BANKING UNION¹

Stefaan De Rynck

Introduction

From 2009 to 2012, Eurozone policy-makers addressed the sovereign debt crisis by focusing their attention on the issues of national fiscal discipline and macro-economic imbalances. The recognition that supranational institutions for banking policy were essential to eliminate a source of sovereign distress emerged after only several years of crisis management. Some may attribute this slow reaction to the protection of national interests. Beyond banking nationalism, however, dominant policy ideas needed time to adjust and view cross-border bank capital flows not just as indicators of economic efficiency but also as causal factors of financial risk.

Most scholars contend that an effective banking union must consist of three pillars: common supervision, resolution, and a single deposit guarantee (Herring, 2013, p. 10). Judged by this definition, the 2016 banking union is unfinished business. Most progress was made in transferring supervision to the ECB, while the resolution regime is a mix of new European powers with a gradual pooling of bank levies in a single fund. The EU has failed to bring the politically salient issue of deposit insurance out of the national remit. The fiscal backstop for resolution and deposit insurance has also remained mostly a liability for member states, shedding doubts on the effectiveness of protecting sovereigns from banking risks.

This chapter will first describe the most significant institutional and policy changes that the banking union has introduced and demonstrate why this represents a rupture with the past. In a second section, it will analyze the impact of the banking union so far and consider the wider ramifications for the EU’s single market. A third section discusses the major claims of the political science literature for explaining the emergence of the banking union on the European agenda and the actual policy outcome. The chapter concludes by outlining questions for further research and policy developments, arguing that Treaty changes are necessary to build the banking union on a firmer political and legal foundation.

The state of the banking union in 2016

On the side of the June 2012 European Council, Eurozone leaders met under huge pressure from financial markets against Spain and Italy. Spain, after months of foot-dragging, had consented to a European Stability Mechanism (ESM) program shortly before the summit, with a
Banking union

credit line of up to €100 billion, or 10 per cent of Spanish GDP, for the sole purpose of bank recapitalization. The consequent drop in the value of the sovereign debt negatively affected many banks, which had just used newly provided ECB liquidity to purchase Spanish bonds. Markets pushed the rate spread with Germany to a record high, which led the government to request a direct ESM recapitalization that would not burden the state budget. In this context, European Council President Van Rompuy submitted the three banking union ingredients for discussion to the summit (European Council, 2012).

Transferring supervisory tasks to the ECB as the foundation of the banking union

At the conclusion of the summit, policy-makers recognized for the first time that a purely national solution to bank recapitalizations could be counterproductive for the stability of the euro area. They stated that creating a European supervisor was urgent as part of an “imperative to break the vicious circle between banks and sovereigns” (Euro Area, 2012), and that supranational supervision was a pre-condition for direct ESM recapitalization. The summit decided that, beyond Spain, Ireland could receive a retroactive reprieve by an ESM take-over of bank liabilities that were on the balance sheet of the Irish taxpayer. The ambiguity of this compromise between creditor and peripheral countries became clearer over time. A legislative process for taking away supervision from national authorities immediately started and led to results quickly. In contrast, the ESM has never used its new, €60 billion recapitalization instrument and made its possible use subject to a German veto.

Schoenmaker’s financial tri-lemma (2013) predicts that a single banking market cannot be stable without centralized supervision. Since the Maastricht Treaty, policy experts had argued that such common supervision was a fortiori indispensable for a single currency area (Eichengreen, 1993, pp. 1343–1345; De Grauwe, 1998). However, the German position prevailed in the Maastricht negotiations. James (2013, p. 116) explains that the Bundesbank successfully insisted on deleting prudential supervision from the tasks of the European System of Central Banks out of fear for undermining the ECB’s independence and monetary stability.

As Table 12.1 shows, banking policy before 2012 was designed from a single market and not a single currency perspective. After an initial period of liberalizing capital flows and eliminating national obstacles to market access, which led to an expansion of banks in other member states, the EU created in 2004 a Committee of European Banking Supervisors (CEBS) for the purpose of better coordinating national action. Some argued that this loose coordination model and its regulatory competition would boost market efficiency (Lannoo, 2002, pp. 6–8).

