

EUROPE'S RADICAL BANKING UNION

by
Nicolas Véron

BRUEGEL ESSAY AND LECTURE SERIES



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Nicolas Véron

Editor: Stephen Gardner

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CONTENTS

Foreword.....	5
Introduction	7
What is banking union?	9
Banking union and positive contagion	14
Banking union and the reduction of moral hazard	20
Four developments to watch	23
<i>Supervisory quality and the repair of banks' balance sheets.....</i>	<i>23</i>
<i>Reversing financial fragmentation in the euro area</i>	<i>29</i>
<i>The transformation of Europe's banking and financial landscape.....</i>	<i>38</i>
<i>A new institutional order for European and global financial sector policies.....</i>	<i>44</i>
Conclusion.....	49
References	51
Notes.....	57

FOREWORD

Banking union is perhaps the most transformative institutional response to the crisis experienced by the euro area in the last few years. Bruegel scholar Nicolas Véron argues in this thought-provoking essay that banking union ultimately enabled the European Central Bank's announcement that it would buy large quantities of government bonds if needed and on the condition of a financial support programme. The Outright Monetary Transactions (OMT) programme was only acceptable to the ECB and governments in the context of a significant and substantial step towards more institutional integration, which the banking union project arguably constitutes. I am sure this link between OMT and banking union will be much debated. But there is no doubt that the OMT programme was central in calming markets and bringing to an end the very acute phase of the euro-area crisis.

Banking union, as it stands, remains unfinished. However, important building blocks have been put in place. The creation of a new single supervisor in the ECB, the Single Supervisory Mechanism (SSM), is a substantial step forward. This new euro-area institution now has the authority to supervise but also to withdraw the banking license of any bank in the euro area. A single resolution mechanism has also been created to carry out the task of resolution and recovery.

The extent to which these new institutions transform the European banking landscape and how they improve crisis management in the euro area will depend on how they deliver. As always, new institutions will have to pass leadership tests with determined and courageous action.

In the unfolding Greek crisis, the new supervisor has already played a positive role by clearly laying out the supervisory limits to the Greek banks. More specifically, the SSM has put a ceiling on Greek banks' exposure to the Greek government. Some have criticised this as a step that puts undue pressure on the Greek government to come to an agreement with its creditors. However, the imposed limits actually make the Greek banking system more resilient in the face of Greek political uncertainties. This increases the probability of liquidity provision in the case of an outright default because Greek banks will be less exposed to the Greek government.

The SSM has therefore already made an important contribution to crisis management. The exposure limits increase the chances that Greek banks will survive a Greek government default and will continue to receive ECB liquidity. This, in turn, increases Greece's chance of staying in the euro area. Arguably, therefore, exposure limits imposed and executed by the SSM increase the stability of the euro area. Generalising this policy should now be considered and is also feasible thanks to extraordinarily low interest rates.

Time will tell how much European banks will change their business models and to what extent cross-border banking integration will happen. It is possible that the institutions created so far remain too weak and that more fiscal integration and ultimately political union is needed to sever the link between banks and sovereigns to the extent needed for a sustainable economic and monetary union. But the current banking union is certainly a radical and a welcome break from past national banking policies. Please enjoy this authoritative new Bruegel essay.

*Guntram Wolff, Director, Bruegel
Brussels, May 2015*

EUROPE'S RADICAL BANKING UNION

INTRODUCTION¹

Developments in the financial system remain in many ways the hidden story of the European crisis. The dominant storyline follows the mantra that 'it's mostly fiscal'². This narrative dates the start of the crisis to late 2009, when the Greek government started losing market access in the wake of revelations about its misreporting of its past fiscal position. The narrative is punctuated by the sovereign assistance programmes extended to Greece and Ireland in 2010, Portugal in 2011, and Cyprus in 2013; the protracted negotiations that led to the Greek government's default on its obligations to private-sector creditors in March 2012; and the ongoing drama following the Greek elections of January 2015³.

Fiscal developments easily grab the public attention because they feature larger-than-life politicians, late-night summits, public services and taxpayers' money. They are evidently of crucial importance. But an exclusive focus on fiscal questions tends to obscure less-visible dimensions of the crisis that relate to deeper layers of solidarity and trust, or the lack of them. Below the surface, financial-sector weakness has been the thread running through the European crisis since it began in mid-2007, long before Greek fiscal shenanigans first caught the world's attention. The European crisis was financial before it was fiscal, and has remained a financial crisis all along until now. At no point since 2007 has the European financial system emerged from a state of abnormal fragility, even though the restoration of trust in Europe's banks has recently become a less remote prospect.

The public under-estimation of Europe's financial problems has been mirrored by a parallel under-estimation of its main financial policy response: banking union. Banking union was first announced on 29 June 2012 following a crucial meeting of European leaders. But the terms of the commitment were ambiguously worded, and some elements were contradicted by key players in the following days. Only the passing of time and the concrete implementation of the mid-2012 announcement have established its watershed nature. Many participants and observers have yet to fully wake up to its implications. Even in its current incomplete form, banking union marks a radical change that profoundly modifies the nature of European integration and the balance between member states and European institutions. But a mix of healthy scepticism, misplaced cynicism and lazy inattention has prevented a general recognition of its true significance.

This essay aims to contribute to redressing this imbalance in public perception and understanding. It focuses on the assessment of banking union's economic impact, thus complementing numerous prior contributions (including those from the author and his colleagues at Bruegel) which emphasised policy recommendations as banking union was still unborn or in the process of being designed⁴. To be sure, the definitive history of Europe's banking union, and particularly of the crucial developments of summer 2012, is still to be written⁵. For several important assessments, including the landmark meeting of 28-29 June 2012 and its immediate aftermath, the analysis presented in this essay has relied on the author's private conversations with key players and witnesses. It is hoped that further future work will help fill remaining gaps in documentary evidence and correct any misjudgements.

The essay is organised as follows. The first section summarises the banking union policy framework as currently enacted, and its sequence of implementation. The subsequent sections make two arguments on the early impact of the decision to initiate banking union: respectively, that it enabled the European Central Bank (ECB)'s action that led to a general decrease in sovereign bond spreads, and that it allowed Europe to credibly shift away from its earlier policy stance of

bailing out most creditors of failed banks. The next section explores banking union's possible future impact in terms of four key aspects: supervisory quality and balance sheet repair; the reversal of financial fragmentation; the transformation of Europe's banking and financial landscape; and institutional implications. The last section concludes.

WHAT IS BANKING UNION?

The expression 'banking union' first appeared in the European public debate at the end of 2011, and became widely used in the media and among European officials in the spring of 2012⁶. It indicates both a framework in which banking-sector policy is pooled at the European level, and the process of transition to such a framework from the prior situation in which banking-sector policy was mostly national. In this context, banking-sector policy is often defined as including regulation, supervision, resolution and deposit insurance, even though the precise policy scope may vary depending on context. As further analysed in the next section, the starting point for banking union was a summit of euro-area heads of state and government in Brussels on 28-29 June 2012, at which the critical decision to centralise supervisory authority within the ECB was made. The decision to complement this with European-level arrangements for bank resolution was announced at a later summit, in December 2012.

These decisions did not transfer all responsibilities from the national to the European level. Thus, in its current form, banking union, even at the end of planned transitional arrangements, cannot be considered complete, especially with regard to deposit insurance and many aspects related to crisis management and resolution. In addition, some aspects of the banking-policy framework were already European before 2012, including competition policy, many harmonised rules and a modicum of supranational supervisory coordination through the European Banking Authority (EBA). Nevertheless, the decisions initially made in 2012 and currently being implemented have substantially moved the locus of decision-making about banks in the euro area from national to

European authorities, as will be further demonstrated in this essay. Thus, unlike many other European monikers, 'banking union' is not a misnomer and can be accepted as an adequate label for the cluster of policies that it encompasses.

Banking union is mainly defined by two of these policies, known as the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM). The core of the SSM is the transfer of the power to grant or withdraw banking licenses and of related supervisory duties from national authorities in the euro area to the ECB, effective since 4 November 2014. A Supervisory Board was created within the ECB to serve as the SSM's main decision-making body⁷, and is supported by an entirely new administrative organisation, which is further detailed below. The SRM will centralise much, but not all, of the decision-making process for the resolution (an administrative alternative to court-ordered insolvency) of non-viable banks, granting a key role to another new organisation, the Single Resolution Board (SRB), which, under certain conditions, will be able to draw resolution financing from a Single Resolution Fund (SRF). Unlike the SSM, which deserves its name since it has been given sole licensing authority for all banks in the euro area, the SRB and SRF are 'single' in name only, because they will co-exist with national arrangements for decision-making and funding of resolution processes, as also discussed in more detail below.

