Part I General Aspects, 1 The Economic Consequences of Europe's Banking Union
Nicolas Véron

From: European Banking Union (2nd Edition)
Edited By: Danny Busch, Guido Ferrarini

Content type: Book content
Product: Financial Law [FBL]
Series: Oxford EU Financial Regulation
Published in print: 23 January 2020
ISBN: 9780198827511

Subject(s):
Banks and cross-border issues — Deposit insurance schemes — Eurozone — Liquidity — Monetary sovereignty — Monetary union — Basel committee on Banking Supervision — European Central Bank — Financial Stability Board (FSB)
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debt spreads of the more fragile periphery country over the stronger core ones, or ‘positive contagion’, during the following two-and-a-half years.

1.05 From a banking standpoint, the shift of key components of the banking policy framework from the national to the European level gave initial credibility to the claims by European policy-makers that bank creditors would share at least part of the losses in future cases of bank crisis resolution, contrary to what had been an almost universal practice of bank creditor bail-outs in the first half-decade of crisis from mid-2007 to mid-2012.

1.06 The combination of these two interrelated shifts has markedly improved the stability of financial conditions in the euro area, even though it is not sufficient to revive the region’s current anaemic growth. The rest of this section examines them in more detail.

1. Banking Union and Positive Contagion

1.07 The leaders’ declaration of 29 June 2012 represented a significant, and arguably unprecedented, commitment by euro area Member States to support each other at a time when their willingness to do so had come under increasing doubt. Beyond the rhetorical aspiration to break the bank-sovereign vicious circle, it included two specific policy commitments. The first commitment was the creation of a (p. 5) Single Supervisory Mechanism (SSM), understood as the pooling by euro area Member States of their sovereign responsibility over banking supervision, which would be entrusted to the ECB in application of Article 127(6) of the Treaty on the Functioning of the European Union (TFEU). The second commitment was the pledge to introduce a mechanism allowing the direct recapitalization of a country’s banks by the European Stability Mechanism (ESM), the common euro area fund whose creation had been enshrined in a treaty signed by all euro area Member States a few months earlier, on 2 February 2012, and which was then in the course of being ratified.

1.08 During the summit, leaders had agreed that such direct recapitalization of banks by the ESM may be applied retroactively, at least in the cases of Spain and Ireland. This meant that the ESM would take over capital instruments in the banks from Member States some time after the initial recapitalization of these banks by their home country’s government. However, this agreement was not made explicit in the public statement, as negotiations on Spanish banks were still ongoing. The declaration also included language that could be interpreted as making it easier for the ESM to buy Italian and Spanish sovereign bonds, with the ECB acting as its agent.²

1.09 With the summit’s decisions, euro area leaders signalled that they were ready to go much farther in tying together their financial systems and supporting each other through joint financial instruments than had been the case until then. This was particularly significant, as doubts about the future integrity of the euro area had been rising fast in the previous few weeks, exacerbated by the drama of Greece’s two successive general elections of 6 May and 17 June 2012 and by increasingly pressing problems in the Spanish banking sector. How far the commitment really went, however, was a matter of interpretation, given the vagueness and ambiguity of the content of the public declaration. In the days and weeks that followed the summit, the German government was seen as backtracking on the commitment about direct recapitalization by the ESM. Senior German government officials argued that the financial risks associated with the capital instruments thus transferred should remain the responsibility of the Member State in which the banks were headquartered, which defeated the whole risk-pooling purpose of the policy proposal. The initial market reaction immediately after the summit had been positive, but was rapidly reversed and gave way to new peaks of market volatility and uncertainty in July 2012.
1.10 The pledge of mutual support in late June was thus not sufficient to alter market perceptions directly. However, it had that effect indirectly by broadening the scope of possible initiative by the ECB. Significantly, the signal of political cohesion of (p. 6) the summit was further reinforced by a vote of confidence by the political leaders in the ECB itself. The choice of Article 127(6) of the TFEU as the legal basis of the future SSM meant that the ECB would become the central authority of the euro area’s future banking supervision. This new context enabled the ECB to take action, first with the statement on 26 July by its president, Mario Draghi, in London\(^3\) that ‘within its mandate, the ECB is ready to do whatever it takes to preserve the euro’ and the subsequent announcement by the ECB of a new OMTs programme, first in general terms on 2 August and then in more technical detail on 6 September.

1.11 From a market perspective, it was Mr Draghi’s London speech of 26 July 2012, rather than the Brussels summit of 28–29 June, that reversed the earlier trend of rising volatility and marked the beginning of the long phase of ‘positive contagion’ that has continued almost uninterrupted in the following two-and-a-half years. Nevertheless, there are strong indications of a causal link between the summit and the OMT programme. When presenting the OMT programme at the European Parliament a few weeks later, Mr Draghi called it a ‘bridge’ to a destination towards which ‘the establishment of the SSM is a key step’.\(^4\) Almost exactly a year after the June 2012 summit, in a speech in Berlin, he singled out that moment’s unique importance in providing ‘a clear vision of what is necessary’.\(^5\) More explicitly, other leaders have asserted that the ECB’s action would not have been possible without the decision to initiate banking union. In a speech in Brussels, the President of the European Council who had chaired the June 2012 summit declared:

> the [European] Central Bank was only able to take this [OMT] decision because of the preliminary political decision, by the EU’s Heads of State and Government to build a banking union. This was the famous European Council of June 2012, so just weeks before [Mr] Draghi’s statement [in London]; he himself said to me, during that Council, that this was exactly the game-changer he needed.\(^6\)

Similarly, Mario Monti was quoted in 2014 as arguing that ‘Mr Draghi had been able to say it [the London speech] because he had received the political support of the leaders’ during the summit, in which Mr Monti had participated as Prime Minister of Italy.\(^7\)

