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What a banking union means for Europe

By Philip Whyte

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★ If the eurozone is to become a more stable currency union, key policy functions relating to banking will have to be transferred from the national to the European level.

★ Political realities mean that only a partial federalisation of banking supervision is in prospect in the short term. For the time being, functions such as resolution and deposit protection will remain national responsibilities.

★ The resulting institutional configuration will not solve the problem it is intended to tackle – that is, to break the lethal interaction between weak banks and weak sovereigns inside the single currency.

★ The partial federalisation of banking supervision could, however, drive a wedge between the eurozone and the EU-27 by relegating eurozone outs to the status of second class citizens inside the EU.

★ The prospect of being side-lined in key EU bodies poses particularly large questions for the UK, which is host to Europe's largest financial centre and its most eurosceptic government.

During the eurozone's first decade in existence, few observers would have expected it to become a threat to financial stability or to the integrity of the EU-27. All this has now changed. Since 2010, it has become clear that flaws in the eurozone's original design actually amplified the shock imparted by the financial crisis. And it seems increasingly likely that the integrity of the EU-27 may have to be sacrificed if the flaws in the single currency's design are to be corrected. No issue has brought these difficulties into sharper relief than current discussions on forming a banking union. This essay consequently tries to answer two questions: first, can Europeans form a banking union that turns the eurozone into a more stable currency union; and, second, at what cost to the EU-27?

The essay starts by asking why the aftermath of the financial crisis has proved so much more troubled in the eurozone than in the US. The answer, it argues, is that the eurozone is a more decentralised monetary union: key functions that are carried out at federal level in the US are undertaken at national level in the eurozone. If the eurozone is to become a more stable arrangement, these functions will have to be transferred to federal level. The term 'banking union' refers to four such tasks: banking supervision, bank resolution, bank recapitalisation and deposit protection. An important question is whether each of these elements needs to be federalised to turn the eurozone into a more stable currency union. The lesson from the US is that it is more important for certain tasks to be federalised than others.

Political realities dictate that the eurozone will start with the partial federalisation of one function (banking supervision), while leaving other ones (like resolution and deposit protection) at national level for the time being. Such a configuration would be at best embryonic – further federalisation would be needed to stabilise the eurozone and its financial system. Even an initially incomplete banking union, however, will do just enough in the short term to make life very difficult for EU member-states that do not (yet) belong to the single currency. The risk is that the new arrangements transform them into 'policy-takers' rather than policy-makers. Nowhere does this possibility provoke more disquiet than in the UK, which is host to Europe's largest financial centre and its most eurosceptic government.

Why does the eurozone need a banking union?

The US and the eurozone are two very different monetary unions. The US currency union is embedded in a fully-fledged federation; the eurozone, in a much more decentralised confederation. Myriad functions that are performed at federal level in the US are consequently carried out at state level in the eurozone.[1] This institutional difference has had a critical impact on the way the two monetary unions have fared since the global financial crisis in 2008. Its policy response to the financial crisis may not always have been optimal, but the US's federal set-up has unquestionably been a factor for stability. In the eurozone, the reverse has been the case: its decentralised configuration has actually amplified the initial shock, transforming a financial crisis into an existential crisis for the single currency.

Why has the eurozone's institutional design proved so much less stable than the US's? The answer is that banks and the states in which they are based interact very differently inside the eurozone than they do in the US. In the eurozone, the stresses and strains of the shared currency are borne individually by the member-states, not collectively by a federal centre. The eurozone, for example, has no federal budget to speak of. Public debt is overwhelmingly issued by the member-states. Fiscal backstops to banks are national. And the eurozone has no federal agency to resolve banks or protect bank deposits, like the Federal Deposit Insurance Corporation (FDIC) in the US. The eurozone's decentralised nature reflects the fact that the bonds of solidarity between its states are weaker than they are in the US.