The new institutions, ECB Supervisory Board and SRB, are in many ways the visible faces of banking union. The Supervisory Board, which is legally part of the ECB, is located in Frankfurt, in a separate building from the rest of the institution⁸, and started operations in early 2014. The SRB, a newly formed EU agency with autonomous legal personality, is located in Brussels and started operations in early 2015. Both starts were preceded for a few months by prefiguration teams, respectively from the ECB and the European Commission. The Supervisory Board is headed by Daniele Nouy, formerly secretary-general of France's national banking supervisory authority (ACPR), and includes five other members appointed by the ECB⁹ and the heads of each national supervisory authority in the 19 countries of the euro area. The

SRB is headed by Elke König, formerly president of Germany's national banking supervisory authority (BaFin), and includes five other Executive Representatives¹⁰. Both organisations use English as their internal working language and for most (but not all) of their communication with stakeholders¹¹.

The legal basis for banking union is a series of legislative texts that were adopted in 2013 and 2014 following initial political decisions in 2012. The SSM Regulation of October 2013 is based on Article 127(6) of the Treaty on the Functioning of the EU (TFEU), which was included in the Maastricht Treaty to enable the conferral of supervisory responsibilities to the ECB, but had barely been activated before 2012¹². The SRM Regulation of July 2014, which establishes the SRB, is based on Article 114 TFEU, the common basis for internal market legislation which had already been used to create new EU agencies. The SRM Regulation also establishes the SRF under the authority of the SRB, but its financing arrangements are detailed in a separate intergovernmental agreement signed in May 2014. These were complemented by other pieces of EU harmonising legislation that were adopted during the same period (even though some were initially drafted before the decision to initiate banking union). These are also based on Article 114 TFEU: the Capital Requirements Regulation (CRR) and fourth Capital Requirements Directive (CRD4) of June 2013; the Deposit Guarantee Scheme Directive (DGSD) of April 2014; and the Bank Recovery and Resolution Directive (BRRD) of May 2014, which establishes and harmonises special resolution regimes for banks in all EU member states, as well as national resolution authorities and national resolution funds¹³.

For the moment, the geographical scope of the SSM and SRM includes only the 19 member states of the euro area. However, other EU member states may choose to be included through a voluntary adhesion, labelled 'close cooperation' in the SSM Regulation. In November 2014, the ECB reported that it had "*received informal expressions of interest from some member states (...) with a view to their possible entry into close cooperation arrangements*"¹⁴. Notably, the intergovernmental

agreement on the SRF was signed by all EU member states except Sweden and the United Kingdom. It thus appears likely that a ‘banking-union area’ will emerge in the future as a ‘concentric circle’, encompassing all member states of the euro area but also a few more, without however including all EU member states. There are strong indications, in particular, that Denmark may decide to join the banking union early.

This would mirror the hybrid nature of banking union, which is partly based on the euro-area policy framework with Article 127(6) as the basis for the SSM, and partly on the EU single market framework, with Article 114 as the basis for the SRM. On the one hand, the sequence of decision-making that led to the creation of banking union was clearly specific to the euro area. Indeed, the founding decision of 29 June 2012 was made during a euro-area summit, even though it was later endorsed by other EU countries: in compliance with Article 127(6) TFEU, the SSM Regulation was unanimously approved by all 28 EU member states, including the UK. On the other hand, as this essay will show, the underlying logic of banking union is that of the single market. Its key objective is the elimination of national competitive distortions that tie banks to the creditworthiness and political idiosyncrasies of the member state in which they are headquartered. From that standpoint, the fact that banking union did not initially cover all EU member states was a matter of political expediency rather than of fundamental policy underpinnings. Indeed, most of the early (pre-2011) advocacy of EU banking policy integration was not limited to the euro area, but envisaged encompassing all EU member states¹⁵. Even in the UK, a recent parliamentary report notes that “*the Government would be wise not to close the door on the possibility of participation in some elements of Banking Union in the future*”¹⁶.

As further detailed below, the SSM and SRB have more direct authority over banks that are considered ‘significant’ under a set of pre-determined criteria. According to the ECB’s counting, there are 123 ‘significant’ banking groups in the euro area, including all those with more than €30 billion in total assets. According to the ECB, significant

banks represent almost 85 percent of the euro area's total banking assets¹⁷. Of these, also measured by aggregate assets, French banks represent around 32 percent, German banks 22 percent, Spanish banks 14 percent, Italian and Dutch banks 10 percent each, and all other euro-area countries a total of 13 percent¹⁸. The 3,520 'less-significant' banks are mostly concentrated in Germany (1,688 banks, or 48 percent of the total number), Austria (16 percent) and Italy (15 percent)¹⁹.

From a practical standpoint, the transition towards the banking-union framework, as defined by the EU legislation of 2013-14, started with the Comprehensive Assessment of 130 euro-area banks in 2014 (on which more below) and the subsequent assumption of supervisory authority by the ECB on 4 November 2014. This transition is still ongoing, which implies that any current assessment of banking union can only be considered tentative. It will be substantially completed on 1 January 2016, when the SRB acquires its resolution authority and the key bail-in provision of the BRRD (the ability of resolution authorities to impose losses on senior creditors and uninsured depositors of non-viable banks) enters into force. Even after that, it will take some time for the dust to settle and for the structural consequences of banking union to become fully observable. Furthermore, one piece of the new framework, the SRF, will be only gradually built up and mutualised from its initial setup as a juxtaposition of so-called national compartments. This process is currently scheduled to be completed at the time of final disappearance of these national compartments in 2024. Overall, the journey towards European banking union has irreversibly started. But even though almost three years have passed since the initial decision, it is still in its first stages.

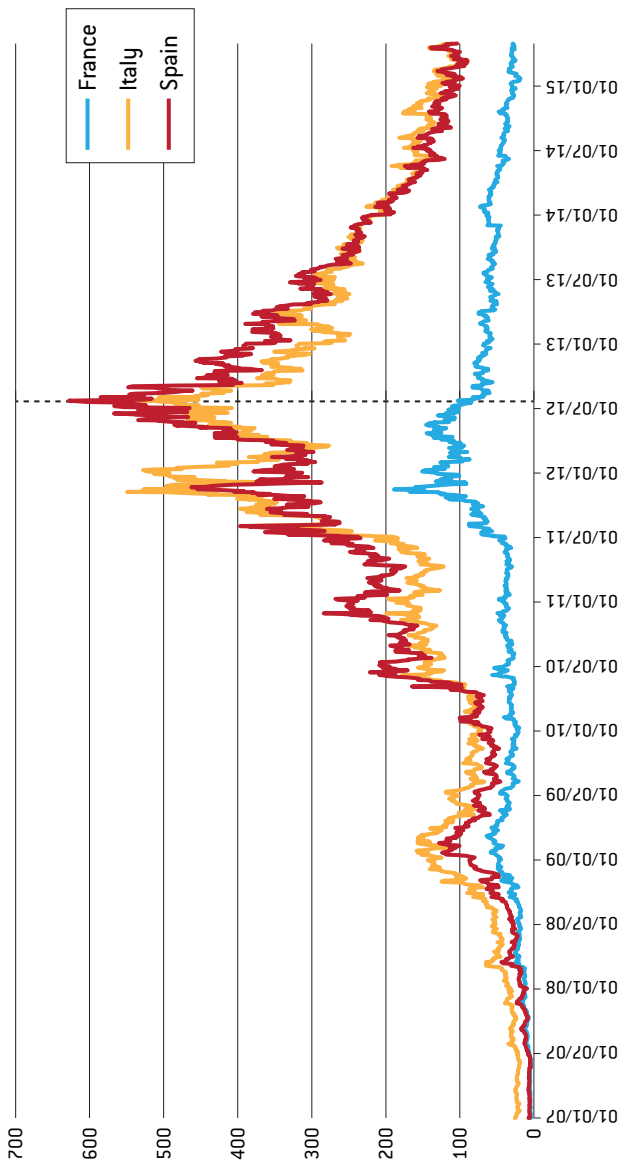
BANKING UNION AND POSITIVE CONTAGION

The decision to initiate banking union was part of a complex sequence of European decision-making in the late spring and early summer of 2012, which makes it difficult to identify unambiguous lines of causality. The sequence included, among other critical developments, the Greek election of 17 June 2012, which allowed the formation of a government that would work cooperatively with the country's official creditors; the euro-area summit of 28-29 June; and the statement of 26 July by ECB President Mario Draghi in London that "*within [its] mandate, the ECB is ready to do whatever it takes to preserve the euro*"²⁰. Following the latter pronouncement, the ECB announced its unprecedented Outright Monetary Transactions (OMT) programme, first in general terms on 2 August and then in more technical detail on 6 September.

