor. However, it is already the explicit intention of the UK's current regulatory authorities to foster a more pro-active, interventionist regime. Concerns about the potential for the capital of European finance to move away from London have been recurring for decades, for instance relating to the original decision to locate the ECB in Frankfurt, with no real shift in the locus of activity.

21. One area in which the UK may be disadvantaged in the long-term is in a convergence of supervisory cultures across participating member states. The ECB will have the power, for instance, to require home supervisory teams to employ supervisors from other member states, and there are likely to be many secondments across borders. This may lead to a cultural convergence of supervision in the eurozone, to which the UK would not be party. Aside from voting arrangements at the EBA, this may disadvantage the UK in the long-term, as its views may become those of an outlier. The UK may as a result find its voice diminished relative to the proportion of EU financial activity which it hosts. However, the UK is not alone in its concerns about consolidation within the eurozone, with Sweden's Finance Minister Anders Borg having expressed substantial concerns. Mr Borg referred to "red lines" for the Swedish government and said: "There is [sic] a large number of countries that are not members of the eurozone that find this solution unacceptable."[57] It is unclear at this stage as to whether any non-eurozone countries will opt-in to the proposed system.

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[56] Patrick Jenkins and Brooke Masters, 'Bankers focus on key forum', 13 September 2012, Financial Times
[57] 'ECB bank supervision plans 'unacceptable': Sweden', EUbusiness, 15 September 2012, available online at http://www.eubusiness.com/news-eu/finance-public-debt.idj

22. The UK has not been successful in getting its views heard in Brussels since the financial crisis. There are a variety of reasons for this: structural reorganisation and staff turnover within British regulatory institutions that made it difficult for other member states to feel they had a long term interlocutor with real power to affect change in front of them, a view that lax regulatory surveillance in the UK (from the perspective of some continental Europeans) sowed the seeds of the crisis, and the current government's stance with respect to EU negotiations at ECOFIN and EU Parliamentary levels. There is the potential for the SSM to further marginalise the UK's political voice, less as a consequence of EBA voting arrangements, but more as a result of potential convergence of supervisory culture within the banking union. Therefore, the UK should see the ongoing work to move towards the banking union as an opportunity to constructively engage in the regulatory debate, and reverse the trend of the last five years.

23. The short-term nature of politics means that insufficient thought is often given to what is in the United Kingdom's long-term economic interest and how to achieve this. Fortunately, the nature of the House of Lords permits a place for this reflection. Reaction to the current proposals on EU bank supervision should be done in this context. We recommend thoughtful consideration of the value of having a strong voice at the table that will shape the future of European bank supervision, and ultimately regulation. Such consideration should be based on the perceived importance of Europe to future UK growth, the advantages and disadvantages of being a fully-signed up member to the world's largest economic zone, and the likelihood of major international financial institutions continuing to make their base in London as European regulatory convergence eases their costs and complexity.

This evidence is submitted on a corporate basis.

24 September 2012

Italian Federation of Credit Cooperative Banks (Federcasse)—Written evidence

The House of Lords EU Sub-Committee on Economic and Financial Affairs has launched an inquiry into reform of the EU Banking Sector. The Italian credit Cooperative Banks are pleased to share their view on some aspect of this important subject.
Sovereign debt crises and the risks of systemic instability of the European banking sector have brought the Heads of State and Government, gathered in the European Council of June 28 and 29, to focus on the goal of the European Union represented by the constitution of the Banking Union. The apex bodies of the Union have since then made clear in various communications that the Banking Union will be formed by three pillars:

A) a single supervision at ECB level;
B) a single deposit guarantee scheme;
C) a single recovery and resolution scheme.

On September the 12th 2012, responding to the input of the cited European Council, the EU Commission has published the proposal to lay the first brick of the Banking Union: single supervision by the ECB and the amendments to the EBA functions.

The setup of a single supervision authority should stem from a common view of the future structure of the European banking sector in order to avoid the causes that brought about the recent financial crisis. As pointed out in a recent IMF publication, "*a surge of market-based financial intermediation and new financial products led to structural features that were associated with the recent financial crisis*"[58]; most relevant were: the growing size and complexity of financial institutions, their interconnectedness, the increasing concentration of the banking industries, the reliance on volatile funding (mainly wholesale), weak supervision. The regulatory agenda, aiming at reducing the likelihood and the cost of a new financial crisis, should therefore pursue a model of financial intermediation in which financial institutions display the following characteristics: more transparency and better governance; less leverage and higher capital; better understanding by market and supervisors of risk taken by banks and shadow banking sector; effective resolution tools for large financial institutions. If one of the aims of the single supervision by ECB is to be sure that each country pursues this common project, it follows that banks that already behave according to the desired structural landscape (and did not contributed to the financial crisis) should not be harmed. In this framework the Italian Cooperative Banks welcome the strategic goal outlined by the European Council but are aware that it presents the risk of certain unintended consequences. In detail, we would like to point out the following:

1) potential risks of homologation of different business models deriving from the necessary homogeneity of rules;
2) risks of efficiency and efficacy loss, should the implementation of the supervisory mechanism not be sufficiently focused on the principles of proportionality and subsidiarity.

[58] Global Financial Stability Report, October 2012, chapter 3.

1. Homogeneity of rules and risks of homologation of the institutional mission of intermediaries

The Italian Credit Cooperative Banks appreciate the effort towards an increased homogeneity of the rules which discipline the banking activity. However, it is of the utmost importance that such rules do not entail the homologation or the leveling amongst intermediaries for their institutional mission and the business model shaped around it. To such purpose, it must be recalled that in Italy as in many other European countries, the supervisory Authority has developed a supervision style and culture founded on a dialectic between the supervisor and the supervised, with a strict definition and rigorous respect of each other's roles. Such approach has delivered an articulation of the banking system which mirrors the diversity of intermediaries and better responds to the articulated necessities of each country's economic system. Within such context, small local banks and cooperative banks have affirmed themselves as the segment of the banking sector serving communities and local economies.

We hope that the single European supervision will not cancel local articulations where banking realities such as small local banks can foster local economies abiding by their mission. Therefore, the single supervision should not:

1) hamper the principle of proportionality, which must instead take into account the size and the nature of the different intermediaries' business models;
2) become the source of new rules. Specifically, we signal the risk of doubled supervision communication, both to the National authority and to the ECB. Such cost would be absolutely unbearable by local banks.

In order to avoid such dangers, we believe that a specific chapter within the single rule book should be dedicated to the cooperative banks and to small intermediaries. In any case, precise and effective rules must be adopted in order to grant an indispensable proportionality between the discipline imposed on banks, their institutional and dimensional profile and their mission. This is the only way through which the level playing field between banks of different size and business model will be achieved.

2. Implementation of the supervision mechanism, efficacy/efficiency of the supervision and the principle of proportionality

The proposal for the Regulation published by the Commission makes it clear that National supervision authorities must assist and follow the instruction of the ECB, especially the preparation and implementation phase of its decisions. This means that the criterion of subsidiarity is recognised. Concretely, we could imagine that the supervision activity, although pertaining to all banks, should be carried out through different layers of centralization, according to the different type of activity of the intermediary: whether it is local, regional, National or cross-border. However the principle of subsidiarity demands the promotion of:

1) the best practices already existing within styles and cultures of supervision, especially where involving local realities, however essential for the liveliness of the social and economic tissues of the territories they serve;
2) the best practices in the prevention and management of crises. With such regard, we explicitly refer to the consolidated experience of many European Depositors

Guarantee Fund and to the further schemes protecting our consumers. Italy has not seen any public finances expenditures to save failing or likely to fail banks. This is an asset that must be enhanced and valorized, because this has not been the case for many other situations in Europe.

With reference to the above observations, we propose that:

1) the degree of "assistance" by the National authorities to the ECB should be highly increased in the case of small local banks, guaranteeing at the same time the constant dialogue between National supervisions, coordination at ECB level (supervision of supervisions), in order to avoid unjustified discretional application of the same rules to the same categories of intermediaries;

2) in an initial phase, the DGS discipline should be standardized, which means a swift approval of the *Deposit Guarantee Schemes* Directive, full recognition of the value of the existing Institutional Protection Systems in the construction of the unitary framework of crisis management (*Recovery and Resolution*) and finally, the encouragement to the setting up of similar mechanisms, according to the rules set forth under Directive 2006/48, Art. 80(8).

The Italian Credit Cooperative Banks reaffirm their determination and resolution to pursue their mission in favor and at the service of small communities and local economy. They also firmly believe that organizational and governance diversity is a stability factor that should be taken into account in the process of designing the new landscape of the European banking sector.

Annex

The Italian Credit Co-operative Banking System

The Italian Credit Cooperative Banks (**BCC - Banche di Credito Cooperativo** and **Casse Rurali**) are *nonprofi*t co-operative societies. Their aim is to promote participation in economic and social life, and ensure that each member may at least partially be responsible for their own personal growth.

The **BCCs** are established throughout Italy. With more than **400 banks** and more than **4,300 branches** (over 13% of the Italian banking system), they are closely interwoven in the social fabric.

From the economic point of view, BCCs have been showing steady growth in:

- total retail funding, now amounting to over 151 billion euro;
- loans of up to 138 billion Euro;
- capital and reserves, totaling more than 19 billion Euro.
- 32,000 employees

From the operative perspective BCCs present a strong specialized expertise in the activity of traditional intermediation, based on the originate-to-hold model and on long-lasting fiduciary relationships with customers.

BCCs are part of an internal safety net which makes them more effective in coping with capital, liquidity or insolvency problems without external intervention or taxpayer aid.

To this regard central initiatives are represented by the Fondo di Garanzia dei Depositanti (depositors' protection scheme, hereinafter "FGD"), Fondo di Garanzia degli obbligazionisti del Credito Cooperativo (bondholders' protection scheme, hereinafter "FGO") and Fondo di Garanzia Istituzionale (institutional protection scheme, hereinafter "FGI").

For more information please refer to FEDERCASSE web page (www.creditocooperativo.it)

1 October 2012

Philippe Lamberts, Member, European Parliament—Oral evidence (QQ 1–18)

Evidence Session No. 1. *Heard in Public.* *Questions 1 - 18*

MONDAY 1 OCTOBER 2012

3.35 pm

Members present

Lord Harrison (Chairman)
Lord Flight
Lord Hamilton of Epsom
Lord Jordan
Lord Kerr of Kinlochard
Lord Marlesford
Baroness Prosser

Examination of Witness

Philippe Lamberts MEP

Q1 The Chairman: Thank you ever so much, Philippe, for coming. We would be very grateful if you could sketch out an idea of what you think this beast, banking union, which has landed on your doorstep, is. It would be very good to know what you define it as and what you think are the opportunities or, indeed, the difficulties, associated with it.

Philippe Lamberts MEP: Let me first say that when I got the invitation, my attention was immediately attracted to it because I would like to see more of the UK in Europe. I am one of those who think that it would be a great loss to the European Union if the UK were to go its own way, which I know is a subject of popular debate in the UK at the moment. However, I also know that your people are realists. I have said openly that my bet is that you will always choose what is in the best interests of the United Kingdom and, if that means more integration, ultimately you will make that choice because I think that the Brits are fairly rational people. That is my view and so spending time engaging in dialogue with, in your case, representatives of the House of Lords is certainly an opportunity not to be missed. I am saying that not just to be pleasant but because the UK is very important to me. It is not the only country that is important to me but it is certainly very important. I want the UK in. If the price to pay for that is to be too lax on regulating finance, then I may think twice about it, but still I would prefer the UK to be in rather than out.

I could present banking union to you in several ways. I could say, if I were a Eurosceptic, that that is probably the most powerful Trojan horse that the federalists have chosen with which to bring about a federal Europe. I think that if we are serious about banking union, that is exactly what it means—that is, sharing financial sovereignty. I do not know whether there is anything more important to people than financial sovereignty. That is one way to put it. Another way to look at this is to say, "This is just a by-product of the need to recapitalise Spanish banks." Of course, you do not want to give anyone a blank cheque without having the opportunity to control what is going on. That was how it came about in June in my view. It was brought about by the Germans, who said, "If we want to recapitalise the Spanish banks directly, yes, why not? Let us do that."

The European Commission interpreted that as a signal for a bold proposal and came up with a three-step approach, the first of which is to have common supervision of all eurozone participating member states' banks—that is, central supervision, unified, integrated, or whatever you like. That is a precondition for not only the recapitalisation of the banks but also a common deposit guarantee scheme and a common recovery and resolution scheme. Seen from a Green perspective, these are things that we support. With two notable exceptions, these being the Green Party of England and Wales, I am afraid to say, and the Green Party of Sweden, all the European Green parties are rather federalist. Being federalist does not mean just having a European federation for the sake of it. We believe in a nutshell that since we are so few on the planet and occupy such a tiny speck of land, we will not be successful in the 21st century without being united, which does not mean one size fits all or that we should all be the same, but it does mean acting as a team, not as a loose connection of individual member states. In that sense, banking union from all perspectives is something that we would tend to support as one of the ingredients, but not the only one, of greater financial and political integration in Europe.

I will come to the political aspect later but some problems arose with the Commission's proposal as it came out. I would tend to say that a big majority of members of the Economic and Monetary Affairs Committee support what I am going to say, perhaps for different reasons. The Commission says, "The Council gave us the mandate to put everything under the aegis of the ECB." In our view, that causes more problems than it solves. In terms of inclusiveness, the ECB is, of course, the bank of the euro and the euro is the currency of the European Union, not just of the euro group, so that should not be a problem except that the ECB is run by eurozone member states. Therefore, if we are serious about this being an inclusive endeavour and not a sort of second club within a club, we need to give equal decision-making powers to every member of the banking union. That will be the case if we lose the ECB as the key pillar of the architecture, because, of course, the decision-making powers of non-euro member states there are non-existent. Of course, you can exempt all sorts of structures, but ultimately the ECB board of governors and the ECB governing council are concerned with eurozone member states. For me—when I say "me", I speak not just about the Greens but about the majority of parties represented on the ECON Committee—this issue really needs to be inclusive. The target is to have everyone on board. We send the wrong signal if we say, "It is the ECB; you can participate but without full decision-making powers." That is the first problem that we have with the ECB.

The second problem with the ECB is that if we are serious about this—that was the position of the Parliament two or three years ago when we discussed the supervision package, whereby we put in place the supervisory architecture in Europe—we should have a single integrated supervisor for banks, the insurance industry and financial markets in Europe and not a collection of three. The same article of the legal basis that underpins banking union and the ECB expressly forbids the ECB to exert any role in supervising interest rates. You might wonder how that came into the treaties. I do not know—I was not at the convention—but that is the result. What are we going to do with major conglomerate bank insurance groups? Does the article forbid the ECB to supervise them because they are also insurers? I do not know, but that is certainly a problem if we want the ECB to carry on with that role.

The third problem that we have arises more from a German perspective. Do we want to dilute the monetary policy role—an exclusively monetary policy role of the ECB—by giving it obligations? Do we not create a risk that at times of crisis conflicts of interest might arise between the two roles of the ECB which might cause problems?

The fourth point is the accountability issue. In its supervisory role, the ECB must be accountable to democracy. While the treaty expressly says that in its monetary policy function the ECB is totally independent, the same institution will need to be dependent or subservient to democracy in its supervisory role. You might say, "There is no problem because the treaty says only that it is in its monetary policy role that the ECB should be independent but it can be dependent in other functions." But then there is the question of corporate culture. If you have a corporate culture of non-accountability, which the ECB fiercely defends, how can you ask the same people then to have a different attitude and take directions from elected politicians in a supervisory role?

We believe that for all these reasons putting the thing at the ECB may not be a very good idea. Some of us may use those arguments to derail the banking union, but even if you are serious about making that argument, the consensus that I could hear from the debates we had last week was that we should locate the function or role close to but not under the ECB. We could find a wide majority in the Parliament in favour of such a solution. That is the first aspect.

The second aspect is what the scope is. Do we want the common supervision to address all banks? That has a number of practical problems. I can perfectly understand and sympathise with the attitude of Barnier, who says that a bank that may not be perceived as systemic may have a systemic impact. Bankia is a good example in Spain. Before becoming Bankia it was a collection of savings banks. Each of those savings banks, taken separately, might have been seen as being innocuous to us, whereas taken as a system they cause problems. Therefore, I tend to sympathise with the fact that we want to supervise them all, but how do we organise that, because what we do not want to do is build up a separate duplicate structure to the national supervisors that exist over there. That would be irresponsible financially but also practically because all the expertise that has been built up by the national supervisors should be used. What we want to break is a sort of complicity that comes from too much closeness between supervisors and supervisees. Therefore, I would like some British supervisors to supervise some Belgian banks as, especially in a small country such as ours, skills are not that abundant and people know each other too well. We need some distance between the cops and the potential thugs. For us that is an advantage of the system.

Whereas we would say that the goal must be to have all financial institutions supervised by a common structure, there is some intelligence to be had as to how we organise this, taking into account the existing supervisors, the to be created or expanded European authorities, if we have the expanded EBA, and how we use the resources well without duplicating them. Then there is the time aspect. What is the target architecture and how much time do we take to get there? If we want this to be efficient, we cannot just say, "On 1 January 2013, we will have all the banks that the ECB chooses, six months later all the systemics and then, six months later, everyone." That is totally unrealistic.

