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European Banking Union – Democracy, Technocracy and the State of Integration

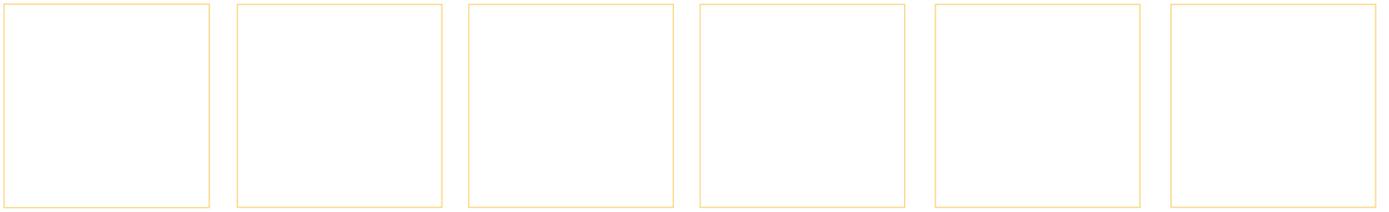
**Conference at the European University Institute
22nd May 2015**

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Highlights

The European Banking Union's institutional structure, democratic legitimacy and future outlook were discussed at a conference organised by the European University Institute on the 22 May 2015. The conference brought together lawyers, economists and political scientists as well as EU practitioners to discuss the nature of the processes that gave rise to the banking union. Its aim was to retrace the decision-making process leading to the Banking Union and to address the trade-off between efficient problem solving, on the one hand, and democratic legitimation on the other. Given the emergence of new conflict lines among and within European Member States (creditors/debtors; pro-centralization/anti-centralization; banks/tax-payers), another central intellectual concern was to understand how the adopted institutional arrangements reflected these frictions, and how they are likely to influence the functioning of the Banking Union in the future.

The Banking Union represents a substantial set of new competencies for the European Union. Building on the diversity of participants' disciplinary backgrounds, the conference hence discussed some of the legal and political issues this delegation of competencies raises. One was the extent to which the Banking Union looks similar or different to the way EU competencies in competition policy have developed and more generally to the regulation of the single market. There were broad concerns about the accountability of the current institutional arrangements, and indeed a lively debate about what the demands of democratic legitimacy entail and how accountability mechanisms could be designed in the case of the Banking Union. Whether the future of the Banking Union involves continued muddling through, or whether it will eventually require a strong fiscal capacity and thus treaty change, was a lively topic of discussion.



Background

In 2012, at the height of the sovereign debt crisis, European decision makers decided that the next step in developing an ever closer union involved the formation of a Banking Union (BU). One important goal of the reform was to break the dangerous link between government debt and national banks buying government bonds to finance this debt. A Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM) followed suit in October 2013 and in June 2014, respectively. The political decision-making that resulted in the two mechanisms involved difficult bargaining. Governments had diverging preferences, particularly with respect to the mutual insurance of bank deposits in case of bank failure, but also as regards the distribution of decision-making competences under both the SSM and the SRM.

The Banking Union was also an attempt to balance the effectiveness of technocratic governance with the necessity of establishing democratic oversight in a multinational polity. The SSM was introduced on the basis of a unanimity vote of Member States. It earned the support of the European Parliament only once the latter had been granted additional powers. In the case of the SRM, the decision-process significantly involves national decision-makers and limited burden sharing as the rescue fund is relatively small (55 billion euros) and will be built up over 8 years. The upshot of the modest SRM compromise is that the ECB is indirectly gaining more relevance, because it is under more pressure to ensure that banks can withstand another shock. Despite the advances made, the overall impression is hence that the EU does not yet dispose of a full-fledged banking union.

1. Technocratic and Centralized Decision-Making in Banking Union

The first panel focussed on the Banking Union's technocratic and centralized decision-making. It retraced the key elements of the process that led to its establishment and discussed the BU's implications from a democratic and constitutional perspective.

Niamh Moloney (LSE) addressed the functional effectiveness of the overall BU architecture, based on recent evidence. She examined recent developments, including the recruitment of over 1000 staff members to the ECB/SSM, the establishment of a number of key systems and procedures (including the critically important Supervisory Review and Evaluation Process (SREP)), the important allocation of banks to direct supervision by the ECB, and the success of the Asset Quality Review, a major test for the ECB. Niamh Moloney underscored, however, that the jury is still out on the effectiveness or otherwise

of the horizontal interaction between the institutional governance of BU and the EU's wider financial governance system for the single market (i.e. the single rulebook and the European System of Financial Supervision, notably EBA) - she warned of the risks of this 'fragile institutional ecosystem.' She pointed in particular to the existence of both arbitrage opportunities and positive competition between the two governance orders for the SSM-zone and the single market. But drawing on recent evidence as to the nature of EBA/ECB interaction she was reasonably confident as to the future success of the two sets of institutional structures and, in particular, as to the likely development of a productive 'axis of technocracy' between the ECB and EBA.