(p. 7) 1.12 Somewhat ironically, the decrease in market pressure that followed the announcement of OMT may have encouraged the governments of Germany and other Member States to keep backtracking on their initial commitment of 29 June about the ESM direct recapitalization programme. On 25 September 2012, the finance ministers of Finland, Germany, and the Netherlands issued a joint declaration according to which ‘the ESM can take direct responsibility of problems that occur under the new supervision [once the SSM is in place], but legacy assets should be under the responsibility of national authorities’. This cemented the position according to which direct bank recapitalization by the ESM would not be applied retroactively, contrary to the agreement made (but not publicized) on 28–29 June. A few weeks later, German Chancellor Angela Merkel confirmed that ‘there will be no retroactive direct recapitalization’,\(^8\) a reversal of position that was met with incredulity in the countries that felt they had been given assurances in June, particularly Ireland.\(^9\) This reversal, however, was not enough to alter the improvement of sovereign debt market conditions that had been started by the ECB’s announcements.

1.13 To be sure, the definitive history of developments in the summer of 2012 remains to be written. The sequence of events during those weeks was dense and convoluted. Even so, the available indications suggest that the decision to create a banking union on 29 June 2012, even though it was not an explicit promise of financial support to struggling Member
States, was the central political turning point that enabled the subsequent ECB initiatives and decrease in periphery countries’ sovereign debt spreads.

2. Banking Union and Moral Hazard in Banking

1.14 The other key consequence of the announcement of banking union in late June 2012 was to give initial credibility to the proposition that European policy would move away from the earlier preference for bailing-out the creditors of failing banks and would instead establish a regime in which moral hazard among banks and investors is mitigated by the prospect of financial participation of creditors in future bank restructurings, or ‘bail-in’.

1.15 The link between banking union and the mitigation of moral hazard in banking stems from the unique political economy of banking supervision in Europe under the previous regime, when banking supervision remained a national competency while other EU policies (single market, competition policy, and (in the euro area) economic and monetary union) introduced an increasingly binding framework of cross-border financial integration. This combination created powerful tensions between each national banking supervisor’s prudential mandate, on the one hand, and the concern to protect and promote the domestic banking industry in the increasingly open cross-border competition, on the other hand. The latter objective tended to prevail, especially in countries where elites share a belief that the national interest is somehow aligned with the interest of iconic companies or ‘national champions’, a group that typically includes banks.

1.16 Such ‘banking nationalism’—by analogy with the broader phenomenon of economic nationalism—predated the crisis. For example, the avowed objective of the governor of the Bank of Italy in 2005, Antonio Fazio, had been to use the central banks’ supervisory authority in order to preserve the ‘italianity’ of two banks that were the targets of takeover bids by companies headquartered in Spain and the Netherlands respectively and ensure that they would remain in domestic hands. (The ensuing developments were complex. Governor Fazio resigned after the wire-tapping of his phone conversations with Italian financiers revealed blatant favouritism. One of the two banks, Antonveneta, was purchased by ABN AMRO of the Netherlands, then taken over by Banco Santander as part of a separate acquisition of ABN AMRO, and subsequently sold to Banca Monte dei Paschi di Siena, contributing in no small part to that Italian bank’s current difficulties. The other, Banca Nazionale del Lavoro, escaped the initial bid from Spain’s BBVA, but was eventually purchased by France’s BNP Paribas.)

1.17 During the first five years of financial crisis in Europe from mid-2007 to mid-2012, banking nationalism prevented national public authorities from adequately addressing the systemic problem of weak bank balance sheets and led them to an almost universal preference for regulatory forbearance in order not to put ‘their’ champions at a competitive disadvantage. When a bank became obviously too weak for authorities to pretend it was sound, banking nationalism led to an almost universal preference for bail-out of all creditors no matter how subordinated (and no matter how small the bank), sometimes even extending to shareholders, ostensibly to preserve financial stability but often also motivated by the desire to bolster financing conditions for the country’s other banks.

1.18 Thus, the structure of banking supervision in Europe and its division across national borders encouraged moral hazard and excessive risk-taking by the banks, in spite of various forms of political backlash against government-funded bank bail-outs that gathered steam after the first few years of crisis. Conversely, the shift towards banking union in mid-2012 suddenly made the participation of bank creditors in future bank restructurings a more credible proposition. Indeed, the first instance in which the European Commission’s competition policy arm was able to impose shareholder wipe-out and junior creditor bail-in on a large scale was on Spanish banks in the assistance programme that was negotiated at the same time as the banking union decision. This is also when the European Commission published its first proposal of a Bank Recovery and Resolution Directive (BRRD) that would
enshrine in EU law the hierarchy of creditors in future cases of bank restructuring and the bailing-in not only of junior creditors but also of senior ones as a precondition for the use of public funds beyond 2018 (that date was later changed to 2016). In the summer of 2013, the European Commission’s competition policy arm enacted new rules that made state aid to banks conditional on junior creditor bail-in and the BRRD was eventually finalized in May 2014 after a protracted negotiation. The management by public authorities of the collapse of Dutch bank SNS Reaal in early 2013, of Cypriot banks in March of that year, and of Portugal’s Banco Espirito Santo in the summer of 2014, confirmed that the imposition of losses on junior creditors has become the ‘new normal’ in European bank restructuring, in contrast to the pre-banking union era. The leading credit rating agencies have also factored in a decrease in future government support in their expectations about future banking crises, even though only to a partial extent that differs across EU Member States.

1.19 In sum, there appears to be a strong case that the inception of banking union in mid-2012 enabled both the de-escalation of sovereign debt spreads in the euro area and the shift of European preferences in bank crisis resolution from almost systematic bail-out towards an approach that emphasizes creditor loss-sharing and market discipline. These two developments have appeared robust, at least in the two-and-a-half years following the critical euro area summit of 28–29 June 2012. Whether they are durable over the long-term remains of course to be seen.