Q2 The Chairman: Let me ask a couple of supplementary questions that arise from that, and I know that my colleagues want to comment in particular on the role of the ECB. You mentioned two parts: the necessity to think more profoundly about this, which I think means considering the timetable being proposed; and, secondly, the democratic side. After all, as a European parliamentarian you are going to be charged, along with the Council, to perform the function of accountability. Before we come to the other questions that arise from your very interesting opening report, would you like to say a bit more about how you see the European Parliament acquitting itself in the role of keeping the changes democratic?

Philippe Lamberts MEP: There are several aspects to the question. I could be cynical and say that currently we have no real democratic accountability, because who among the supervisors really acts and feels accountable towards their own national Parliaments? I can say that in Belgium the national Parliament does not often conduct hearings with the Belgian national bank on its role as the supervisor of the previous supervisory authority.

One component is appointing people. I would think that the European Parliament should at least be involved in these appointments. I do not want to delegate that role. If the ECB appoints people to perform its own mission, that would be a group of people deciding on their own who is going to do what. I am sorry, but that is not the way it works. To be honest, and if we really are serious about this, I would go beyond just an assent procedure.

Secondly, the conduct of hearings means that there is an obligation for transparency on the part of the supervisor, wherever the role is located—the ECB or the EBA, those are the options. It will mean real accountability because ultimately it means the ability to fire the current management. If you do not have that, which is currently the case with the ECB, you will have no accountability. Going to a hearing in the European Parliament feels different. In no way would that cost you your job because you would know that it was a conversation among friends. There would not be the same attitude, if you like.

I would say that the two main components are the right to appoint people and the right to hold hearings and enforce transparency on the part of the authority, whichever one it may be, in the conduct of its mission.

Q3 Lord Hamilton of Epsom: Thank you for your interesting comments. Can we go back to the question of timetables? Is it conceivable that this very short timetable has been set in the knowledge that it will not be kept, so that the compromise would be, say, 1 June, and that that was the date they had in mind from the start?

Philippe Lamberts MEP: I do not know because I see a lot of second thoughts around this. The Commission saw a window of opportunity. The Council of 28 to 29 June created the momentum which I think the Commission wanted. I commend it for coming up with its proposals so fast, but there was a very aggressive timetable. I believe that, for the first time, it confused ambition with haste. If we are serious about doing it right, the architectural choices are absolutely essential because they determine whether you will be able to expand the house and whether it will be open and inclusive of bankers. This must be thought about early on because, if the wrong choices are made, they may preclude the possibility of refurbishing the house. It may need to be torn apart if you want to make changes and you do not want to do that. We cannot afford it.

Not only did it want the banking union put in place by 31 December, but it wanted the CRD IV negotiations for Basel III completed by the same date. It also wanted the deposit insurance, recovery and resolution directives. We have limited bandwidth and all these issues are interconnected. Again, it is all about what I call architectural choices. Are we sure about, first, common goals, and of the best way of fulfilling them? My problem is that, as a European federalist, I want to keep up the momentum, but I also want a sustainable and long-lasting house, and to do this seriously. However, I am concerned that some of those who pushed so hard in June—mainly the Germans—are now back-pedalling with the same energy and saying, “Actually, we do not want this if it concerns our own banks. We do not want an external person looking into the intricate relationships between politicians and the banks that are close to politicians in our country." That means, "Discipline for others, but not for me". That is the attitude constantly shown in Germany. I can say that we have another debate right now about statistical accounts, which is a follow-on of the six-pack. A directive is being discussed that basically wants member states to document their contingent liabilities to the European Commission so that the Commission has a better view of the debt burden of member states. That has to do with pensions, bank guarantees, et cetera. Four member states are resisting it, saying that they will hand over the information every three years. A note to that effect landed on my desk early this morning. It said, as a compromise, "We will give you this information every third year, and by the time we give it to you, it will be two years old." It really says that, and it comes from Germany: "Discipline for the others, but I do not want you to see my dirty linen."

The Chairman: I was wondering about Belgian supervisors coming to look at German banks. Would you be so open about Belgium's financial affairs?

Philippe Lamberts MEP: We need to educate them.

Q4 Lord Flight: The term "banking union" has been used, but I am slightly unclear about what is to be achieved. I can envisage pan-European guidelines on how banking regulation and supervision is to be conducted and those being handed down to the existing central banks with instructions to get on with it. That arrangement could evolve in due course into something like the Federal Reserve in the US. Such a path would be realistic. However, setting up anything in competition with the existing central banks would, I think, be completely out of the question. I am not clear what the role of the EBA versus the ECB is expected to be—whether the EBA will effectively be an agent of the ECB with the ECB laying down policy, or vice versa.

As you know, the UK is in the middle of a significant change in banking regulation with a Bill currently going through both Houses of Parliament that will switch us back to having our central bank as the regulator. But that is very much in a supervisory context. I think what we learnt was that rules do not work and that in fact they are positively harmful. What you absolutely must have is an astute central bank which is on top of things, knows what is going on and has the natural power and authority to step in and stop undesirable things from happening. Again, I do not think that can be done from on high, such as by moving someone from Belgium into Germany. My final point is this: I can envisage all this being put in place in due course for the eurozone, but I do not see that the UK would participate because it has its own currency.

Philippe Lamberts MEP: I look at this not as a means of defending the common currency but as a means of promoting the integration of Europe. Let us face it, we have the single market and that is really the driver. Finance knows no borders, not even between currencies. The financial health or lack thereof of the City of London has ramifications for Europe, and vice versa. That is why I said that we want the architecture to be really inclusive; we want everyone in. I would say that it would be pointless to do all that without the UK. I am very much of that view, although we may disagree on it.

I believe that it starts with the common rulebook to be implemented and enforced in a similar way in each of the member states. There should then be, on occasion, a means of exchanging people in order to build up a common culture of supervision. Let me take the example of Belgium and the cosiness that existed there. There was also a lack of skills—if I can put it that way. That could have been helped if there had been more exchanges with larger countries in which the skills base is much wider, even if the cultures were different. I would like to import sometimes some German and sometimes some British culture into Belgium because I think that that would help, and it would encourage a more integrated approach.

Secondly, on the respective roles of the EBA and the ECB, the more I think about it, unless we totally change the architecture of the ECB, the less I want to give the supervisory role to it. Another reason is that it would mean that too much power would be concentrated in one place, which in a democracy is never healthy. To me, democracy means checks and balances. The ECB is already the most powerful central bank on the planet, so I am not sure that I want to give even more power to that institution. That is my gut feeling.

Lord Flight: You say we should use the EBA.

Philippe Lamberts MEP: The question we are asking is this: The EBA is the regulator. Do we want the same institution to make the rules and to enforce them? I would say that if there is a good case for doing that, there might also be a case for a separation of powers. However, you do not want to disperse your power because checks and balances mean that there needs to be a very strong institution in front of the ECB. That is what concerns me about the current construction as proposed by Michel Barnier. That is because if we are totally democratic and say that the ECB represents the euro member states and the EBA, it would mean that the ECB would rule the EBA. Do you want that? I would say no. Conversely, I do not want to twist the system in a way that would somehow preserve for the non-euro member states a form of veto power. That would be a perverse incentive because it would give them more decision-making powers by staying out than by being in. That is a bit tricky but, again, my gut feeling tells me that since we have yet to come to a conclusion about it, it is still a work in progress. We could locate the supervisory, enforcement and regulatory powers for the single market in the EBA, but it means that we would have to convince all the member states to take part. Of course I understand that that is where there might be some friction with the UK because sometimes you may get the impression that we are setting rules for the common financial market in which the City of London is the biggest player. Not everything we do is welcomed by the City of London.

On the other hand, on banking rules, I feel more like a Brit than anyone else. That is because at the moment I see more ambitious reforms being made in the UK than anywhere else in Europe. Vickers is in the UK; it is not anywhere else. When we want to set binding liquidity or leverage ratio levels in CRD IV, basically, only the UK supports us. Remuneration is another story, but that is not for today.

Back to the calendar, if we want to do this right, we need to take some time. I know that some member states are saying, “Yes, but we want direct recapitalisation, otherwise we have a problem,” but I would rather say, “Let us find another way of solving the Spanish crisis than by building up the wrong banking union.” To me, the next steps are these: If we are serious about a banking union, it is about the mutualisation of risk. That means deposit insurance, recovery and resolution, which have strong fiscal implications. That is why I say that this is the Trojan horse of a federal state in Europe. We cannot do that unless we have a working democracy in Europe.

Q5 The Chairman: How long might that timetable be? I understand that with the amount of work involved you may not be able to put an end date on it.

Philippe Lamberts MEP: For the supervisory part, to do it properly I would think that before the summer of next year is reasonable. The tough discussion is on the target architecture, as working out the details is not that complex. In the transition period we need to make sure that we do not duplicate things. The question is whether we agree on what the target architecture should be, which requires study between now and December/January—certainly in the Parliament and in the Council as well, as Governments need unanimity. Once we have got the architectural choices right, designing the rules and doing the blueprints requires another two or three months of negotiations until the summer. That would be my ideal calendar. Then, there is the deposit insurance and rescue recovery and resolution. It is so heavy in terms of fiscal implications and the need to have democracy to ensure that there is no taxation without representation that it may take years.

Q6 Lord Kerr of Kinlochard: That was very interesting. Because you are rather against the idea of the ECB role, you did not need in your presentation to talk about how the supervisory board structure under the governing council would work, with four coming from the governing council and the rest coming from the member states, the voting rules, and so on. I am not convinced that it would work very well. I would like you to tell us how you think it would work and perhaps, in addition to the four arguments you made against the involvement of the ECB, whether you think that we would be asking rather a lot of monetary policy experts, which basically is what we have in the governing council of the ECB, also to take on the key role in banking supervision. That is question 1.

Question 2 is about the EBA. You made the point on voting rules that one would need to be careful to ensure that the "outs" do not have excessive rights. On the other hand, we need to ensure the protection of the rights of the "outs" from the dictatorship of the ECB position being spoken to by all the others. Can you talk to us a little more about what sort of voting rules could square this circle?

My third question is about Liikanen. Presumably that will be all around town this week, so how does that impinge on everything you have been saying so far, apart from making your life even more difficult and complicated? This may be a silly question, but is it your impression that Liikanen would in any way cut across what the Government in Britain are planning to do following Vickers?

Philippe Lamberts MEP: I can be very brief on the first two questions because we have not come to any conclusions so far on those issues. The more we think about it, the more we believe that the architectural choice of the Commission, based on the Council decision, was wrong. We did not spend a lot of time trying to improve it. I do not think that we can work satisfactorily with appropriate checks and balances with no incentives. We cannot devise that but we can still look at devising complex institutions, although I am not sure that we would want to do that. I am afraid that I do not have complete answers. We can remain in contact after this meeting while exchanges and reflection progress in the next few weeks. We will need to say something about that, but do we want to be involved in it? In this respect, I would say that you have greater power than we have. Do not forget that we are co-legislators on the EBA part of the two parts, and we will leverage to become co-legislators on the ECB part. Your Government have a veto right on that, because you need unanimity to confer powers to the ECB. The British Government can say, "This cannot work and we oppose it." It may be only your Government but it will make it awkward because people will say, "You are blackmailing the eurozone." What I hear from many people, including the Germans, is that this does not work.

Lord Kerr of Kinlochard: Surely this is Article 127.

Philippe Lamberts MEP: It is Article 127.6, but what the Council makes it can undo. No one prevents the Council from reaching the conclusion, "Actually, we were a bit fast in June and, without losing face, we can retain some role for the ECB in the overall architecture. We believe that it should be oriented that way rather than this." To me, that should have priority. Increasingly, I hear the Polish Government, the Swedish Government, the German Government—of all Governments—and the British Government saying, "This doesn't work." Rather than spending time and energy trying to make something work that cannot, I would rather that those people would sit together and say, "Maybe we were a bit too fast and when the rules are in place we will steer the boat in a slightly different direction." I would really encourage you to work that way if you share our concern that this cannot be made to work satisfactorily. It would be interesting to have constructive proposals from London, saying, "It will not work like this but it may work like that." Alternative proposals could be suggested that do not question the idea of moving towards common supervision but making it architecturally different. That covers the first two questions. I know that it is a bit unsatisfactory, but that is all I can offer at this stage.

Liikanen to me is a different animal. What we are currently discussing with banking union is devising a common police force, whereas here we are talking about rules that the police will need to enforce. That is a different animal. We welcome this. Maybe you noticed that up until last year this idea of structural reforms for the banking industry was taboo in the Commission. The universal model had been the mantra of the Commission for the past 15 to 20 years, so maybe we now need to make a U-turn and reconsider. We will see what the Commission comes up with. I have read the same rumours as you did as to the whether it will be a European Vickers. The Greens' performance in CRD IV demonstrates that we will do everything we can to make sure that Vickers is not prevented by anything we do in Brussels. I do not want to slow down the boldest who want to do something. So count on us to be on your side on that. If we can import that to the continent and piggy-back Liikanen and Vickers into bringing about a performance in the continental banking industry, I would welcome that. Frankly speaking, we know what we are up against—that is Commerzbank, Deutsche Bank, BNP Paribas, Soc Gen, et cetera. That is part of life.

Q7 Lord Kerr of Kinlochard: Were you going to say anything about the voting rules on the EBA?

Philippe Lamberts MEP: No. If we do not put the power at the ECB, it is not the ECB representing the member states in the EBA, so we are still at stage IV.

Lord Kerr of Kinlochard: In logic, you are right. We do not have to settle it now. If you were to be illogical and say something, what would you say?

Philippe Lamberts MEP: Currently, we are facing a conundrum. The Greens have not yet come up with a satisfactory answer.

Q8 Baroness Prosser: You have sort of touched on the area that I have been thinking about while you have been talking, which is the prospect of all this being realistic. Suppose, for example, that we transposed the banking and finance industry for industry generally—manufacturing, say, or service providers, which themselves have the opportunity, should they so desire, to forge some kind of financial mayhem in different countries, not perhaps at the level of major banks but, nevertheless, significantly. Let us suppose that the European Parliament, in some form or another, was able to come into those countries and oversee their activities—investigating their bank accounts, et cetera. The vast majority of businesses are very wary of any kind of political involvement, or interference as they would see it.

What do you think the realistic prospect of success of this activity would be? I think that most people out there would think that this—

Philippe Lamberts MEP: There is a difference here. We are not speaking of the European Parliament supervising any enterprise—banks or whatever else. We are speaking about a supervisor doing that. That is the difference.

Baroness Prosser: But it is not going to be seen like that outside, is it? I do not think that it would be seen like that. It would be seen as a European decision—an instrument of Europe in some way or another.

Philippe Lamberts MEP: But in the UK you have a Government offering supervisory powers to an institution.

Baroness Prosser: But our Government do not even interfere in the banks that are almost entirely owned by the Government.

Lord Flight: There is strict regulation.

Baroness Prosser: Exactly. It is one thing having regulation but supervisory interference, which people would interpret this as, is rather different, don't you think?

Philippe Lamberts MEP: No, to me, it is the exact parallel. The British Government and the British Parliament are devising the rules. They are devising the supervisory architecture—that is, the way the rules will be enforced—and they are making sure that the enforcers do their job. It would be exactly the same thing at a European level. It may be seen differently but I do not see any reason for that. The European Parliament and the European Commission are devising the rules and the way they will be enforced. They are making sure that those who need to enforce the rules are doing a proper job but they are not interfering with the management of a company. We are not doing that.

Q9 Lord Hamilton of Epsom: Two quick points. Regarding the ECB, you say that you think it should be responsible for the Union's monetary role but not the supervisory activities. Where does this leave the buying of bonds in Spain? Is that part of the monetary role? Are you quite comfortable with it doing that?

Philippe Lamberts MEP: I could not say yes.

Lord Hamilton of Epsom: But you could say that actually it is quite contradictory. If you are buying bonds and printing money, you are going against the role of trying to control inflation, which is really the main monetary role.

Philippe Lamberts MEP: You should probably ask that question of the Bank of England, which does it all the time.

Lord Hamilton of Epsom: Everybody is printing money.

Philippe Lamberts MEP: I know. I am not sure that it is very healthy but that is not the question. No, I do not think that there would be any interference. I think that they are acting within their role in doing what they are doing. I still believe that we need a lender of last resort for all states, but I know that this is forbidden by the European treaties for the eurozone member states. In my view, that is a bit stupid because I believe that we should have limits. We need a framework that prevents the moral hazards. But now, with all the governance instruments that we have put in place, either we believe that they are serious and the moral hazards issue is tackled or we believe that this is all bullshit and we ask why we started this in the first place. It is an either/or question.

Q10 Lord Kerr of Kinlochard: Is it not in principle wrong that the lender of last resort should also be this new supervisor?

Philippe Lamberts MEP: Absolutely. To me, they are two different functions. Now, we are speaking about Europe, which is a big animal. To me, then, the argument is about the concentration on power—something that is not happening.

Q11 Lord Hamilton of Epsom: You made reference to Vickers in England. The leader of the Labour Party, of which I am very much not a member, is saying today that he feels that Vickers does not go far enough. Vickers is talking about ring-fencing. Many of us in the Conservative Party do not think that ring-fencing is worth the paper it is written on and that banks will always find a way of getting through Chinese walls. Where do you stand on Glass-Steagall?

