SAFEGUARDING THE SINGLE MARKET:
How to achieve a balanced European Banking Authority

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Open Europe
7 Tufton Street
London
SW1P 3QN

Tel: 0207 197 2333
Fax: 0207 197 2307
www.openeurope.org.uk

EXECUTIVE SUMMARY

Proposals for a eurozone banking union, currently being negotiated, could act as a template for how to reconcile further eurozone integration, driven by the on-going crisis, with the interests of all 27 member states. The UK Government and others have acknowledged that, at worst, these proposals could set the stage for a two-tier and fragmented single market. Although the discussion is technical, it is nonetheless of huge political and economic importance – for euro and non-euro members alike.

The UK is home to over 36% of the EU's wholesale finance market,[1] but only accounts for 8.2% or 3.6% – depending on the voting system used – of the voting weight within the EBA's Board of Supervisors. In contrast, Germany accounts for roughly 13% of the market, but enjoys the same voting weight as the UK.[2] This institutional bias against Britain is exacerbated by a proposal which will make the ECB the single supervisor in the eurozone – a structure which non-euro member states will be free to join. The UK will almost certainly remain outside of the new structure.

The eurozone will in future have much a greater incentive to take a common position on banking matters, unlike non-euro countries. First, to avoid free riding on future potential joint backstops for banks, a much greater degree of regulatory harmonisation within the eurozone may be needed, which could spill over to the single market. The eurozone will want to avoid an 'uneven playing field' in the single market. Secondly, the Commission's first banking union proposal envisions the ECB to "coordinate" the position of the euro countries at the EBA, with dissenting opinions actively discouraged. Thirdly, under the EU's new voting rules, the eurozone will have an inbuilt majority in the EBA from 2014.

In effect, if national supervisors within the eurozone agree to follow the ECB's lead, the eurozone's position will either likely (pre-2014) or automatically (post-2014) become the EBA's position, on issues relating to standards for banks, restrictions on financial activities or the EBA's own budget, for example. Therefore, the current proposal will significantly shift the balance of power in favour of the eurozone.

The Commission's proposed safeguards against eurozone caucusing and a two-tier single market are inadequate. Instead, the principle of 'double' Qualified Majority Voting (QMV) should be introduced. At the request of one national supervisor, this would see two separate votes taking place when the EBA considers a key decision: one amongst euro countries and a separate one amongst non-euro members. If a weighted majority (via so-called QMV) cannot be achieved in both groups, the proposal should fall.

This would deter eurozone caucusing and establish a positive principle for how to safeguard the single market in financial services. It should therefore be in the interest of both eurozone and non-eurozone members.

[1] Data from 2008, see *London Economics*, 'The importance of wholesale financial services to the EU economy 2009', City of London, September 2009, p33, http://217.154.230.218/NR/rdonlyres/DF649F73-2F5D-4C3E-AA24-E491A280A9B5/0/BC_RS_ImportanceofWholesaleFStoEUEconomy09.pdf

[2] Germany is set to gain greater voting weight within the Council of Ministers from 2014 (see following sections)

Table 1: Summary of Open Europe's proposal for safeguards

	EC proposal	OE proposal
Technical standards / End of restrictions on financial activities / EBA budget	QMV in Board of Supervisors	Double QMV (one among euro countries and another one among non-euro countries)
Breaches of EU law	Decision by independent panel can be overturned by simple majority in Board of Supervisors (with at least three votes from non-banking union countries)	Decision by independent panel has to be confirmed by double QMV, if one country requests it
Dispute settlement	Decision by independent panel can be overturned by simple majority in Board of Supervisors (with at least three votes from non-banking union countries)	Decision by independent panel has to be confirmed by double QMV, if one country requests it
Appointment of members/substitutes of independent panel	Preferably consensus, otherwise three quarters majority in Board of Supervisors	Three quarters majority in Board of Supervisors, including at least three quarters of non-euro/non-banking union members
Decisions within the independent panel	Subject to adoption of rules of procedure, but currently majority (i.e. two of three members)	Broader panel, composed of nine members (EBA Chairperson, five 'ins' and three 'outs'). Decisions possibly taken by unanimity

1. Background

With a view to establishing a 'banking union' for the eurozone, eventually meant to include a joint backstop for banks (i.e. a joint resolution fund and deposit guarantee scheme), the European Commission tabled two separate proposals in September:[3]

- A regulation to make the ECB the supervisor for "all" banks in the eurozone – the so-called Single Supervisory Mechanism (SSM) – with non-euro countries allowed to join if they wish.