II. Six Developments to Watch

1.20 There are many possible scenarios on the future implementation of existing banking union legislation in the EU and the emergence of new EU banking legislation, in interaction with other financial and economic policy developments as well as political and institutional shifts. There is nothing deterministic in how the economic consequences may unfold.

1.21 Looking ahead, key economic implications of the transition towards banking union may be grouped alongside six broad directions, each of them significant. It can be expected that:

(1) the ECB becomes a strong supervisor and gradually brings the euro area banking sector back to soundness;
(p. 10) (2) the fragmentation of the euro area’s financial system is reversed;
(3) future banking crises are addressed with limited recourse to public money and in a consistent manner across Member States;
(4) the euro area banking system becomes more integrated, with pan-European banks coexisting with local credit institutions on a broadly level playing field across countries;
(5) banks become a relatively smaller part of a more diverse euro area financial system, with more balance between bank and non-bank funding; and
(6) the institutions of banking union become authoritative players in the European and global policy environment.

1.22 The early implementation of the banking union legislation of 2013–14, and legislation enacted since, suggests that all these expectations will eventually be fulfilled, albeit at differentiated paces. But the early development path of banking union has been protracted and complex, and future evolutions will not be linear either. Transitional challenges will be significant and reversals cannot be ruled out. The rest of this section provides a summary overview of possible trends and challenges on each of these six dimensions.
1. Supervisory Quality and the Repair of Banks’ Balance Sheets

1.23 The first and most basic test of success of banking union is about the effectiveness of the ECB as a bank supervisor and its ability to restore the euro area banking system back to soundness. The SSM was largely born from the failure of the previous national supervisory regimes to fulfil their prudential mandate. Its initial challenge has been to steer the repair of euro area banks’ balance sheet, so that trust could gradually return to the entire system.

1.24 The initial basis for this was the ‘comprehensive assessment’ of the euro area’s 130 largest banks that was carried out in late 2013 and most of 2014 and whose results were published on 26 October 2014. This massive undertaking was co-ordinated by the ECB with the help of external consultants (Oliver Wyman). It included an Asset Quality Review (AQR), for which the ECB was assisted by national supervisors and thousands of auditors (mostly from the big four audit networks of Deloitte, EY, KPMG, and PwC) hired for the occasion; and a stress test, co-ordinated by the European Banking Authority (EBA) and also including banks from EU Member States outside of the euro area. The AQR resulted in the identification of €136 billion in non-performing exposures that had not been adequately acknowledged so far. Combining the findings from the AQR with the stress testing, the ECB identified actual capital shortfalls (at the time of announcement of results) in 13 of the 130 banks examined.12

1.25 The ECB subsequently built on the insight it had gained through the AQR process to apply a gradually more consistent and demanding definition of capital to all banks under its direct supervisory authority. This could not be fully achieved in 2014, given the constraints of the comprehensive assessment in terms of time and resources, as well as the lack of prior supervisory experience at the ECB itself. The ECB has rolled out a single methodology and toolkit for its yearly Supervisory Review and Evaluation Process (SREP) which forms the backbone of its interaction with supervised banks. It has demonstrated an ability to ‘pull the trigger’ on banks it deems failing or likely to fail, in the cases of Banco Popular Español (June 2017), Banca Popolare di Vicenza (June 2017), Veneto Banca (June 2017), and Latvia’s ABLV (February 2018). Nevertheless, as of 2019, pockets of fragility linger in several countries, particularly Italy, Greece and Cyprus where levels of non-performing loans remain elevated.

1.26 The ECB’s ability to achieve credibility and effectiveness as a bank supervisor has been bolstered by the build-up of its own supervisory capacity in terms of governance, resources, operations, and practice. This process started in 2013-14 with the initial recruitment of nearly 1,000 supervisory staff in Frankfurt, most from national supervisory authorities but many also from the broader financial industry (and some, mostly on support functions, from the ECB itself). On the basis of its own communication and of anecdotal observation, the ECB appears to have had access to a wide pool of talent and to have managed to attract experienced candidates with a high level of initial motivation.

1.27 The governance framework of the SSM, in which representatives from national supervisory authorities hold a majority of votes in the ECB’s Supervisory Board, is not necessarily conducive to consistently impartial decisions on matters of general policy and on individual banks. This is a different set of challenges from, say, monetary policy decisions within the ECB’s Governing Council. While deliberations of the Supervisory Board are not public, there is reason to expect tensions between the objective that individual Supervisory Board members act in the common European interest, as is their mandate under the SSM Regulation, and the potential for coalitions of special national interests that could be at odds with the SSM’s common objectives.
1.28 Secondly, and related to the previous point, the ECB has to foster a common supervisory culture across the participating national supervisors, a process that can only be gradual given the vast differences of practices and operating principles among them at the outset of the SSM. Personnel policies are important to achieve such cultural convergence. As noted earlier, most of the ECB’s initial supervisory staff comes from the national supervisory authorities and have helped to contribute to an effective communication between the ECB ‘hub’ and the national supervisory ‘spokes’ within the SSM. Conversely, over the medium-term, it is possible that the ECB would encourage its own supervisory staff to work outside (p. 12) of Frankfurt in the national supervisory authorities, on short-term secondment or for more extended time periods. The ECB has also gained from learning from the experience of other large supervisory systems, such as the US Federal Reserve system, as well as from other European networks of regulatory authorities, in particular the network of European competition authorities on which the SSM’s design was partly modelled.