Mr Draghi's London remarks and the OMT programme signalled the ECB's readiness to buy massive amounts of sovereign bonds of fragile countries, under certain conditions, in order to ensure the effectiveness of monetary policy throughout the euro area. They triggered a major turnaround in market perceptions, dubbed 'positive contagion' in contrast with the disruptive contagion of market turmoil from smaller peripheral countries to Spain, Italy and to a lesser extent France in the previous year. The trend of decreasing sovereign spreads has continued essentially uninterrupted until now, as illustrated by Figure 1.

To disentangle the relationship between banking union, OMT and market perceptions, one must go back to the drivers of both the crisis and the policy response. It is now widely accepted that the root cause of the (negative) contagion before mid-2012 was the interdependency between sovereign credit and bank credit, or bank-sovereign vicious circle. The fact that the banking systems of most euro-area countries were essentially national, rather than integrated into a broader European system, meant that a key determinant of banks' real and perceived strength would be the contingent or actual support provided to them by the sovereign. In such a setting, banking-system fragility

Figure 1: Sovereign spreads over 10-year German Bund, 1 January 2007 to 1 May 2015



Source: Bloomberg. The vertical line marks the date of Mr Draghi's remarks in London, 26 July 2012

results in growth-crippling credit scarcity and a potentially massive financial burden for the government. Sovereign weakness, in turn, is transmitted to the banks, directly through their holdings of sovereign debt and indirectly through the erosion of value of the explicit and implicit public guarantees. In a monetary union, this deadly embrace is compounded by the impossibility of mitigating a 'sudden stop' through devaluation, and by the tendency among many policymakers to view the competition among European banks as a proxy for competing national interests, or 'banking nationalism'²¹.

The pattern of sudden stop was familiar in the context of emerging economies, but was difficult to accept for European policymakers who could not think of their ostensibly developed countries as subject to the same type of risk. Thus, they had to come very close to the brink of euro-area breakup to accept that the crisis could not be addressed without accepting that "*it is imperative to break the vicious circle between banks and sovereigns*", the very first sentence of the public statement following the euro-area summit of 28-29 June 2012²². Put simply, this could be done either through fiscal union, or through banking union. After the failure of half-hearted attempts to make meaningful progress towards fiscal union in the second half of 2011, banking union was in practice the only remaining option. To its credit, the International Monetary Fund, which had more familiarity with similar situations in emerging economies, was the first public organisation to articulate this vision with clarity in late January 2012, following years of advocacy of EU banking policy integration²³. It would take five more months for European leaders to reach a similar conclusion.

Beyond the aspiration to break the bank-sovereign vicious circle, the leaders' declaration of 29 June 2012 included two specific policy commitments. The first announcement was the creation of the SSM, with the specific reference to Article 127(6) that implied that the ECB would be the new central supervisor. The second commitment was a pledge to allow the European Stability Mechanism (ESM), the common euro-area fund that was then in the process of being established, to recapitalise banks directly under certain conditions.

Conversations with key witnesses confirm that leaders had agreed during the summit that such direct recapitalisation of banks by the ESM may be applied retroactively, at least in the cases of Spain and Ireland. In other terms, member states that recapitalised troubled banks could expect that the ESM would, at some point in the future, take over the corresponding capital instruments from them. However, this agreement on retroactive effect was not mentioned explicitly in the public statement, partly because negotiations on Spanish banks were still ongoing, and only the general principle of ESM direct recapitalisation was announced²⁴. The declaration also included language that could be interpreted as making it easier for the ESM to buy Italian and Spanish bonds, with the ECB acting as its agent²⁵.

The promise of direct bank recapitalisation by the ESM followed almost a year of debates on this option, initially championed by the EBA and resisted early on by the German government²⁶. At the time of announcement, it appeared more tangible than the creation of the SSM. The latter had until then been described as a long-term vision rather than an immediate policy action. No specific details were given about it in the declaration of 29 June, making it conceivable that it would not mark a major step towards policy integration beyond what had already been achieved with the EBA. Then, in the days and weeks that followed the summit, several governments including Germany's were seen as backtracking on the commitment about direct recapitalisation 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 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.

However, from the ECB's standpoint, the announcement of the SSM was a firm enough commitment about the separation of banking risk from sovereign risk, and political cohesion more generally, to serve as a basis for further action. This was not least because the central role in

the system was granted to the ECB itself. This represented both a vote of confidence in the institution from the euro area's political leaders, and a guarantee that the ECB, being in the driving seat, would be able to avoid a watering down of the original vision. When Mr Draghi pre-announced OMT on 26 July, there were already widespread doubts that direct bank recapitalisations by the ESM would ever happen. But the SSM alone would provide enough mitigation of the bank-sovereign vicious circle, and thus enough resilience of the euro area in the medium term, to make the risk of OMT worth taking for the ECB. The 'positive contagion' that followed suggests that this risk assessment was correct, because the SSM was effectively put in place, and the OMT announcement had massive market impact without even requiring actual implementation.

The passing of time has strengthened the indications of a causal link between the summit decision to initiate banking union in late June 2012 and the OMT announcement a month later. In a speech in 2014, Herman Van Rompuy, who had chaired the summit as President of the European Council, noted that:

"...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"²⁷.

Similarly, Mario Monti, who had participated in the summit as Italy's prime minister, argued in a later interview that "Mr Draghi had been able to say it [OMT] because he had received the political support of the leaders" during the meeting in late June²⁸. The ECB cannot be so explicit, as it is bound to deny any direct link between a political decision and its own monetary policy action. Nevertheless, when presenting the OMT programme at the European Parliament in the autumn of 2012, Mr Draghi called it a 'bridge' to a destination towards which "the establishment of the SSM is a key step"²⁹. Almost exactly a year after the June

2012 summit, in a speech in Berlin, he singled out that moment's unique importance in the entire sequence of crisis management³⁰. More recently, Mr Draghi wrote that *"the setting-up of European banking supervision has been the greatest step towards deeper economic integration since the creation of Economic and Monetary Union"* and noted that the decision to create the SSM *"was a fundamentally political one"*³¹.

In the end, the commitment about ESM direct recapitalisation was not implemented. Somewhat ironically, the decrease in market pressure following the announcement of OMT might have encouraged its shelving. 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 recapitalisation by the ESM would not be applied retroactively, contrary to the agreement made (but not publicised) in late June. A few weeks later, German Chancellor Angela Merkel confirmed that *"there will be no retroactive direct recapitalisation"*³², a reversal of position that was met with incredulity in the countries that felt they had been given assurances in June, particularly Ireland³³. This reversal, however, was not enough to alter the improvement of sovereign debt market conditions that had been started by the ECB's announcements.

To be sure, the sequence of events during those critical weeks around mid-2012 was dense and convoluted. It can be expected that firmer evidence about the process of decision-making will gradually emerge in the years ahead, and will improve the current incomplete record. On the basis of available information, though, it is the decision to create the banking union, and in particular the SSM, that appears as the central political turning point that enabled the subsequent ECB initiatives and the decrease in periphery countries' sovereign debt spreads.

BANKING UNION AND THE REDUCTION OF MORAL HAZARD

In addition to creating the space for the ECB's announcement of OMT, the commitment to banking union in June 2012 had another short-term impact. It lent credibility to the notion that the EU would gradually move away from its almost universal preference for bank bailouts (the reimbursement by governments of all creditors of failing banks, and even in some cases of shareholders) towards a default recourse to 'bail-in' (the forced imposition of losses on creditors and other claimants to finance a non-viable bank's orderly resolution). This in turn reduced the perception of contingent government liabilities arising from problems in individual countries' banking systems, further contributing to the reduction of the bank-sovereign vicious circle.