- A regulation making adjustments to the EBA in light of the new powers of the ECB, with the objective to avoid the banking union fragmenting the single market. This is the one we look at below.

2. The current role of the EBA

The EBA currently has the following powers:

Decided by Qualified Majority Voting (QMV), where votes are weighted based on each country's size:

- Technical standards (binding);
- Recommendations and guidelines (non-binding);
- End of restrictions on financial activities;
- EBA budget.

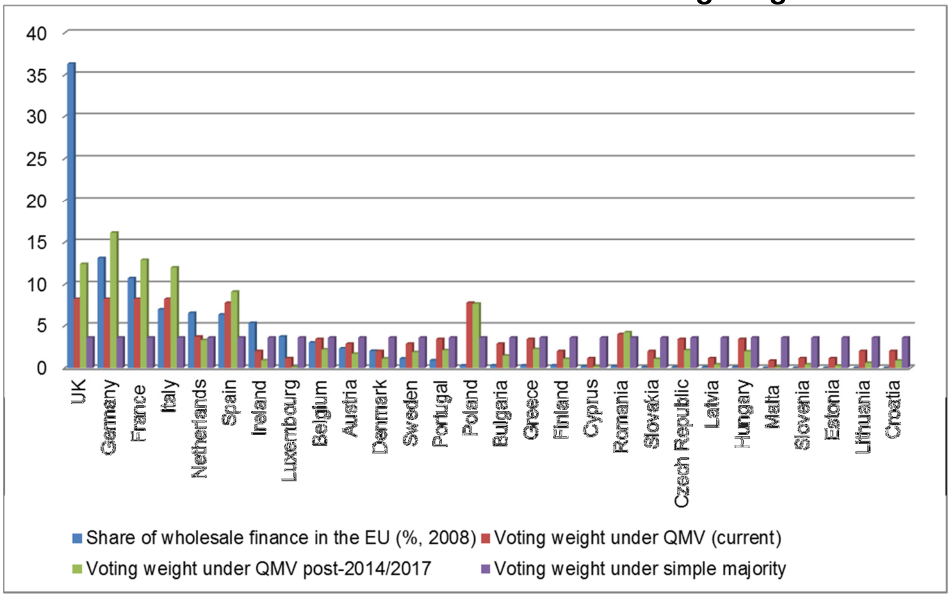
[3] The proposals are available on the European Commission's website, see http://ec.europa.eu/internal_market/finances/committees/index_en.htm

Decided by simple majority:

- Breaches of EU single market rules;
- Measures adopted to tackle 'emergency situations';
- Settlement of disputes between national regulators;
- Composition of the EBA's Management Board.

With respect to voting weights, the UK is massively under-represented within the EBA relative to the size of its financial sector – as the graph below illustrates. The UK controls over 36% of the EU's wholesale finance market, but only has 3.6% of the votes within the EBA's Board of Supervisors under simple majority and 8.2% under QMV (under the pre-2014 rules, but after Croatia's entry). In contrast, Germany has 13% of the market, and France 10.7% – but both have the same voting weight as the UK at the EBA (and will have greater weight under post-2014 rules).

Graph 1: Share of wholesale finance in the EU versus voting weight at the EBA



Therefore, the EBA is a perfect illustration of the potential economic benefits of a 'single rulebook' for financial services pitted against the potential drawbacks for the UK of loss of control over a key economic sector. Clearly, the EBA can benefit the City of London and the UK economy by stamping out protectionist or diverging implementation of EU financial services regulation, and drafting sharp technical standards. But if that does not happen, the UK is hugely exposed to unwanted financial rules. Crucially, the proposed banking union set up – and the eurozone crisis – increases the risk of the latter happening.