In his intervention, **Hans Micklitz (EUI)** considered the move from the internal market to the Banking Union (BU), i.e. from 'the technical, de-centralised Internal Market programme to the technocratic, financialised, centralized Banking Union' and asked whether its advent constituted an evolution or a revolution. Using the regulation of the internal market as a standard reference, he suggested parameters of comparison (type of crisis induction, actor leading the process, means of implementation, ex ante/ex post nature and harmonisation technique, etc). He underscored that while the internal market relied mostly on harmonization and on decentralized mutual recognition to develop, the BU also includes central institution building. His assessment singled out a differing role for law in the two areas: while the single market is characterised by integration through law and governance, the banking union is so far moving towards enforcement without law. As if Europe were a laboratory, it is now in the search of some quasi-constitutional mechanism to control its new banking union governance, Hans Micklitz added.

2. A Second Step of Integration Through Constitutionalisation? From Competition to Banking Union

The second morning session considered the inherent constitutional dimension of the project, comparing the emergence of a Banking Union to the EU constitution-building after the establishment of the competition order in the 1960s and 1970s.

Relying on a recently published report by a CEPS Task Force on Financial Markets and Institutions, **Karel Lannoo (CEPS)** characterised the Banking Union as 'the biggest step forward in European integration that we have taken in years.' He addressed the current state of financial integration (as measured by cross-border holding of securities and cross-border action in inter-banking markets) and explained that a crucial challenge for the ECB will be to re-establish an integrated market in a context marked by re-nationalisation. As regards the effective-



ness of the SSM, he positively evaluated the first Comprehensive Assessment/Stress Tests exercise jointly conducted with the European Banking Authority: it provided a credible health check of the soundness of Europe’s banking sector and so far the reaction of media and public at large proved positive. Mr Lannoo also pointed at the diversity of the banking sector in Europe (commercial, public and cooperative banks) as a supervision challenge and noted that as the ECB has to oversee some banks which are in the hands of governments, it will be confronted with political problems sooner or later.

Heike Schweitzer (Free University of Berlin) stressed that the Banking Union can be seen as an attempt to translate constitutional norms and principles such as the integrity of the single currency, the internal market for banking services, competition and/or balanced economic growth into concrete rules (i.e. prudential rules; regime of supervision and enforcement). Despite some similarities in enforcement and governance, Mrs. Schweitzer argued that the parallel with competition policy should not be pushed too far. In truth, the Banking Union can be fundamentally narrowed down to a regulatory and managerial approach. It resides in relatively low capital requirements, central supervision and strong discretionary powers of intervention for the ECB. This method should be distinguished from a possible alternative „rule of law approach“ that would see high capital requirements, clearly-cut prudential rules and less, ad-hoc regulation and intervention. Overall, this second model may be more in line with European constitutional principles and might yield better results in terms of competition, she concluded.

Figure 1: Sergio Fabbrini | LUISS Rome



Stefan Grundmann (EUI) discussed what role the Banking Union plays and might play in integration dynamics from positive and normative perspectives. He pointed out that the BU’s big step has been to shift administrative implementation to the central level – thus striving for much more uniformity in detail than could ever be possible under a system of prelimi-

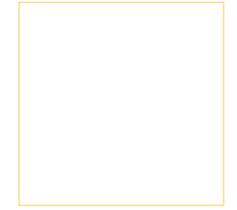
nary reference only. He predicted that with the practices of the SSM and of the EBA (in implementing the single rule book), ‘a uniform and standardized administrative practice more generally for all banks in Europe will emerge’. He recalled that the question of the optimal level of centralization/decentralization was treated in the literatures on federalism and regulatory competition. The findings thereof was that economies of scale, the risk of negative external effects, but also the homogeneity of the legal regime are seen as strong arguments for a decision making at the central level, while deeper information and better experimentation would speak in favour of decentralization. Stefan Grundmann concluded by stating that one should go beyond the analysis of those advantages and disadvantages and strive to combine them in an intelligent order for regulatory competition.

3. Integration without democracy?

The two afternoon panels discussed the consequences of the BU for the overall institutional architecture of the EU, in particular as regards its democratic legitimation.