The 2008 banking crisis led in 2010 to the creation of a European Banking Authority (EBA) as part of a policy shift to adopt a single rulebook and enforce European standards more vigorously. Yet, a single supervisor was considered to be unrealistic (de Larosière, 2009). Thus, the “sudden creation” (Glöckler et al., 2016) of a single supervisory mechanism (SSM) for the Eurozone in 2012 marks a watershed both in terms of changing policy substance and side-stepping an incremental approach to reforms. It also shifted the focus of banking policy from the single market of 28 to the Eurozone. Herein, it juxtaposed the EBA model, which continued the single market policy of intense “trans-governmental” networking between national authorities (Posner, 2010, p. 58), with a hierarchical model for the Eurozone, built around exclusive powers of the ECB.

The choice for the ECB as being in charge of the SSM was driven by the need for speed, which discarded the reluctance within the Commission and the European Parliament on a
possible marginalization of the newly created EBA. It also wiped off the table options that would involve lengthy Treaty change, such as the creation of a new Eurozone body as preferred by the German Ministry of Finance and the Bundesbank. For micro-prudential supervision (i.e., supervision of individual banks), the ECB’s new powers include the exclusive competence to license any bank in the Eurozone and approve share acquisitions, and a capacity to inspect bank proprietary data, which is a power that the EBA never obtained in spite of its mission to conduct stress tests. For approximately 130 large banks, including the largest three banks in each country, the ECB replaces national supervisors, and works with joint supervisory teams headed by a national from another country than the supervised bank. As most of these banks operate across borders, the single supervisor replaces the existing mechanisms for cooperation and dispute settlement between home and host authorities, for instance on issues such as national ring-fencing of liquidity. The prisoner’s dilemma type of coordination within colleges of supervisors (Kudrna, 2012), which contributed to the intensity of the financial crisis, is hereby replaced with a central decision-maker.

While the EU’s post-crisis capital requirement legislation and single rulebook scrap more than 100 national discretions (Quaglia, 2013, p. 20), a large degree of national administrative flexibility persists today, often as a result of bargaining by member states. Banking union, however, entrusts the use of this flexibility in the Eurozone largely to the ECB, which for instance has harmonized the bank capital value of the controversial deferred tax assets. Harmonization of standards brings the policy for the Eurozone back to a 1970s approach. But at that time, attempts at harmonization failed and gave way to mutual recognition.

Beyond its micro-prudential remit, the ECB receives macro-prudential powers, which new EU-wide rules introduce. In a recognition that policy-makers underestimated the risk of private debt accumulation before the crisis, such powers allow regulatory interventions in the whole or a segment of a national market, for instance by imposing additional capital on all banks to make credit more expensive, or by limiting bank holdings of specific assets such as national debt paper. The ECB, for instance, used the latter powers during 2015 in Greece to shield banks from a possible sovereign default. Centralizing macro-prudential powers offers the possibility to internalize the problem of uncoordinated national measures, whereby cross-border capital flows could render any solo action ineffective (Kincaid and Watson 2015, pp. 795–796). Legislation centralizes powers less, however, compared to what the Commission had proposed, as the SSM and national authorities can both act independently from each other, and national supervisors maintain the exclusive use of policy instruments that constrain borrowers, such as loan-to-value ratios. Still, the new set-up goes beyond the initial EU reaction to the financial crisis, when a 2010 reform gave recommendation powers only to a new European Systemic Risk Board.

Finally, one other issue that was hotly debated during the ECOFIN negotiations on the Commission’s SSM proposal concerned how many Eurozone banks would be part of its scope.
Banking union

Germany eventually dropped its request to have two parallel systems and agreed that all banks would be captured, as the Commission and a coalition of countries led by France preferred. This coalition included the Netherlands, a creditor country with a highly concentrated banking market, as well as Italy with a decentralized banking sector. Beyond the risks of arbitrage and deposit shifts between two autonomous systems, an important argument to settle this debate was that non-systemic medium-sized banks had to be bailed out in various countries during the crisis.