Philippe Lamberts MEP: We have yet to come to a conclusion, so I shall speak in my own name here. The more I dig into Volcker and Vickers, the more I believe that there is a negative associated with complexity. If we have rules that are too complex, they are too easy to circumvent. We had a working economy under Glass-Steagall, so I will not buy any argument that says that that will be the outcome. It will probably make the profits of banks smaller than they used to be. My father ran a business and I worked at IBM for quite a few years. There is nothing wrong with having profits of 5%, 6% or 7%. As long as you are profitable, that is good business. You do not need 20% or 25%. A European Glass-Steagall would prevent that. I did not come to a final conclusion on that in my reasoning but, all in all, I believe that our financial industry has become way too complex. Of course, there is going to be a conflation between the complexity of the rules and the complexity of the supervision, but there is a cost associated with that. There is a societal cost but also a practical cost. Do you really want that complexity? I would tend to say, "Not sure".

Lord Hamilton of Epsom: Can I just add to that? The real argument for Glass-Steagall is that the taxpayer has absolutely no role to play in bailing out businesses that go bust. If you have a very speculative business, then the position should be that it can go bust and make no demands to counter that. That is where I come from on this.

Philippe Lamberts MEP: That is where I come from, too.

Q12 Lord Marlesford: I have two points. First, you indicated that certainly you—and I think you suggested also your ECON Committee—feel that the timetable for the Commissioner to report is unrealistic. Can I ask whether that has been communicated to the Commission and, if so, what did it say in response?

Philippe Lamberts MEP: It is a game of chicken—of who says it first. Everyone does it, and I think that it will be easier for the Parliament to come to a united view on what the banking union should be than for the Council, especially as we do not need unanimity and it does. But, yes, I think that the Parliament is overly cautious in saying, "Well, we'll do our utmost to be there on time," et cetera, even if everyone knows that this is impossible. No one wants to call it a day, and that is a fact. So I am afraid that it is a game of chicken with no one wanting to say it in the open.

Q13 Lord Marlesford: My second point, having listened carefully to what you have said, is that it seems to me in one sense that the whole project is not getting under starter's orders. You have said, very frankly, that you see it as part of a federalist agenda. That is a perfectly fair position to take. It does of course mean that those who do not share the federalist agenda will not support it. They may even oppose it. On the other hand, there are other reasons for this and it seems to me that they have not been clearly identified. Are they, in fact, to prevent what has happened in the banking sector, which has put us all into a mess, from happening again, or are they intended to correct the problems which we are currently suffering? Whichever of those it is, once you have decided on that—and it seems sensible to be pretty clear on that—there are two subsequent parts to this. First, what are the rules we put forward for either of those objectives and, secondly, what is to be the machinery or mechanism for implementing the supervisory role? Until all those points have been dealt with, it seems to me that we will not evolve very far.

Philippe Lamberts MEP: I agree. It started from the perspective of solving the current problem. We want to have the ESM recapitalising the Spanish banks without passing through the Spanish Government. We do not want to do that without controls, so we need a banking union. You might think that it is a bit short-sighted, and to some extent it is, but that was the way it started. If people now backtrack on that and say everything we do not want, with direct recapitalisation you might as well close the book on banking union. You do not need it. Let us look at the Spanish situation. Yes, there was a real-estate bubble in Spain that was fuelled by—

Lord Flight: By the euro.

Philippe Lamberts MEP: By the euro, yes, and by poor supervision in Spain but also by the flow of easy money from other eurozone countries—not just from the eurozone but from other parts of Europe—into Spain. How to tackle that? You may say that we need a better supervisor in Spain, but actually we should have supervised a bit better Deutsche Bank and other banks that were investing in Spain. You may think that these groups have grown so big that if we do not act together with common rules these people will play us one against the other. That is basically the rationale for saying that this cannot continue and that we have to have a single rulebook and supervise them together. Then, we have a chance of preventing the next crisis. When we go through the various agendas, common supervision—if it stops there—may be seen as a federalist agenda. There is no real financial solidarity because this comes with common deposit insurance and common recovery and resolution. Then we are exposing European taxpayers to the potential issues of the banks of one country, if that means something, and that does indeed pose the federal question.

I agree with you that not everyone believes that we should have a federal state in Europe but I just intend to expose the Green view on that. It is this simple. Europeans are 7% of the global population. I know that it is easy for someone from a small country to say that. When I go to Paris or Berlin, people look at me awkwardly but that is the reality, and we are heading towards 5%. Your country used to rule not just the waves but one third or one half of the world. This is no longer the case. Do we want to have a say in global affairs and to be able to decide for ourselves what we believe needs to be done—that is, sovereignty? We tend to say yes. Whatever sovereignty you can cling to, even as a nation of 80 million people—for example, Germany—it is an illusion. We can only reconquer sovereignty together. That is our starting point. What we cannot do—and on this I am absolutely adamant—is to move to a federal state in Europe in a multi-layer democracy. I know that in central member states such as France or the UK there is no tradition of multi-layer democracy, with strong regions, et cetera, but in my view in a federal state such as Belgium it is natural. We have cities, provinces and regions. We have Belgium and we have Europe, and that is just another layer. There is nothing wrong with that as long as we have something which makes sense and which is not too expensive to manage, and that is something that we have to revisit.

I finish by saying that we cannot do that if it means weakening democracy. That means accountability, checks and balances and no taxation without representation. A federal state would mean discretionary powers for the Commission or the ECB without democratic accountability. A Belgian economist who is now teaching at the London School of Economics has said that we cannot have bureaucrats in Brussels making political decisions for which they do not have to pay the political price—that is no longer democracy. If that is the case, we cannot go to a federal state. They must go hand in hand. That is what I take from the ruling constitutional court in Germany and from the debate in the UK. To me, these are two instruments to make sure that we do not hand over powers to an emerging state in Europe, because of its size, without very strong—and I would say stronger—democratic accountability and checks and balances at the European level, more so than at the national level.

Q14 The Chairman: Colleagues, I welcome Lord Jordan to our ranks. Philippe has been very kind to be with us for nearly an hour and I know that he has to deal with his Austrian business. I will conclude with one question. Let me ask about the recovery and resolution directive, the banking union, the bail-in proposal and the *Roadmap Towards a Banking Union* proposal for a single resolution mechanism. Would you help the Committee with your thoughts on those interesting proposals?

Philippe Lamberts MEP: This is where it becomes really tough and where we need to be in agreement as to the finality of all this. Given the size of the European financial institutions and having seen how the resolution of cross-border institutions, such as Fortis and Dexia in my case, has been going, and with the emergency horse-trading between member states which do not have fiscal accountability to their taxpayers, we believe that this is not satisfactory and that we need to go towards not just common rules but common instruments to resolve banks. This is not part of the current proposal. The current proposal seeks better co-ordination. Besides bail-in, which we support, until now it has sought only for co-ordination between national resolution authorities. We believe that we will need a common European resolution regime because when there is a crisis you will need unity for a decision. There again, it cannot be an unaccountable decision, because taxpayers' money is potentially involved. Again, this is not a reason to worry but neither should the decision be delayed.

Our view is that we are facing too-big-to-fail institutions—too big to fail means too dangerous to exist. Ultimately, we should move to a situation where we have no too-big-to-fail institutions. Then we would have a real competitive market, which we do not have now. Today, we are no longer in a functioning market economy as far as the financial industry is concerned. Those are the people we face and we need to play at the same level as them. The problem is that we have 27 member states and do not have a European federal state. The fact that we are facing such a behemoth should encourage us to speed up into integration but we should not do it in the wrong way. That is where we need the sense of urgency, but we need to do it properly. We need to decide together whether we want to pool financial risk, because that is what the common recovery and, especially, resolution scheme is all about. Do we want to pool financial risk with deposit insurance? Do we want to pool financial risk because, again, you cannot do that without pooling sovereignty and democratic accountability. The two go hand in hand. We cannot do that through the back door because it would weaken European democracy. As a taxpayer and a citizen, I would oppose that even though I am a federalist. We cannot do that at the expense of democracy.

That is absolutely critical. We need to demand that. I think that the European Parliament wants to see a common resolution scheme and common resolution authorities at European level, but that will take time. We need to take first things first: common rules and common supervision is where it should start. If it takes another five years, that is life. We want to get this right. I do not know whether that answers your question. Perhaps it is not enough.

Q15 Lord Hamilton of Epsom: On democracy, you are reaching a position now where the Commission does everything possible never to get into a position where there is a treaty that has to be ratified and needs referenda. I am not talking about just the United Kingdom; I am talking about across Europe. The problem is that there would be a no vote. How are we going to rectify this problem?

Philippe Lamberts MEP: I do not agree with that. I believe it is clear that we have to reopen the treaty. We need to make a choice about very basic things. Do we realise that we are only 5% or 7% of global population and that it is in our best interest—it is not just an ideal—to act as a team? Or do we come to the opposite conclusion and believe that the UK would fare better on its own, as well as Germany and Belgium? That is the question we need to ask our peoples. I am saying that we need to reopen the treaty and, at the conclusion of that, have a Europe-wide referendum. If we agree with that, we should not be afraid of asking our people. If we have a good case and believe that we need a federal state in Europe, we should make our case. I trust that our arguments are strong enough to carry the day. But to say that you do not want the referendum is to admit that you cannot sell your stuff.

But there is one difference, which is very important. In our view—here I speak for the Greens—we need a pan-European referendum and not a collection of 27 referenda. If we come to a treaty revision that has to be submitted to the peoples, we need to have a decision by majority. Any member state whose electorate by majority had said no, or has said to the contrary of the majority in Europe, would then have to choose between accepting the rule of the majority or leaving. That is the question I want to ask. I may be dead wrong but I believe that we could win the day even in the UK if it comes to the best interests of the UK.

I am not a romantic pro-European. My father was young during World War II. When I got elected three years ago, he was in tears. He told me, "You know, when we started all this, it was not out of love or fondness for the Germans; it was because we knew what the wars had cost us." Ultimately, do we see not just the threats but also the opportunities of globalisation, as well as the threats of climate change and disruption? Do we see that as reason enough to act and play as a team, or do we believe that we should just scatter? I have made my point.

Q16 Lord Flight: You commented that the problems might have to be solved otherwise. It seems to me that we are all saying that there is no way in which you can craft all the architecture and everything else for a common financial programme. On a second obvious point, I can see Germany agreeing to the common crafting of banking supervision. It may say that it applies only to banks that are bigger than a certain size. But I cannot see Germany ever being a part of an unlimited financial bail-out commitment that goes with it. I think that you have got to content yourself with common supervision.

Philippe Lamberts MEP: Maybe.

Q17 Lord Kerr of Kinlochard: I must say that I find your position on a pan-European referendum admirably romantic. Your proposal was made in the European Convention by some of your colleagues in the European Parliament. One Government said that they could live with the idea—your Government.

Philippe Lamberts MEP: Yes, Belgium.

Lord Kerr of Kinlochard: But no other Government said that. Lots of them said, "Imagine a situation in which the British are firmly against but there nevertheless is a majority across Europe. What would happen then?" If it is a treaty amendment, it needs ratification nationally. A pan-European referendum could be indicative but cannot be definitive.

Philippe Lamberts MEP: I agree. However, this is so important and so crucial that you need to have your people with you. You cannot do that against the common good. You have to be bold as a politician and you need to provide a sense of direction but we are still living in a democracy. Ultimately, we want people to decide whether they feel a common sense of belonging and a common sense of purpose. It must also be clear to people that the UK—but not just the UK—would be facing the choice of saying, "If the majority of European citizens want to go this way but the majority of British citizens want to go another way, we have to part ways amicably." It would be interesting to hear what you have to say about that. I believe that if it comes to that, the sense of realism that may prevail in the UK would be to say, "Well, actually our best interest is to be with them." It is not certain that that would be the scenario but basically the vast majority of the continent would unite in a political federation. In that case, the worst nightmare of Britons for centuries would materialise with the island isolated in front of a united continent. My bet would be that Britons would say, "No, no. We are going to play within it because then we can still play, let us say, divide and rule."

Lord Kerr of Kinlochard: Be careful. There are some very articulate Britons around who might take a different view.

Q18 The Chairman: Philippe, you have given us a wonderful start. We have been thrilled to listen to you. Perhaps I may say that Belgium always plays an important part in European affairs. You have been a Nicolas Colsaerts and have helped us with these very important European questions. We are most grateful to you and hope you will keep in touch with us.

Philippe Lamberts MEP: I intend to return to London before the end of the year, which might provide an opportunity to meet again. I really value what the UK has to say on these matters. To me, that is the value of European diversity. Indeed, Germany does not look at things in the same way as France, the UK, Italy or Spain et cetera. It is through diversity that we can devise better solutions. I am not anxious. I know that some of my friends are saying, "Let us put the Brits before a decision and then we will get rid of them." I want you to know that that is not my view.

The Chairman: Many thanks.

Professor Rosa M. Lastra, Centre for Commercial Law Studies, Queen Mary University of London—Written evidence

In response to the call for evidence by the House of Lords' European Union Committee – EU Economic and Financial Affairs Sub-Committee (Sub-Committee A), chaired by Lord Harrison – with regard to its inquiry into the reform of the EU Banking Sector, I respectfully submit this memorandum. This inquiry is most timely; accountability requires ex ante scrutiny, consultation and adequate debate. The House of Lords' initiative in launching the inquiry should be emulated by national legislators in other EU Member States.
This memorandum has two parts. The first part offers some general thoughts and reflections on the proposals to create a banking union in the eurozone. The second part addresses some of the specific questions raised in the inquiry.

The Banking Union and the Single Market

1. The financial crisis that commenced in the US in August 2007 and that became a global financial crisis in 2008 has had a profound effect in the EU. In the eurozone, the financial crisis mutated into a sovereign debt crisis in May 2010 and the twin banking and sovereign debt crises have spearheaded a frenzy of legislative and policy reforms at the EU level. At the root of the eurozone problems lies a fundamental inconsistency between a relatively strong monetary pillar (with the euro and the ECB at the centre) and weak economic and supervisory pillars. The challenge for the UK is that while the strengthening of those two pillars responds to the needs of the eurozone (Chancellor Osborne referred to the 'inexorable logic' of fiscal union), the efficient functioning of the single market in financial services is essential for the UK and for the City of London as a leading financial centre.

2. The issues of 'jurisdictional domain' haunt the current banking union proposals, since two of the four cornerstones of such proposals relate to the EU as a whole (namely a framework for recovery and resolution and a single rule-book), while the other two relate more specifically to the eurozone (the Single Supervisory Mechanism or SSM and a single Deposit Insurance/Resolution Fund). The needs of a well functioning single market in financial services cannot be disentangled from the design of the supervisory pillar.

3. On 12 September 2012, the European Commission published proposals for a single supervisory mechanism (SSM) for banks in the eurozone, following the 28/29 June EU Council conclusions and the report of the President of the European Council, Herman Van Rompuy, *Towards a Genuine Economic and Monetary Union*. The proposals, consisting of two Regulations (which I will call in this memo 'the ECB Regulation' and 'the EBA regulation') and one Communication, are a first step in the road to a banking union**.** According to Recital (9) of the ECB Regulation: 'A European banking union should therefore be set up, underpinned by a true single rulebook for financial services for the Single Market as a whole and composed of a single supervisory mechanism, and a common deposit insurance and resolution framework (...). The banking union should also be open to the participation of other Member States'. Political expediency and the need to break the vicious link between sovereigns and their banks explain the ambitious timetable for the implementation of

these reforms:[59] 'When such mechanism [SSM] will be in place for banks in the euro area, the ESM could ... have the possibility to recapitalize banks directly'.[60] A big question mark is whether the resources of the ESM will be sufficient. Fiscal union looms in the distance. For the time being, though, we have to rely upon the instruments we have, one of the latest being the controversial ECB's bond purchasing program: 'Outright Monetary Transactions'.[61]

4. The major change in the SSM is the advent of powerful European supervision for all eurozone credit institutions (around 6000). The European Central Bank (ECB) will have "ultimate responsibility", and national authorities will be required to "assist the ECB on its request with the preparation and implementation" of the ECB's supervisory tasks. The ECB will be responsible for licensing and withdrawal of licences for banks; capital adequacy and capital buffers; supervision of conglomerates on a consolidated basis; leverage and liquidity requirements; stress tests; early intervention. The tasks left to national authorities will include non-prudential aspects of supervision such as consumer protection and the prevention of money laundering. The explanatory memorandum of the ECB regulation observes that for the tasks conferred upon it the ECB will assume the role of both home and host supervisor for credit institutions exercising the right of establishment and the free provision of services in other eurozone Member States. Cross border banking groups will continue to be supervised by a lead supervisor and a college of supervisors. According to the ECB Regulation, the ECB will play a full role in these colleges, acting as lead supervisor where appropriate.

5. Article 127 (6) of the Treaty is the legal basis of the ECB regulation. This provision allows the Council to confer "policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings" upon the ECB by unanimity. Though 'prudential supervision' is a broad and discretionary concept, it has some contours. Interestingly, the ECB regulation does not mention some important elements of crisis management, notably lender of last resort, while it includes early intervention. Some of the policies conferred upon the ECB – such as licensing, revocation of a licence and sanctioning – stretch the definition of prudential supervision. Indeed, the principle of subsidiarity comes to mind when reading the ECB regulation.