1.29 Thirdly, the ECB has created information and data systems to support the vision of a well-functioning SSM. The ongoing operation of the SSM involves the collection and analysis of data from the supervised banks and the broader economic and financial system on a regular basis, with a requirement of cross-border consistency among all participating Member States. This applies to a range of data categories. Looking ahead, banks’ financial information will need to be further standardized, an aim that is likely to require new EU legislation. Many banks, including all those that are publicly listed, publish consolidated financial statements using International Financial Reporting Standards (IFRS), but others, for example German local banks, only use national accounting standards. Auditing practices and standards also vary widely and are subject to national supervisory frameworks, with only limited European harmonization and co-ordination. At the outset of the SSM, definitions of capital (as well as risk-weighting practices) were still far from uniform across the euro area, and while their harmonization has been an early area of focus for the ECB, not all differences may have been eliminated yet. One may expect that the ECB will be increasingly compared to its US equivalents and thus be fostered to increase supervisory transparency, even though this does not appear to have been an ECB priority during the early years of the banking union.¹³

1.30 Fourthly, the ECB faces the challenge of achieving consistent supervisory outcomes for, on the one hand, the banks which it supervises directly on the basis of their size or systemic significance (116 as of October 2019) and on the other hand, all the other ‘less significant’ banks which are supervised by national authorities on a day-to-day basis, but for the soundness of which the ECB retains ultimate responsibility according to the SSM Regulation (nearly 3,000 banks in 2019, most of which are in Austria, Italy, and Germany). A specific challenge is posed by those smaller banks that guarantee each other in regional or national systems, such as the German savings banks’ ‘institutional protection’ schemes. These banks are not independent from each other in terms of systemic risk analysis, even though their operational management is decentralized. The ECB has signalled attention to their specificity at an early stage of the SSM.¹⁴ However, enforcing their (p. 13) effective oversight from the European level may lead to contention, particularly in Germany where local savings banks (and to an extent also co-operative banks) retain unique features in terms of the regulatory and supervisory framework that applies to them.

2. Reversing Financial Fragmentation in the Euro Area

1.31 The imperative to break the bank-sovereign vicious circle in the euro area was the primary driver of the mid-2012 decision to initiate European banking union. Consistent supervision and repair of the banks’ balance sheets will help reassure financial market participants that banks are held to identical regulatory standards, irrespective of their location within the euro area. However, regulatory and supervisory differences have not been the only cause of ‘financial fragmentation’, or the divergence of financing conditions.
across euro area countries as has been observed since 2010–2011, especially as regards access of small- and medium-sized enterprises (SMEs) to bank credit. As of early 2019, the bank-sovereign vicious circle remains largely intact, and further legislative action will be needed to address other factors that have contributed to financial fragmentation.

1.32 Firstly, banks should be allowed to manage their operations without regard to internal national borders within the euro area. During the crisis, national supervisory authorities imposed various constraints on the circulation of capital and liquidity inside cross-border banks. Motivations included, for financially weaker countries, the concern to retain scarce liquidity within national borders or, for financially stronger ones, the fear that banks might be exposed to the weaker countries’ risks. Legitimate though these actions may have been from a national standpoint, they contribute to European financial fragmentation and to the bank-sovereign vicious circle. Such ‘geographical ring-fencing’ cannot be eliminated by the ECB alone. In some countries, national legislation empowered national authorities (for example BaFin in Germany) to impose geographical ring-fencing or upper limits to intragroup exposures as an instrument to protect national deposit insurance systems. In such cases, the SSM Regulation does not directly deprive the national authority of its ability to create intra-euro-area barriers to the freedom of banks to manage their capital and liquidity across borders. As Supervisory Board Chair Danièle Nouy has put it, ‘the fences should be removed; they are out of place within a banking union’. But this will require new EU legislation, for which no political consensus has emerged yet.

1.33 Secondly, initiatives are needed to force an erosion of the high home bias that exists in many banks’ sovereign bond portfolios. It is not unusual for euro area (p. 14) banks, including many medium-sized ones in Southern European Member States, to hold sovereign bonds issued by their home country’s government in amounts that vastly exceed their regulatory capital. These banks’ sovereign bonds portfolios typically display a high home bias, with much lower exposures to other euro area countries than the one in which the bank is headquartered. Such home bias is not directly the result of regulation, since EU capital requirements do not grant any specific capital privilege for holding home country bonds. Its causes may include the anticipation of differentiated treatment in euro area breakup scenarios (however small the corresponding probability), as well as ‘moral suasion’ from national authorities to help the national government finance itself. Irrespective of its reasons, however, this home bias is a key component of the bank-sovereign vicious circle, since the banks’ balance sheet strength is directly reduced when the government’s creditworthiness deteriorates.

1.34 The Capital Requirements Regulation (CRR) of 2013 gives the ECB the option to impose a maximum ratio on banks’ exposure to their home country government as a proportion of capital. While such pillar-2 measures are not publicized, there are indications that the ECB has used this option to reduce the home bias and force banks to diversify their sovereign debt portfolios, but only to a limited extent. But the political salience of sovereign exposures suggests that this issue can only be fully addressed through pillar-1 requirements enshrined in new EU legislation amending CRR. In any case, exposure limits to address concentration risk should be preferred to the imposition of positive risk weights on banks’ sovereign exposures in regulatory capital calculations, which could be more destabilizing in the absence of a sustainable European fiscal union.

1.35 Thirdly, the diversity of bank insolvency arrangements across the banking union area also contributes to the fragmentation of the banking market, and may be addressed with EU legislation over the medium to long term. Bank resolution regimes are defined by the BRRD as alternatives to insolvency, with the principle that no creditor should be worse off as a result of the resolution process than in a court-ordered insolvency. As a consequence, differences between different countries’ insolvency laws will result in differences in resolution outcomes, in spite of the labelling of the SRM as a ‘single’ European mechanism. How much of a market distortion these differences will create is difficult to predict, but
their perceived impact can be expected to become more significant over time. A first wake-up call was the liquidation in June 2017 of Banca Popolare di Vicenza and Veneto Banca, through an idiosyncratic administrative process in Italian law that allowed the authorities to protect many creditors (including all senior ones) from having to incur losses. This greatly raised awareness in the EU policy community (p. 15) about the need for bank insolvency law harmonization to ensure that the SRM would fully deserve its name.