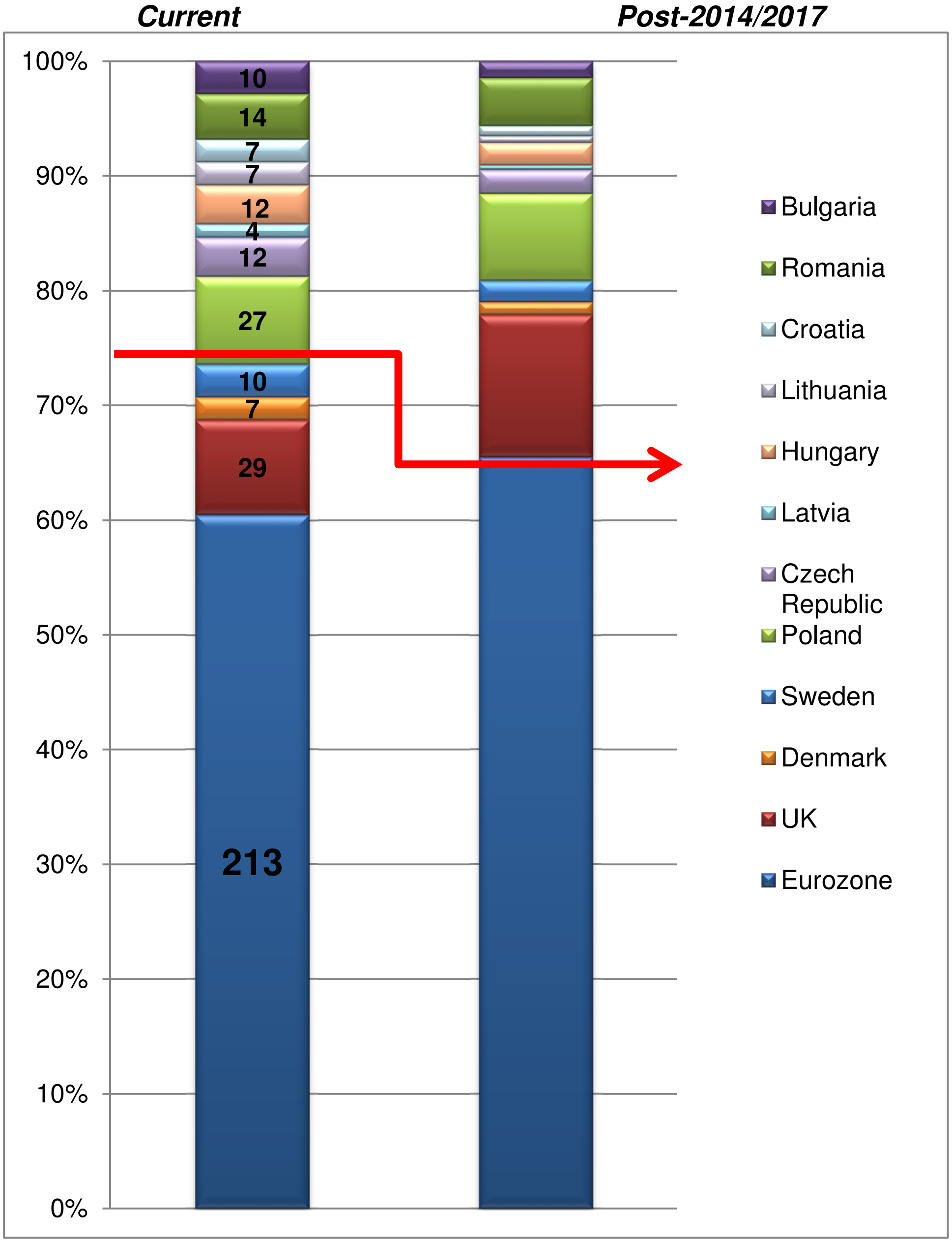
3. The risk of eurozone caucusing

The eurozone already has a majority at the EBA in those instances where simple majority applies. With the help of a few countries it could also quite easily muster a majority under the current QMV rules. From 2014, the eurozone will also gain a permanent *qualified* majority of the votes within the EBA (mirroring the voting system in the Council of Ministers) – although until 2017 the current rules would apply for a vote if one EU member state requests it. Regardless of the system, it is clear that, if the voting weights are kept unchanged, every time the eurozone votes as a bloc, the eurozone's decision will likely become the EBA's decision. This could cover decisions on technical standards, restrictions on financial activities (which may, in future, include short-selling), the size of the EBA's budget and key appointments, for example.