6. Financial stability is a key goal for national, European and international authorities. To achieve this goal the authorities have a variety of instruments at their disposal: regulation, supervision (micro and macro), lender of last resort, recovery and resolution tools, orderly insolvency and others. The challenges the ECB will face as a monetary and supervisory authority are similar to those faced by the Bank of England in its dual mandate to safeguard both monetary and financial stability. The transfer of prudential supervision away from the central bank in 1997 deprived the Bank of

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[59] The proposed entry into force is 1 January 2013 according to Art. 28 of the ECB Regulation. Art. 27 suggests phasing out: 1 July 2013 for commencement of supervisory role of institutions, a list of which will be published by 1 March 2013 and full assumption of tasks by 1 January 2014.

[60] See explanatory memorandum of the ECB Regulation. As Barroso stated on 12 Sept 2012: 'We want to brake the vicious link between sovereigns and their banks'. The banking union plan is a political precondition for the ESM to be able to directly recapitalise eurozone banks. In its ruling of 12 September 2012 http://www.bverfg.de/en/decisions/rs20120912_2bvr139012en.html the German Constitutional Court said that Germany can ratify the European Stability Mechanism (ESM), provided it includes sufficiently binding conditionality agreements.

[61] http://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html

England of a major instrument – i.e., supervision – to deal with financial stability (leaving it 'only' with a lender of last resort role). A return of supervision to the Bank of England after the financial crisis characterises the new financial legislation in the UK (the logic being 'if I am going to assist you on a rainy day, I need to know what is going on in a sunny day'). The advent of macro prudential supervision has further reinforced the link between monetary stability and financial stability.

7. The proposals of 12 September 2012 address micro supervision in a broad sense (including licensing and revocation of licenses) and early intervention, but do not mention lender of last resort nor macro supervision. The latter is the responsibility of the ESRB, while responsibility for the former is currently divided between the ECB (when it comes to 'market' liquidity assistance) and the national central banks (when it comes to collateralized lines of credit to individual illiquid but solvent banks, according to the ECB's own restrictive interpretation of article 14.4 of the ESCB Statute).

8. What is in a name? A banking union is a bit of a conceptual accordion, with different layers. Arguably, the first layer of a banking union has already been achieved via European regulation, namely the Directives and Regulations that forms the corpus of common rules under which banks operate in the EU/EEA. Of course, this first layer, this 'narrow' banking union, was incomplete – as evidenced by the financial crisis – due to the lack of rules on cross-border crisis management and insolvency. A 'broad' banking union goes beyond regulation, and encompasses also supervision (micro and macro) and crisis management – including lender of last resort, deposit insurance, resolution and insolvency.

9. Supervision and crisis management are part of a seamless process. The framework for crisis management must be clarified better if the banking union is to succeed. In particular, while the ECB has powers for early intervention and withdrawal of licenses under the proposals, it is unclear how we go from early intervention to crisis management, namely what happens next once the ECB intervenes, i.e., how banks will be resolved and how deposits will be protected.

10. The problems of coordination amongst different authorities – in the case of the EU, the ESRB, EBA and ECB – are real, as the tripartite arrangement in the UK showed during the Northern Rock episode. The issues of jurisdictional domain further haunt the banking union project, since the European Banking Authority (EBA) will remain in charge of the single rule book (i.e. regulation) and will be guardian, with the Commission, of the single market. But the ECB will be a very powerful institution. EBA's existence and powers (strengthened by the EBA regulation) are justified because of the different jurisdictional domain EU/Eurozone, but add a layer of complexity to the supervisory picture. That complexity is further compounded by the need to coordinate with ESMA and EIOPA. And complexity frustrates accountability.

11. The Communication of 12 September 2012 addresses the conundrum of the uneasy co-existence between a banking union and the single market. It states: "The single market for financial services is based upon common rules which ensure that banks and other financial institutions ... are subject to equivalent rules and proper supervision across the EU. The creation of the banking union must not compromise

the unity and integrity of the single market which remains one of the greatest achievements of European integration(...). The single market and the banking union are thus mutually reinforcing processes".

12. Issues of jurisdictional domain have characterised the design of financial regulation and supervision in the US, with a mix of federal and state powers. Federal law prevails in securities, while insurance has traditionally been a matter of state law and banking offers a mix of federal and state powers. Over the years, however, there has been a process of federalisation in the supervision and crisis management of financial institutions, with the latest addition, the Dodd Frank Act, substantially increasing federal powers for any financial institution that is deemed to be systemically significant. Lender of last resort was federalised in 1913 with the Federal Reserve Act, while the Federal Deposit Insurance Corporation (FDIC) was established in 1933. FDIC has three hats as receiver of failed or failing banks (and now also financial institutions under the Orderly Liquidation Authority), deposit insurer & supervisor.

13. My preference for a 'Champions League' model of supervision (only systemically relevant pan European credit institutions would have been supervised by the ECB, while the other smaller credit institutions would have continued to be supervised by national authorities, following guidelines dictated by the ECB) has not been followed. The problems of the Spanish 'cajas de ahorro', as before the experience with Northern Rock, have made the European authorities wary of anything less than supervision of all credit institutions in the eurozone. But I worry about inadequate ECB supervisory resources in this humungous task. Supervision, the ECB should remember, is a thankless task, where reputational damage can be severe.

14. The key underlying challenge in the reform plan is legitimacy (to avoid a growing disconnection between the intellectual elite and the general population), while the key problem is stagnant growth (are pro-cyclical measures and fiscal austerity the right medicine?). Europe needs fiscal consolidation (not simply deficit cutting that can jeopardise the social fabric of a nation), economic reform and banking reform.

15. As regards the accountability mechanisms of an independent institution such as the ECB, when it comes to prudential supervision, they should be properly designed not only vis-à-vis European institutions but also vis-à-vis national authorities. Supervisory independence is not the same as monetary independence. And as long as national governments continue to provide a fiscal backstop (in the absence of a fiscal union and considering that ESM resources are finite), we should remember the adage: 'he who pays the piper calls the tune'.

16. The UK risks being marginalised from the European debate if concerns regarding the coexistence of the Single Market and the Banking Union are not properly addressed. The UK Government faces a dilemma. I for one believe that the destiny of the UK should be firmly anchored in Europe. European integration is much more than an economic project. It is at the root of the peace and prosperity that Europe has experienced since World War II. As such, it is a dream worth preserving.

Answer to some of the questions raised in the Inquiry

17. The euro area crisis has revealed the extent of the too-big-to-fail problems and its variants (too complex to fail, too interconnected to fail, too politically sensitive to fail, too big to save etc) and the associated moral hazard incentives (privatisation of gains, socialisation of losses) that pervade ubiquitous government assistance. Lack of transparency & accountability, poor corporate governance, inadequate supervision, captured regulation, misguided economic theories, excessive group think, unbridled greed, poor risk management, unethical behaviour, bad lending and investment decisions and inadequate systemic risk control are weaknesses that show the fundamental need for reform of the banking sector.

18. Adequate rules on deposit insurance and resolution are a fundamental part of a properly functioning Single Market in Banking Services. However, the banking union proposals go further and plan to establish a common system for deposit protection and a more centralised management of banking crises. A single Deposit Guarantee Scheme and a Single Resolution Mechanism are presented as a logical extension of the granting of supervisory powers to the ECB. But the contours of these two key elements are not specified (even the terminology varies).[62] The rationale for a common deposit insurance scheme is clear: with perfect capital mobility, in order to prevent a flight of deposits from troubled countries to countries perceived to be 'safe', one needs to convince ordinary citizens that a euro in a bank account in one eurozone Member State is the worth the same and is as secure as a euro in a bank account in another eurozone Member State (though as Tom Huertas warns, Reuters, 21 September 2012, 'such a scheme would potentially have an enormous contingent liability'). As for resolution, there are the needs of the internal market (i.e., adequate rules) on the one hand, and the needs of the eurozone on the other hand (single resolution mechanism to complement the SSM).

19. With regard to the proposed Directive for bank recovery and resolution (COM (2012) 280) establishing a framework for the recovery and resolution of credit institutions and investment firms, it is an essential element for the completion of the single market in financial services.[63] In order to prevent another Lehman we do need adequate rules for orderly cross border resolution and insolvency at the EU and international level. No financial institution should be too big to fail. A key challenge for the UK is whether the proposed Directive will hinder the UK's own resolution efforts (Banking Act 2009) in particular with regard to depositor preference, intra-group support (in the light of the Vickers report) and cooperation agreements with third countries.

20. With regard to the wider reform of the EU banking sector, the so-called Liikanen group[64] is a welcome initiative, and hopefully the report the group produces will be

[62] It has been suggested that the deposit insurance scheme and the resolution fund could be set up under the control of a common resolution authority. But the credibility of any deposit guarantee scheme requires access to a solid financial backstop. As regards the euro area, the European Stability Mechanism could act as the fiscal backstop to the resolution and deposit guarantee authority.

[63] As regards the bail-in tool, see memo by Lastra in http://www.bsg.ox.ac.uk/gandf/crossborder

[64] In January 2012 European Commissioner Michel Barnier set up a high level expert group to examine possible ways to reform the structure of the EU banking sector, chaired by Erkii Liikanen. The group's mandate is to establish whether, in addition to ongoing regulatory reforms, structural reforms of EU banks would enhance financial stability and improve efficiency and consumer protection. The report is expected in October 2012. As part of its consideration of structural

bold enough.[65] The competing demands between competition and regulation, the existence of highly protected and oligopolistic banking markets, unethical practises, the separation between 'casino banking' and 'utility banking' and even more radical proposals such as the mutualisation of the financial industry (as proposed by Lawrence Kotlitkoff) are all issues that must be discussed thoroughly, leading then, where appropriate, to adequate structural reforms.

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reform the group is tasked with considering activity restrictions, such as the Volcker Rule (proprietary trading) and size limits as proposed under the Dodd-Frank Rule, and/or structural separation of retail deposit banks from investment banking, as suggested by the UK Independent Commission on Banking (the Vickers Report).

[65] For an analysis, see http://www.dw.de/dw/article/0,,16087817,00.html

Professor Rosa M. Lastra, Centre for Commercial Law Studies, Queen Mary University of London and Professor Kern Alexander, Senior Research Fellow, The Centre for Financial Analysis and Policy University of Cambridge, and Professor of Law and Finance, University of Zurich —Oral evidence (QQ 103–118)

Transcript to be found under Professor Kern Alexander

Professor Rosa M. Lastra, Centre for Commercial Law Studies, Queen Mary University of London—Supplementary evidence

At the request of the Chairman of the House of Lords' European Union Committee – EU Economic and Financial Affairs Sub-Committee (Sub-Committee A), Lord Harrison – with regard to its inquiry into the reform of the EU Banking Sector, I respectfully submit this supplementary memorandum in relation to the final question (Q118), on the Liikanen report, and the end of Q 117, on the proposed Recovery and Resolution Directive.

What is your assessment of the findings of the Liikanen Report on reforming the structure of the EU Banking Sector?

1. The Liikanen report[66] is a welcome initiative *that* deals with bank structural reform. However, it is not sufficiently bold in my opinion, perhaps a reflection of the background of the members of the group, perhaps a reluctance or hesitation to alter the universal banking model prevailing in continental Europe. The common denominator behind the Liikanen Report, the Volcker rule and the Vickers Report, is the need to protect depositors and to prevent the use of depositors' money to finance risky trading activities and the avoidance of too-big-to-fail policies that lead to an implicit or explicit government guarantee (deteriorating the fiscal position of the government and putting at risk taxpayers' money). They aim at limiting the incentives for banks to take on excessive risks with insured deposits.

2. My concern with the proposals in the Liikanen report is threefold. First, Liikanen is legally different from Vickers and the Volcker rule and, thus, may provide incentives for financial institutions to go 'jurisdiction shopping', opportunities for regulatory arbitrage. While the Liikanen proposes the ring-fencing of trading activities, Vickers recommends the ring-fencing of retail activities, and the Volcker rule limits proprietary trading, without ring-fencing. [Of course, in the case of the UK, if Liikanen becomes law, the UK will have to adopt the Liikanen proposals as long as it remains in the EU and committed to the obligations of the single market].

3. My second concern (and this applies both to Liikanen and to Vickers) is that whenever a fence or boundary is established, there is an incentive for institutions to place themselves or part of their business inside or outside the boundary depending on what appears to be more advantageous or beneficial for them. My third and perhaps major concern is that Liikanen preserves intact the universal banking system model in Europe. The competing demands between competition and regulation, the existence of highly protected and oligopolistic banking markets, unethical practises, the separation between 'casino banking' and 'utility banking' and even more radical proposals such as the mutualisation of the financial industry (as proposed by

[66] In January 2012 European Commissioner Michel Barnier set up a high level expert group to examine possible ways to reform the structure of the EU banking sector, chaired by Erkii Liikanen. The group's mandate is to establish whether, in addition to ongoing regulatory reforms, structural reforms of EU banks would enhance financial stability and improve efficiency and consumer protection. The report was published in October 2012: http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf

Lawrence Kotlitkoff[67]) are all issues that should have been further discussed, leading then, where appropriate, to adequate structural reforms.

4. The efforts to address the too-big-to-fail (TBTF) issue have so far focused on the "to fail" part of TBTF. But we also need to address the issue of size (the "too big" of TBTF), which requires adequate competition law and policy. That is something that neither Liikanen nor Vickers address properly. The reasons for saving troubled banks these days go beyond the protection of insured depositors. If we want to reduce taxpayers' liability, we must also address the issue of size. No institutions should be too big or too complex to fail. If that requires smaller size or simplicity then that should be the solution we should contemplate, regardless of vested interests. The implicit government guarantee must stop.

5. Liikanen endorses the loss absorbency of debt via bail in instruments, in line with the proposed Resolution and Recovery Directive. This is of course a very positive aspect of the report, which requires that the subsidiary with the ring-fenced risky trading activities develop a recovery plan. It was the failure of an investment bank (Lehman Brothers) that triggered the great financial crisis.

Recovery and Resolution Directive

6. The proposed Directive for bank recovery and resolution (COM (2012) 280) is an essential element for the completion of the single market in financial services, and, if formally adopted, it will be the first hard law instrument in the field of cross border resolution and insolvency and, in principle, a very significant and positive development. In order to prevent another Lehman we do need adequate rules for orderly cross border resolution and insolvency at the EU and international level. A key challenge for the UK is whether the proposed Directive will hinder the UK's own resolution efforts (Banking Act 2009) in particular with regard to depositor preference, intra-group support (in the light of the Vickers report) and cooperation agreements with third countries. Another aspect that requires further consideration is the ex ante allocation of resolution costs.

7. The timetable for the adoption of the Directive is a problem in itself. Member States will be required to implement most requirements of the Directive by 1st January 2015, whilst the Directive's bail in requirements must be implemented by 1st January 2018. These provisions should be incorporated into national law as soon as possible.

8. The Directive includes a number of resolution tools. Resolution needs to be understood in the context of its intimate relationship with regulation and supervision on the one hand and emergency liquidity assistance and deposit insurance on the other hand. And it is one step before insolvency. One of the key tools in the RRD is the bail in instrument.

9. Bail-in is a resolution technique or tool that offers a way for rapid recapitalization and avoids value destruction by keeping an institution as a going concern. There are two types of bail in: bail in via write down (partial wind down) of debt and bail in via

[67] Laurence J. Kotlikoff (Wiley, 2010), *Jimmy Stewart is Dead. Ending the World's Ongoing Financial Plague with Limited Purpose Banking.*

conversion of debt into equity. The proposed Directive[68] focuses on the latter. The essence of bail in is to keep a streamlined bank (balance sheet restructuring) by allocating losses amongst bank creditors and shareholders as a going concern.

10. Bail-in by definition addresses capital rather than liquidity. Hence, it needs to be complemented with liquidity provision by the central bank. Indeed, the two key challenges when discussing the effectiveness of bail in are: liquidity and credibility (given the stigma likely to be associated with the use of bail-ins). The 'spirit' of the bail-in technique, as well as the spirit of prompt corrective action (PCA) in the USA or the now ubiquitous concept of living wills (recovery and resolution plans) is the same: act early, act promptly, act preventively before losses are potentially inflicted upon taxpayers. (As the old English adage says: an ounce of prevention is worth a pound of cure).

11. Bail-in in a group context – as proposed in the Directive – raises a number of issues. First of all, there are different types of groups: banking groups, financial groups and mixed financial and non-financial groups. Secondly, if different group companies are bailed in, that may break group relationships (because shares in subsidiaries are issued to third parties). Therefore, bail-in will only work smoothly if groups are required to restructure their external funding in order to ensure that it enters the group at holding company level. Thirdly, the legal and economic treatment of groups is rather different, with the law somewhat 'lagging behind'. Insolvency and company laws are currently structured under the concept of specific corporate entities, not groups. [This is particularly important in the context of the discussion of asset transfers within a group]. Finally, resolution in a group context can be best addressed via RRPs or living wills.[69]

12. The UK will of course need to amend its legislation – wherever necessary – to comply with the requirements of the Directive. Significant in this regard are Articles 24 and 32. Article 24 of the Proposed Directive enables national authorities to replace the management of a firm with a special manager ahead of resolution if the firm's recovery plans have not stabilised the firm. Effectively this is a resolution tool, not a recovery one. Article 32 deals with the asset separation tool. This allows resolution authorities to transfer impaired or problem assets to an asset management vehicle to allow them to be managed and worked over time.

Concluding observation

13. During the session of oral evidence, Lord Harrison put to us the following question: "I identify a Manichaean struggle between the European Commission defending the single market, which is its purpose and raison d'être, with growth of the ECB and the supervisory role plus the EBA's interesting relationship with it".