3. Bank Resolution Funding and Market Discipline in Bank Credit Markets

1.36 The expectation that banks will receive financial support from their home country government in a crisis, and that this support will be dependent on the home country’s own sovereign creditworthiness, has arguably been the biggest of all drivers of the bank-sovereign vicious circle. As described earlier, the mid-2012 decision on European banking union has contributed to the erosion of this expectation, but is far from having eliminated it entirely. Indeed, for all the claims that taxpayers’ money will no longer be used to address financial crises, most market participants believe that some form of public support will be provided at least in severe crisis scenarios.

1.37 As emphasized earlier, the transition to the SRM has lagged the SSM by more than a year. The Single Resolution Board (SRB) was established as a new agency in Brussels on 1 January 2015. The Single Resolution Fund (SRF) was created on 1 January 2016, which is also the date when the SRB acquired the authority to handle resolution procedures at the European level and when both the SRB and national resolution authorities were empowered to impose the bail-in of bank creditors under the conditions defined by the BRRD. The SRF belongs to the SRB but retains ‘national compartments’ under the complex arrangements of an intergovernmental agreement signed on 14 May 2014, until these compartments are fully ‘mutualized’ in 2024. As a consequence, the framework for future crisis management and resolution in the euro area, and in particular for the possible use of public money, is affected by a number of important uncertainties.

1.38 Firstly, the mechanism and instruments for the bail-in of bank creditors (and possibly also of uninsured depositors) in a future resolution process are set by the BRRD in principle, but it remains to be seen how the directive’s arrangements will work in practice. The much longer experience with special bank resolution regimes in the US suggests a protracted process of adjustment before market participants gain a degree of predictability on how bail-in may work in isolated bank failures, let alone in future systemic bank crises. The pace of such adjustment will of course depend on the frequency and features of future cases of bank resolution in the EU, especially the first few ones which can be expected to establish significant precedents. At the time of writing, there has been only one case of SRB-led resolution, that of Spain’s Banco Popular in June 2017, which is not enough to answer all the corresponding questions.

1.39 Secondly, as mentioned earlier, euro area leaders agreed on 28–29 June 2012 that the ESM would be able to recapitalize banks directly in the future, even though they later backtracked from their initial decision to use this option retroactively in the cases of Ireland and Spain. While the ESM has no bank supervisory powers (p. 16) of its own, it has built up a permanent team of banking experts that may manage this recapitalization instrument in future crisis situations. The specific conditions set by euro area countries in 2014 for ESM direct recapitalization were so restrictive as to practically prevent its use, and the decision was made in 2018 to phase it out. Nevertheless, the need for an ESM direct recapitalization instrument might come back in some future crisis.
1.40 Thirdly, future decision-making by the SRB, on resolution processes and on the use of the SRF, is also untested with the only exception of Banco Popular in June 2017. The SRB’s decision-making arrangements have been widely criticized for their complexity, which makes it more difficult to predict how they will play out in future situations. The SRF remains relatively small, at €33 billion in mid-2019, with the expectation that it will eventually reach a total size of about €60 billion, an amount which itself is rather small compared to what could be future funding needs in many systemic crisis scenarios. Whether the SRF could be allowed to borrow from other sources, possibly including the ESM, is also still to be determined.17

1.41 Fourthly, the exact status of the public guarantee that applies to national deposit insurance schemes is also untested, in future crisis scenarios that involve the loss of a euro area government’s creditworthiness. The Cyprus crisis episode of March 2013 has powerfully contributed to uncertainty. Representatives from all euro area countries, as well as from the ECB and the International Monetary Fund (IMF), initially decided to link their financial assistance to a breach of the national guarantee of bank deposits, including all those under the guarantee threshold of €100,000. But after this plan was rejected in the Cypriot parliament, they shifted to a different approach and made the guarantee of deposits up to €100,000 an integral part of the assistance package that was eventually approved (even though uninsured deposits in failing banks were subjected to a harsh bail-in and capital controls had to be introduced). In November 2015, the European Commission published a legislative proposal to address this challenge through the creation of a European Deposit Insurance Scheme (EDIS), but subsequent negotiations have stalled even though many EU policymakers, not least at the ECB, have called for EDIS to be implemented.

1.42 Fifthly, and probably most importantly, there remains a general uncertainty regarding the balance between national and European sources of funding in future cases of bank crisis resolution. On the one hand, the argument that bank failures should be seen as the ‘legacy’ of past national supervisory failures, and that any public money to address them should therefore come from the corresponding (p. 17) national budgets, has proven very powerful politically since 2012. The broader prevention against any mutualization of the financial burden from crisis management remains strong in most of the Northern half of the euro area. On the other hand, the establishment of banking union was entirely predicated on the ‘imperative to break the vicious circle between banks and sovereigns’ as formulated in the leaders’ statement of 29 June 2012. Furthermore, the legacy argument is set to gradually lose its potency over time. Increasingly, future problems in banks supervised by the ECB are likely to be seen as linked to supervisory failures of the ECB itself rather than of any national authority. In this context, a call for public support to come from a national government’s budget may be far from straightforward. In other words, the German view of bank crisis resolution in the transition towards banking union has focused on Altlasten (legacy assets) but future problem assets will be Neulasten (new burdens) that will have arisen under the ECB’s watch. How the tension between the two narratives, about Altlasten and Neulasten respectively, is resolved in the future will depend in no small part on the actual sequence of future bank problems in the euro area, where they will materialize first, and how large they will be. This is inherently unpredictable.