Before 2012, almost all bank failures in the euro area had been addressed with full publicly-funded bailouts of all creditors no matter how junior, and no matter how small the bank, with only a partial exception in Ireland. This near-absolute pro-bailout stance had been established at the very outset of the crisis in late July 2007 with the rescue of IKB, a medium-sized German bank, and also echoed previous episodes of bank crisis management in Europe, eg in France and Scandinavia in the early 1990s³⁴. It had been further reinforced by the unique political economy of banking in Europe. Supervision had remained a national competence even as other EU policies (single market, competition policy, and in the euro area, economic and monetary union) had introduced an increasingly binding framework of cross-border competition and integration. This combination had created powerful tensions between each national banking supervisor's prudential mandate and the concern to protect and promote the domestic banking industry in the increasingly open cross-border competition. 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. Such banking nationalism predated the crisis. For example, the governor of the Bank of Italy in 2005, Antonio Fazio, was alarmingly explicit about wielding his supervisory

authority to preserve the 'Italianness' of two banks that were the targets of takeover bids by companies headquartered in Spain and the Netherlands respectively, and to ensure that they would remain in domestic hands³⁵.

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 reinforced the preference for bailouts, ostensibly to preserve financial stability but also largely motivated by the desire to bolster financing conditions for the country's other banks³⁶. This misalignment of the incentives of public authorities with their prudential mandate goes a long way to explain the failure of successive EU-wide stress testing exercises in 2009, 2010 and 2011 to restore confidence, because the crucial balance sheet assessments remained in the hands of national authorities³⁷. Most euro-area member states had never bothered to pass legislation that would allow the orderly resolution of non-viable banks while bailing-in creditors. Even those countries that adopted such legislation in the wake of the crisis, such as Germany, were reluctant to use it in actual cases of bank crisis management. Thus, the structure of banking supervision in Europe and its fragmentation in line with national borders encouraged moral hazard and excessive risk-taking by the banks, in spite of various forms of political backlash against government-funded bank bailouts 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, because it promised to remove many of the drivers of the prior race to the bottom. 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. The BRRD legislation, which enshrines a preference for bail-ins over bailouts in EU law, was first proposed by the European Commission only a few weeks before the banking union decision of late June 2012, and was much strengthened in the subsequent legislative process. The final text considerably restricts the possibility of using government resources in bank restructurings, and, compared with the initial version, advances the date of entry into force of mandatory bail-in from 2018 to 2016. In summer 2013, the European Commission's competition policy arm enacted new rules that made all state aid to banks conditional on junior creditor bail-in. The management by public authorities of the collapse of Dutch bank SNS Reaal in early 2013, of Cypriot banks in March of that year, of several Slovenian banks in 2013 and 2014, and of Portugal's Banco Espírito 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 sharp 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 still differs across EU member states.

It is very doubtful that the EU policy shift from bailout to bail-in could have occurred so comprehensively in the absence of banking union. A strong common decision-making framework for bank resolution (even though the SRM is incomplete and untested, as discussed in the next section) was necessary to overcome the firmly rooted belief of many national banking policymakers that the imposition of bail-in in a single bank failure would put all 'their' banking champions at a competitive disadvantage. In other terms, without banking union, the reality that *"banks may be global in life, but they are national in death"*³⁸ would have continued to lead to excessive protection of creditors because of cross-border competitive concerns. Indeed, the reality of banking nationalism has only been openly recognised by banking policy officials since the shift to banking union. To take one example among many, a senior German central bank official recently said that *"taking*

*banking supervision from the national to the European level will add a degree of separation between supervisors and the banks they supervise. This will prevent supervisors from handling their banks with kid-gloves out of national interest*³⁹. No senior euro-area official would have made such a comment in public before mid-2012.

FOUR DEVELOPMENTS TO WATCH

The economic implications of the transition towards banking union may be grouped according to four broad questions, each of them significant. First, will the ECB be a more effective supervisor than the national authorities it replaced, and can it put an end to the fragility that has continuously affected the euro-area banking system since 2007? Second, will banking union reverse the fragmentation of the system along national lines that has been observed since 2008-09? Third, will it lead to a more resilient and balanced European financial landscape, with more cross-border banking integration and more non-bank funding? Fourth, what will be the impact on public institutions at the national, European and global levels?

Of course, there are many possible scenarios for 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 and political and institutional shifts. There is nothing deterministic in how the economic consequences might unfold. The development path is likely to be protracted and complex. Transitional challenges will be significant, and setbacks might occur. With all these uncertainties in mind, the rest of this section attempts to assess prospects under each of the four above-listed themes.

1 Supervisory quality and the repair of banks' balance sheets

The SSM was largely born from the failure of the previous national supervisory regimes to fulfil their prudential mandates. The SSM's

immediate challenge is to establish a higher standard and to steer the repair of euro-area banks' balance sheet, so that trust can gradually return to the entire system.

The ECB's new bank supervisory arm starts its activity with a number of advantages. Its legal basis is robust, and the SSM Regulation gives it unambiguous central authority. The ECB is sole decision-maker on the granting or removal of all banking licenses in the banking union area, and on related decisions such as the vetting of changes in bank ownership and of newly appointed bank executives as 'fit and proper'. This is also true of the 3,520 smaller banks that are considered 'less significant' in the language of the SSM Regulation – all are under the threshold of €30 billion in total assets. For these, day-to-day supervisory tasks are left to the national supervisor, but the ECB retains ultimate decision-making authority. In this capacity, the ECB can wield all the tools that are given to national supervisors by EU banking legislation, including the CRR and CRD4.

The ECB has created a fairly strong organisation from the outset, even though some parts of it might require time to become fully operational. It hired about 1,000 staff for its supervisory arm in 2014, of which almost three-quarters came from previous jobs in national supervisory authorities, and the rest from other public institutions and from commercial banks⁴⁰. As a consequence, the ECB employs about a fifth of all bank supervisory staff in the euro area, the remaining four-fifths being in national authorities⁴¹. 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.

The ECB has a budget of €300 million for the supervisory arm's first 14 months of operations (up to the end of 2015), covered by a fee that it is empowered to collect directly from all banks in the euro area⁴². Each of the euro area's 123 'significant' banks is overseen by a Joint Supervisory Team (JST) that brings together ECB staff (up to a dozen for the largest banks) and national supervisors. Each JST is headed by an

ECB agent, who is always a national of a different member state from that in which the bank is headquartered, and who has the final say in making proposals for decisions to the Supervisory Board (any dissenting opinions from national supervisors are reported). The internal working language is English, which is also the language chosen by most significant banks – with the notable exception of those in Germany⁴³ – for their communication with their JST.

The initial test of the SSM's operational credibility was the 'comprehensive assessment' of the largest euro-area banks⁴⁴ carried out in late 2013 and most of 2014, the results of which were published on 26 October 2014. As its supervisory arm was still in the process of being built up, the ECB conducted this exercise through a relatively small coordination team of its own and with significant external help from Oliver Wyman, a consulting firm. For much of the actual assessment work, the ECB was very reliant on national supervisors, which at the time still had autonomous supervisory authority over banks in their jurisdiction. To ensure a degree of uniform reliability, the ECB formed peer review groups and directed the national supervisors to hire independent auditors, generally from the 'big four' accountancy firms, to check the collection of data and evaluations. Even so, it is useful to note that the organisation under which the comprehensive assessment was conducted was markedly more decentralised than the set-up which is now in place with the JSTs, with much less in-house supervisory experience inside the ECB than is the case now.

The comprehensive assessment included an Asset Quality Review (AQR), to check the quality of loans and other claims in the reviewed banks' balance sheets as of end-2013, and a stress test. The latter was coordinated by the EBA and also including banks from other EU member states, including the UK. However, the AQR, the most novel and critical part of the exercise, was specific to the euro area. The AQR resulted in the identification of €136 billion in non-performing exposures that had not been adequately acknowledged, and of almost €48 billion in adjustments to asset valuations as of end-2013. Combining the findings from the AQR with the stress test results, the ECB identified

actual capital shortfalls (at the time of announcement of results) in 13 of the 130 banks examined, after having taken into account capital raised by some of the weaker banks during 2014⁴⁵. In contrast with the ill-fated European stress tests of 2010 and 2011, the credibility of the comprehensive assessment has not yet been ruined by subsequent revelations of massive asset quality problems missed by the examiners, as was the case with, for example, Allied Irish Banks in 2010 and Bankia in 2011. Nevertheless, it is only the start of a process of systemic repair and restoration of confidence.