The European Central Bank (ECB), meanwhile, has been more conflicted than the US Federal Reserve when acting as a lender of last resort to governments and banks. Its hesitancy in relation to governments reflects legal constraints (perceived or real), as well as German hostility to anything that smacks of monetary financing. Its caution in relation to banks reflects unease about the terms on which it often has to intervene. The ECB has no influence over whether insolvent institutions are wound up or restructured, and the member-states with fragile banks have strong incentives not to wind them up and to try and shift costs on to the ECB (and hence, ultimately, on to other countries).[2] Neither the lender of last resort nor the resolution functions work as smoothly in the eurozone as they do in the US.

All this has had major consequences. The most dramatic has been the emergence of 'death spirals' inside the eurozone. These spirals, which have no counterpart in the US, arise because the eurozone's structure locks states and 'their' banks in a potentially deadly embrace. Since fiscal backstops are national, individual states can be pushed towards insolvency by bank rescues (as happened in Ireland). Since they do not fully control the currency in which they issue their debt, financial markets start treating such states as if they had issued it in a foreign currency.[3] The resulting rise in borrowing costs pushes states closer to insolvency – weakening domestic banks on the asset side (because of their large exposures to home country sovereign debt) and the liabilities side (owing to depositor flight).

The eurozone's institutional configuration, then, has turned out to be much less stable than the US's. Despite chronic political dysfunctions at its very centre (like the collapse of bipartisanship in Congress), the US has managed the aftermath of the crisis far better than the eurozone. The underlying reason is that post-crisis policies were implemented by federal bodies, and that these bodies were symbols and guarantees of states' commitment to the union. In the eurozone, by contrast, the dearth of federal bodies and instruments has highlighted the limits of its member-states' commitment to each other and to their shared currency – with damaging results on the way the currency union works. The eurozone's decentralised structure may reflect underlying political realities, but it has turned out to be highly unstable.

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A banking union is best understood as a solution to some of the flaws that the financial crisis has exposed in the eurozone's design. Its purpose is to put an end to the volatile and destabilising way in which weak states and weak banks interact. Any set of measures that fails to break this lethal interaction will not have achieved its purpose. Far from being an obscure technocratic fix, the formation of a banking union is a deeply political exercise. If it is to work better and doubts about its future are to be dispelled, the eurozone is going to have to become more like the US – a currency union with more federal properties than it has at present. This means handing control of key instruments to European institutions – something that many countries are reluctant to do.[4] Unsurprisingly, the details are highly contentious.

1: Philip Whyte, 'The eurozone and the US: A tale of two currency zones', CER Insight, November 21st 2011.

2: Charles Wyplosz, 'Banking union as a crisis management tool', *VoxEU*, October 16th 2012.

3: Paul De Grauwe, 'Managing a fragile eurozone', *VoxEU*, May 10th 2011.

4: Philip Whyte, 'Alice in euroland: What political union for the single currency?', CER Insight, October 9th 2012.

What should a banking union consist of?

In June 2012, the president of the European Council, Herman Van Rompuy, submitted a plan to put the eurozone on a more stable long-term footing. One of its central proposals was to establish an 'integrated financial framework' – a bureaucratic formulation for a banking union – consisting of four elements: a common authority to supervise the banking system; a European authority to restructure or wind up banks that run into difficulties; a common deposit protection scheme; and a joint fiscal backstop.[5] This list prompts two questions. First, which elements are the most important to break the vicious spirals that debilitate the eurozone? Second, are all of them necessary or sufficient? A good way to answer these questions is to look again at the US, where such spirals do not arise.

The first lesson from the US is that it is quite possible to have a stable currency union without having a single supervisory authority for the banking system. The US supervisory system is notorious for its myriad bodies with overlapping and sometimes conflicting responsibilities. The reason for this fragmentation and complexity should be familiar to Europeans: "state governments have been reluctant to cede power to federal agencies, while changes in legislation have increasingly allowed financial institutions themselves to operate on a federal basis".[6] The US system imposes large costs on the banks and other firms that are supervised – and its design may not produce the best outcomes. But its awkward structure has not provoked vicious spirals in which weak states and weak banks undermine each other.

