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Witnesses: Georg Boomgarden

Mats Persson, Philip Whyte

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Members present

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

Examination of Witnesses

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 euro zone?

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 her to take over supervision herself 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 euro zone. What about those that are not in the euro zone? Will the supervisors have a natural bias, as their job is protecting the euro zone, 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 euro zone/non-euro zone. There are dividing lines, particularly north/south, inside the euro zone. There are also a lot of interests that we in Germany share with non-euro zone members that we may not share with those who are inside. So Euro zone 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 euro zone members and those non-euro zone 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-euro zone 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 subsidiary. 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 decision 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 Boomgaarden: 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 euro zone 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 euro zone. 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 for 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 that are exceptions.

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 legitimation. 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 on 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 euro zone members have much more in common with each other than they do with non-euro zone 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 euro zone and non-euro zone 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 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 euro zone. 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 euro zone and non-euro zone 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 premises 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, 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, to just harmonise 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.

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; secondly, 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 euro zone. 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 euro zone. 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 euro zone 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 starts 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 euro zone 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 euro zone. 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 trying to get my head round 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 bail-in 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 euro zone 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 euro zone account for about 95% of total banking assets. When you are talking about the euro zone 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 euro zone 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 the baby 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 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 euro zone 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 euro zone 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 will be much keener to close down, say, an insolvent German Landesbank than the German authorities necessarily will be.

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 European MPs. 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 euro zone 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 but an attempt to square the circle, in that you might have certain non-euro zone 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 euro zone-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 euro zone, if they are to join the banking union they clearly want to have some sort of active decision-making.

Q199 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 euro zone 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 euro zone. 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.

Q200 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 euro zone 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 euro zone 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-euro zone 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 euro zone 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 euro zone 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 put into question and there might be more of an incentive for firms to relocate inside the euro zone. 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.

Q201 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 block 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.

Q202 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 euro zone caucusing. We proposed in a report last December the principle of a double qualified majority, where you would have one vote among the euro zone bloc and a separate vote among the non-euro zone 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 euro zone integration in financial services and banking with the EU single market, which remains the property of all 27 member states. Those are the kind of proposals that we have to look at.

Q203 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?

Q204 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 the lack 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 to actively 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 euro zone.

Q205 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 that 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.

Q206 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 begin 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 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 euro zone 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 euro zone level. If you are talking about the stability of the euro zone, 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.

Q207 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 euro zone 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 euro zone, 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.

Q208 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 euro zone 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 regular 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 White to respond to all that.

Q209 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. First, 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 euro zone, 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 euro zone 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 euro zone. They will make sure that euro-denominated business has to take place in the euro zone. 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 euro zone.

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 euro zone 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 euro zone is

not in the interests of either the euro zone 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.