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[68] See also http://ec.europa.eu/internal_market/bank/docs/crisis-management/discussion_paper_bail_in_en.pdf

[69] See IMF staff paper 'From Bail-out to Bail-in: Mandatory Debt Restructuring of Systemic Financial Institutions' at http://www.imf.org/external/pubs/cat/longres.aspx?sk=25858.0 published on 24 April 2012. The paper cautions about the fact that if the use of bail-in is perceived by the market as a sign of the concerned institution's impending insolvency, it could trigger a run by short-term creditors and aggravate the institution's liquidity problem.

Indeed, the fact that the geographic perimeter of the banking union is limited to the eurozone, compromises the needs of the single market. If/when the proposals of 12 September 2012 get adopted, they key supervisory actor for all eurozone banks will be the ECB, while the European Commission will retain its key legislative functions (level 1 legislation). This risks making EBA irrelevant. The one task, however, which can add relevance to EBA's mandate concerns recovery and resolution, but in order to exercise such task efficiently EBA's resources and personnel would need to be substantially expanded.

I am also concerned about the accountability arrangements of the ECB. As acknowledged, Article 130 TFEU protects the independence of the ECB in very strong terms: 'When exercising the powers and carrying out the tasks conferred upon them by the Treaties and the Statute of the ECB and the ESCB, neither the ECB, nor a national central bank nor any member of their decision making bodies, shall seek or take instruction from Union institutions, bodies, offices or agencies from any government of a Member State or from any other body". While this degree of independence has served the ECB well in the discharge of its monetary policy responsibilities (with relatively limited mechanisms of accountability, including testimonies before the European Parliament, publications, financial controls, interviews and press conferences), when it comes to supervision, the situation is different. If the proposals of 12 September 2012 to grant prudential supervision to the ECB get adopted, the ECB will become a very powerful institution. Article 16 of the proposed ECB regulation proclaims its independence and Article 17 only says about accountability: 'The ECB shall be accountable to the European Parliament and to the Council for the implementation of this Regulation in accordance with this Chapter'. Is that enough? No, in my opinion, it is not. With power comes responsibility. If the ECB does something which goes wrong and affects citizens of an individual Member State, then those citizens would want to hold the supervisor to account. To whom should the ECB be held to account and in relation to what (policy, individual cases)?

Debates about accountability and institutional design should take place ex ante, not ex post. Now is the time to discuss these important issues.

26 October 2012

Lloyds Banking Group—Written evidence

Lloyds Banking Group is predominantly a UK bank focused on retail and commercial business. We are active in a small of number of EU states, mainly as branches of the UK business. Our Spanish business is a subsidiary, which would potentially fall under the auspices of the Banking Union and the Single Supervisory Mechanism (SSM).

Banking reform, banking union and the euro area crisis

1. What has the Euro area crisis revealed about the weaknesses of the EU banking sector? In what ways do you believe that the EU banking sector needs to be reformed?

1.1. In general, the crisis has shown that Eurozone banks have not prioritised the build up of additional capital reserves to the extent that UK banks have following Government intervention in 2009. Within the EU, some national governments and their respective banks remain overly dependent on each other.

2. Steps towards 'banking union' were set out in the Van Rompuy report *Towards a Genuine Economic and Monetary Union*. How would you define 'banking union' in the EU context?

2.1. In its broadest sense, a banking union is the integration of supervision, regulation and crisis management procedures, with common rules and practices for all Eurozone banks (with the potential opt-in for other EU member states).

What is your assessment of the report's conclusions?

2.2. The Van Rompuy report sets out high-level proposals for the development of a more integrated financial framework as a building block of a more stable and prosperous Economic & Monetary Union (EMU). If achieved, these measures represent a significant step towards resolving the crisis in Europe. Given the impact of continuing Eurozone instability on the UK economy, the development of the Banking Union is welcomed.

What will its impact be on existing proposals (such as CRD IV)?

2.3. It is not clear that there is any substantive impact on CRD IV. There has been mention of using the CRD IV package to enact elements of the Banking Union proposals but the specifics are unclear. More importantly, banks require clarity on timescales as the consensus is that the original implementation date of 1st January 2013 is no longer feasible.

What are the key elements of such a banking union if it is to function effectively?

2.4. The Van Rompuy report sets out the key elements. In addition to a common supervisory framework and culture, the key element is a consistent approach to resolution. Without this, the proposals could introduce moral hazard – i.e. an incentive for a member state to resolve a bank early to take advantage of the shared deposit guarantee scheme. A single resolution authority, as envisaged, removes this potential risk.

3. The 28/29 June euro area summit statement said that when an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could recapitalise banks directly. What is your assessment of this proposal?

3.1. The ESM is well placed to recapitalise banks following implementation of the Banking Union proposals.

How likely is it that this would successfully stabilise the EU banking sector?

3.2. The success of recapitalisation by the ESM will depend on the assessment of potential losses and, therefore, the appropriateness of capital levels and solvency. This requires rigorous and extensive stress testing which has the full confidence of the market. The ESM would need to work with other regulators for firms such as ourselves with subsidiaries within the Banking Union.

3.3. The experience of the 2011 EBA stress testing exercise suggest that, to maximise stability, any capital injections from the ESM would need to be made in equity (avoiding complexity in terms of structure of instruments) and be immediate.

4. In January 2012, the European Commissioner Michel Barnier set up a high level expert group to explore possible ways to reform the structure of the EU banking sector, including consideration of structural reforms such as activity restrictions as applies under the Volcker rule, size limits, and structural separation of retail deposits from investment banking. What is your assessment of such proposals for structural reform? Which, if any, would help ensure the future health of the EU Banking Union?

4.1. The Vickers version of ring-fencing is, on initial inspection, largely compatible with the separation of trading activities proposed by the Liikanen Expert Group earlier this week. We are supportive of steps to achieve alignment between the two initiatives, as required.

Banking supervision

5. The European Commission are expected to present proposals for a single European banking supervisory framework in September. What is the purpose of such a framework?

5.1. The SSM helps address the Eurozone debt crisis by breaking the link between some banks and indebted national governments. Responsibility for the safety and soundness of participating Member State banks will be placed in a credible pan-European institution with access to central bank funds. This should provide a framework within which Member States can confidently allow the direct recapitalisation of banks.

What key elements need to be included if it is succeed?

5.2. The SSM should cover all Eurozone banks, thereby avoiding situations where different banks within a market are supervised by different supervisors (which may lead to an unlevel playing field or competitive distortion). Moreover, the recent past has demonstrated that it is not just large banks that have systemic impact during a crisis.

How likely is it that such a framework will be adopted?

5.3. There appears to be political will within Eurozone and non-Eurozone Member States to ensure the proposals for the SSM are adopted. The timescales remain ambitious.

6. What is the most appropriate division of responsibility between national and EU supervisors under such a framework?

6.1. The Banking Union proposals achieve a balance: supervision is managed locally by the national authority within a framework set by the centre. This is needed as national supervisors are attuned to the practices and traditions of the local market.

7. In what way, if at all, should supervisory powers vary depending on the size and nature of banks?

7.1. All banks within the Eurozone should be covered by the same supervisory framework. The role of the ECB for firms with head offices outside the Eurozone will differ, depending on the nature of the business. The proposals are proportionate – national authorities will have more autonomy for smaller firms.

8. What powers and responsibilities is it appropriate for the ECB to possess in relation to regulation of the European banking sector, and in particular in relation to supervision of euro area banks?

8.1. We support the extended remit of the ECB to encompass supervisory responsibility for the prudential regulation of banks. In effect this is a variation on the 'twin peaks' model that is being implemented in the UK in early 2013: prudential and conduct of business regulation sit with different regulators. The Commission proposes an appropriate set of powers and responsibilities for the ECB to fulfil its role.

8.2. The powers proposed under Article 15 in the ECB Council Regulation – enabling the ECB to fine firms up to 10% of their global turnover – should be reviewed. Given their remit, a more appropriate focus would be 10% of Eurozone/Banking Union turnover.

How should the ECB be held accountable for the exercise of such responsibilities?

8.3. It is proposed that the ECB is accountable to the European Parliament and to the Council/Eurogroup. This appears appropriate and delivers democratic oversight. An appropriate level of supervisory transparency and disclosure would be welcomed.

European Deposit Insurance Schemes

9. What is your assessment of the Van Rompuy proposals for a European deposit insurance scheme for banks, to be overseen under the new European banking supervisory framework and with the ESM as a fiscal backstop? What is the purpose of the proposal and what will its impact be on the existing Deposit Guarantee Schemes Directive proposal?

9.1. The Banking Union proposed the mutualisation of deposit guarantee schemes (DGS) and resolution funds. The attractiveness of pooling national DGS schemes is a matter for each national government within the Banking Union.

9.2. If you adopt a mutualised DGS, you also need to mutualise the resolution regime. Otherwise, it could create an incentive for national authorities to place financial institutions early into resolution (potentially unnecessarily) in order to leverage the deeper pockets of a mutualised fund. The creation of a resolution authority will remove this moral hazard.

9.3. The development of the Banking Union offers an opportunity to reconsider the shape and terms of the EU DGS Directive currently under scrutiny. The UK has requested greater flexibility of the funding arrangements where states already operate an ex-ante scheme.

Is it likely to be effective? How likely is it that such proposals will be enacted?

9.4. The mutualisation debate is clearly political. It is an issue of national sovereignty. In September the FT, quoting an unnamed German source, said that the proposals were "premature and unrealistic".

9.5. The broader debate on DGS schemes awaits conclusion of the Banking Union proposals. We expect that the proposals will be enacted, once a conclusion has been reached on the issues discussed above.

The proposed Directive for bank recovery and resolution

What is your assessment of the proposed Directive (COM(2012)280) establishing a framework for the recovery and resolution of credit institutions and investment firms? What will be the impact on these proposals of the steps towards banking union (including a resolution framework) as set out in the Van Rompuy report? What will be the impact of the Directive upon the European Banking Authority (EBA)? Are the new responsibilities proposed under the Directive for the EBA appropriate? What is your assessment of the proposed 'bail-in' tool (Articles 37-38 and 41-50)?

9.6. Under the proposals (Articles 51-55), at the time resolution has been triggered by calling the point of non-viability (PoNV), control passes from the management and shareholders to the resolution authority. At that stage, the bank's capital instruments (i.e. instruments which are legally subordinated to senior debt) will be written-down or converted to equity to the extent that the resolution authority deems necessary to recapitalise the bank. This will be done strictly in the order that respects creditors' hierarchy – i.e: equity, AT1, T2 and other notes containing subordination clauses.

9.7. If, and only if, this is insufficient then the Resolution Authority can use the resolution tools made available by declaration of PoNV. We believe that any Resolution Authority should be required to consider the use of all of these instruments in the most effective combination. The use of senior debt bail-in only arises in the context of the application of the other resolution tools (that is to say in the post-PoNV resolution phase). This allows the orderly liquidation of the bank with preservation of those functions necessary for the public good.

9.8. Where a senior debt bail-in is deemed necessary, the pool of instruments to be bailed-in on a *pari-passu* basis should be as wide as possible. It should include all unsecured debt categories that would not be afforded specific protection under an insolvency (i.e. including wholesale deposits taken, regardless of maturity) and it should include the local deposit protection scheme. In the case of derivatives, these should be assessed after set-off and netting. However, the Resolution Authority may wish to exempt them from the senior bail-in process.

9.9. We are concerned that the difference between "recovery" and "resolution" is not acknowledged when discussing the senior debt bail-in tool. In particular, Article 37(2a) would benefit from revision to avoid suggestions that this item sanctions senior debt bail-in as a tool available to supervisors to "recapitalise a failing bank".

What is your assessment of the following specific elements of the Commission's proposals, as set out in the Directive, in relation to:

Recovery and resolution planning (Articles 5-12)?

9.10. Resolution planning is appropriate at entity-level but Recovery planning is best conducted at a consolidated level, with sub-plans provided only for material subsidiaries.

Group recovery and resolution and cross-border activity (including resolution colleges) (Articles 7-8, 11-12 and 80-83)?

9.11. These articles should not create an additional tier of pan-European supervision. The existing Regulatory Colleges (especially those that are wider than the Eurozone) should be vested with the powers and obligations provided for by these Articles.

Preventative powers (Articles 13 and 14)?

9.12. The power which allows a competent authority to require changes to a firm's business model would reduce impediments to resolution needs to be carefully managed.

Intra-group financial support (Articles 16-22)?

9.13. These Articles should be viewed as an expression of "best practice" for banks wishing to put in place such arrangements. The existence of these Articles should neither be seen as directing a requirement for such arrangements, nor as prohibiting banks from agreeing processes aiming at a similar result but via different mechanisms.

Early intervention measures, including the 'Special Manager' tool (Articles 23 and 24)?

9.14. Most regulatory authorities already have some variant of these powers. We are concerned at the negative signalling to the market (and the likelihood of moral hazard) for the special manager themselves which may arise. On balance, we feel the Special Manager tool is more appropriate at or after the PoNV.

The various resolution tools, including sale of business, bridge institution and asset separation (Articles 31-55)?

9.15. We believe the list of proposed resolution tools is useful and pragmatic, however we would reiterate our comments in Q12 on senior debt bail-in, namely that these are tools only to be considered in the context of an orderly wind-up of the non-viable bank, with a view to preserving functions necessary in the public interest. It also should be clarified in Article 35 that any bridge bank should be managed in such a way as to minimise any distortion of competition in the financial services markets. This avoids any bridge bank benefiting from the perception of state backing.

Cooperation with third country authorities (Articles 84-89)?

9.16. It is possible to interpret Article 84 as requiring European Council mediation in any negotiations between an individual resolution authority and a non-European counterpart. This may not always be the case – or necessary. It is possible for bilateral contacts and negotiations to take place. We would support greater clarity regarding "competent ministries" within the scope of the information exchanges and assurances regarding confidentiality requirements.

The proposed system of financing arrangements (Articles 90-99)?

9.17. We support the dual use of DGS funds in resolution, as long as they are not used to provide liquidity. This must remain a Central Bank responsibility.

The impact on the UK

14) The Government have made clear that the UK will not take part in the fundamental elements of a banking union, and will neither be part of common deposit guarantees nor come under the jurisdiction of a single European financial supervisor. What is your assessment of this position?

14.1. We respect the UK Government's position in protecting the primacy of the UK authorities while at the same time, ensuring a fair, vibrant and competitive Single Market for financial services in the EU.

How should the UK respond to these proposals?

14.2. The UK Government should continue to play an active role in shaping the development of the Banking Union proposals. This should help ensure that the wider EU Single Market in financial services is safeguarded. As the proposals evolve there may also be aspects of the Banking Union that it is in the UK's interest to be part of.

15) What will be the implications of steps towards banking union for those countries, such as the UK, that intend to stand apart?

15.1. All EU countries should benefit from the greater financial stability that Banking Union promises to bring to the Eurozone. It is hard to predict the implications for countries that will not fully participate in the Banking Union. There is a risk that countries participating in the SSM drive the debate on financial services reform. This may make it harder for non-SSM countries to influence the agenda and debate at the EBA.

How realistic is the Government's argument that the UK's non-participation should not and need not adversely affect London's position as the leading financial centre in Europe, nor adversely affect the operation of the single market?

15.2. The Government's position that London (or more accurately the UK's financial services industry) will not be adversely affected is realistic, if the access to the EU Single Market is safeguarded.

15.3. The European Banking Authority (EBA) will have an important role in driving the Single Rulebook. The changes to the EBA voting mechanisms may have mitigated the risk of an 'ECB voting bloc', which is potentially disadvantageous to those Member States that fall outside the Banking Union.

16) How do you assess the risk that, as elements of a banking union, including supervision, are addressed by a subset of its members, the Council's role in banking regulation will be undercut, with its legislative debates pre-empted and/or decisions pre-determined in discussion amongst banking union members?

16.1. There is always a risk that being in one bloc or another alters the balance of influence in Europe. Such risks can be mitigated by appropriate governance and transparency at the key EU institutions. The European Commission has a key role to play in ensuring that the EU Treaties are upheld.

3 October 2012

Lloyds Consulting Associates (LCA Europe Ltd)—Written evidence

1. Background

There are a number of objectives behind the European Commission proposal to establish a European Banking Union (EBU). Foremost among these aims is to be able to break the link between bank failures and sovereign debt. The 2008 global financial crisis and its continuing aftermath has necessitated the bailing out of a number of bankrupt banks, and other financial institutions, by sovereign governments and their taxpayers. The attendant Eurozone sovereign debt crises have overwhelmed a number of the national governments involved and led to the establishment of the European Financial Stability Facility (EFSF) and, subsequently, the European Stability Mechanism (ESM) being established to provide support to Eurozone national governments whose rising sovereign debt interest rates threatened to lead to debt defaults. The EBU proposal is an attempt to regulate, at Eurozone level via the ECB, and at wider EU level involving the EBA, the banking system to avoid future systemic bank failures or, if these should occur, to manage the resolution of the banks concerned.

The EBU supervisory (and funding availability) framework will be established to be able to operate across the whole of the EU; though non-Eurozone members would have to opt in to the framework. One major reason for this EU-wide structure is that there are a number of currently non-Eurozone member countries who will wish to adopt the Euro, an option which was always open to any EU country. The UK has exercised its Maastricht opt-out clause not to adopt the Euro. It seems unlikely that the UK would opt in to the EBU in the foreseeable future.