The second lesson is that a monetary union is more stable if it has a collective fiscal backstop to the banking system. The reason the US state of Delaware was not pushed into a sovereign debt crisis after 2008 is that responsibility for bailing out AIG – a systemic institution that had recklessly written credit default insurance to countless banks across the world – fell to taxpayers across the US, not just local taxpayers in Delaware. In the eurozone, responsibility for rescuing banks was left to individual member-states acting separately. This was what pushed a country like Ireland, which was home to banks that were too big for it to save, into a sovereign debt crisis. The absence of a joint fiscal backstop to the banking system has, then, been a leading trigger of vicious spirals inside the eurozone.

The third lesson is that it is highly desirable for a currency union to have a common framework, administered by a federal agency, for 'resolving' weak banks. In the US, this task has been undertaken very effectively by the FDIC, which has wound up close to 450 insolvent banks since 2008.[7] In the eurozone, which has no counterpart to the FDIC, a large number of insolvent banks that should have been liquidated have been kept alive as 'zombies' by policies of regulatory forbearance at national level and cheap ECB funding at eurozone level. The provision of liquidity support to banks that are probably insolvent has sapped trust between the ECB and the national authorities who should have wound such institutions up. It has also stoked controversy about the ECB's role as lender of last resort.

The fourth lesson is that a currency union not backed by a common deposit protection scheme is more vulnerable to bank runs. In addition to highlighting the weakness of solidarity between its member-states, the absence of a eurozone-wide scheme does two further things: it increases the risk that one of the national schemes will be exhausted; and it gives national authorities the freedom to pursue policies that destabilise neighbours in times of crisis (as Ireland did in late 2008 when it raised the amount by which deposits were insured well above its neighbours). The US is less vulnerable to bank runs because it has a federal-wide scheme run by the FDIC, the institution responsible for resolving banks. The FDIC's twin functions send the message that the body that winds up banks also protects depositors.

"A comprehensive banking union is necessary, if the eurozone is to become a more stable monetary union."

The US example suggests that the most important elements of a banking union are the resolution and recapitalisation functions, followed by deposit protection. It also suggests that the structure of the supervisory system is not the most important of the four elements in forestalling the vicious spirals that debilitate the eurozone. A single supervisory authority may still have a purpose for the eurozone, but it is primarily political: countries that may have to contribute to bank rescues outside their borders naturally want some control over the way in which banks in other countries are supervised and run. It should be clear, however, that a single supervisory authority without the other elements would not amount to a banking union proper and would not turn the eurozone into a more stable currency union.

A comprehensive banking union is necessary, then, if the eurozone is to become a more stable monetary union. But even the establishment of a fully-fledged banking union will not be enough to make the eurozone as stable a monetary union as the US. One reason is that it will still

5: Herman Van Rompuy, 'Towards a genuine economic and monetary union', European Council, June 26th 2012.
6: Howard Davies and David Green, 'Global financial regulation: The essential guide', Polity, 2008.
7: Gillian Tett, 'America's lessons in killing toxic banks', *Financial Times*, July 16th 2012.

be more vulnerable to redenomination risk: even a pan-regional deposit protection scheme will not necessarily stem runs (or 'jogs') on banks based in countries that are thought to be at risk of leaving the eurozone. Another reason is that in the absence of federally-issued debt (a 'Eurobond'), banks in the eurozone will continue to be highly exposed to the debt of the state in which they are domiciled. Federally-issued debt would diversify banks' balance sheets by giving them exposure to a greater variety of underlying issuers.[8]

The June 2012 summit and its follow up

Ever since the Greek sovereign debt crisis broke out in late 2009, the laborious pace of European politics has struggled to keep up with the frenzy of financial markets. Policy-makers have consistently appeared to be 'behind the curve'. The summit of June 2012 seemed to mark a turning point. The period of relative calm that has prevailed in financial markets since that date rests on two perceptions: that the eurozone is now backed by a central bank that has shed some of its inhibitions about acting as a lender of last resort to governments; and that eurozone member-states are now committed to breaking negative feed-back loops between weak banks and weak sovereigns. One factor contributing to the latter perception was the commitment to consider forming a banking union "as a matter or urgency".