To restore trust, the ECB will have to build on the insights gained through the AQR. Since November 2014, it has started using a single methodology that takes into account a fuller range of risk factors than the comprehensive assessment, known as the Supervisory Review and Evaluation Process (SREP). This should ensure that banks are not only sufficiently capitalised, but have a business model that can sustainably support their operations.

There are already indications that such ‘SREP decisions’ include requirements on some banks that go beyond the numbers that were published at the end of the comprehensive assessment – even though the first batch of such decisions was mostly based on assessments made by the national supervisors, and only the next round of decisions to come in late 2015 will be fully based on the new structure of JSTs⁴⁶. Subject to decisions by the Supervisory Board, the ECB can now apply a truly consistent definition of capital to all the banks it supervises, something it did not have the legal and operational capacity to do in October 2014. It might gradually phase out the inclusion in solvency ratios of questionable forms of capital, such as deferred tax assets, which depend on a long-term promise from tax authorities that might or might not be kept. It can use its supervisory authority to bring its capital yardstick closer to the international accord known as Basel III than the legal minimum currently applicable in the EU under CRR. The latter diverges from Basel III on several significant aspects, including some aspects of capital definitions and the regulatory treatment of the capital of banking groups’ insurance subsidiaries⁴⁷. The ECB might also work

at acquiring a more accurate understanding of certain complex assets and liabilities than it could in the context of the comprehensive assessment, such as wholesale trading and derivatives exposures, ad-hoc modelling or shipping loans, and of risk-weighting practices that are also far from coherent from one bank or one member state to another.

The extent to which the ECB takes such measures, and the speed of adjustment, will become gradually observable during 2015. One milestone will be at the end of July, nine months after the publication of the comprehensive assessment's results, which is the deadline for capital shortfalls identified in the stress test under the adverse scenario to be covered⁴⁸. More generally, the key question the ECB still has to answer to establish its supervisory credibility is whether it will be willing and able to 'pull the trigger' on a bank it deems not to be viable, and to initiate a resolution process that may result in the bank being closed⁴⁹. Banks to watch in 2015 from this standpoint include, but are not limited to, all those that failed to pass the stress test under the more demanding 'fully-loaded CRR' measure of capital. There were 35 such banks out of the 130 tested, the list of which was published by the EBA in October 2014⁵⁰.

On a more medium-term basis, the ECB will need to convince observers that 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 conducive to consistent, impartial decisions on matters of general policy and on individual banks. This is a different set of challenges from monetary policy decisions within the ECB's Governing Council. Under the SSM Regulation, individual Supervisory Board members, including representatives of national supervisors, must act in the common European interest. But the experience of the EBA and other similar bodies has provided cautionary tales of coalitions of special national interests that could be at odds with the shared European objectives. The ECB's ability to create a cohesive spirit among the majority of national supervisors, and ideally all of them, will be critical in attaining this goal.

More broadly, the ECB will have to foster a common supervisory culture among the participating national supervisors, a process that can only be gradual given the vast differences in their practices and operating principles at the outset of the SSM. Personnel policies will be important to achieve such cultural convergence. As noted above, most of the ECB's initial supervisory staff come from national supervisory authorities and can thus be expected to contribute to effective communication between the ECB 'hub' and the national supervisory 'spokes' within the single supervisory mechanism. Conversely, over the medium term, the ECB could encourage its own supervisory staff to work outside Frankfurt in the national supervisory authorities, on short-term secondments or for more extended periods. The ECB can also be expected to exchange experiences and practices with other continent-sized supervisory systems, such as those in the US and China, and with other European networks of regulatory authorities, in particular the network of European competition authorities on which the SSM's design was partly modelled.

Another medium-term challenge is to create information and data systems that support the vision of an integrated supervisory framework. Last year's comprehensive assessment involved the collection of vast amounts of data, but was a one-off exercise. By contrast, the ongoing operation of the SSM will involve the collection and analysis of data from supervised banks and the broader economic and financial system on a regular basis. Cross-border consistency among all participating member states will be required, and will imply adequate supporting systems. This applies to a range of information categories. Banks' financial information will need to be further standardised, 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, not least many German small and not-so-small banks, only use national accounting standards.

Legal frameworks and practices for auditing also vary widely. Auditors are supervised at national level, with only limited EU harmonisation and

coordination. Starting from 2016, the ECB is also likely to conduct stress tests on an annual basis. It will need to decide what level of public transparency to provide on stress-test results and other supervisory findings. The comparison with US equivalents suggests that there is great potential for improving supervisory transparency in the EU⁵¹. One might expect that the ECB will be more intensely subject to such benchmarking than national supervisors have been so far, and that this will result in greater transparency in the future.

In addition to the many challenges of directly supervising significant banks, the ECB will need to aim at consistent supervisory outcomes for thousands of less-significant banks that remain supervised by national authorities on a day-to-day basis, but for which the ECB retains ultimate responsibility. One might expect the ECB to focus, at least initially, on groups of 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 decentralised. The ECB has started characterising such schemes as 'virtual groups' and has signalled attention on their specific characteristics⁵². However, enforcing their effective oversight from the European level can be expected to lead to some contention.

2 Reversing financial fragmentation in the euro area

By highlighting the multiple links between banks and sovereigns, the crisis led to significant and harmful divergence in bank credit conditions in different euro-area countries, otherwise described as banking system fragmentation. 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, this will not be sufficient to sever the bank-sovereign link.

The major driver of fragmentation has been the realisation on the part of market participants of how dependent banks were on implicit and

explicit guarantees from their home-country sovereign. Indeed, in the early phase of the crisis in 2007-08, the emphasis of policy initiatives was the reinforcement of national guarantees for banks in the name of safeguarding financial stability. Most notably, a meeting of euro-area heads of state and government together with the British prime minister on 12 October 2008 in Paris decided to extend a vast array of such guarantees in a coordinated manner, and was widely credited at the time for putting an end to the most acute phase of market panic following the collapse of Lehman Brothers a few weeks earlier. The ECB and the International Monetary Fund (IMF) also encouraged national guarantee systems for fear of the possible systemic instability consequences of bank defaults. But once banking problems were increasingly compounded by sovereign debt concerns from 2009 onwards, the strength of the public guarantee became increasingly differentiated across countries because it was correlated with sovereign creditworthiness. Even deposit insurance systems, the only component of this web of guarantees that is both explicit and permanent, came under question in the countries with the weakest sovereign credit. This was especially the case after the ill-fated proposal to tax all deposits in Cyprus in mid-March 2013, which was quickly rejected but left bitter memories.

Furthermore, since the start of the crisis, many banks in the euro area have been prone to building up disproportionate inventories of sovereign bonds issued by their home country, especially in countries under sovereign debt market pressure⁵³. As of late 2013, the ratio of home-country sovereign debt portfolios to the widely used 'core Tier 1' measure of capital was higher than 100 percent in dozens of significant European banks, and even higher than 200 percent in a meaningful number, including most of the largest German public and cooperative banks and major Italian banks such as Intesa Sanpaolo, Monte Paschi Siena, UBI and Banco Popolare⁵⁴. By contrast, these banks hold few sovereign bonds from other euro-area countries than their home state, even though these receive the same regulatory treatment under CRR.

There is no current consensus on the causes of such high home bias.

The reasons might 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. The long-term liquidity (known as 3-year LTRO, or long-term refinancing operations) provided to banks by the ECB in late 2011 and early 2012 unwittingly reinforced this nexus, because banks were not dissuaded from engaging in what became known among market participants as the 'Sarko trade': shortly after the ECB's announcement, France's then president Nicolas Sarkozy bluntly commented that "*this [3-year LTRO] means that each state can turn to its banks, which will have liquidity at their disposal*" to buy the bonds⁵⁵. Of course, the home bias in banks' sovereign debt holdings reinforces the bank-sovereign vicious circle, since the banks' balance sheet strength is directly reduced when the home government's creditworthiness deteriorates.

In addition, national supervisory authorities have imposed various constraints on the circulation of capital and liquidity inside cross-border banks during the crisis. 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 might have appeared from a national standpoint, they contributed to European financial fragmentation and to the bank-sovereign vicious circle. Where such actions of geographical ring-fencing invoked national supervisory authority, it should be relatively easy for the ECB, as the new euro-area-wide supervisor, to put an end to them. However, in some countries including Germany, national legislation empowered national authorities (BaFin in the German case) to impose geographical ring-fencing or upper limits to intra-group 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. How compatible such national laws are with the EU internal market framework and other aspects of EU legislation, however, remains to be determined.