1.43 In addition, the legal uncertainties associated with the new framework should not be underestimated. The legal robustness of both the SRM Regulation and the intergovernmental agreement on the SRF remains to be tested: the former invokes the Internal Market framework (Article 114 of the TFEU), but its geographical scope is restricted to a subset of Member States; the latter is awkwardly set outside the Treaty framework even though it is about a policy instrument created under EU law. Decisions by the SRB are subject to both national and European judicial review. The state aid control framework is also likely to evolve over time. Finally, the institutional strength of the SRB is
a crucial question mark. It is possible that it would evolve into a strong and autonomous institution, somewhat akin to the US Federal Deposit Insurance Corporation, with full effective authority over national resolution agencies. But this will depend on its leadership and political support from Member States, and on future cases of weak banks on which its effectiveness will be practically tested.

4. The Transformation of Europe’s Banking Landscape

1.44 Banking union will have significant consequences in terms of the structure of the banking industry in the euro area. As suggested above, earlier banking nationalism had motivated many national authorities in the euro area to prevent inward acquisitions of domestic banks by foreign ones (even those from fellow euro area Member States). By contrast, the ECB has an incentive to favour cross-border bank acquisitions as a way to reduce the fragmentation of the euro area financial space, and has explicitly called for such cross-border consolidation. This may prove significant over the medium-term, but has not much materialized in the banking union’s early years. While some euro area Member States (such as the (p. 18) Baltic countries, Belgium, Finland, and Slovakia) have high rates of penetration of foreign groups into their domestic banking sector, most others (including all five largest ones: France, Germany, Italy, the Netherlands, and Spain) still have more than 80% of national banking assets in the hands of domestically headquarteried groups.

1.45 While the ECB (and the SRB) can be expected to be more sanguine about intra-euro area cross-border bank combinations than national prudential authorities have been until now, it also remains to be seen whether the potential scope of acquirers will be enlarged beyond euro area banks. There is a strong case that private equity investors and non-EU banks could contribute positively to the repair of the euro area banking sector in the years ahead, as has been the case in various contexts following past systemic banking crises in Mexico, Japan, South Korea, and Indonesia, to name only a few. Such actors have already played a role in a few cases in Europe, such as private equity investments in BAWAG (Austria) in 2006, IKB (Germany) in 2008, and Bank of Ireland in 2011, as well as the purchase of NCG Banco in Spain (formerly NovaCaixaGalicia, now renamed Abanca) by Banesco, a Venezuelan banking group, in 2014, as exits from these banks’ nationalization by their respective governments. The ECB has allowed several further partial or full acquisitions by private equity groups, in Greek banks (late 2015), Portugal’s Novo Banco (2017) or Germany’s HSH Nordbank (2018).

1.46 One possible objection to cross-border acquisitions in the euro area is that they might lead to large increases in the size of already significant banking groups and thus exacerbate the problem of ‘too big to fail’ (TBTF) financial institutions and the corresponding moral hazard. On the one hand, as compared with intra-country combinations, cross-border bank acquisitions tend to lead to more complex groups and complexity tends to exacerbate the TBTF problem. But on the other hand, genuine banking market integration could make it possible to consider the TBTF effect on a European rather than national level in the future, which might significantly mitigate it. The aggregate value of a large European bank’s assets represents a much smaller share of euro area GDP than its share of the bank’s home country national GDP. The ECB has indicated that it would take into consideration these advantages of market integration as regards the TBTF issue when considering future combinations of euro area banks, including among the larger ones.

1.47 Several structural consequences may emerge from the constitution of a broader set of pan-European banking groups, which would have an impact on the political economy of the European banking sector. Genuine cross-border banks can be expected to call from more European banking policy integration, as this may help to reduce costs and maximize synergies among their operations in different euro area countries. This could help cement and reinforce the banking union policy framework with the support of an influential interest group. It will also call for checks (p. 19) and vigilance to ensure that the ECB and other
European-level authorities are not unduly captured by powerful pan-European banking interests.

1.48 Cross-border banking integration may also lead to further differentiation across euro area Member States, because the pan-European banks’ headquarters can be expected to cluster in a limited number of financial centres. As a consequence, an increasing number of Member States may be left without any significant ‘domestic’ banks of their own. This is already the case in several Central and Eastern European countries. At the national level, it could create political incentives to penalize the foreign-controlled banking sector as a whole, for example through significant increases in sector-specific taxation, as was done in Hungary in the early 2010s. At the European level, it will affect the dynamics of intergovernmental decision-making, including voting patterns in bodies such as the EBA, the ECB’s Supervisory Board, and the SRB’s plenary sessions, since a growing number of participants in such processes will no longer be motivated by the promotion or protection of national banking ‘champions’.

1.49 At the other end of the spectrum, banking union could also result in a more favourable environment for the creation of new (or ‘de novo’) banks that would not be linked to long-established financial groups. There have been remarkably few de novo banks in Europe in the past century: almost all significant European banks trace their roots back to the 19th century, if not earlier, as do most small banks as well. By contrast, there has been a near-constant flow of creation of de novo banks in the US: while the largest American banks all have old roots, many active local banks are of relatively recent origin. This feature of the current European banking landscape has many causes, one of which may be the protection of incumbent banks by national public authorities under the influence of banking nationalism. The combination of a more assertive EU competition policy framework, reduction of banking nationalism within the SSM, and post-crisis restructuring of overbanked countries and market segments could create an environment that may be more favourable to the emergence of European de novo banks in the future than has been the case in the past.

5. Diversification of Europe’s Financial System Away from Banks

1.50 Banking union is likely to have further structural impact beyond the banking sector itself, and to contribute to a reshaping of the broader European financial system, which until the crisis has been notable for its overwhelming dependency on banking intermediation. This transformation, however, is unlikely to be rapid and will only be observed over the longer term.