On September 12th, the European Commission published three documents designed to give effect to this commitment: a Communication setting out a road map for the creation of a banking union; a proposed regulation creating a 'Single Supervisory Mechanism', in which the ECB would play a key role; and a proposed regulation to adapt the European Banking Authority (EBA) to the creation of the Single Supervisory Mechanism. Unlike the Van Rompuy report in June, the Commission did not propose to federalise all the functions of a banking union – supervision, recapitalisation, resolution and deposit protection – immediately. This largely reflected Germany's insistence that the other pillars of a banking union could not be established before the first had been created and proved itself.

Two broad areas of controversy have emerged during discussions of the Commission's plan. The first (discussed later in this essay), has been how to reconcile the interests of the eurozone with those of the single market: EU member-states that have not (yet) joined the single currency fear that a more integrated eurozone core will become a caucus that effectively dictates policy to the rest of the EU. The second area of disagreement has centred on the ECB's supervisory writ. A number of countries, Germany among them, have opposed the Commission's proposal that the ECB should take over responsibility for directly supervising all 6,000 banks in the eurozone. They have argued that it would be impractical to do so, and that the ECB should supervise only a small number of systemic banks.

The compromise reached by European leaders at a summit in October was that the ECB should have ultimate responsibility for supervising all banks in the eurozone, but that it would only have day-to-day responsibility for supervising a small number of mostly large banks. Day-to-day responsibility for supervising the overwhelming majority of relatively small banks would remain with national authorities, although the ECB would have the right to step in if necessary. Member-states have since been discussing the details of what they agreed in October: exactly which banks the ECB should have day-to-day responsibility for supervising (the probable number seems likely to settle around 60 banks); and the terms on which the ECB should engage national supervisory authorities when it needs to.

> *"When European leaders committed themselves in June to consider forming a banking union, the sense of urgency was palpable."*

When it submitted its proposals back in September, the Commission's ambition was for member-states to agree the detail of the Single Supervisory Mechanism before the end of 2012, and for the system to be operational by the middle of 2013. Nothing has happened since to alter the initial suspicion that this target erred on the side of optimism. At the time of writing (in early December 2012), several issues had still to be resolved. The ECB was fighting to counter efforts to restrict its legal authority over eurozone banks; some eurozone outs, like Sweden, were talking of the need to amend the EU treaties to make sure they would be treated equitably under a banking union; and a group of countries was stressing the importance of getting the agreement right, as opposed to reaching it by an unrealistic date.

When European leaders committed themselves in June to consider forming a banking union, the sense of urgency was palpable. Sentiment in financial markets was febrile and leaders recognised that a strong show of political intent was needed if doubts about the eurozone's long-term survival were to be dispelled. With financial markets becalmed since then, that sense of urgency has gradually receded. The risk that the Commission's end-year deadline will not be met is not

8: Simon Tilford and Philip Whyte, 'Why stricter rules threaten the eurozone', CER Essay, November 2011.

the only problem. Even if that deadline is met, progress on other critical issues is still needed if the eurozone is to be placed on a more stable footing. Two of these issues are crisis management and the final design of the banking union. On both of these issues, the June summit turns out to have been studiedly ambiguous.

A close reading of the summit's conclusions shows that European leaders committed themselves to two things in June. The first was to consider establishing a banking union. Unlike the Van Rompuy report, however, they did not specify what such a union should consist of – should it be limited to the formation of a Single Supervisory Mechanism, or should it also consist of other elements too? The second commitment was arguably even vaguer. European leaders declared that once the Single Supervisory Mechanism had been established, the European Stability Mechanism (ESM) "could have the possibility to recapitalise banks directly". Ever since June, eurozone member-states have been arguing about what these twin commitments entail for crisis management and the final design of the banking union.