However, the position of the countries which remain outside the EBU is of concern in relation to the operation of the Single Market and the role and operation of the already existing European Banking Authority. The UK has particular concerns in respect of the single market in financial services given the dominant role in this area by the City of London.

Notwithstanding these concerns of non-participants there are also issues relating to the political implications of the EBU for Eurozone countries (and, *ipso facto*, for non Eurozone countries). The EBU is not simply a *technical economic fix* for the problems created for the avoidance of sovereign debt problems caused by the failure of systemically important banks which may run into severe liquidity or balance sheet problems and require bail-outs.

This paper examines these issues from two perspectives: 1) a general perspective, drawing conclusions as to issues relating to the EBU as it is proposed, and 2) the position of the UK government in relation to the EBU and the protection of its financial and economic interests.

2. Objectives

The main objectives of the EBU are as follows:

- Achieving an EU financial services supervisory structure which avoids financial crises which threaten sovereign debt stability and impose costs on the taxpayer.
- Preserving the single market for financial services,
- Avoiding competitive distortions in the single market.

3. Implementation

The Commission sees the objectives of the EBU, in the first stage of its development, being secured in the following manner.

1. The granting of European level supervisory powers to the ECB (*separate from its monetary policy role*), covering all banks in the Eurozone (Euro area), with provision for non-Eurozone countries to join on a voluntary basis.

2. A provision to align the powers of the European Banking Authority (EBA) to ensure that distortions in rule-making between to two bodies are avoided and the integrity of the Single Market is preserved; this will be done by close co-operation between the ECB and the EBA and via the completion of the EBA single rule-book covering all 27 Member States.

3. An indication of the Commission's overall vision for the banking union, covering the single rulebook and the single supervisory mechanism (SSM), as well as the next steps involving a single bank resolution mechanism.

Agreement is intended to be reached for the SSM to start from January 1, 2013, covering all systemic risk banks by July 1, 2013 and reaching the final stage of covering all banks by January 1, 2014. The ECB will then become responsible for tasks such as authorizing credit institutions; compliance with capital, leverage and liquidity requirements; and conducting supervision of financial conglomerates. The ECB will be able to carry out early intervention measures when a bank breaches or risks breaching regulatory capital requirements by requiring banks to take remedial action.

4. Likely Evolution of the EBU

Gaining agreement on the establishment of the EBU, covering the whole of the EU, from the 10 Member States currently outside the Eurozone in the short term is going to be impossible. Even those Member States, e.g. Poland, are likely to wait and see how it works as applied to the Eurozone countries. The key issue is how to gain agreement for the EBU proposal, including the new supervisory role for the ECB, from all 27 Member States.

If we concentrate on the EBU in the context of the current Eurozone countries – its likely area of applicability – then, though the tight timescales laid down by the European Commission are not likely to be observed, an agreement is likely for the second deadline of January 1, 2014. However, even within the Eurozone – and despite the proposal for the EBU being part of the attempted resolution of the current Eurozone sovereign debt crisis (i.e. by attempting via the EBU to insulate sovereign governments' debt from the liquidity and bankruptcy problems of EU banks) – there remain significant technical and political problems to be overcome.

So what are these problems?

1) A general political problem is immediately obvious. Settling for a banking supervisory regime which covers only the Eurozone banks, with wider EU coverage via the EBA, supplemented by opt-in arrangements for the 10 'out' countries, breaches the key underlying principle of an integrated pan-European supervisory structure, avoiding fragmented national supervision, plus whatever coordination can be achieved. This is particularly true as the UK will almost certainly remain outside. This is not a fatal objection and the likely agreed proposal will reduce the number of national supervising authorities, but it is not ideal and may lead to competitive distortions in the Single market, particularly in the area of financial services.

2) The principal targets of the EBU supervisory structure and operations are the 'systemically important' banks. It is easy to identify, and potentially to regulate, the large banks which simply because of their size and the nature of their activities (e.g. significant 'trading' operations or high dependence of leverage). However, it should be noted that the mortgage debt problems in Spain have been incurred by the regional/local savings banks, the *Cajas*; and in Germany by the regional *Landesbanken*. Regulating these banks at European level will not be easy. It seems likely that the supervision and regulation of these 'lower level' banks will still be done via national regulators, but with substantial and final control by the ECB.

3) It is arguable that giving the supervisory power to the ECB may lead to a situation where, to an extent, the ECB is adjudicating on its own monetary performance. However, this would apply equally to the new regime in the UK and that in the US; again this is not a fatal objection. More serious is the issue raised by the ECB eventually dealing with banks' resolutions. In the US, for instance, and in Germany the resolution authorities are separate institutions from the banking supervisors. It would seem essential for a revamped ESM (European Stability Mechanism), which effectively will deploy the Eurozone 'Resolution Fund', which should be the resolution authority and not the ECB. It should be noted that there is a political dimension to resolution. With judgements to be made as to the share of the financial burden to be borne by creditors, borrowers, and, finally, taxpayers. It is also important that beyond fees being demanded from credit institutions/banks to support the SSM it is equally important that substantial amounts from the banks are deposited with the ESM as a form of mutual insurance against bank failure. (*It should be noted that the idea of an EBU is precisely to avoid financial burdens being placed on taxpayers by ensuring that systemically important banks do not fail, or if they do then the principal financial burden should fall on the owners and creditors of the failed banks*).

4) The proposals cover only the banks (strictly credit institutions). There will be a need at some stage to cover other financial services organisations, e.g. insurance companies and stock exchanges. This is, however, a problem for the longer term (but not too long).

5) Even with an efficiently operating EBU in place the structure of the European and global financial system is such that cross-border transfers, involving either the private

sector (via cross-border deposit guarantee schemes) or via the public authorities, taxpayers. This does mean that there are likely to be political objections to the potential for such transfers; the German public is particularly sensitive on this issue. Moreover, it cannot be denied that the establishment of the EBU is a step towards a greater degree of political integration at Eurozone, and, to a limited extent, for the entire EU.

5. Implications for the UK

5a General Impacts

The establishment of the EBU will bring about greater financial and economic stability within the Eurozone. This greater stability will be of considerable benefit to the UK. Assuming the UK remains outside the ECB supervisory regime, governing the Eurozone, any impacts on UK sovereignty in this area of activity will be limited to any overlap between the ECB supervisory actions and those covered by the EBA. However, as the aim is to use the EBA to maintain the integrity of the Single Market, the overall industrial and commercial impacts should show a positive gain. (*It should be noted, in passing, that simply by being outside the Eurozone single currency area already has a negative, albeit limited, impact on the UK*).

(It should be noted that the new role of the ECB as banking supervisor is matched in the UK now by the bank of England being 'restored' as the banking supervisor in relation to macro-prudential supervision).

However, the key issue relates to the situation where there is a disagreement between the EBA members, or some of them, including the UK. Here the proposal will require a simple majority to make the decision; noting that under the new arrangements the Eurozone members would usually vote as a bloc. In fact to be blocked 3 Eurozone countries and 3 non-Eurozone countries would have to be opposed. However, one can be too obsessed with majority voting when most of the time in EU decision-making there is unanimity or close to it.

The problem may be simplified if the nature of the regulation under the EBU and the EBA regimes is simpler. *Leverage ratios* are by far the best method of controlling unacceptable risk taking by banks, plus some changes in culture. They work well in Canada for instance. Andrew Haldane of the Bank of England has recently made the point forcibly about there being too much regulation of financial services. Better by far to keep it simple and then monitor closely any avoidance movements. Complex rules mean complex and over-burdened bureaucracy which ultimately fails to deal with regulatory arbitrage. Simple rules and changes in culture are what is required. In any future discussion about the EBU this aspect should be kept to the fore. Banking regulation would also be simpler if structural reform proposals to split retail banking from investment banking were to be adopted. (see evidence of Global Policy Institute to Vickers Commission, submitted by Michael Lloyd). The main reason given by the Vickers Commission for shifting to the essentially unworkable 'ring-fencing' proposal was that the EU might be opposed. Ironically, the EU may well propose such a reform.

5b Impacts on City of London

The City of London appears to be concerned about the possibility of operations of UK and UK-based banks within the Eurozone being subject to different regulatory control than in the UK. While this may be irritating for the banks concerned this is no different from their having to operate in say the US under a different regime.
The City position on EU financial services issues always exhibits a confusing mixture of claims that the City is the dominant market player in Europe and yet concern that it requires protection to maintain this position.

6. Conclusions

Principal Conclusion

The establishment of the EBU will cover the Eurozone, but with a structure intended to cover ultimately the whole EU of 27 Member States, via either countries adopting the Euro, and the Eurozone becoming larger, or by countries opting-in to the supervisory system. The principal conclusion is that this step towards a closer economic and monetary union (EMU) structure should be welcomed by the UK, given its likely positive overall commercial impact of the financial and economic stability of the UK's main trading partner, in the context of the Single European Market. Any potential negative impacts are likely to be confined to the financial services sector and are unlikely to be damaging given the financial strengths of the City of London.

Other Conclusions are:

1) The City of London appears to be concerned about the impact of the EBU. Its concerns do not appear to be well-founded and should not determine the UK government attitude towards or position on the EBU proposal. Instead a wider commercial interest position should inform the private sector view, going beyond financial services *per se*.
2) The proposal, despite a number of unresolved concerns alluded to above, should be welcomed by the UK government. The issues of financial regulation to ensure that, even though a future global or regional financial crisis cannot be ruled out, the impact should be as far as is possible contained within the banking sector and not spread to the taxpayer and hence to sovereign debt. If a new, integrated regime that works can be established via the EBU then this should be extended to all 27 countries. For those countries outside the Eurozone there are net benefits which should be appreciated by policy-makers.
3) Clearly, as indicated earlier, the EBU is a step in the direction of further monetary integration. It will not complete the economic and monetary union and this point should be understood. It does *not* strictly involve the UK in any overall loss of political sovereignty, but it does hasten the day when the UK (and some other countries) will have to make up its mind as to whether it is a full partner in the direction in which the EU is travelling.

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N.B. *These are the personal views of the author.*

25 September 2012

Nationwide Building Society—Written evidence

Introduction

Nationwide Building Society welcomes the opportunity to provide input to the Lords EU Committee's considerations on reforming the EU banking sector. This response outlines our views on two aspects of the inquiry: first, we briefly discuss structural banking reform in the context of the Liikanen High Level Expert Group inquiry and second, we answer the Committee's questions in relation to the draft bank recovery and resolution directive. The Society's views on the wider issues of a banking union and a single supervisor, and their impact on the UK, are well reflected in the evidence provided by our two trade associations, the BSA and BBA.

EU structural banking reform

Nationwide recognises the need, following the financial crisis and in anticipation of any future crises, for significant reform of the banking sector to ensure greater financial stability and competition. We believe that a retail ring-fence, the ICB's core structural proposal and one of the models being examined by the Liikanen Group, is an appropriate measure to reduce the risk to taxpayers from future crises and ensure vital banking services are protected. Nationwide has been operating under ring-fence-type conditions for many years and we have shown that 'ring-fencing' and a growing, competitive business are not mutually exclusive.
It is important that competitive alternatives to the plc banks for consumers are encouraged. Ensuring that a diversity of business models is able to succeed will also support greater stability and competition within the financial system. Nationwide has historically played a challenger role in support of consumers through acting as a competitive constraint on banks' pricing; a consumer champion on issues such as free ATM use and positive credit card order of payments; and providing leadership in customer service as evidenced by complaints levels far lower than those of the major banks).

As banking reforms are implemented, it will be important that Nationwide is able to continue to provide this challenge, both in traditional markets and as we enter SME lending, to the benefit of consumers and small businesses. We believe that the Liikanen Group should therefore be guided by the following:

- The reforms should not dilute the ability of existing and future challenger brands to compete effectively with the big banks.

- The reforms should not discriminate against or disproportionately impact particular business models, such as low-risk, retail-focused mutuals.

- Building societies and ring-fenced banks should remain distinct – but the Government should ensure consistency, as far as is appropriate, between the permitted activities of the two business models.

Draft bank recovery and resolution directive
10. What is your assessment of the proposed Directive (COM (2012) 280) establishing a framework for the recovery and resolution of credit institutions and investment firms? What will be the impact of these proposals of the steps towards banking union (including a resolution framework) as set out in the Van Rompuy report?

Nationwide agrees with the principle behind the directive to create a framework where banks can fail without endangering financial stability and that losses should be borne by bank shareholders and creditors in a legally predictable way, and not by taxpayers.
As an institution with a low risk business model, Nationwide wants to see such proposals applied in a proportionate and risk-based manner in relation to individual firms. This is important if the objective is to maintain a level playing field with diversity in banking models encouraged so that better consumer outcomes are realised.
There are a few areas of concern that are covered in our response to the remaining questions.

11. What will be the impact of the Directive upon the European Banking Authority (EBA)? Are the new responsibilities proposed under the Directive for the EBA appropriate?

The EBA is granted a significant role in relation to promoting consistent implementation of the directive and in facilitating the supervision and resolution of groups. We note that there are a significant number of tasks to be delegated to the EBA and care must be taken to ensure that policy decisions are not inappropriately delegated.
Whilst we broadly agree with the way in which the Commission has sought to capture the point of non-viability, this necessarily provides the supervisor with significant discretion. We welcome the suggestion that the EBA should issue guidelines to promote the convergence of supervisory practice.

12. What is your assessment of the proposed 'bail-in' tool (Articles 37-38 and 41-50)?

We strongly support the concept of bail-in within resolution. However, the bail-in tool, as currently articulated, is not nuanced to take account of different business models.
We do not believe it is appropriate to specify that the minimum requirement should be set by reference to *total liabilities*. On the assessment of the amount of bail-in capacity (Article 41(2)), this should be calculated on a risk-based approach, preferably using risk weighted assets (RWAs) for consistency. Further, the approach of the draft Directive for a minimum requirement set against total liabilities would be inconsistent with the PLAC metric (based on 17% of RWAs), proposed by the UK government. We support the alignment of a bank's loss absorbency requirement taking account of the riskiness of its assets.

13. What is your assessment of the following specific elements of the Commission's proposals, as set out in the Directive, in relation to:

a. Recovery and resolution planning (Articles 5-12)?

We believe that the proposals need to distinguish more clearly between recovery and resolution and to consider the differences when deciding which of the various crisis management tools should be applied and at what point.
We agree with the current proposals for the development and implementation of the recovery plan being a task for management under the oversight of the relevant supervisor (Article 5). During this period the Board of Directors remain responsible for the management of the group. A transfer of control away from management before the point of non-viability (PONV) risks disadvantaging members and opens the supervisors up to moral hazard and criticism if disproportionate and premature action is taken.

Whilst we agree that deficiencies with the recovery plan or its potential implementation identified by the supervisor require attention, we do not agree that these should give rise to a requirement to alter strategy or change business structures (Article 6). Institutions should be required to demonstrate how the deficiencies are being addressed and provide detailed timelines to improving the current situation.

The development of the resolution plan is a task for the Resolution Authority with input from the firm (Article 9). In the UK this input is by way of the Resolution pack containing detailed information about the critical business functions and structure of the group. This information needs to be detailed enough to provide sufficient information for the Resolution Authority to compile a suitable resolution plan. Firms should have the right to review and challenge the assumptions on which Resolution Authorities have identified potential impediments to resolution before measures in response to those impediments are mandated (Article 15).

b. Group recovery and resolution and cross-border activity (including resolution colleges) (Articles 7-8, 11-12 and 80-83)?

It is our view that recovery planning is most effective when conducted at group level. As with most groups, Nationwide uses a central services model and most actions available to the group as a whole would be unavailable to our subsidiaries as all capital and costs are held in the parent entity. Therefore, there should be no general requirement for the individual entities within a group to produce standalone recovery plans, particularly where all entities within the group operate under the same supervisor. We believe that this requirement should be removed completely.

c. Preventative powers (Articles 13 and 14)?

Further details of the preventative measures are required before we can make an informed comment on this content.

d. Intra-group financial support (Articles 16-22)?

Nationwide does not operate a cross-border group and would therefore not be affected by these proposals.

e. Early intervention measures, including the 'Special Manager' tool (Articles 23 and 24)?

Early intervention measures should not be utilised until such a point as one or more early warning signals have indicated the need for action (Article 23). The EBA has a vital role to play in promoting the convergence of supervisory practice in this area and ensuring that undue supervisory intervention does not cause further damage to institutions during a crisis. In terms of the early intervention measures themselves (Article 23) we are comfortable that the majority are part of the existing supervisory tool kit. Others, however, appear more like resolution tools which we firmly believe should not be utilised until the PONV has been reached. Specifically, the power for the supervisor to contact potential purchasers to prepare for the resolution of the institution (23.1(g)) confuses the role and responsibilities of the supervisor and resolution authority and blurs the functional separation required by Article 3.

We view the Special Manager power as a resolution not a recovery tool. Its use as a recovery tool risks signaling to the market that the firm is failing which will in all likelihood bring forward the point of failure and open the supervisor to moral hazard (Article 24).

f. The various resolution tools, including sale of business, bridge institution and asset separation (Articles 31-55)?

Resolution tools, such as bail-in, must only be utilised once a firm is in resolution (Articles 31(2)) and not as a first resort. In terms of the resolution tools themselves, we are comfortable that these are suitable for a resolution situation.

g. Cooperation with third country authorities (Articles 84-89)?

