Job Name: Video 4 – Audio 1
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Welcome to video 4 of Banking Union in the EU. This video is concerned with problems and prospects for the Banking Union in the future. Before watching this you should have read the prescribed reading and you should have also looked at the previous videos, video 1 was on the single rulebook, video 2 was on the single supervisory mechanism, and video 3 was on the single resolution mechanism. So this now looks at problems and prospects for Banking Union in the future, and that builds on all of the others.

So what I= am going to cover in this is four items., First of all in what ways is the Banking Union in the inverted comma sense, deficient? What would you need which would complete a Banking Union? Secondly, we will look at why Banking Union is needed at all. Thirdly, we will look at will it work? And fourthly, we will look at what might a full Banking Union actually be?

So let us start with the missing parts and we have already talked about the fact that the non-euro area countries are not involved in the Single Supervisory Mechanism, or the Single Resolution Mechanism. And we have already said that because it only covers banks it doesn't cover the other parts of financial conglomerates. So I am looking for extra bits here which are still missing beyond that. And the first thing is that they proposed in early 2014 that it was necessary to decide how banks should be structured in order to make it easy to continue the essential parts. If you can divide a bank up so that the essential parts are in one entity and the non-essential parts are elsewhere, then it makes it very easy to resolve the essential bits without bothering about the non-essential ones.

And the EU actually commissioned a report on this from a committee headed by Erkki Liikanen, the governor of the Bank of Finland, to look at bank structure. And that report came out suggesting there should be just that sort of separation. If we look at the United States, that has already got that sort of separation in place through what is called the Volcker Rule, which separates out high risk activities from the standard banking ones which are lower risk. And the idea of that therefore is that the high risk things don't bring down the essential parts of banking, they can just quietly fail on their own where it doesn't cause a problem for the entire system.

The second area where they haven't managed to agree is that they haven't managed to harmonise deposit insurance. What they did do was increase the minimum coverage of deposit insurance from 20, 000 euro per person per bank to 100,000 per bank, and this is now then a common level. But it is still the case that each country has got its own deposit insurance fund and each deposit insurance guarantee system, so that it makes separate decisions about what to do. And that is because it has been too difficult to put these together. So that is something else which doesn't exist yet. So why do we need to have this whole system of Banking Union? And the problem is first of all that it seems to be so hard, from the experience in the past to be able to resolve cross-border banks without calling on the taxpayer, in experience it just wasn't possible.

I said earlier on that you had to be able to sort this out over a weekend, countries just can't agree on what to do in a period like that. It is not quite fair to look at it this way because you can tell that banks are getting into difficulty some time before hand. It is not the first you hear of it when the bank comes knocking on your door on the Friday evening and says I am terribly sorry, we are not going to be able to open on Monday morning unless you do something. You will have had a number of weeks or months notice of what is going to happen. But even so it is only when you come to the crunch time of actually doing something that you've got to consult ministers and make sure things are going to go through. If you have got to consult ministers in quite a large number of euro area countries this is just not going to work, you are going to have to do something fast and therefore you need the SRB to be able to do that, so a single authority needs to be able to do it.

Let’s just look at the example of Fortis, which failed in 2008 just after the failure of Lehman Brothers. What happened there was that this was a bank which had got large activities in Belgium and in The Netherlands, and a small amount in Luxemburg, although important from the size of the Luxemburg economy. When this failed the initial idea was that both the Belgian and Dutch authorities would bail the bank out to the extent of 49 percent of its share capital. In other words neither country would have a majority interest, but they would contribute as much as they possibly could short of that majority.

When the Dutch took home this idea the government reflected on it and said no-no, the part of the Fortis which is good, is the part which is in The Netherlands. The part which has the problem is the part in Belgium. Why should we be contributing to trying to solve a joint problem when we can get a much better solution for The Netherlands. What we should do is buy the entire Dutch operation and reorganise that. And that therefore meant that it was not possible to come to the original agreement. Of course the Belgium authorities were really upset about this, and indeed the shareholders were upset. Because of course if there was no controlling interest, then they could continue to run the bank. What the Dutch did made very good sense for The Netherlands and indeed probably much more sense for the resolution. But it shows that you just can’t manage to do this in a hurry because each country’s got a different interest. You have got to be able to push this up to the EU level so that you can make those decisions.