Managing the crisis and completing the framework

One set of countries, led by Germany, effectively argues that the commitments entered into in June were modest. All that the June summit said was that the Single Supervisory Mechanism has to be established before anything else can happen. This does not mean that functions like deposit protection will necessarily be federalised once the ECB assumes responsibility for supervising banks. Nor is it an agreement to 'Europeanise' crisis management. The purpose of a banking union is preventative, not corrective: it is to forestall problems arising in the future, not to resolve problems inherited from the past. Fiscal costs needed to be borne where policy failures actually arise. To do otherwise would be like agreeing to pay out to an individual who only took out insurance after the event.

Another group of countries – France among them – interprets the conclusions of the June summit quite differently. For this group, the purpose of the summit was to persuade financial markets that eurozone member-states were serious about breaking the lethal interaction inside the single currency between weak banks and weak sovereigns. This means two things. First, it is not enough to build a banking union 'lite' – all the banking union tasks identified by the Van Rompuy report eventually need to be federalised. Second, legacy issues have to be dealt with collectively. Financial markets would react badly if it transpired that the establishment of a Single Supervisory Mechanism was just a delaying tactic and that weak banks in, say, Spain will not be directly recapitalised by the ESM.

As has often been the case during the eurozone crisis, it is hard to know how much such arguments owe to principle and how much to brinkmanship. In an ideal world, Germany would obviously like legacy costs to be borne solely by private-sector creditors and by taxpayers in countries where policy failures occurred. But this line may be harder to sustain in the real world: not only could unresolved problems in one part of the monetary union spill over elsewhere, but a Spanish sovereign debt crisis would threaten financial stability across the eurozone and impose costs that would be shared by all. Germany's current opposition to using ESM funds to recapitalise banks may therefore soften. (One interpretation is that it is trying to exert pressure on Spain before ESM funds are released to Spanish banks.)

"It is hard to know how much such arguments owe to principle and how much to brinkmanship."

It may be difficult, then, to completely subordinate crisis management to institution building. If the ESM is used to recapitalise banks directly, the eurozone will effectively have created the foundations of a joint fiscal backstop to the banking system. The ESM, however, would not be large enough to reassure financial markets in the event of a large-scale crisis. Over the longer term, the eurozone would need to develop a larger collective fiscal capacity to backstop the banking system. One option would be to create a common bank resolution fund, which might be funded by ex ante contributions from the banking sector. Another would be to develop a contingent taxation capacity at eurozone level.[9] Such options, however, are well beyond the outer reaches of what is currently politically feasible.

The prospects for federalising the bank resolution function are unclear. For the time being, the Commission has not proposed establishing a eurozone authority with resolution powers over banks. Instead, it has focused on ensuring that all EU member-states have special frameworks for resolving banks, and that such frameworks are based on common EU principles. The trouble with a system consisting of European supervision and national resolution is that it sets the wrong incentives.[10] In particular, it does nothing to break the intimate links between local banks, politicians and supervisory authorities that encourage regulatory forbearance inside member-states. Ultimately, granting a eurozone body the power to restructure and wind up banks remains essential if the single currency is to work better.

9: Jean Pisani-Ferry and Guntram Wolff, 'The fiscal implications of a banking union', Policy Brief, Bruegel, September 14th 2012.

10: Dirk Schoenmaker, 'Banking union: Where we're going wrong', *VoxEU*, October 16th 2012.

Up to a point, similar considerations apply to deposit protection. A system combining eurozone level supervision with national level deposit protection could be a recipe for conflict between the ECB and the member-states. National deposit protection schemes would have to bear the costs for supervisory failures at eurozone level, and member-states would have incentives to minimise their costs by getting the ECB to keep 'zombie' banks alive with cheap funding. The political obstacles to federalising deposit protection remain formidable, however. These do not simply reflect a reluctance to share costs. They also reflect the practical difficulties of merging existing schemes. Germany, to cite just one example, has three separate domestic deposit protection schemes that it has not been able to merge.