Against this backdrop, the trend towards financial fragmentation has been halted by the positive contagion since mid-2012, but has not so far been entirely reversed. Of particular concern is the lack of sufficient clarity about the arrangements for future bank resolution. As previously mentioned, the SRM is a more muddled construct than the SSM, with a complex and still untested juxtaposition of national and European arrangements. To start with, 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, but its geographical scope is restricted to a subset of member states. The latter is awkwardly set outside of the Treaty framework, even though it is about a policy instrument created under EU law. Resolution decisions made within the SRM are likely to be subject to both national and European judicial review, possibly simultaneously, which could lead to significant inconsistencies⁵⁶. The state aid control framework is also likely to evolve over time.

Moreover, as of late April 2015, only 18 out of 28 EU member states were expected to have transposed the BRRD by June, even though the deadline for transposition was set at 31 December 2014. Even those who have completed the transposition might not have done so in a fully consistent way. Italy, the country with most banks not passing the 2014 Comprehensive Assessment, meaning they must implement capital plans before the end of July, is among the countries in which BRRD transposition, including the creation of a national bank resolution regime and authority, is most delayed. Furthermore, as of April 2015, most member states still had to ratify the intergovernmental agreement on the SRF.

The future institutional strength of the SRB represents another question mark. It starts relatively small compared to the SSM, with about 100 employees expected to be recruited during 2015 and a medium-term target of 250 staff. It is possible that it would evolve into a strong and autonomous institution, somewhat akin to the US Federal Deposit Insurance Corporation, with effective authority over national resolution agencies. But it might also end up being little more than a forum for

inter-agency coordination, with value added in terms of technical expertise but limited if any decision-making power of its own – similar in this to the European Banking Authority (EBA). This will depend on its leadership and political support from member states, but also on the first cases of weak banks over which its effectiveness will be tested. Banking crises are often disruptive, politically-charged events, and it is not self-evident that the current EU legal framework to address them is sufficiently robust, binding and legitimate to avoid the sort of breakdown of trust that was observed in the traumatic cross-border banking crises of September-October 2008, including Lehman Brothers between the UK and US, Fortis between Belgium, Luxembourg and the Netherlands, or the tussle over Icelandic bank liabilities between Iceland, the Netherlands and the UK – perhaps the most searing experience of all, with the UK even invoking anti-terror legislation against a NATO ally to protect its nationals' savings.

The recent furore in Germany about the Austrian authorities' decisions in the case of Hypo Alpe Adria, a regional bank in Carinthia with a troubled history, could be a taste of future difficulties to come, even though it is also affected by unique legacy features. Legal arguments about alleged gaps in Austria's transposition of the BRRD imply that the recognition of the Austrian resolution authority's decision by courts in other member states, a crucial principle of both the BRRD and the SRM, should not be taken for granted. Furthermore, the rush of German banks to bail out Düsseldorfer Hypothekenbank, a small covered-bond-issuing bank that was crippled by possible losses on assets linked to Hypo Alpe Adria's bad bank, raises awkward questions about the claim that the BRRD would unambiguously foster market discipline and put an end to moral hazard in European banking⁵⁷. Other legal twists and question marks will undoubtedly be uncovered in future real-world cases of bank resolution.

The more deeply entrenched components of the bank-sovereign vicious circle are still present, and policymakers will need to deploy sustained efforts and attention to gradually dismantle them. To start with, the ECB still has to ensure that capital and liquidity can be allo-

cated seamlessly by large banks across their operations throughout the banking union area, thus putting an end to the geographical ring-fencing that was overtly or covertly mandated by national supervisors in recent years. The ECB might need to lobby for the abrogation of any national legislation that prevents this shift. This includes legislative provisions adopted under the guise of privacy concerns, preventing entities of the same banking group in different euro-area countries from sharing credit and risk data, or of deposit protection, as in Germany, but the effect of which is to perpetuate national government control over local banks in a way that becomes obsolete and counter-productive as a consequence of banking union.

Simultaneously, the ECB has announced its intent to nudge the banks it supervises into gradually reducing the home bias in their sovereign-bond portfolios. In March 2015, the European Systemic Risk Board published a report on *“the regulatory treatment of sovereign exposures”*, in the foreword of which Mr Draghi wrote *“I trust that the report will help to foster a discussion which, in my view, is long overdue”*⁵⁸. Shortly afterwards, ECB Supervisory Board member Danièle Nouy opined in an interview that *“large exposure limits should apply to government bonds, as is the case for all other loans [under CRR]. Banks should not lend any one debtor more than one quarter of their equity capital. That would also be a sensible order of magnitude for government bonds.”* She also hinted at modest but positive risk weights on sovereign risk exposures, which currently carry a risk-weight of zero under CRR⁵⁹. The exposure limit proposal, in particular, would be an effective way to reduce the home bias and force banks to diversify their sovereign-debt portfolios, with a suitable transition period in order to limit the impact on sovereign debt markets.

Just as it took the crisis to reveal that banks that were thought ‘global in life’ were in fact ‘national in death’, the reversal of financial fragmentation is crucially linked to how future banking crises will be addressed by national authorities during the transitional year 2015 and presumably under the SRM framework starting on 1 January 2016. The most basic question is whether the ‘bail-in’ framework enshrined in the

BRRD, which has many novel and untested features, will work in practice as designed in theory.

The much longer experience with special resolution regimes for depositary banks in the US suggests a protracted process of adjustment before market participants gain a degree of predictability on how bail-in could work in isolated bank failures, let alone in future systemic bank crises. As argued above, the decisions made in 2012 on banking union started eroding the expectation of taxpayer-funded bank rescues, but this is far from being eliminated entirely. The rules that apply until end-2015, including on state aid, mandate the bail-in of junior creditors but not of senior ones, let alone depositors; indeed, senior claimants have been bailed out with public money in a number of recent cases, such as *Crédit Immobilier de France* in 2012, *SNS Reaal* in 2013, or *Banco Espírito Santo* in 2014. Despite all the claims that taxpayers' money will no longer be used to address financial crises, many market participants believe that some form of public support will be provided at least in crisis scenarios affecting large banks.

This is mirrored in significant 'uplifts' in credit ratings granted to European banks by rating agencies in anticipation of public support, which have mostly been maintained in spite of the passing of the BRRD even though some agencies have announced they might consider lowering them⁶⁰. Politicians have incentives to speak against taxpayer-funded bank bailouts as a matter of general principles, but not when significant corresponding losses are imposed on their own constituents. Thus, the political economy of bank crisis management in Europe is far from settled, and it will take nerve for the SRB and others to ensure that the BRRD's promise of bail-in is honoured in practice, and not in breach. One more determinant of future practice will be the finalisation of global banking reforms known as TLAC (total loss-absorbing capacity), which would impose additional buffers of 'bail-inable' debt on large banks. This policy concept is currently in a phase of consultation by the Financial Stability Board (FSB), and its transposition into EU law can be expected in 2016-17.

All things considered, it appears reasonable to anticipate that at least some public money will be used in at least some cases of euro-area bank crisis management (including resolution) in the future, in addition to existing formal deposit insurance commitments. The question then becomes one of funding of this contingent public financial need. National funding would perpetuate market fragmentation, as it would be linked to the country's sovereign credit strength. Conversely, European funding would contribute to the weakening of the bank-sovereign link.

Here again, the landscape is complex and the outcome uncertain, even if one leaves aside the transitional year 2015. The SRF will have a European 'mutualised' compartment, but also national compartments that are scheduled to exist until at least 2024, and may be replenished with additional resources (from a country-specific levy on that country's banks) in case they would be used in a future crisis. In any case, the SRF will initially be rather small, with the expectation that it would eventually reach a total size of €55 billion by the mid-2020s, and it is unclear whether it will be allowed to borrow from other sources such as the ESM. In addition, national resolution funds created under the BRRD (or, in some country cases, pre-existing it) will co-exist with the SRF. The ESM also has a not insignificant facility available for direct bank recapitalisations, in spite of not having used it in 'legacy' cases so far, as described earlier in this essay. While it has no supervisory powers of its own, the ESM has built up a permanent team of banking experts for this purpose, and euro-area countries reached a "*political understanding on the operational framework of the ESM direct [bank] recapitalisation instrument*" in June 2014⁶¹. *Ad-hoc* funding from public sources not previously earmarked also remains a possibility, as it has occurred repeatedly in the past.