Sergio Fabbrini (LUISS University) lined out the institutional structure and logic of the Banking Union. He emphasized that the real building blocks of the BU are the SSM and the SRM since a deposit guarantee scheme remains so far in the books. He argued that the SRM set-up was driven by a tension between inter-governmentalism and supranationalism, a clash of institutional logics which is particularly present in European integration since the Maastricht Treaty. Europe thus seems to be left with a new puzzle as integration proceeds in specific policy areas without that implying the traditional supra-nationalization of those areas. This leads the analyst back to the original failed design of EMU: while there is a clear single authority in monetary terms, there is only a coordinated authority (at best) in economics terms. Mr. Fabbrini then turned to the crucial dilemma of accountability in the BU structure. He observed that the EU was acquiring growing executive powers in the financial area without there being credible checks in the system to make these powers accountable to the European Parliament and to national parliaments. In his view, the accountability challenge is reinforced by the absence of an institutionalized political responsibility in the EU polity.

Christoph Möllers (Humboldt University) looked at the democratic implications of the banking union. He lined out two conceptions of democracy: ‘democracy as political contestation’ and ‘democracy as rational deliberation’. He argued that what is problematic in the case of the EU, is the fact that the political process is full of distrust, including inside the European Central Bank. Talking about monetary dialogues, he deemed them only relevant if they would be linked to issues



in which the EP detains legislative or appointment powers. In other words, parliamentary accountability makes sense only if there can be a follow-up. This is why in his view, ‘accountability enables democratic legitimacy but cannot substitute it’. He concluded by underscoring a general tendency in the EU to satisfy the self-interest of all EU institutions to keep its polity legitimate, a trend confirmed by the structure of the Banking Union. Yet, if the granting of veto rights to everyone and the fostering of dialogues creates the appearance that all together the system is legitimate, there is ‘no necessary legitimate value in integrating all the actors’, Mr. Möllers suggested.

Erik Jones (John’s Hopkins University) explained that ‘Europeans have already created a financial system within which institutions and expectations exceed the scope of democratic accountability: that happened more than twenty-five years ago’. Europe’s political leaders thought they could ‘run those risks on the back of a democratic mandate’. Mr Jones thus underlined that democracies have put themselves into a situation that they cannot retreat from easily. No wonder then to see anti-austerity and welfare-chauvinist movements popping up in Europe. Their roots lie in the frustration that the pursuit of versatile financial market integration implies: ‘Northerners have to learn to accept lower rates of return; Southerners have to accept slower rates of growth and development’. Banking union, he argued, provides a convenient escape from this dilemma as it makes the challenges of financial integration more manageable by pooling resources and by stabilizing financial integration. What should be obvious, however, is that they will be winners and losers from financial market integration. Those mutual liabilities are reinforced by the ECB’s unconventional actions which bear distributional consequences. If things go terribly wrong, there will be no banking union to talk about, he concluded.

Johannes Lindner (ECB¹) emphasized the degree of complementarity that the implementation of one of the unions laid down in the “Four Presidents Report” (banking union, fiscal union, economic union and political union) would imply, pointing at the existence of neo-functional spill-overs between them. Mr. Lindner argued that central banks achieve best their objectives if they are insulated from political pressure, because of the time inconsistency problem. Turning to the Banking Union governance, he explained that independence features among the key principles laid down by the Bank for International Settlement (BIS) for effective banking supervision. The sui generis institutional character of the EU and in particular its multi-level governance set a specific environment for the institutional design of the SSM. Describing accountability and independence as “two sides of the same coin”, Mr Lindner went through the accountability mechanisms for the

SSM pointing out also the elements where they go beyond the existing accountability arrangements for the ECB’s monetary policy function. Speculating about the future shape of EMU, he argued that there is an awareness among policy-makers that EMU is an unfinished business and that over the long term, progress in the other unions, including a fiscal capacity and a European Treasury, would probably emerge to further stabilize the euro area.