In the short term, therefore, what the eurozone appears to be inching towards is an institutional set up in which banking supervision is partially federalised and the demands of crisis management possibly create the first outlines of a joint fiscal backstop to banks (in the form of the ESM). There is no immediate prospect, however, of responsibilities for resolution and deposit protection being transferred from national to eurozone level. The problem with such a configuration is that it could create new problems without resolving old ones. In the end, a greater degree of federalisation will still be needed to provide the single currency with the institutional underpinning that it requires. The eurozone needs its version of the FDIC as much as a common banking supervisory authority – arguably even more so.

Does a banking union pose a threat to the single market?

The need for a banking union proceeds more from the logic of monetary union than the EU and its internal market. Since not all EU members belong to the single currency, the establishment of a banking union – even in incomplete form – has potentially important consequences for the EU's single market. A pessimistic view is that Europe faces a tragic trade-off: the eurozone can only save itself by destroying the EU.[11] A more optimistic one is that the Commission is determined to protect the single market's integrity and that the EU has always displayed a genius for devising clever institutional solutions to seemingly intractable difficulties. Both sides are partly right and partly wrong: clever institutional arrangements may be able to accommodate some EU member-states, but probably not all of them.

Why might the gradual formation of a banking union for the eurozone threaten the integrity of the EU and its single market? The answer is two-fold. First, a banking union would create a more integrated core in which eurozone members might develop policy together. The emerging eurozone core would form a caucus inside the EU, potentially dictating policy to the rest of the EU. EU countries that did not belong to the eurozone would become 'policy-takers', rather than policy-makers (a status analogous to that of Norway outside the EU). Second, a tighter eurozone core could call into question the sanctity of the four freedoms of movement between the ins and the outs. The ECB has already tried to force euro-denominated trades to be cleared in the eurozone, rather than elsewhere in the EU.

The European Commission is well aware of these difficulties, and has done its best to address them. Central to its proposed solution is open architecture: EU member-states that have not joined the eurozone will be allowed to join the banking union (and hence the single supervisory system administered by the ECB) if they wish. The European Banking Authority (EBA), one of three new bodies set up in the wake of the 2008 financial crisis, will continue in existence, with all EU countries represented on it. The EBA will play a critical role in preserving the integrity of the single market – notably by developing a single supervisory rulebook, ensuring that banking supervisory practices across the EU-27 are aligned, and mediating between supervisory authorities when disputes between them arise.

"The emerging eurozone core would form a caucus inside the EU, potentially dictating policy to the rest of the EU."

The Commission's proposals, however, are not quite sufficient to ensure that the eurozone and the single market co-exist peacefully with each other. One problem is how the eurozone 'outs' that decide to join the banking union should be represented on the ECB. Since countries cannot sit on the ECB's Governing Council until they join the euro, the Commission has proposed that they should sit on a supervisory board instead. The board would "plan and execute" the tasks conferred on the ECB, but decision-making authority would rest with the Governing Council. In other words, the eurozone outs that joined the banking union would be sitting on a body that advised the Governing Council and implemented its decisions. How many countries will put up with such a status is not yet clear.

Another problem resides in the EBA. The Commission recognises that the ECB risks becoming an 'elephant in the room' if it coordinates the positions of eurozone member-states before the EBA meets. It therefore proposes that the EBA's Management Board include at least two members from EU states not participating in the banking union; and a new voting procedure to ensure that eurozone members cannot have a blocking minority when decisions are taken

11: Wolfgang Münchau, 'The only way to save the eurozone is to destroy the EU', *Financial Times*, December 9th 2011.

to resolve disputes between supervisory authorities. What the Commission does not propose, however, is a new voting procedure to mitigate the impact of 'caucusing' on rule-making. Rule-making in the EBA will continue to be carried out by qualified majority voting, giving the eurozone as a bloc the power to dictate policy to the outs.