This is critical for two key reasons:

De facto incentives to take a common euro position: To avoid banks free-riding on taxpayers in creditor countries, the ECB, Germany and others could well insist on putting into place perfectly harmonised eurozone regulations before moving to financial backstops. This could include single-target capital requirements, rules on leverage or bonuses – and could even spill over to market access issues. In turn, this would heavily shape decisions at the EBA, as the eurozone is unlikely to accept an uneven playing field within EU financial services as a whole.

Box 1: Current vs. post-2014/2017 QMV voting weights



Under present rules, a 'qualified majority' requires 260 votes out of 352 in the Council of Ministers.[4] *At the moment, the eurozone can muster 213 votes – meaning that the eurozone could obtain a qualified majority with the help of a few non-euro countries. After 2014, when the rules change (as specified by the Lisbon Treaty), a qualified majority would require 65% of the EU's total population, which the eurozone would muster on its own (it would have around 65.5%).*[5] *In other words, the eurozone would have a permanent majority.*

[4] After Croatia's EU entry, due in July next year. The threshold is currently 255 votes out of 345
[5] Based on *Eurostat*, 'Population at 1 January 2012', http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tps00001&plugin=1 – Data for certain countries are still provisional

De jure incentives to take common position: This incentive is reinforced by the way the Commission's ECB/EBA Regulations are currently drafted. For example:

- The ECB Regulation envisions the ECB acting as a coordinator of eurozone national supervisors, with the view for them to take a common position. The ECB has already dropped hints that it intends to actively discourage dissenting opinions amongst eurozone national supervisors.

- Through a eurozone caucus, some member states will indirectly boost their influence as their voting weight amongst eurozone countries is proportionally much greater than in the EU-27 (EU-28 with Croatia). This is particularly true of the larger eurozone member states.

- The safeguards proposed by the European Commission (see Section 5 below) leave the eurozone with the upper hand. Given that the 17 eurozone countries already constitute a simple majority, these countries would only need to seek the support of three 'outs' – whereas non-euro countries would need at least four countries.

Taken together, the EBA structure will therefore significantly shift the balance of power in favour of the eurozone, at the expense of the UK and other 'outs'.

4. Will non-euro countries take a common position?

At the same time, non-euro members will not have the same incentive to act jointly as those sharing the single currency – the structures of their banking sectors differ radically and most consider themselves euro 'pre-ins', at least politically. The table below illustrates the diverging interests:

Table 2: The diverse interests of the non-euro countries

Country	Legally obliged to join the euro?	Will it join banking union?	Characteristics of banking system
UK	No	No	Global financial centre
Poland	Yes	Not under current proposals but likely later	Underdeveloped financial sector, significant eurozone ownership of banks
Sweden	Yes (but voted 'No' in referendum)	Not under current proposals	Regional centre of well-capitalised domestic banks
Czech Republic	Yes (but current government is opposed)	No	Strong banking system, with domestic and foreign owned banks
Denmark	No	Not under current proposals but likely later	Banking sector stable following state bail-outs, close ties to eurozone
Bulgaria	Yes	Unclear (but central bank is against)	Banking sector largely owned by eurozone banks
Romania	Yes	Possibly (central bank in favour, government more cautious)	Domestic banks heavily dependent on foreign finance from the eurozone
Hungary	Yes (but current government is opposed)	Not under current proposals	Financial sector dominated by foreign (eurozone) ownership
Latvia	Yes (and keen to join)	Likely	Stable, less significant eurozone ownership of banking sector
Lithuania	Yes	Not under current proposals	Weak banking system, depending on foreign (Swedish) finance

5. The Commission's solution will not be enough to safeguard the single market

In its proposed EBA amending Regulation, the Commission acknowledges the above problem and proposes that for mediation decisions and breaches of EU law:

- A new 'independent panel' of experts is created by the EBA to judge on breaches of EU law i.e. when a country breaks single market rules or when two "competent authorities" (of which the ECB could be one) disagree on whether rules have been breached.