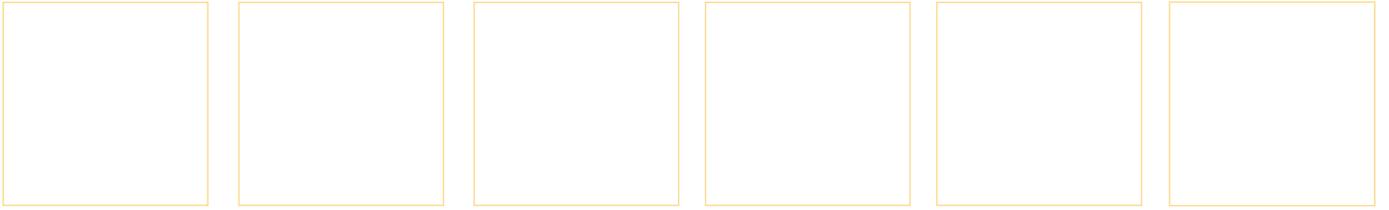
After recalling the key role played by financial services in the UK and in the relationship between the UK and the EU, **Angus Armstrong (National Institute of Economic and Social Research)** explained that in his view, one shouldn’t lose sight of what has been achieved in past years. The discussion about financial stability and central banking goes straight to the core of UK debates where the task of banking supervision has been re-appropriated recently by the Bank of England. The question remains of the consistency with financial stability of two sets of regulations (ESFS and the Banking Union). This is problematic as ‘any lack of integrity (consistency, wholeness) of financial arrangements will be exploited by financial markets’. He expressed his doubts as to whether a bank resolution could really be conducted over a week-end and in secret, given the complex procedure set in the SRM.

4. The Banking Union in 2020

The last panel asked how the political play of power in building the Banking Union is likely to influence its likely functioning and discussed potential dysfunctions of the banking union.

Martin Hellwig (Max Planck Institute for Research on Collective Goods) insisted that Banking Union was necessary to avoid the ECB’s becoming a victim of weaknesses in the banking system that national authorities could not or would not address. Procrastination of national authorities was caused by an unwillingness to have problems come into the open, by connections between politics and banking, and finally, the desire to get indirect access to the printing press as ECB loans in support of weak banks were used to fund weak governments. Mr. Hellwig also pointed to serious open problems: the legal basis is dubious, and European supervision and jurisdiction are in an awkward position when they have to apply national laws implementing the European directives. Rules for cross-border resolution were impractical, and there was a complete lack of provisions for liquidity in resolution. Resolution funds were much too small for that; these funds might be used for covering losses ex post, but not for ensuring interim funding on the order hundreds of billions of euros. Finally, the lack of a fiscal backstop might become a problem in a systemic crisis in which losses exceed the capacity of resolutions funds, including further levies on the industry. He concluded that the Banking

1. Speaking in a personal capacity.

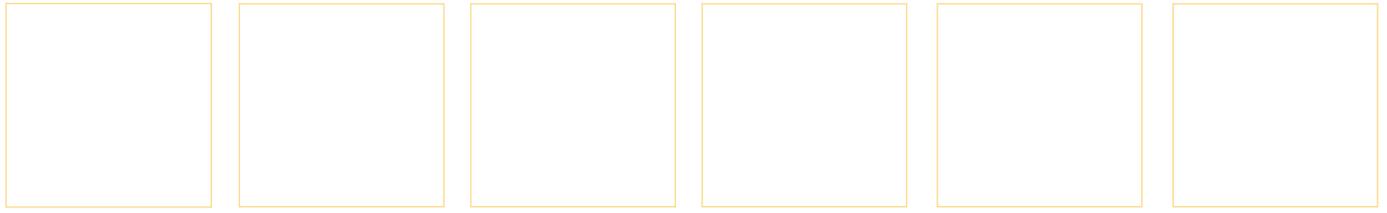


Union will require more legislation, including a Treaty change, in the not too distant future.

Given the numerous institutional and political contingencies at play, **Brigid Laffan (EUI)** stressed the arduous task that it is to give an educated guess about the shape of the Banking Union in 2020. She provided a classification of possible types of European Unions along two dimensions: (1) more or less Europe; (2) more or less adaptation/transformation. Mrs. Laffan then addressed the two possible disintegration processes currently uncovering under our eyes: Grexit and Brexit. She observed that horizontal spill-overs from Tsipras to other leftist parties in Southern Europe seem to have stopped as many parties now tame down their rhetoric, perhaps due to the uncertainty of the Greek situation. While the Grexit prospects remain difficult to assess, she highlighted that the recent electoral landslide by David Cameron would yield better chances of convincing the British people to stay in the EU than the situation before. Mrs. Laffan argued that the overall system remains fragile and in need of further credibility, but that it is by far not as fragile as in 2011-2012 where policy-makers were deeply concerned about the contagion of the financial crisis. Looking ahead and paraphrasing Lindblom, Brigid Laffan explained that the 'euro is still muddling but is not yet through' and hypothesized that Europe would be locked in functional federalism for some time to come.

Figure 2: Martin Hellwig | Max Plank Institute for Research on Collective Goods Bonn





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