While this issue would not directly affect Nationwide, we are comfortable with the arrangements proposed and agree that these must be workable for internationally active groups. Clarity is required over whether the EU requirements proposed supplement existing international arrangements where these exist or whether the proposed EU Resolution College would operate in parallel. We would wish to avoid duplication and, where an international arrangement currently exists, this should be deemed to meet the requirements of the directive. Doing otherwise risks duplication and uncertainty which could be destabilising during a time of instability.

h. The proposed system of financing arrangements (Articles 90-99)?

We accept the development of resolution funds on the basis that there is recognition of the substantial synergies between DGS schemes and ex-post resolution funds and that the framework permits the use of such schemes during resolution. However, we believe that developing the pre-fund over the 10 years currently proposed would be extremely difficult in the current economic climate. We would urge that the Commission reconsiders this timeframe.

This support, however, is based on the clear understanding that the purpose of resolution funds is tightly constrained and that they should be used only to provide funds to meet the immediate costs of resolution. It is important to ensure that resolution funds not be viewed as a source of liquidity provision and normal central bank liquidity provision facilities must remain available.

We are opposed to the potential for the fund in one Member State to be under an obligation to provide assistance to a fund in another Member State. This obligation would dilute the link between responsibility and liability creating moral hazard, and has the potential to act as a contagion across Member States. We believe that once the pre-funded element of a Member State's Resolution Fund is exhausted it should raise finance (through a Government line or commercially) at no cost to taxpayers, with surviving institutions funding the interest costs and repaying the principal over time.

Depositor preference

Article 99 deals with the role of Deposit Guarantee Schemes (DGS) in the resolution framework. DGS must contribute for the purpose of ensuring continuous access to covered deposits. The current proposals introduce ranking of deposit guarantee schemes in the hierarchy of claims, with DGS ranking pari passu with unsecured non-preferred claims.
In line with the HM Treasury White paper, we believe that retail depositors should rank senior to unsecured creditors, but further believe this should include all retail deposits and not just those below the FSCS limit.

We fully support a move to depositor preference, ensuring retail depositors are nearer the head of the queue at insolvency. The potential burden on the rest of the industry through the FSCS charge will also be reduced and retail investors should derive confidence from their preferred position, thus supporting stability in this key funding market. Further consideration should therefore be given to depositor preference for all retail depositors, which would create a situation where all senior unsecured debt-holders were effectively automatically 'bailed-in' on insolvency without needing to tackle the complex and potentially destabilising topic of formal bail-in of senior unsecured creditors.

3 October 2012

Open Europe and Centre for European Reform—Oral evidence (QQ 195–208)

Transcript to be found under Philip Whyte, Senior Research Fellow, Centre for European Reform

Royal Bank of Scotland (RBS)—Written evidence

Royal Bank of Scotland (RBS) welcomes the committee's timely investigation into the implications of the current EU agenda for banking sector reform, including notably proposals for a banking union, and is grateful for the opportunity to submit our thoughts. We have addressed the questions in the committee's call for evidence, grouping those questions where our response addresses more than one. We should like to emphasise that the fast moving nature of the current policy debate means that the following inevitably represent initial thoughts, which will develop over time as the details and the implications of the EU Commission's recently published proposals are fully absorbed. Nonetheless, we hope that our evidence sufficiently addresses those areas where we are able to do so.

Q1. What has the euro area crisis revealed about the weaknesses of the EU banking sector? In what ways do you believe that the EU banking sector needs to be reformed?

1. Many of the weaknesses seen in the EU banking sector are similar to those revealed and addressed earlier in the US and UK banking systems, including several of RBS's own failings. On top of this, however, the euro area crisis has revealed negative feedback between euro area banks, eurozone sovereigns and a weak economic outlook. Solving the crisis requires a decisive break of these links.

2. Euro area banks continue to show weakness – for example, in May 2012, Bankia approached insolvency, provoking the Spanish government to the largest bail-out in that country's history.

3. Eurozone governments' fiscal position also remains fragile. Deficits expanded rapidly since the 2008 financial crisis, notwithstanding longer-standing structural problems that exist in the euro area. The Irish government, for example, has 64 billion euros of legacy troubled assets on its balance sheet, as a result of its bank bailout programme. Investors have become sceptical about certain countries' ability to meet their debt repayments, elevating those governments' borrowing costs. Markets in turn have become less sanguine about the ability of those governments to stand behind their troubled banks.

4. Private debt also grew substantially over the past decade. Deleveraging across the public and private sectors has resulted in low economic growth.[70] This undermines the ease with which governments and banks can rectify their respective financial positions.

5. In addition to longer-term regulatory developments to reduce EU bank dependence on sovereigns, additional shorter-term measures are needed to break that link in the euro area. The EU's immediate priorities – the Recovery and Resolution Directive, the Capital Requirements Directive IV, measures to improve the transparency and robustness of securities markets – are the right ones. Banking union is necessary to resolve the specific circumstances of the euro area, but it is not sufficient. As suggested by the Van Rompuy report, fiscal and further economic reforms are required too.

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[70] IMF, 'Threshold effects of sovereign debt', 2012.

Q2. Steps towards 'banking union' were set out in the Van Rompuy report *Towards a Genuine Economic and Monetary Union*. How would you define 'banking union' in the EU context? What is your assessment of the report's conclusions, and what will the impact be on existing proposals (such as CRD IV)? What are the key elements of banking union if it is to function effectively?

Q3. The 28/29 June euro area summit statement said that when an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could recapitalise banks directly. What is your assessment of this proposal? How likely is it that this would stabilise the EU banking sector?

6. RBS supports further financial integration in the eurozone. Broadly, the best way to break the link discussed above is to pool resources and strengths across the currency union. This will go some way to ensuring that euro area monetary policy is effective.[71]

7. The EU Commission proposal for a Single Supervisory Mechanism (SSM) is one aspect of this. It will be effective if markets have confidence that the new single supervisor will be willing to take the necessary action to shore up euro area banks. The SSM must therefore decisively grant prudential authority for euro area banks to the single supervisor.

8. Further integration in the eurozone should not undermine the continuing development of the Single Market. Proposals, such as CRD IV and the Recovery and Resolution Directive (RRD), are necessary for all 27 EU Member States. In pressing ahead to pool resources in the euro area, the EU must ensure that further euro area integration does not fragment the Single Market.

9. Using the ESM to directly recapitalise banks is a positive development, in our view. Had this recourse been available sooner, Ireland's readjustment, for example, would have been less severe.[72] The Irish bail-out would have only had to repair the Government's balance sheet and not bail-out its banks too.

Q4. In January 2012 European Commissioner Michel Barnier set up a high level expert group to explore possible ways to reform the structure of the EU banking sector, including consideration of structural reforms such as activity restrictions as applies under the Volcker Rule, size limits, and structural separation of retail deposit banks from investment banking. What is your assessment of such proposals for structural reforms? Which, if any, would help ensure the future health of the EU banking sector?

10. EU banks display a wide range of business models to meet customers' needs. Furthermore, there has been a consolidation in the sector over the past decade,

[71] Financial Times, 'Loan rates point to eurozone fractures', 3 September 2012.
[72] Ireland currently has a budget deficit roughly equivalent to 30% of its GDP.

primarily driven by the Single Market. However, the evidence of the crisis is that banks of all sizes and business models can potentially pose systemic risk. Well-known and telling examples are the collapse of Lehman Brothers, a large US investment firm, and Northern Rock, a relatively small UK retail bank that precipitated the crisis in 2007. RBS therefore does not believe that structural reform is the best way to ensure stability and meet the demands of customers. Ex ante reforms are costly and potentially counterproductive. Recovery and Resolution Plans require firms and regulators to set out the structural reforms that will best address the particular problems that might afflict them. These 'ex post' reforms are far more likely to be effective than a one-size-fits-all change that consolidates risk rather than diversifying it.

11. RBS will, of course, be complying with the ring-fencing requirements proposed by the UK's Independent Commission on Banking and will be developing its plans for this as details of the precise legislative and regulatory requirements involved become clearer. This will necessarily entail considerable customer disruption.

12. New rules to ensure banks resilience; an effective regime to recover or resolve failed institutions; better supervision; protection for customers; and greater transparency will create a safer banking environment. It is important for policymakers to focus on getting these rules right and delivering them, instead of being tempted by more complex and uncertain measures.

Q5. The European Commission are expected to present proposals for a single European banking supervisory framework in September. What is the purpose of such a framework, and what key elements need to be included if it is to succeed? How likely is it that such a framework will be adopted?

Q6. What is the most appropriate division of responsibility between national and EU supervision under such a framework?

Q7. In what way, if at all, should supervisory powers vary depending on the size and nature of banks?

Q8. What powers and responsibilities is it appropriate for the ECB to possess in relation to regulation of the European banking sector, and in particular in relation to supervision of euro area banks? How should the ECB be held accountable for the exercise of such responsibilities?

13. Banking union is one aspect of further financial integration in the euro area to enable monetary policy to be effective. Specifically, banking union should break the dependency of euro area banks upon their sovereigns.

14. The Van Rompuy proposal sets out two main areas for banking union: the SSM; and mutualisation of losses, comprising common deposit guarantees and resolution funding. RBS broadly agrees that these elements could form an effective banking union, though care must be taken to ensure that this does not weaken the Single Market.

15. The primary purpose of the SSM is to create confidence that the single supervisor will take the necessary steps to ensure the stability of euro area banks. The Commission's

proposal locates responsibility for prudential supervision in the ECB, with the support of national supervisors. If in practice, it is clear that the ECB has ultimate responsibility for decisions, this may be effective.

16. Under the Commission's proposal, national supervisors will continue to be responsible for conduct regulation. This is appropriate because conduct is typically dependent on the local tax regimes, saving behaviour and culture of an economy.

17. Furthermore, keeping conduct supervision and prudential supervision operationally distinct should ensure that proper attention is devoted to each task. In a sense, the Commission's proposal is a variation of the 'twin peaks' model that the UK will implement through the Financial Services Bill. In this respect, it will be essential to carefully demarcate policy responsibilities and ensure adequate communication between national and European regulators under any new system. Adequate resourcing will also be critical.

18. The Commission proposes the ECB will prudentially supervise all euro area banks, regardless of size and business model. Noting our observations in response to question four, and the basic principle that it must be clear that ultimate authority resides with the single supervisor, this is the correct approach. The Spanish *cajas* demonstrate that banks of all sizes can pose systemic risk.

19. It is important that the ECB remains politically and financially independent, both as a supervisor and as a central bank. However, there must be a mechanism whereby the EU Parliament and Council of Ministers can ensure that the ECB is effectively performing its mandate under the SSM. Of more concern is the political weight that the ECB is likely to carry in the wider EU. We address our concerns more fully under question 10 below.

Q9. What is your assessment of the Van Rompuy proposals for a European deposit insurance scheme for banks, to be overseen under the new European banking supervisory framework and with the ESM as a fiscal backstop? What is the purpose of the proposal and what will its impact on the existing Deposit Guarantee Schemes Directive proposal? Is it likely to be effective? How likely is it that such proposals will be enacted?

20. It is important for all EU Member States to provide for deposit guarantees, as required by the Deposit Guarantee Schemes Directive, and to fund resolution measures, as the Recovery and Resolution Directive will likely require. Mutualisation of those losses is an appropriate part of banking union for the euro area, over and above the wider EU. Mutualisation of losses outside of banking union would likely produce moral hazard, i.e. by firms and supervisors inadequately managing risk because some of the costs would be borne elsewhere.

21. As discussed in our response to question 3 above, it is helpful to use the ESM as a fiscal backstop for bank bail-outs. This would go some way to alleviating pressure in sovereigns, and is therefore desirable whilst arrangements are put in place to mutualise bank losses.

Q10. What is your assessment of the proposed Directive (COM (2012) 280) establishing a framework for the recovery and resolution of credit institutions and investment firms? What will be the impact on these proposals of the steps towards banking union (including a resolution framework) as set out in the Van Rompuy report?

Q11. What will be the impact of the Directive upon the European Banking Authority (EBA)? Are the new responsibilities proposed under the Directive for the EBA appropriate?

Q12. What is your assessment of the proposed 'bail-in' tool?

Q13. What is your assessment of the following specific elements of the Commission's proposals, as set out in the Directive, in relation to: (a) – (h) (see consultation for list)?

22. RBS is broadly supportive of the RRD. A clear and effective regime for resolving and restructuring failing banks is an important and essential step to solve the problem of 'Too Big to Fail'.

23. Whilst supportive of much of the Commission's draft RRD, there are a number of areas where RBS has particular concerns:

    - Early intervention powers: at the stage where the bank remains privately controlled (i.e. not in resolution), measures such as the special manager cut across Board Directors' duties under corporate law. There is also a significant risk that evoking early intervention will push a firm more rapidly into resolution by signalling to the market that there are problems. Instead there should be a more collaborative approach between the firm and the authorities to address recoverability and resolvability.
    - There must be international alignment for the regime to work and not to disadvantage the EU by being super-equivalent. Contractual bail-in provisions in third countries, in particular, may not be effective if local law has precedence. The EU should seek international agreement where possible.
    - There must be some mechanism for the industry to finance the resolution of failed banks. The Deposit Guarantee Scheme and the pre-fund element that is under discussion in the EU are likely to meet this requirement. As discussed above, there should be no mutualisation of losses outside of banking union.

24. RBS believes that bail-in is potentially a powerful tool to recapitalise failed banks and spread losses amongst creditors, significantly reducing the likelihood the taxpayers would have to contribute to bail-outs again. As a matter of principle, the creditor hierarchy under insolvency law should be respected, and the regime should ensure that no creditor will be worse-off than they would be in insolvency.

25. We agree that the Commission should seek to spread the scope of eligible liabilities as wide as possible, although the exact quantum of eligible liabilities should be determined for each firm by the relevant competent authority. The Deposit Guarantee Scheme should be bailed-in in place of covered depositors, widening the bail-in base whilst ensuring those schemes will not be disadvantaged as compared with if a bank failed. We

do, however, argue that there should be an exclusion based on the liabilities' term maturity. Excluding under six months should be sufficient. Allowing shorter-term liabilities to be bailed-in would disrupt short-term funding markets and would ultimately make a bank run more likely in a crisis. We recognise that banks will therefore have to pay more for their longer-term funding, but believe the trade-off for greater financial stability is acceptable.

26. As previously noted, the RRD arrangements for the entire EU should not be compromised. Banking union addresses several elements of implementing the RRD in the eurozone by, amongst other things, mutualising resolution costs. The draft ECB Regulation is silent on the issue of whether the ECB should be the competent authority under the RRD for determining when a failing euro area bank has met the Point of Non-Viability (as defined by the RRD). In line with our view that there needs to be clear authority in the single supervisory framework, the ECB Regulation should make plain that the ECB would bear ultimate authority for deciding when the Point of Non-Viability has been met. This also accords with the Commission's proposal for the ECB to both authorise and prudentially supervise euro area banks – both of which are clearly akin to determining when resolution is required.

27. It is equally important that the role of the EBA as a rule-making institution for the whole EU is protected and maintained. The Commission's proposed amendments to the EBA Regulation attempt to protect the voting rights of non-eurozone Member States but do not go far enough. To ensure that the ECB does not dominate rule-making for the rest of the EU, there needs to be more fundamental changes to vote-weights in the EBA's decision-making committee.

Q14. The Government have made clear that the UK will not take part in the fundamental elements of a banking union, and will neither be part of common deposit guarantees nor come under the jurisdiction of a single European financial supervisor. What is your assessment of this position? How should the UK respond to these proposals?

Q15. What will be the implications of steps towards banking union for those countries, such as the UK, that intend to stand apart? How realistic is the Government's argument that non-participation should not and need not adversely affect the UK's position as the leading financial centre in Europe, nor adversely affect the operation of the single market?

Q16. How do you assess the risk that, as elements of a banking union, including supervision, are addressed by a subset of its members, the Council's role in banking regulation will be undercut, with its legislative debates pre-empted and/or decision pre-determined in discussion amongst banking union members?

28. For the reasons given above, banking union is a solution to the structural problems of the euro area and is not suitable for the UK at the current time. It is important for the UK to play a constructive role, recognising the need for further integration in the euro area, while ensuring that the integrity of the Single Market is maintained. We recognise

the challenges inherent in preserving the UK's role in the development of the banking union blueprint while at the same time remaining outside it.

29. What is important is to ensure continuing market access for those outside the banking union, primarily by maintaining the role of the EBA and protecting the position of non-euro area Member States in the EU's voting procedures.

12 October 2012

Royal Bank of Scotland (RBS) and Barclays—Oral evidence (QQ 119–148)

Transcript to be found under Mark Harding, Group General Counsel, Barclays

Royal Bank of Scotland (RBS)—Supplementary evidence

1. The Commission has also called for agreement by the end of 2012 on its proposal for a Directive on Deposit Guarantee Schemes. In addition, the Commission's longer term vision for a banking union includes a common system for deposit protection. What are the likely implications for the proposed Directive on Deposit Guarantee Schemes of the banking union proposals?