(p. 20) 1.51 An early indication of a shift away from the current dominance of banking in European finance was the decision by Jean-Claude Juncker, at the time of his confirmation by the European Parliament as newly elected President of the European Commission in July 2014, to announce the creation of a Capital Markets Union (CMU), in other terms a renewed agenda of development of capital markets and other non-bank financial channels to help reinvigorate the European economy. This initiative, however, has not resulted in major legislation in the subsequent years of the Juncker Commission, partly as a result of the disruption brought by the 2016 British referendum on leaving the European Union (‘Brexit’).

1.52 There is a direct link between banking union and CMU. The same crisis experience that led to banking union underlies the policy momentum behind the CMU agenda, as the prior financial sector policy framework is largely considered to have failed to provide either stability or efficiency, at least in euro area countries. Furthermore, the perceived early successes of implementation of banking union may have contributed to the European
1.53 The primary motivation of CMU is the observation that Europe’s near-exclusive reliance on banks for the financing of its economy has been shown by the crisis experience to be more of a vulnerability than a strength. In the US, the phase of significant bank restructuring and deleveraging in 2008–2009 did not generally result in credit scarcity, in large part because alternative channels of financing, largely based on capital markets activity, could still provide credit to economic actors even as banks were retrenching. By contrast, in the EU, bank deleverage has an essentially unavoidable contractionary impact on the economy, which is one of the reasons why it has proven so difficult to address the continent’s systemic banking fragility through adequate restructuring since the inception of financial crisis in 2007.

1.54 The ECB itself has expressed support for the prospect of a more diverse European financial system that would rely less exclusively on banks in the future. In comparison to national prudential authorities, the ECB may be more supportive of the CMU agenda, and of more European capital markets development, for a number of reasons. Some national authorities may have been driven by banking nationalism to repress non-bank finance, as alternative credit channels may create additional competition that could have eroded the market position of their national banking champions. Moreover, the underdevelopment of capital markets in the euro area has created challenges to the ECB’s monetary policy, as the transmission of monetary policy signals to the broader economy has been impaired by the fragility of the banking system in a number of Member States since 2010–2011. It has been very hard for the ECB to emulate the US Federal Reserve’s success with programmes of large-scale purchases of securities other than government bonds.

1.55 In principle, the CMU agenda could include a number of significant items, namely: reforms of EU securities regulation to unlock the potential of some underdeveloped market segments; changes to prudential rules, particularly those that apply to insurance companies and pension funds, to better take into account the long-term horizon of their investments and consequences in terms of risk management; integration of policy frameworks on accounting, auditing, credit information, and other forms of financial information, whose inconsistency across Member States until now has limited the potential for investment in the corporate sector on a pan-European basis; an overhaul of national insolvency frameworks to make them friendlier to creditor interests and the preservation of employment, and to reduce differences among them in order to facilitate the emergence of pan-European credit market segments; a partial harmonization of certain aspects of the taxation of savings and investments, perhaps limited to a subgroup of Member States; and a supervisory and resolution framework for financial infrastructure firms (such as central counterparties) that would be better aligned with the objective of an integrated marketplace across national borders. The lack of a similar pressure of emergency as existed in June 2012 when banking union was initiated, however, suggests that many of these dimensions of CMU will only unfold gradually in the future, if at all.

6. A New Institutional Order for the Elaboration of European and Global Financial Sector Policies

1.56 Lastly, the advent of banking union is bound to modify the balance of institutions at the national, European, and global levels and thus to affect the elaboration of banking policies. The central development is the emergence of the ECB as a uniquely influential institution at the EU level, given the relative deficit of executive capacity of other European institutions including the European Commission. The strengthening of the ECB’s
comparative position in the balance of European institutions predated banking union, but has been significantly reinforced by it.

1.57 At the national level, the activity of bank supervisory authorities is increasingly determined by their participation in the SSM, which now binds them on most of their policy scope. This evolution has taken different forms in different countries, depending on idiosyncratic features that include whether the supervisory function is under the aegis of the national central bank (as in Belgium, Cyprus, France, Greece, Ireland, Italy, Lithuania, the Netherlands, Portugal, Slovakia, Slovenia, and Spain) or at least partly lodged in a separate institution (as in Austria, Estonia, (p. 22) Finland, Germany, Latvia, Luxembourg, and Malta). On the one hand, being part of the SSM has helped national supervisors to gain more independence from their national political environments and related pressures, including in terms of banking nationalism; on the other hand, the loss of autonomy in formal decision-making has often been resented as a form of institutional downgrading. The balance of these effects depends strongly on country-specific institutional legacies.

1.58 The ECB appears to have been rather adept at managing such tensions during the early years of banking union, but at the price of delaying some of the more controversial issues in its relationship with national supervisory authorities. Time is on the side of the ECB, however, as the SSM Regulation provides a firm basis for its centralization of policy authority on most aspects of banking supervision. Furthermore, a common culture is gradually emerging within the SSM, through the harmonization of supervisory definitions and processes, the operation of joint supervisory teams, joint on-site inspections, the fact that most ECB supervisory staff come from national authorities, and occasional secondments of ECB staff to those authorities.

1.59 At the European level, the new reality created by the crisis is one of multiple new agencies that play a role in banking policy and more generally in the oversight of the financial system, with a corresponding proliferation of inelegant acronyms. These include the ECB as a bank supervisor (operational since late 2014), the EBA and its siblings the European Insurance and Occupational Pensions Authority (EIOPA) and European Securities and Markets Authority (ESMA) (all three created in 2011), the European Systemic Risk Board (ESRB) (also started in 2011 and hosted by the ECB) and the SRB (started in 2015 and fully operational since 2016). To these may be added the above-mentioned possible role of the ESM in bank recapitalization or in backstopping the SRF, which is supported by a permanent banking team at the ESM.