- The panel's decision could be over-turned by a simple majority at the EBA's Board of Supervisors, which needs to include at least three votes from non-euro members (if they have not opted in to the banking union) and three votes from euro members.

The safeguards envisaged by the European Commission look inadequate. First, the principle of a committee decision followed by reversed majority still makes it very difficult for non-euro countries to block discriminatory EBA decisions (while strengthening the powers of the EBA, and multiplying the effect of potential eurozone caucusing at the EBA).

Secondly, other areas, notably including binding technical standards, are subject to virtually no safeguards at the moment, but could well be subject to eurozone caucusing. This has already happened in some cases. For example, it was the ECB who developed the macro-economic and sovereign shock scenarios and parameters then used by the Committee of European Banking Supervisors (CEBS, the predecessor of the EBA) to carry out the 2010 EU-wide bank stress tests.[6]

6. The fair solution: Double QMV?

As Open Europe suggested in a report published last December – foreseeing the developments surrounding the banking union – the principle of "double" qualified majority should be introduced.[7] At the request of one national supervisor, a decision should be subject to two separate votes: a qualified majority vote amongst the 17 eurozone countries and a separate qualified majority amongst non-euro countries. If a qualified majority is not achieved in both groups, the proposal will fall.

Under this 'safeguard', in addition to a qualified majority amongst national supervisors of eurozone countries, a qualified majority would also be needed amongst the non-euro supervisors to endorse a position already agreed by the eurozone block. If this system were to be introduced, a blocking minority in the 'non-euro' group under the existing Nice Treaty voting weights would require 36 out of 139 votes (see Box 2).[8]

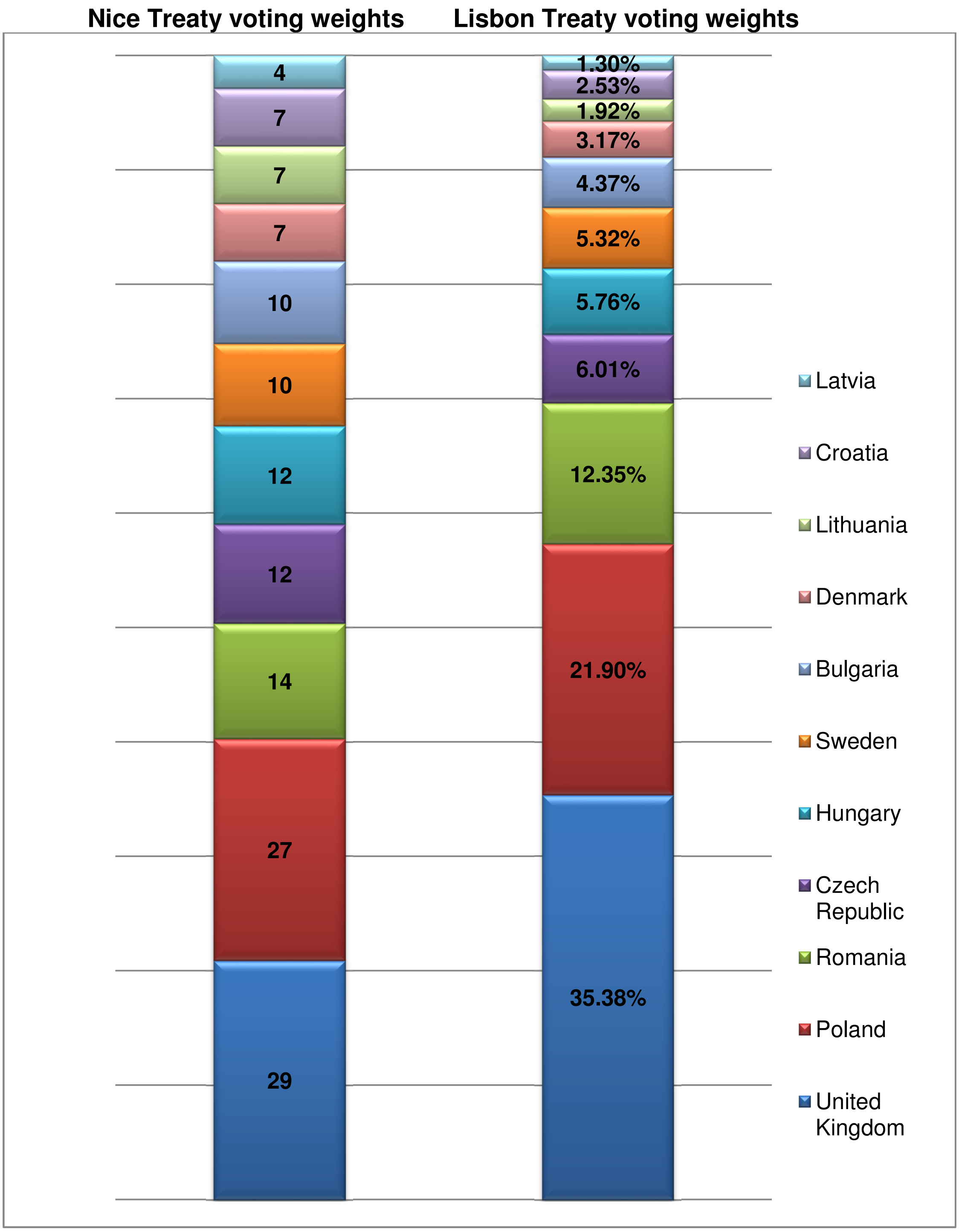
Under the Lisbon system, a blocking minority in the non-euro group would require at least 35% of the EU's total population, and would have to include at least two member states.[9] Therefore, under either scenario the UK would need support from at least another country to set up a blocking minority.