The second thing which we get out of this is of course that the authorities didn't have the power to step in and resolve the banks. The only way that they could manage to keep them going was to give them enough capital for them to continue in operation, running themselves. The country which stepped in and did this first was the UK. The UK had thought that it could apply ordinary insolvency procedures. But Northern Rock collapsed a year ahead of the other banks, so it collapsed in 2007. What the UK then did was to resolve its own system and have a new Banking Act which enabled it to step in. All it could do with Northern Rock initially was try to bail it out and then eventually all it could do was purchase it and nationalise it. So that gives another example of why some big changes were needed.

The problem however with Banking Union as it stands at present is that it’s very complicated. So asking the question will it work is going to be something which is really going to be one to which we are not too clear about the answer because it depends actually how these new institutions and new procedures are going to develop. The reason we can be rather worried about it is simply that if we are trying to resolve a problem we are going to be involving a whole lot of people. And the way in which the Basel committee and the Financial Stability Board in Basel has gone, is to say that they think there are two possible ways of dealing with this. The first is known as single point of entry and what single point of entry does is it is the home country who is responsible for the parent, the group as a whole, is going to resolve the problem on its own.

So if it does that then it doesn’t have to worry what is going wrong in any of the other countries, it is just that the home country is going to do the whole thing, so they can see that working. The alternative is that you separate the bank out so that for all of the parts which are essential in each of the different countries, the authorities in each of those countries can sort those bits out on their own. So in other words we don't have to worry too much about coordination, everybody can solve their own problems. What the EU is trying to do is somewhere half between those two , it is trying to coordinate what is going on, but it is still going to be the case that the national authorities in each country will actually carry it out. So the question is, is that going to work? The UK and the US think that it won't work; both the UK and the US have agreed to go down the single point of entry route.

So there is obviously going be a slight confusion there where there are banks which run across the UK and across the euro area. But the way in which the single point of entry works is you have got to have enough means of absorbing the losses in the parent, or in automatic systems with each of the component parts of the bank which don't require intervention in each of the countries. So that is going to mean that the structure of the bank has to be organised in a particular way. In the US, that is going to be relatively easy because most bank parents are holding companies. So there is a whole lot of component banks and they are owned by the holding company. So it will be the holding company which issues the debt and therefore you will be able to work out that you have actually got debtholders who can be bailed in. In the UK case, the banks are more complicated and therefore that is going to be more difficult.

One of the other issues of course is simply that this is untried territory, nobody has actually contemplated doing a major bail in. There have been some small bail ins and those have actually been rather difficult and rather contentious. There have been a couple which have been tried in Denmark and it was quite a problem to do that, and they were really something which the Danish authorities were not very happy with at the end of it. So this is asking something new. Maybe it is just not going to be possible to have that sort of size change, and one of the main reasons for this is that the people who are bailed in are going to make losses. You haven't somehow managed to make the losses disappear, somebody is bearing them. If you are bailing out it is the taxpayer who bails them and you spread that out over a large number of years and over the whole of the economy. With a bail in it depends who is being bailed in.

The resolution funds which help the cost of that process are actually quite small, and indeed they can’t be used until you have bailed in 8 percent of the liabilities. Eight percent may sound a magic number, but there is actually a reason behind that, which is that there has to be 8 percent value held by the shareholders. And that therefore has to have been bailed in first, so if you= have got a capital cushion of 8 percent all of that has got to be used up and somebody has got to have stepped in instead before you can then get on and use the resolution funds. So maybe there isn’t enough capacity there.

One of the other problems about the system working is simply the complexity of decision-making. This whole process is complicated and one look at this slide will give you some idea of the sorts of complication. What this slide is looking at is the process which has to be gone through in the period when the bank is closed. So starting at the left-hand side of the slide, this is what you would start doing as soon as the bank closes on Friday night. And you have got to have got not just the right-hand side of this slide, but to have absolutely everything implemented by the time the bank reopens on Monday morning if it is to continue in operation with the essential functions continuing.

So if you look at this you can see that it starts off with the Single Resolution Board telling the Commission what it wants to do, so that is the proposal. And the European Commission has 12 hours to decide whether it is going to object. If it doesn’t object then of course it is possible for the Resolution Board to go ahead. If it does object then there is a next step. As soon as the Commission has objected then the European Council can act. So if the Commission says no it wants a change, then ministers are going to be consulted. And these ministers now have 12 hours. So the Commission had 12 hours whether to decide to object, the ministers now have another 12 hours when they can decide if they want to accept what the Commission has said, or suggest something different. So you have had these two steps, now the Single Resolution Board has got to work out what to do in the light of that, and I ha's got 8 hours to work out what is going to happen.