Although the Commission has tried to assuage the concerns of the eurozone outs, therefore, it has not fully succeeded in doing so. Countries that do not belong to the eurozone remain concerned that they will be side-lined, whether they join the banking union or not. Countries in East and Central Europe worry they will have no influence over the fate of foreign banks that dominate their financial sectors. And some of the outs fret about their exposure to competence creep if they do not join a banking union. Sweden, for example, has tried to fend off suggestions that the ECB should assume responsibility for supervising Nordea – which is the largest lender in Finland (a eurozone member), but is headquartered in Sweden (a eurozone out that will probably decide not to join the banking union).

A host of proposals have been circulating that might ease some of the concerns of the eurozone outs. A possible way to get round the problem of the eurozone outs not being represented on the ECB's Governing Council if they join the banking union would be to hand responsibility for banking supervision to a new EU institution rather than the ECB (a possibility mooted by Sweden). If this proposal is a non-starter, alternative ways of mitigating the fears of the eurozone outs can be imagined. One option would be to give the eurozone outs the freedom to ignore decisions of the ECB Governing Council if these conflicted with the Supervisory Board's advice. Others would be to change voting in the EBA to reduce the dominance of the ECB, or to allow the eurozone ins to vote against the ECB in the EBA.

Can British interests be reconciled with a banking union?

Nowhere in the EU are the concerns of the outs felt more acutely than in the UK. All countries like to tout their exceptionalism. But two factors really do make the UK a special case among the eurozone outs. First, it stands to be disproportionately affected if it is side-lined under a banking union, because it is host to Europe's largest financial centre (a fact not universally welcomed in the eurozone, where a general feeling persists that the City of London and 'unregulated Anglo-American finance' must be tamed if the single currency is to survive). Second, Britain is led by the most eurosceptic government in the EU. The result is that the stakes for the UK are higher than for any of the other eurozone outs, but the margin for compromise is narrower. The UK, in short, is in a very awkward place.

Given the potentially catastrophic economic consequences that would result from the eurozone's collapse, Britain has a clear interest in the single currency surviving. Since a banking union is necessary to turn the eurozone into a more stable monetary union, the British government supports the construction of an arrangement it has no intention of joining. At the same time, however, it fears being marginalised under a banking union, with rules affecting the City of London potentially being decided by the eurozone acting as a bloc. So it wants safeguards to ensure that it will not find itself being dictated to by a eurozone core. The UK's concerns have a more permanent quality than those of the other eurozone outs, because most of the latter aspire – indeed are legally obliged – eventually to join the euro.

The traditional image of a 'light touch' Britain permanently at odds with a continent hungry for stricter regulation is, to some extent, a thing of the past. Since 2008, the UK has been at the strict end of the European spectrum on regulatory policy towards banks.[12] It is not impossible, therefore, to imagine a world in which the *esprit de corps* of central bankers mitigates conflicts across the Channel and in which everyone understands that it is not in the ECB's interest for it to ride roughshod over the Bank of England. But this would require a lot more trust than is currently available. Britain has been scarred by the ECB's efforts to force euro-denominated business to be cleared in the eurozone, and by pressure to introduce an EU financial transactions tax (a measure that would hit the UK disproportionately).

> *"Nowhere in the EU are the concerns of the outs felt more acutely than in the UK."*

The British government has therefore pressed for a change to voting procedures in the EBA, arguing (like the other eurozone outs) that policy for the EU-27 cannot simply be dictated by the eurozone – and that the UK's concerns must be satisfied because of the City of London's importance to the British economy. Several proposals for new voting procedures have been circulating. One would require the votes of at least three of the eurozone outs for an EBA rule to be adopted; another would require a simple majority of the outs.[13] These variants, however, would give Britain no more power than Lithuania. Britain would prefer a variant requiring a qualified majority among eurozone ins and outs (so a proposed rule would be rejected if it did not garner a weighted majority among both groups).[14]

12: Philip Whyte, 'Britain, Europe and the City of London: Can the triangle be managed?', CER Essay, July 20th 2012.
13: Alex Barker, 'Bank union proposals put curbs on ECB', November 19th 2012.
14: Open Europe, 'Safeguarding the single market: How to achieve a balanced European Banking Authority', Briefing, October 16th 2012.