For EBA decisions, this voting procedure should apply to technical standards, budget matters and restrictions on financial activities. For mediation and decisions on breaches of EU law, instead of a decision by the independent board only being over-turned by reversed simple majority, the decision would, in exceptional circumstances, have to be *confirmed* by a double QMV (at the request of one national supervisor) or it would fall. In addition, a broader

[6] See *CEBS*, 'Questions & Answers. 2010 EU-wide stress testing exercise', http://www.eba.europa.eu/cebs/media/2010Stress/QAs.pdf
[7] *Open Europe*, 'Continental Shift: Safeguarding the UK's financial trade in a changing Europe', December 2011, http://www.openeurope.org.uk/Content/Documents/Pdfs/continentalshift.pdf
[8] Including Croatia. The current threshold is 34 out of 132 votes
[9] Article 238 TFEU reads, "A blocking minority must include at least the minimum number of Council members representing more than 35% of the population of the participating Member States, plus one member, failing which the qualified majority shall be deemed attained"

panel of independent experts should be explored, on which decisions could potentially be taken by unanimity. The summary of our proposed safeguards can be seen in Table 1.

Box 2: Additional qualified majority vote for the 'non euro' states



It is true that this is unprecedented legally. However, reversed qualified majority already exists, without legal grounding treaties. In addition, the new voting system only applies to the EBA – not the council – which may make it legally justifiable.

Is this politically possible?

It is likely that this proposal will generate resistance in some national capitals, given that double QMV will act as an effective non-eurozone veto on EBA decisions and give the UK a powerful voting position in that group. However, first, the UK will have a veto over the proposed ECB regulation and therefore leverage in negotiations. Secondly, this could serve as a huge incentive to create a good working relationship between the ECB and the Bank of England, as agreement between the two will be vital to avoid a standoff between euro and non-eurozone supervisors at the EBA. Finally, though some of the non-euro countries – including Poland and Denmark – are likely to join the SSM, this should serve as a guarantee that the single market will not be artificially divided, a main concern for these countries. Additionally, it is not in the interest of most EU countries to drive a wedge between the UK and a banking union, as it could risk pushing Britain closer to the EU exit door. There could also be language inserted, obliging all supervisors to exercise this mechanism responsibly and only in extraordinary circumstances.