So you can see that we have got something of the order of 60 hours all together in which to implement what is going to happen. We've now used up over half of that procedure already in decision-making. So you are only left with about 30 hours to complete what is going on. Most people feel that they need the entire time between the Friday evening and the Monday morning if they are going to implement it. So just having this complexity of decision-making means that it is going to be very difficult for the system to work. And you can see that there is actually a second level which there can be objections down the bottom of the page, but we don't need to consider that at this stage, just the generalised points that it is still very complicated here. And until we see how it works in practice it is not at all clear whether this is going to pan out as intended.

The next question I had was: what are we looking at as something which will be a proper Banking Union, what would that look like in the EU? Well you would look at this a rather different way round, you would look at it from the point of view of customers and from the point of view of the banks themselves. So from the point of view of customers they would be able to operate in exactly the same way wherever they are in the EU. So that they would be able to have access to whatever bank they liked and access to whatever services they wanted irrelevant of where they are. But in practice at present the way in which the Banking Union works is it actually as a series of national systems. Although there are cross-border banks, those cross-border banks are operating different systems in each country.

So for example when I was in Norway at the end of last year: I have an account with Nordea Bank in Finland. I can't just use that in Norway, I have to be able to go into a branch in Norway, sort out myself as a new customer and do it again. Even though I am recognised in the system I have actually got to turn up and go through all of the processes. So, in a full Banking Union I would just be able to walk into a branch in Norway and use my Finnish account without any trouble. The same is true for the providers. All of the providers need to compete on an equal basis in all of the countries. And then that is what you would have in any national system, so the EU level system would look like the national one and it doesn't at present.

Also, we have the problem of what would the institutional framework look like, and there are five institutional players which you have to have in a national system. You need a supervisor and regulator, secondly, you need a resolution agency. Thirdly, you need a lender of last resort, the institution that is going to provide liquidity if something starts going wrong. You need a deposit insurer, and then finally, you need the government backstop of the taxpayer if none of this works. So how are you going to translate that into a European level? Well, at present, we have the ECB acting as the supervisor for the euro area, we also have the SRB acting as the resolution body for the euro area.

We have the national banks acting as lenders of last resorts and we have deposit insurers which are different in each of the countries, and we have the different governments. It is only the resolution funds which are pooled, so you are quite some way away from having a neat system whereby there is this hierarchy. And you have each of those five agencies existing at the European level and then implementing what they want through the national agencies at the national level. Also, of course, we don't actually have any examples previously of a multi-currency system, which is what we have in the EU. So it is not just the euro area, there are the other countries who have got their own currencies and of course Liechtenstein, Norway and

Iceland, which also have their currencies. Nobody has tried to put this sort of thing together before, and so we need some sort of institutional arrangement to do that.

So that leaves us with our final questions. Should we complete the Banking Union by harmonising deposit insurance? And should we divide up the activities of banks into the risky parts and the non-risky parts, so that we can resolve the non-risky parts much more readily? So that is the first part of completion which we talked about. Secondly, perhaps we should go further and take a step towards having the ideal system. And this is going to be offered because the UK has said that it wants to have a referendum on whether it should continue as a member of the EU and as a precursor to that it is going to try and get a renegotiation of the treaty.

So the problem so far has been that the treaty couldn't be reopened, now it is going to have to be reopened. Perhaps one can push the supervision and the resolution arrangements into this and have agencies which will cover the whole of the EU.

And lastly, are bail ins realistic as a resolution tool? Is it actually going to be the case that you can bail in all of these people and not have a systemic crisis? Think about the case of New Zealand. Here we don't have deposit insurance, so if you get a bail in, it will be ordinary depositors that are going to be bailed in. Is that actually going to happen? Are governments going to have the strength of mind to impose losses on a large number of their electors? If this is just going to be a threat aren’t in fact you' are just going to cause a crisis straightaway? So the idea that a bail in is going to be triggered is going to introduce exactly the crisis you hoped to avoid.

So this completes video 4 on Banking Union, video 1 considered the single rulebook, video 2 considered the single supervisory mechanism. And video 3, the single resolution mechanism, and this video 4, the problems these pose. So between them, when you have looked at them and you have looked at the backing material which is there, the readings and the suggested ways of going further, and you have looked at the suggested answers to the discussions, you should be in a position where you can now understand what Banking Union is, you can understand why the EU went to the trouble of creating it, and you can see the problems that this system faces. But like all good academics you should also be able to assess how this can go better in future.

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