Gren, Howarth and Quaglia (2015, p. 182) analyze “the compromise of two-level supervision” and the expected principal-agent relationship between the ECB and national bodies. They identify a wide range of ex ante and ex post controls that the ECB can exert, such as an obligation for national supervisors to notify any important decision, or the last-resort option of the ECB taking over the supervision of any bank. Nevertheless, the authors conclude that there is space for slippage and national discretion for less significant banks because of the soft law nature of many tools.

Pooling resolution powers and resources without a common deposit guarantee

In terms of breaking the sovereign-bank nexus, it is surprising that the sequence of constructing the banking union started with supervision. In 2010, already at the start of the Greek debt crisis, the IMF had called for a resolution authority with a fiscal back-up. With the benefit of hindsight, Gros and Belke (2015, p. 42) argue that Ireland would have been spared the full brunt of its financial crisis if creditor bail-in and a European resolution fund had existed in 2010. Obviously, the moral hazard fear of the stronger economies, in the sense that their resolution levies would end up funding a lenient policy in the peripheral countries, underpinned this sequence. Jacoby (2015, p. 188) discusses the “timing of politics” whereby Germany picks the “optimal time of intervention to maximize the efforts of private actors and deter public and private behaviour that might require more bailouts in the future.” In the same vein, the German, Dutch and Finnish finance ministers demanded in September 2012 an in-depth asset quality review by the ECB and a national purge of unhealthy bank assets before starting the European supervisory operation and creating the ESM recapitalization tool. This request became the death knell of the June 2012 deal. From then onwards, the banking union was about making the future Eurozone more solid and not about crisis management. While this fitted the German preference, the importance of the June 2012 deal evolved over time. The creation of the single supervisor opened the door for Germany and others to accept a resolution fund financed by all banks.

Like the Spanish banks for SSM, the Cypriot fiasco in March 2013 became a “focusing event” for resolution. Epstein and Rhodes (2014, p. 20) document how the six ECB executive board members started a campaign for a single resolution regime after the Euro group had to overturn its decision to impose a haircut on insured Cypriot depositors. Before that, the ECB had expressed its anxiety about a mismatch in the new system between European supervision and national liability for resolution.

The EU legislators finally reached a compromise in March 2014 on a single resolution mechanism, in spite of the absence of crisis and pressure for immediate action at that time. Most of the key features proposed by the Commission survived the negotiation in spite of German reluctance. The ECB should trigger resolution when it considers that a bank falls short of its requirements. Together with the responsibility of a new European board to prepare and safeguard the correct implementation of resolution plans, this gives EU bodies a decisive voice in private property rights, as shareholders can be forced to sell part of the business, or assets can be transferred to a bad bank. Germany, in contrast, had insisted on a national veto
right over such decisions. In the new system, if the single board and the Commission agree, the Council will not have a say.

But the decision-making system has multiple veto points when the Commission disagrees with the single resolution board, which then gives a role to the Council within time limits defined in hours. At the heart of this complexity lies the Meroni doctrine of the Court of Justice, which prohibits EU institutions from giving discretionary powers to agencies such as the resolution board.

Finally, funding the cost of resolution through, say, loans or guarantees to a bridge bank can only happen after shareholders and junior creditors first take losses. Senior creditors and ultimately depositors above €100,000 can also be called upon to reach a mandatory bail-in threshold of 8 per cent of total liabilities. The regulation creates a fund for pooling bank levies from Eurozone banks, while the Commission and European Parliament had to concede that the national obligation to feed that fund is contained in an intergovernmental agreement, partly to make the system immune from constitutional challenges in Germany. By 2024, the resolution fund will have €55 billion at its disposal and have the capacity to raise additional money from banks. Each year until then, segregated national compartments will diminish in importance to the benefit of the common part. French and German banks alone will each contribute around €10 billion based on their size and risk profile.