Considered from a more political angle, there remains a general uncertainty about the balance between national and European sources of funding in future cases of bank crisis resolution. 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 national budgets, has proven extremely powerful since 2012. The broader prevention of any mutualisation of the financial burden from crisis management remains strong in many euro-area countries. However, the legacy argument is set to gradually lose its potency over time. Beyond a transition that is still ongoing but may be largely over by 2016, 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, it will become harder to argue that any public support should come from a national government's budget. In other words, while much of the German debate on bank resolution funding in recent years has focused on *Altlasten* (legacy burdens), future problem assets will be *Neulasten* (new burdens) that will have arisen under the ECB's watch. How the tension between these two narratives of *Altlasten* and *Neulasten* 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 materialise first, and how large they will be. This is inherently unpredictable.

The exact status of the public guarantees that apply to national deposit insurance schemes is also uncertain in future crisis scenarios that would involve the loss of a euro-area government's creditworthiness. The bungled Cyprus crisis episode of March 2013 has powerfully contributed to this lack of clarity. Representatives from all euro-area countries, the ECB and the IMF initially decided to link their financial assistance to a breach of the national guarantee of bank deposits, which took the form of a levy on all deposits including those under the guaranteed 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. (Uninsured deposits in failing banks were subjected to a harsh bail-in, and capital controls had to be introduced.) It is possible that, partly on the basis of this unfortunate experience, euro-area policymakers might choose to 'reinsure' national deposit insurance systems in future sovereign crises, but the lack of confidence about this can be expected to have an impact on

depositors' behaviour. More generally, it is indisputable that Europe's banking union will remain unfinished as long as the deposit insurance system has not been fully transferred from the national to the European level⁶².

Last but not least, the diversity of bank insolvency arrangements in the banking union area also contributes to the fragmentation of the banking market. This could be addressed in future with new EU legislation, even though there is no indication of current plans to do so. 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 misleading labelling of the SRM as 'single'. 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. An appropriate policy response might be the creation of a European insolvency regime for banks, or at least for the largest ones on an opt-in basis, which would be administered by a European court⁶³.

3 The transformation of Europe's banking and financial landscape

The advent of banking union results in major changes to the environment and incentives for European banks. These will inevitably drive a transformation of the structure of the euro-area banking market and, beyond banks, of the broader European financial system.

The first impact is to encourage banks that already have operations in several euro-area member states to adopt more integrated legal, financial and organisational structures as policy drivers of intra-euro-area fragmentation are gradually dismantled, as suggested in the previous section. This might come in parallel with the eventual finalisation of legislation still being discussed at time of writing, on separation between different types of activities within banking conglomerates, known as 'bank structural reform'. Furthermore, the above-mentioned global

TLAC reform is likely to create incentives for large and complex banks to adopt a so-called 'holdco model' of corporate organisation, in which 'bail-inable' debt is issued from a holding company which has no operational activities of its own. The holdco model is expected to make resolution simpler and more predictable, a claim which is buttressed by experience in the US⁶⁴. At the same time, banks face complex requirements to update their data systems, partly driven by regulatory and tax-policy requirements. In the new context created by banking union, they have an opportunity to save costs and reduce operational risk by shifting from separated national systems towards a banking-union-area-wide information infrastructure.

A second and possibly much more visible change would be an acceleration of cross-border mergers and acquisitions among European banks that would lead to the emergence of more pan-European banking groups. Before the crisis, banking nationalism had effectively acted as a brake against such combinations. National authorities signalled to potential foreign acquirers that their bids would not be welcome. Simultaneously, they favoured intra-country consolidation, particularly in the late 1990s and early 2000s in France, Italy and Spain.

There were exceptions of course. On a sub-regional scale, some European banks were also able to acquire smaller peers in neighbouring (often also smaller) member states in the decade preceding the crisis, such as the mergers that created Dexia, Fortis, ING Bank and Nordea, the acquisitions of Portugal's Banco Totta by Santander, of Finland's Sampo Bank by Danske Bank, and of Italy's BNL by BNP Paribas. In central and eastern Europe, privatisations of formerly state-operated banks were widely open to western European acquirers. Other combinations that went beyond the immediate neighbourhood and signalled a pan-European ambition were few. They included the purchase of France's CCF by HSBC in 1999, of Britain's Abbey National by Santander in 2004, of Bavaria's HVB by UniCredit in 2005, and the ill-fated bid for ABN AMRO in 2007 by a consortium of Fortis, RBS and Santander. During the crisis since 2007 there have been even fewer significant cross-border acquisitions, the main exceptions being the

purchase of Fortis's banking activities in Belgium and Luxembourg by BNP Paribas in 2008, and those of Bradford & Bingley and of Alliance & Leicester in Britain by Santander in 2010. As a result, the banking sectors of the larger euro-area member states remain dominated by domestic institutions, with the share of foreign banks in total assets lower than 10 percent in Italy, the Netherlands and Spain, and even lower than 5 percent in France and Germany⁶⁵.

If history is any guide, the eventual resolution of Europe's current banking fragility will result in significant consolidation – as was the case in the US in the 1990s after the savings and loans crisis and again in the late 2000s, or in Japan with the formation of three 'megabanks' (Mitsubishi UFJ Financial Group, Sumitomo Mitsui Financial Group and Mizuho) from a series of acquisitions between 1999 and 2004. It is too early to predict the patterns of such consolidation in the euro area, but it is likely that they will include a much more significant cross-border component than the previous wave that started in the mid-1990s. The ECB, which under the SSM Regulation has sole supervisory authority to approve changes of bank ownership, will view cross-border deals much more favourably than national authorities of acquisition targets did in the previous period. Furthermore, a more assertive competition policy will act as a comparative disincentive to intra-country mergers, especially in those countries (such as France or the Netherlands) where the banking sector is already highly concentrated.

One open question is whether the potential scope of acquirers will be enlarged beyond euro-area banks. There is a strong case that private-equity investors and non-euro-area 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 investors 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, and the purchase of NCG Banco in Spain (ex-NovaCaixaGalicia, now renamed Abanca) by Venezuela's Banesco in 2014, as these banks exited from government

ownership. It is too early, however, to judge whether the ECB and SRB will encourage or discourage such patterns of acquisitions.

A possible objection to transformative 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. Compared to intra-country combinations, cross-border bank acquisitions tend to lead to more complex groups, and complexity tends to exacerbate the TBTF problem. However, genuine banking market integration could make it possible to consider the TBTF effect on a European rather than national level, which might significantly mitigate it – as a large European bank's total assets evidently represent a much smaller share of euro-area GDP than of the bank's home-country GDP. The ECB has signalled that it would take into consideration these advantages of market integration in relation to the TBTF issue when considering future combinations of euro-area banks, including among the larger ones⁶⁶.

The constitution of a broader set of pan-European banking groups would have consequences, not least on the political economy of the European banking sector. Many local banks resent the more intrusive supervisory model of the SSM, which is more arm's length and less based on cosy relationships than in the earlier national settings, and some are even trying to challenge it⁶⁷. By contrast, genuine cross-border banks can be expected to call for more European banking policy integration, because this might help them to reduce costs and maximise synergies among their operations in different euro-area countries. This support of an influential interest group could reinforce the banking union policy framework. It will also call for vigilance to ensure that the ECB and other European-level authorities are not unduly captured by powerful pan-European banking interests.

Also as a consequence of cross-border consolidation, an increasing number of member states could be left without significant domestic banks of their own. Already, in smaller euro-area countries including Belgium, Estonia, Finland, Ireland, Latvia, Lithuania, Luxembourg, Malta

and Slovakia, most banking assets belong to foreign not domestic banks⁶⁸. The same could also soon become the case in Cyprus, Greece, Portugal or Slovenia. This could create national political incentives to penalise the foreign-controlled banking sector as a whole, for example through significant increases in sector-specific taxation as was recently done in Hungary⁶⁹. More surely, 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, because a growing number of participants in such processes will be less motivated by the promotion or protection of national banking champions.

Aside from cross-border consolidation, banking union might also result in a more favourable environment for the creation of new (*'de-novo'*) banks. 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 nineteenth century if not earlier, as do most small European banks. By contrast, there has been a 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 might 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 over-banked countries and market segments⁷⁰ could create an environment that may be more favourable to the emergence of European *de-novo* banks. The advent of innovative banking business models based on new information technology could also contribute to that trend.