Before November, neither the concerns of the eurozone outs generally, nor those of the British specifically, were formally discussed at the highest level. (For members of the eurozone, the status of the outs is a second order question to that of the establishment of the banking union.) That has now changed. Proposals on how to accommodate the outs are now circulating and are being actively discussed. However, there is great reluctance among the eurozone ins to countenance new voting procedures in the EBA. For one thing, they fear that the UK could effectively have a veto over everything the EBA did and that all business might grind to a halt. For another thing, they worry that giving the UK special voting treatment in financial services would set a harmful precedent for other areas of EU business.

Although it shares many concerns with the other eurozone outs, therefore, the UK still looks isolated. It believes that the City of London's importance gives it the right to special treatment. But few other EU countries agree – and, just as importantly, few are prepared to lend a sympathetic ear. Britain's reputation across the EU is toxic. It has been damaged by the eurosceptic clamour among Conservative backbench parliamentarians – to which the prime minister is now seen to be hostage – and by the perceived incoherence and extravagance of its broader demands. Not content with wanting to repatriate powers from the EU, Britain also demands special treatment in those areas in which it still participates. To make matters worse, it periodically threatens to veto any agreements that do not give it total satisfaction.

Britain's demands to repatriate powers are a rejection of club rules and its increasing inability to compromise a violation of club norms.[15] That being so, a growing number of EU member-states assume that Britain has chosen a path that leads to its inexorable exit from the EU. And if this is the case, some of them ask, why should they waste their time bending over backwards to accommodate its concerns on the banking union? In the UK, meanwhile, the prime minister is under huge pressure from members of his own party to defend British interests and to 'wield the veto' every time he goes to Brussels. It cannot be excluded, therefore, that the UK will seek to block the establishment of a European banking supervisor if it cannot obtain the safeguards that it seeks for its influence in the EBA.

Conclusion

European leaders have been slow (as well as reluctant) to accept that the eurozone's decentralised configuration makes it an inherently unstable currency union. Politically, this is not surprising. The reason the eurozone is a decentralised monetary union is that solidarity across European borders is weaker than it is within them. To accept that the eurozone suffers from a structural flaw that can only be corrected by more federalism is politically explosive. A more federal structure would go to the heart of sovereignty by allowing European bodies to dictate the fate of national banks – and by placing taxpayer funds at the disposal of the eurozone to solve problems in other member-states. All this helps to explain why it has taken them so long to accept the need for a banking union and everything it entails.

It is clear that a fully-fledged eurozone banking union will not emerge any time soon. Political constraints being what they currently are, the eurozone will start with the partial federalisation of banking supervision, but leave the other features at national level for the time being. This essay has argued that such a configuration will not resolve the problem a banking union is designed to tackle, and that the eurozone is likely to remain an unstable currency union until other functions – recapitalisation, resolution and deposit protection – are federalised. In the meantime, it may be hard to subordinate crisis management to long-term institution building. Legacy issues need to be dealt with, and the instruments used for doing so could form the bases for a more complete banking union further down the line.

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For Europe as a region, the partial federalisation of the single currency risks falling between two stools. While it will not be enough to rectify the eurozone's design flaws, it will do just enough to destabilise the EU-27 by diminishing the status of the eurozone outs. Many of the latter fear that an embryonic banking union will turn them into second class citizens in the EU, condemned – rather like Norway outside the EU – to follow rules they have had little influence shaping. For various reasons, such concerns are felt more acutely in the UK than anywhere else, and are more difficult to resolve. If the interests of the eurozone cannot be reconciled with the concerns of the UK, the risk must be that the banking union becomes another factor that isolates the UK and pushes it ever closer to the EU's exit door.

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15: Martin Wolf, 'UK rushes needlessly towards the EU exit', *Financial Times*, November 2nd 2012.