The third and final leg of the banking union, i.e., a single deposit insurance scheme, has seen barely any progress. Its political salience in terms of protecting consumers complicates the design of a European policy. Moreover, the fact that some banks in countries such as Germany and Austria already have their own insurance schemes in place creates sunk costs that complicate the search for a common Eurozone solution. All the same, three years after the start of the banking union the Commission made a proposal for first reinsuring national schemes and subsequently pooling them. If the past is any good for predicting the future, the actual adoption in the face of heavy German opposition will need another focusing event, perhaps another crisis like a bank run that would endanger a sovereign’s capacity to insure savings. At the end of 2016, the proposal for a European scheme had made poor progress and even led to a polarization between creditor countries arguing that governments should first reduce national bank risks, while others claimed that the absence of a common solution actually increased national risk. Issues on national risk reduction that are likely to be high on the European agenda for the coming period include reducing the discretion given to the resolution process in terms of imposing losses on certain creditors, and changing the risk weight or exposure limits of sovereign bonds on bank balance sheets, which could cause transition costs in some Southern European banks.

**Policy implications**

Assessing the state of play of today’s banking union should take into account its various functions. First, the banking union has not delivered any quick solution for breaking the doom-loop from banks to sovereigns, in contrast to its pronounced objective. But it will gradually protect sovereigns from banks via the single resolution fund (SRF), where the European Parliament obtained a faster pooling of national money than what member states had agreed. Moreover, Germany and other creditor countries insisted that bail-in should apply from 2016 instead of the proposed 2018. Gros and De Groen (2015, p. 1) test the system on the 72 Eurozone banks that received support between 2007 and 2014, and conclude that, in combination with bail-in, even “during its early years, the SRF should be sufficient to deal with almost any crisis scenario imaginable.”

But bail-in could under certain conditions also threaten the sovereign, most likely in cases where bondholder losses would cause a ripple effect throughout a national financial system.
Furthermore, a significant bank crisis in the early years of SRF could entail a scenario that would require a national treasury loan. There is no clarity yet on how a common backstop will be developed by 2024, even though the ESM has been mentioned as a viable solution in the Five Presidents’ report. Alexander (2015, p. 181) writes that currently the “supra-national EU resolution powers end where the Single Resolution Fund proves to be inadequate” and fiscal sovereignty would block a common solution. It is hard to predict how this would affect a fragile sovereign given that markets have reacted in unpredictable ways during the crisis.

Second, the banking union seems to fulfil different missions from the ECB’s perspective. ECB decision-makers stress that they now have “information synergies” on bank solvency that can serve liquidity support operations (Coeuré quoted in Glöckler et al., 2016, p. 8), even though the SSM regulation creates a firewall between monetary and supervisory operations. Banking union should also improve monetary policy transmission by integrating money and credit markets. In this context, the ECB is pushing for consolidation and more cross-border equity in the Eurozone’s banking system, which would contribute to delinking bank risks from national economies. Additionally, the macro-prudential powers of the ECB as well as its general supervisory powers offer the bank a new toolbox to deal with country-specific shocks and complement a “one size fits all” interest rate. More broadly, Véron (2015, pp. 17–19) claims that, as a result of the political commitment to launch the banking union, which Draghi called a “game changer,” the ECB governor could launch the OMT “whatever it takes” operation, which played a crucial role in the survival of EMU. Jones (2015, p. 46), however, argues that the “urgency to build new institutions (for banking) was quietly forgotten” once the ECB unleashed its firepower.

Third and finally, from the perspective of banking policy, there has been “an unprecedented transfer of sovereignty” (Alexander, 2015, p. 158) which transforms governance and implies that Eurozone states give up power over a considerable part of their economy – one that plays a dominant role in allocating credit to corporations and households.

Another issue is how the banking union will operate within the wider single market. So far, only Eurozone countries, which have access to ECB liquidity, participate. Some, such as Romania and Bulgaria, have expressed interest in joining in order to boost the credibility of their supervision. The Danish central bank supports membership of the banking union to fully participate in European standard-setting and to cope better with the possible distress of a large bank. Others, such as Poland, Hungary and Croatia, have a material interest in participating in the supervision of the foreign bank groups that dominate their markets. Their current politics, however, aim to diminish foreign presence and promote banking nationalism. The UK and Sweden, which are the only EU members not to have signed the resolution fund treaty, have excluded membership, though both supervise banks operating in the Eurozone.