1.60 This sudden surge of institutional complexity stemmed partly from the ad hoc nature of the EU’s policy response to the crisis and partly from the fact that not all EU Member States participate in monetary or banking union which creates some need for institutional duplication. It inevitably results in tensions among these agencies and rivalry for turf and resources, which will take time and leadership to fully settle.

1.61 Before the crisis, the European Commission was the undisputed hub of financial services policy at the EU level, but the new situation is markedly different. Indeed, maintaining working relationships with all the new agencies is one of the key challenges faced by the Commission in the new environment. This (p. 23) particularly applies to the Commissioner for Financial Stability, Financial Services, and Capital Markets Union, and the Commission’s Directorate-General (known as DG FISMA) that reports to him, but also to other parts of the Commission. Specifically, the Commission’s competition policy arm (Directorate-General for Competition (DG COMP)) has acquired a prominent role in financial sector policy through its scrutiny of state aid to banks, which generate potential overlap with the new functions of the ECB and SRB.
Furthermore, the current institutional order at the EU level should not be seen as static. The Capital Markets Union agenda may result in new bodies being created at the EU level, to handle areas such as IFRS enforcement, oversight of audit firms, or supervision and resolution of systemically important financial infrastructure firms such as international central counterparties (even though some of these functions may also be located within existing agencies, such as ESMA). The balance between the supervisory and monetary policy functions of the ECB may also evolve over time. The current system, in which the ECB’s Supervisory Board is formally subordinated to the central bank’s Governing Council but practically has wide autonomy, has overall rather well stood the test of its first few years, but is criticized by some analysts as potentially generating conflicts of interest. Looking ahead, the baseline scenario is one of lasting institutional complexity, similar to the US where past attempts to reduce the number of federal financial bodies, for example by merging the Commodities Futures Trading Commission and the Securities and Exchange Commission, have repeatedly failed.

From an international perspective, banking union established the euro area as the largest single jurisdiction in terms of the aggregate balance sheet of the banking sector, a status that had earlier belonged unambiguously to the US—even though, in the meantime, rapid bank balance-sheet expansion in China has relegated the euro area to second position, and the US to third. One measure of this shift is to look at the list of the world’s most systemically important banks, as maintained on a yearly basis by the Financial Stability Board (FSB). On the basis of the latest list of 29 institutions, eight of these are headquartered in the US, four in France, four in China, three in the UK, two in Switzerland, and one in each of Canada, Germany, Italy, the Netherlands, and Spain. But on an aggregate basis following banking union, the euro area reaches equal status with the US with eight banks. This inevitably gives the ECB more clout in global banking policy bodies. In the Basel Committee on Banking Supervision (BCBS), both the ECB and the SSM (in practice, the ECB’s supervisory board) became full members in October 2014 and it is probably only a matter of time before the current full membership of supervisory authorities in Belgium, France, Germany, Italy, the Netherlands, and Spain are downgraded to a less prominent status. A similar dynamic may apply to the FSB itself, in which representatives from the central banks of France, Germany, Italy, the Netherlands, and Spain are present in both the Plenary and the slightly more compact Steering Committee. Beyond issues of formal membership, banking union enhances the global status of EU-level bodies such as the ECB, European Commission, and SRB in global financial standard-setters and policy bodies, partly to the detriment of national authorities from euro area countries.

III. Conclusion

This summary review of possible economic consequences of banking union illustrates how widespread these consequences might be and also the complexity and interrelations between various aspects of such economic impact. Furthermore, the European context remains marked by major uncertainties that will further affect the future of banking union and of the European economy more generally.

The future of the UK relationship with the EU is one source of such uncertainty. The UK voted to exit the EU in June 2016, but at the time of writing, the modalities of that exit remain highly uncertain. Even an eventual return of the UK to the EU following its exit cannot be entirely ruled out, which over the long-term could entail future participation in banking union, even if the UK remains outside of the euro area. Aside from the UK, other non-euro Member States, such as Denmark, may choose the option offered by the banking union framework to join the SSM and SRM on a voluntary basis. Bulgaria is scheduled to do so in 2019 in anticipation of its expected future membership of the euro area. This may add additional complexity to what is already an intricate set of institutional arrangements, but
would also make banking union a stronger framework by enlarging its base of support among EU Member States.

1.66 Continued economic and political fragility in the euro area, of course, is another very significant uncertainty factor. The current environment is of growing popular distrust in established elites and political systems and it is unclear whether a path out of this predicament can be found with incremental reform only. Should further deterioration lead to more radical developments, such as renewed consideration of treaty change, there would surely be implications for the banking union framework. The possibility of separating the SSM from the ECB, as mentioned earlier, is only one of many options that would open up in such a context.

(p. 25) 1.67 Banking union has itself been a radical step, made possible by the unique political context of mid-2012. Even in its current incomplete form, it has had a major stabilizing impact and has mitigated the bank-sovereign vicious circle in its first few years of existence. Its future development and impact are subject to numerous question marks, but there is no prospect of return to the policy status quo that existed before the turning point of 28–29 June 2012. Banking union in its current incomplete form has been insufficient to put the euro area back on a sustainable trajectory. Even so, it has been one of the most constructive and promising developments in the EU since the start of the crisis in 2007, and even arguably since its creation. The early successes of its implementation could serve as inspiration for policy initiatives in other areas, such as energy and digital services, as well as for the Capital Markets Union agenda. The economic consequences of Europe’s banking union cannot be forecast with any precision at this early stage, but it is already sure that they will be significant.

Footnotes:


6 Herman Van Rompuy, speech at the Brussels Economic Forum 2014, 4th Annual Tommaso Padoa-Schioppa Lecture, 10 June 2014.

7 Interview with Mario Monti, de Volkskrant, 13 April 2014.