Currently the EU has a framework of national deposit guarantee schemes (DGS); these must comply with minimum standards set in EU law. The financial crisis saw a series of reforms to these, for instance by increasing the amount of protection provided. The current proposals to amend the Deposit Guarantee Scheme Directive would further raise EU minimum standards, for instance by reducing the time taken to pay out compensation to no more than a week, and to introduce the pre-funding of the DGS. Some of these measures (e.g. faster payout) are already in place in the UK; a move to pre-funding would however represent a significant change for the UK and a number of other jurisdictions, and would potentially have cost implications for banking systems – the size of the pre-funded pot and the speed of transition has been a significant area of debate and source of delay in agreeing the legislation.

Since the purpose of a banking union is to break the link between the credit strength of a sovereign and its national banking system, the cross-border mutualisation of potential liabilities ought to be a fundamental component for those countries within the union. However, at present, no formal legislative proposal has been advanced to replace national DGS and replace these with a single scheme covering the banking union, such that potential calls on the scheme (e.g. through a bank failure in one country), would be met by funds provided by banks (and ultimately their customers), from across the whole of the banking union. A proposal has been talked about for 2013, but clearly this is a sensitive matter. However, without such mutualisation (and not only in terms of DGS, but also in terms of mutualising the funding of bank resolutions, including ultimately the possible recourse to state funds), then it would be difficult to talk of there being a true banking union.

The immediate impact of the banking union debate has been to further delay negotiations on the DGS Directive, which were already over-running. Whilst the two dossiers are linked, however, we believe that the DGS Directive (together with the draft recovery & resolution Directive) should be negotiated and agreed for the EU27 as a whole, as a matter of priority (but without any element of mutualisation). In other words, irrespective of whether or not progress is made on a banking union for the euro-area, the single market as a whole needs to have in place a minimum framework for DGS and recovery and resolution. If members of the euro-area wish to move to mutualise potential liabilities through a banking union, then this should be done through separate measures, without imposing this on the non-euro area members who do not wish to be part of that banking union.

2. Is it feasible to conceive of a banking union without a centralised deposit protection scheme being established from the outset?

There are ways in which a banking union could work without a centralised deposit protection scheme. The key point is mutualisation of liabilities rather than having a single scheme. For instance, instead of a centralised scheme, it could be possible for those in the banking union to be able to draw on funding from other national schemes in the banking union. This would have the same effect of pooling resources, but through multiple schemes rather than a single mechanism. Of course, the precise point at which a national scheme could call on other schemes, and on what terms, would determine the true scale of mutualisation being provided for. Moreover, a single scheme might carry greater credibility with markets.

3. Is it feasible to conceive of a centralised deposit protection scheme that is confined to the Member States that are part of the banking union?

It is not only feasible, but essential that mutualisation is applied only to those Member States that are part of the banking union. There should be no reason why Member States (and their banks) that are outside of a banking union, should potentially be held liable for meeting the costs of bank failures in the banking union, when they are not part of the single supervisory mechanism and thus have no say in how supervisory standards and other preventative measures are to be applied in the banking union. This is a crucial point. With this in mind, it is worth noting that we have concerns with an aspect of the draft Recovery and Resolution Directive proposal (concerns echoed by the EP Rapporteur Gunner Hökmark MEP) - there is a risk within the proposals that national schemes may be able to borrow from each other, which could lead to a mutualising of losses outside of a banking union.

4. What are the likely implications of moves towards a common scheme for Member States that will not be part of the banking union and which are likely to be unwilling to enter into burden-sharing arrangements?

Whilst there has been talk of a pan-EU DGS we have yet to see a proposal. As discussed above, any such proposal would raise serious difficulties for Member States (and their banks) that are not part of a banking union.

21 November 2012

Which?—Written evidence

1. Which? is a consumer champion. We work to make things better for consumers. Our advice helps them make informed decisions. Our campaigns make people's lives fairer, simpler and safer. Our services and products put consumers' needs first to bring them better value.

2. Which? established and supported the Future of Banking Commission, chaired by Rt Hon David Davis MP in 2010. In addition to taking evidence from senior regulators, banking executives and academics, the Future of Banking Commission included the Which? big banking debate – an event attended by 300 members of the public and a process that allowed consumers to make their own submissions through the Which? website. The report was published on 13 June 2010 and made a series of recommendations for changes to the structure, regulation, governance and culture of the banking industry.[73]

3. We welcome the opportunity to provide evidence to the members of the EU Economic and Financial Affairs Sub-Committee about the EU banking sector. This document contains our responses to the questions posed by the Committee. We would be happy to provide any further information and to provide oral evidence to the Committee.

<u>Banking reform, banking union and the euro area crisis</u>

What has the euro area crisis revealed about the weaknesses of the EU banking sector? In what ways do you believe that the EU banking sector needs to be reformed?

4. The euro area crisis has revealed the urgent need for fundamental structural reform of the UK and EU banking sector and the way in which they are regulated. Reform is needed to remove the conflicts of interest within large banking groups and to address the problem of banks which are too big to fail.

5. We need to move away from the current situation where policy-makers have had little choice but to channel billions of taxpayer pounds and euros into banks across Europe to stabilise the economy and as a result have run national treasuries into the red. The banking sector must be reformed in a way that makes individual banks less likely to fail but, when necessary, allows the orderly failure of badly managed institutions, whilst securing the safety of deposits and the continuity of essential services. This is also important to prevent governments from handing out subsidies to banks thus distorting competition in the Single Market.

Which? recommends the following structural reforms:

- **Ring-fencing of essential retail-banking services:** This is required to limit the scope of Government guarantees and to tackle the conflicts which exist in large complex banking groups. It will also reduce moral hazard and protect essential services from instability in riskier investment/wholesale banking. It would help impose a credible threat of failure on the parts of the bank outside the ring-fence, reducing

[73] The full report is available at http://www.which.co.uk/documents/pdf/future-of-banking-commission-report-276591.pdf

the extent of the implicit subsidy and taxpayer exposure to losses from these activities.

- **Introducing depositor preference and a clearly understandable deposit protection scheme:** This will help protect the deposits of retail consumers whilst ensuring that those who lend to banks through the wholesale markets have proper incentives to monitor and constrain the behaviour of banks.

- **Giving consumer protection and prudential regulators a clear mandate to promote effective competition:** Consumer protection regulators should promote transparency, the ability of consumers to switch products and tackle the root causes of mis-selling. Prudential regulators would enable market discipline to operate, removing barriers to exit by ensuring that resolution arrangements involved the continuity of essential retail banking services.

- **Introducing portable account numbers:** This will encourage consumers to switch banks by ensuring a quick and efficient switching process. It will also help guarantee the continuity of essential retail banking services as consumers from a failing bank can easily be transferred to another bank.

Steps towards 'banking union' were set out in the Van Rompuy report Towards a Genuine Economic and Monetary Union. How would you define 'banking union' in the EU context? What is your assessment of the report's conclusions, and what will its impact be on existing proposals (such as CRD IV)? What are the key elements of such a banking union if it is to function effectively?

6. Which? believes that effective competition is fundamental to an effective banking union. Mismanaged banks must be allowed to fail in an orderly fashion. Creating a European deposit guarantee scheme and resolution scheme could, if credible, help break down barriers to exit the market and, as such, enable proper competition which in turn would help stabilise the European economy (see point 7). However, Which? would not want to see British consumers paying for the bail-out of banks in other Member States nor to see the FSA restricted by these new proposals.

The 28/29 June euro area summit statement said that when an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could recapitalise banks directly. What is your assessment of this proposal? How likely is it that this would successfully stabilise the EU banking sector?

7. Stability is not ensured by trying to prevent failure of certain institutions in all circumstances but by ensuring that failure can occur in a controlled way. Creating a new mechanism to recapitalise banks in the euro zone could lead to moral hazard and distort competition if operated in a way which leads bank mangers to think that they will get a fresh capital injection every time their bank is in trouble. This would also distort the Single Market.

8. Special treatment of banks in the past, such as the EU Commission's relaxation of state aid rules for financial institutions, has significantly distorted market structure by increasing concentration (and decreasing competition). This has left consumers exposed to worsening

outcomes and made financial markets less resilient and stable because it has led to more rather than less banks that are "too big to fail". It is essential that this cycle is broken.
9. Competition is in our view fundamental to ensuring financial stability. Which? has long been advocating for competition to be recognised in regulatory systems. Both prudential and consumer protection regulation should focus on eliminating barriers to exit (allow bad, but systemically important, banks to fail) while regulating the structure, conducts and products offered by banks to promote effective competition (e.g. portable account numbers). These principles formed key parts of The Future of Banking Commission and Which?'s views on the UK Government's proposal for regulatory reform.
10. Allowing the ESM to recapitalise banks directly could in effect create a barrier to exit and as such allow mismanaged banks to continue operating instead of allowing them to fail in an orderly fashion. This would neither stabilise the EU banking sector or the rest of the European economy.

In January 2012 European Commissioner Michel Barnier set up a high level expert group to explore possible ways to reform the structure of the EU banking sector, including consideration of structural reforms such as activity restrictions as applies under the Volcker Rule, size limits, and structural separation of retail deposit banks from investment banking. What is your assessment of such proposals for structural reforms? Which, if any, would help ensure the future health of the EU banking sector?

11. Which? has long been calling for several of the structural reforms that the high level expert group was tasked to look at including ring-fencing retail deposit banks from investment banking; promoting competition; and reducing moral hazard by making a market exit a viable option.

12. The benefits of the latter two are dealt with throughout this response while the benefits of ring-fencing are as follows:

- It could make retail banks less likely to fail and help secure the payment system;
- There is no evidence that larger banks are inherently safer, indeed there is a counter argument that they are riskier by virtue of being too large and complex to manage. Therefore they should be made smaller and simpler;
- The current model allows retail banks to use their deposit base – on which there is an implicit government guarantee – as collateral for their speculative trading. Ring-fencing would reduce this incentive and help protect retail banks from the fallout of risky and speculative activities which threaten the integrity of deposits;
- It would help impose a credible threat of failure on the parts of the bank outside the ring-fence, reducing the extent of the implicit subsidy and taxpayer exposure to losses from these activities. There are no good economic arguments as to why UK taxpayers should be subsidising banks making loans to hedge funds based in the Cayman Islands and trading complex derivatives;
- It helps support competition in the retail market by avoiding the typical response to a crisis in commercial and investment banking activities which is to engineer mergers and consolidation which also impact retail banking markets;
- It will draw the market's attention to the fundamental low levels of equity capital in investment banking operations. For example, the Barclays 2010 annual report stated that when it came to allocating 'economic capital' across the business, Barclays UK

retail was assumed to hold capital of around 11% of Risk-Weighted Assets, compared to less than 5.7% in the Barclays Capital investment bank[74];

- It avoids consumers being asked to subsidise losses in the investment banking and commercial banking operations. For example, we note that the UK retail arms of the major high-street banks remained profitable throughout the financial crisis.

13. It is worth noting that other industries have specific arrangements which allow firms to fail while ensuring the continuity of essential services. This requires certain parts of the business to be subject to explicit ring-fencing. For example, in the UK Water industry when Enron acquired Wessex Water, OFWAT (the water regulator) imposed conditions including requiring the Board to act as if it was an independent company and prohibited cross-default operations[75]. Their primary objective was not to protect Enron's shareholders, but to ensure that customers would continue to receive an essential service and that the creditors of Enron corporation should have no recourse to the assets of the Water company. The result was that when a combination of fraud and incompetence caused Enron to collapse, the ring-fencing provisions ensured that Wessex Water was able to continue to function and essential services were maintained.

14. The real problem is the moral one. During the financial crisis, banks supported their Structured Investment Vehicles (SIV) even when they could in theory have walked away from some of them. In fact there was considerable pressure on those banks that were intent on letting the SIV go to support them – and interestingly this pressure came as much from the other banks as the investor financiers of these shadow banks. A bank will inevitably not wish to allow a related company to fail – but that simply means that regulation is required to ensure that it happens when necessary. This means that the composition and duties of the board of the ring-fenced bank will need to be amended to ensure that it is independent of the Board of the wider banking group. A ring-fenced bank must also have its own balance sheet, liquidity and funding mechanism.

Banking supervision

The European Commission are expected to present proposals for a single European banking supervisory framework in September. What is the purpose of such a framework, and what key elements need to be included if it is to succeed? How likely is it that such a framework will be adopted?

15. No comment.

What is the most appropriate division of responsibility between national and EU supervision under such a framework?

16. Which? would not want to see the FSA/FCA be restricted by the single European banking supervisory framework. Given the size of the financial services sector relative to

[74] http://files.the-group.net/library/barclays/annualreport2010/pdfs/barcar10_annualreport.pdf UK Retail banking - risk-weighted assets - £35.3 billion (page 46), Average economic capital allocation by business UK retail banking - £3.9 billion (Page 129) - around 11% of Risk weighted Assets; Barclays Capital - risk weighted assets - £191.3 billion (page 56) Average economic capital allocation by business - Barclays Capital - £10.95 billion (page 129) - around 5.7% of Risk Weighted Assets
[75] For details of the ring-fencing provisions imposed see OFWAT, The proposed acquisition of Wessex Water Limited by YTL Power International Berhad, April 2002

the rest of the UK economy, it is important that UK policy-makers and regulators can take swift measures, when necessary, to protect consumers and ensure financial stability.
In what way, if at all, should supervisory powers vary depending on the size and nature of banks?

17. No comment.

What powers and responsibilities is it appropriate for the ECB to possess in relation to regulation of the European banking sector, and in particular in relation to supervision of euro area banks? How should the ECB be held accountable for the exercise of such responsibilities?

18. No comment.

European Deposit Insurance schemes

What is your assessment of the Van Rompuy proposals for a European deposit insurance scheme for banks, to be overseen under the new European banking supervisory framework and with the ESM as a fiscal backstop? What is the purpose of the proposal and what will its impact be on the existing Deposit Guarantee Schemes Directive proposal? Is it likely to be effective? How likely is it that such proposals will be enacted?

19. The purpose of this proposal seems to be to strengthen the credibility of those institutions belonging to the scheme. Whether that happens in practice will depend on the exact nature of the scheme including how it is funded. It should not have an impact on the Deposit Guarantee Scheme Directive (DGSD), which should at a minimum apply in Member States outside the banking union, like the UK.

20. We are very disappointed that negotiations between Council and the European Parliament continue to drag on over the DGSD given the current state of the EU banking sector and overall economic situation. We urge the UK Government to take any measures it can to move the DGSD forward and to ensure that it is not delayed as a result of the new banking union proposals.

21. We urge the UK and other Member States to support the European Parliament's position which would allow national regulators to introduce per brand protection and ensure that temporary high balances are covered by national schemes.

22. If the deposit insurance scheme proceeds on the basis of coverage per licensed institution, a consumer who has several accounts with different brands covered under the same licence will only be compensated up to £85,000. We are concerned that consumers will not be able to understand the complexities that this approach introduces. Given the plethora of different brands it is extremely difficult for consumers to understand the corporate structure of a bank and determine whether their money is protected. For example, brands including Halifax, Bank of Scotland, Birmingham Midshires, Intelligent Finance, AA Savings and Saga are all covered by a single licence.

The proposed Directive for bank recovery and resolution

What is your assessment of the proposed Directive (COM (2012) 280) establishing a framework for the recovery and resolution of credit institutions and investment firms? What will be the impact on these proposals of the steps towards banking union (including a resolution framework) as set out in the Van Rompuy report?

23. Which? is encouraged by the overarching aim of the proposal to avoid taxpayers once more paying for bank bail-outs. Measures must also be put in place to ensure that banks treat their customers fairly in these situations.

24. Many of the measures set out by the European Commission mirror proposals Which? set out in our Future of Banking Commission report from 2010. In particular, the need for resolution plans to be prepared in advance of financial problems occurring. As such we support the thrust of these proposals.

25. We would also like to highlight the benefit of portable account numbers in this context as they would greatly facilitate the transfer of customers from a failing bank to another bank.

The impact on the UK

The Government have made clear that the UK will not take part in the fundamental elements of a banking union, and will neither be part of common deposit guarantees nor come under the jurisdiction of a single European financial supervisor. What is your assessment of this position? How should the UK respond to these proposals?

26. Which? would not wish to see British consumers paying for the bail-out of banks in other Member States nor to see the FSA restricted by these new proposals. However, given the impact that the European economy has on UK consumers, Which? believes that the UK should do whatever it can to ensure that the banking union helps stabilise the euro and wider European economy.

27. We would also urge the UK to ensure that important financial services legislation, such as the Deposit Guarantee Scheme Directive, is not further delayed as a result of these new proposals.

What will be the implications of steps towards banking union for those countries, such as the UK, that intend to stand apart? How realistic is the Government's argument that the UK's non-participation should not and need not adversely affect London's position as the leading financial centre in Europe, nor adversely affect the operation of the single market?

28. Different regulatory regimes come with the risk of forum-shopping and fragmenting the Single Market. As the banking union develops one could imagine that institutions in the long-term at least will seek to operate wherever the regulatory regime is most beneficial to them either by establishing branches there or through passporting.

How do you assess the risk that, as elements of a banking union, including supervision, are addressed by a subset of its members, the Council's role in banking regulation will be undercut, with its legislative debates pre-empted and/or decisions pre-determined in discussion amongst banking union members?

29. We do think there is a risk that further integration among some Member States in the area of financial services could marginalise the Council's role when it comes to regulating financial services. A banking union is likely to create a uniform set of interests among its members and, as its members will have much more regular contact than the rest of the Member States, they will either formally or informally be able to develop common positions ahead of Council meetings.

1 October 2012