The chair of the EBA, Andrea Enria (2013, p. 12), has warned for “a split” between “ins” and “outs” in terms of standards, abuse of macro-prudential powers for national purposes, and discretionary application of resolution rules. Ferran (2014) also claims that the banking union could undermine the single market, and Brescia Morra (2015, p. 22) calls for stronger EBA coordination “to limit the negative consequences of the plurality of authorities.” The “UK before Brexit,” while supportive of the banking union, drew a red line in negotiations to make sure that EBA governance avoids having a dominant caucus of Eurozone countries. Contrary to the Commission’s proposal, new voting rules foresee separate majorities for “ins” and “outs” on standards and a balanced presence of Euro and non-Euro authorities in mediation panels for settling supervisory disputes.

Still, the EU seems to struggle to make the banking union fit in the single market’s architecture. EBA guidelines and recommendations are now also addressed at the SSM and the
EU resolution bodies, whereby EBA as an agency must guide EU institutions and request explanations for non-compliance. In order to safeguard the single market’s integrity, the Commission itself will need to play a pro-active role and ensure the enforcement of the new capital and liquidity rules in all countries as well as act without a Eurozone bias when adopting EBA standards. A further instrument is the Commission’s state aid policy, since resolution schemes that call on public or resolution money require Commission approval. State aid decisions will be crucial tools to ensure a level playing field between banks in the single market, given that the new resolution board has the discretionary powers, just like national resolution authorities outside of the Eurozone, to invoke exemptions that could justify a more *ad hoc* treatment of bondholders. It also has the power to delay or waive loss attributions.

In short, the banking union shows ambiguities both in terms of the functions that it serves and the territory that it should ultimately cover. Still, it remains a policy innovation of major significance, which – if adopted earlier – would have better protected Eurozone taxpayers from having to guarantee loans to programme countries. Begg, Bongardt, Nicolaïdis and Torres (2015, p. 812) contend that the “banking union is the area that has made the most progress” in terms of tackling the various flaws of EMU.

### Explaining driving forces, timing and policy outcome

The debate on a possible German hegemony in Eurozone reforms, whether reluctant or not, is a good place to start for analyzing the driving forces behind the banking union, its relatively late appearance on the policy agenda, and the final outcome of legislative bargaining. Howarth and Quaglia (2014, p. 128) argue that Germany was the country with most influence on the design of the banking union and state that the political economy of Germany’s banking sector, most notably its relatively low internationalization and its large number of small-sized saving banks, shaped its political preference to water down policy change and slow down the speed of reforms. Within Germany, however, the issue of centralizing EU banking policy was subject to conflicting interests between banks, taxpayers, central bank and export industry. In addition, Schäfer (2016) shows that the German government did not always act on the banking industry’s expressed preferences and selectively picked up cues from the diverging interests of the smaller or larger banks, whereby the latter generally defended streamlined rule-making and oversight.

Hennessy (2014) similarly looks at political economy and banking industry factors but argues that the 2012 crisis led to a shift in cost–benefit analysis by member states. She claims that the increasing taxpayer exposure to programme countries created the genesis of reform by pushing creditor countries to request hard supervisory rules rather than soft law coordination in exchange for further support. But is taxpayer exposure the prime cause for understanding why the shift in national interest calculation occurred? In arguing from a historical–institutionalist perspective, Steinberg and Vermeiren (2015) go one step back in time and claim that the shift is linked to constraining choices at the start of the crisis, which increased the cost of reversing monetary integration, but also pushed up sovereign spreads in 2011 and 2012 due to financial market fragmentation.

Thus, in a way, creditor countries inflicted the banking union on themselves: their banks withdrew from the periphery and their governments insisted on full debt liability of vulnerable states. The trilemma predicts that such capital outflows from a domestic market cannot lead to a stable outcome without strong supranational institutions and solutions. In the more fragile economies, the change in preference, Epstein and Rhodes (2014) argue, is related to the fact that single market integration and globalization increased the cost of banking protectionism. The fact that bank assets in France are above 400 per cent of GDP and concentrated in a few
Banking union

banks only should be studied further for understanding why France did a U-turn compared to its 2010 preference of keeping supervision national.

Furthermore, Epstein and Rhodes (2014) contest the view that the banking union was subject to “the triumph of an intergovernmental logic” with a German dominance. Banking union certainly confirms the view that the European Council is less an intergovernmental arena than the meeting of finance ministers. The German Chancellor imposed her view on the finance minister and Bundesbank (Glöckler et al., 2016) for key features, such as that the ECB would be the supervisor, or for an integrated system with differentiated supervision by the ECB, or more generally for the timing of reforms.

Analysis of agenda-setting confirms that Germany, or a larger intergovernmental logic, was not the sole or even dominant factor. The conundrum is why all member states engaged in a rapid preference shift between 2010 and 2012. During the 2010 negotiations on the EBA setup, Quaglia (2013, p. 24) mentions that Ireland, Luxembourg, France and Germany opposed a transfer of powers. Spendzharova (2012) attributes the reluctance of Baltic countries to relinquish oversight to the large presence of foreign banks in their markets, and Hennessy (2014, 158) writes that Slovakia and Slovenia opposed centralized powers for fear that a coalition of large countries would neglect host country markets. These political economy factors had not changed two years later. De Rynck (2016) argues therefore that supranational entrepreneurship by the new ECB executive board members, in conjunction with a brokerage role of the European Council President, played a determining role in the first half of 2012 and remoulded ideas from the 1990s into actual policy change at a time of high uncertainty for decision-makers. Consistently with this line of argument, Glöckler et al. (2016) contend that the crisis was not sufficient to cause preference shifts, and point to a “situational package deal” at the specific juncture of the June 2012 summit because of the Spanish banks, which was a catalyst for shifting power relations between member states at that time and against a backdrop of the inability of existing institutions to accommodate the pressure for change. Schäfer (2016) claims more broadly that the German government is not opposed to the idea of the banking union per se under the condition that responsibility and liability are at the same level of governance.

In short, a convincing explanation for the banking union must combine a variety of parameters. The sunk cost of having the Euro and wanting to defend the integrity of the Eurozone underpins the cost-benefit analysis of major players, but it has also driven the ECB into more political behaviour focused on policy change. For understanding why member states were receptive to this supranational entrepreneurship, one must go beyond extracting a national interest from economic and political factors, and take policy legacy into account. Furthermore, the high uncertainty of decision-makers also played a key role. EU leaders had introduced various innovations in banking policy before 2012 already, but the crisis kept coming back in different forms. In this context, the ECB advocated its ideas for change and took advantage of failure in the existing institutional setting. Eurozone banks had become European in life but no longer national in death because of the strong interdependency and contagion between Eurozone economies and the EMU’s architecture without a stabilizing lender of last resort.

Future developments and avenues for research

It is too soon to draw firm conclusions because the banking union is still in the making at the time of writing. Whatever the final outcome, for political science and public policy analysis the case offers rich material for research on issues such as national preference formation, supranational entrepreneurship, legislative bargaining, the impact of crises and uncertainty on policy change, learning and the role of ideas, the functioning of EMU, and multi-speed Europe.
One actor that merits further study in terms of its role and behaviour is the ECB. Its new tasks will lead the central bank into political territory as supervisory decisions and triggering resolution entail a distribution of costs and benefits in society.

For the development of the EU itself the German argument that Treaty change is needed for making the banking union more solid merits serious consideration. A fully fledged banking union with common resources requires a more sound footing that would protect it better from legal challenges. Moreover, for the SSM the complicated system whereby non-Euro countries can participate in the supervisory board, which works ultimately under a tacit approval regime by the Governing Council with Euro countries only, needs to be simplified, which cannot be done without changing the Treaty articles on the ECB. Furthermore, the intergovernmental agreement obliging member states to share resolution levies in a single fund as well as the common backstop would ideally become part of the Treaty order, which should also specify the role of ESM. Finally, Treaty change could make sure that the single resolution board would be less vulnerable to claims by investors for exceeding its legally defined powers and using too much discretionary judgement.

Note

1 This chapter does not reflect the official opinion of the European Commission.

References


de Larosière, J. et al. (2009), Report of the high-level group on financial supervision in the EU, Brussels: European Commission.