Banking union has also encouraged a shift of the EU policy consensus towards recognition of the need for a more diverse financial system that would be less predominantly reliant on bank intermediation. The European Commission's proclaimed ambition to foster a 'Capital Markets Union' is a reflection of that shift, even though it remains far

from clear at time of writing what the corresponding policy substance will be⁷¹. The primary motivation appears to be 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 2008-09 did not generally result in credit scarcity, because alternative channels of financing, largely based on capital market activity, could still provide credit even as banks were retrenching. By contrast, in the EU, bank deleveraging has an essentially unavoidable contractionary impact on the economy, which is one of the reasons why it has proved so difficult to address the continent's systemic banking fragility through adequate restructuring since the inception of financial crisis in 2007.

The ECB itself has expressed support for a more diverse European financial system that would rely less exclusively on banks⁷². In comparison to national prudential authorities, the ECB may be more supportive of the capital markets union agenda and of more European capital-market development for a number of reasons. Some national authorities might have been driven by banking nationalism to repress non-bank finance, as alternative credit channels could create additional competition that might 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, because a damaged banking sector has been unable since 2010-11 to efficiently transmit monetary policy signals to the broader economy in a number of member states. 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, including asset-backed securities in the latter part of 2014.

Nevertheless, fostering the greater development of non-bank finance in the EU, and especially in the euro area, is a challenge that should not be underestimated. It would require changes in the behaviour of European savers, who have until now displayed a firmly anchored preference for very low-risk and low-return financial instruments, and of companies,

which have found it difficult to accept the discipline that comes with non-bank external financing in terms of financial reporting and corporate governance. European insolvency frameworks are generally antiquated, inefficient and weakly protective of investors' rights. Heterogeneous tax policies contribute to distortion and fragmentation of capital markets. Myriads of special interests among national authorities, financial infrastructure firms, regulated intermediaries and many of the banks themselves, stand in the way of greater capital-market and non-bank financial development and integration. Against this backdrop, the European Commission's green paper on capital markets union, published in February 2015, raises relevant questions but does not give a strong sense of direction or priorities⁷³.

For these reasons, the shift away from bank to non-bank finance in the euro area and the EU can be expected to be slow and to preserve a larger role for banks than is the case in the US, for the foreseeable future. Nevertheless, the combination of banking union and capital market development, especially if it is accompanied over time by a rationalisation of European capital-market supervision and enforcement, will lead to a more integrated financial system that could vastly improve the euro area's ability to absorb asymmetrical economic shocks⁷⁴. In 2009-10, the Baltic countries suffered no credit crunch in spite of a brutal economic downturn, in large part thanks to the overwhelming presence of foreign (mainly Scandinavian) banks that did not suffer a corresponding simultaneous liquidity or solvency shock. Similarly, a European financial system in which national boundaries would have much lower significance can be expected to offer much greater resilience, beyond the partial mitigation of the bank-sovereign vicious circle achieved by banking union in its current incomplete form⁷⁵.

4 A new institutional order for European and global financial sector policies

Last but not least, 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 evolution 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 (except in the latter's capacity as enforcer of competition policy). The strengthening of the ECB's comparative position in the balance of European institutions predated banking union, but is being significantly reinforced by it.

At the national level, the activities of bank supervisory authorities will increasingly be determined by their participation in the SSM, which is set to bind them on most policy issues. This evolution will take 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, Finland, Germany, Latvia, Luxembourg and Malta). Being part of the SSM will help national supervisors gain more independence from their national political environments and related pressures, including in terms of banking nationalism. However, the loss of autonomy in formal decision-making might be resented as a form of institutional downgrading. The balance of these effects will depend strongly on institutional legacies, and can be safely expected to be more contentious in some countries than others. Danièle Nouy, who chairs the SSM Supervisory Board, made the sober comment recently that the ECB and national supervisors *"have found that we differ more from each other than we would have expected"*⁷⁶.

The ECB appears to have been rather adept at managing such tensions during the phase of comprehensive assessment in 2013-14, but at the cost of delaying some of the more controversial issues in its relationship with national supervisory authorities, which will nevertheless need to be resolved during or after 2015. Commenting on the harmonisation of capital definitions towards a more demanding standard, Ms Nouy noted revealingly:

“The problem is I need to get it voted and I have 25 voters in my supervisory board: six represent the centre [those appointed by the ECB, including Ms Nouy herself], they will certainly be with me to be very rigorous [...] the others that represent the different countries with the banking systems benefiting from the national options, will they vote to be tougher or not? I don’t know”⁷⁷.

The ECB appears to have time on its side, however. The SSM Regulation provides a firm basis for its centralisation of policy authority on most aspects of banking supervision. As previously noted, it can be expected that a common culture would gradually emerge within the SSM, through the harmonisation 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 future secondments of ECB staff to those authorities. In its own communications, the SSM emphasises these factors, including training and human resources policy⁷⁸.

At 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, which started in early 2015 but will only become fully operational in 2016. To these may be added the above-mentioned possible role of the ESM in bank recapitalisation.

This sudden surge of institutional complexity stems 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 duplication⁷⁹. It will probably result in protracted tensions between these agencies and rivalry for turf and resources, which will take time and leadership to

settle. Before the crisis, the European Commission was the undisputed hub of financial services policy at the EU level, but the future situation will be markedly different. Finding a working relationship with all the new agencies is one of the key challenges faced by the Commission in the new environment⁸⁰. This particularly applies to the Commissioner for Financial Stability, Financial Services and Capital Markets Union, and the Commission's directorate-general (now known as DG FISMA) that reports to him, but also to other parts of the European Commission. Specifically, the Commission's competition policy arm has acquired a prominent role in financial sector policy through its scrutiny of state aid to banks, and it remains to be seen how the possible overlap with the new functions of the ECB and SRB will be managed.

Furthermore, the current institutional order at the EU level should not be seen as static. Even though there are no announced plans to do so, 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 might also be located within existing agencies, such as ESMA). The balance between the supervisory and monetary policy functions of the ECB will 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 in practice has wide-ranging autonomy, is mostly untested and could result in operational and governance challenges, as was reportedly the case in the handling of Greek developments in late March 2015⁸¹. It is also possible that future reforms will simplify the landscape. However, the baseline scenario is 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 establishes the euro area as the world's largest single jurisdiction in terms of the aggregate

balance sheet of the banking sector, a status that previously belonged unambiguously to the US. 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 FSB. On the basis of the latest list of 30 institutions, eight are headquartered in the US, four in France, four in the UK, three in China, three in Japan, two in Spain, two in Switzerland, and one each in Germany, Italy, the Netherlands and Sweden⁸². But on an aggregate basis following banking union, the SSM, with nine global systemically important banks under its watch, comes ahead of all other authorities, including those in the US.

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 memberships of supervisory authorities in Belgium, France, Germany, Italy, the Netherlands and Spain are downgraded to a less prominent status. A similar dynamic could apply to the FSB itself, in which the central banks of France, Germany, Italy, the Netherlands and Spain are all represented in both the Plenary and the slightly more compact Steering Committee. Beyond issues of formal membership, banking union will enhance 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. The ECB will chair global supervisory colleges of large cross-border banks in its territorial jurisdiction, and will certainly be invited to sit alongside, and gradually replace, national euro-area supervisors in colleges that oversee banks headquartered outside of the euro area. Its bilateral relationships with the Bank of England and Swedish Riksbank will be especially important, given the substantial operations of UK and Swedish banks (such as HSBC, Nordea or SEB) in the euro area, and of euro-area banks (such as BNP Paribas, Deutsche Bank, Rabobank, Santander or Société Générale) in the UK. Similarly, the SRB can be expected to rapidly acquire prominence in global discussions on bank resolution and in bank-specific crisis management groups.

CONCLUSION

The creation of Europe's banking union has been a radical policy decision. It came under duress in mid-2012, as a result of the dismal failure of the previous regime, in which banking policy remained mostly national, to deliver financial stability, and only when it became clear that it was the only practical way to avert an unravelling of the euro area's monetary union. Even at the time, few policymakers realised all the implications of the decisions being made.

To be sure, there remain many loose ends. The choice of sequence, in which supervisory authority was pooled first and foremost, resolution authority later and less comprehensively, and deposit insurance barely at all, implies a complex transition that carries risks of its own. National interests won compromises. Local German banks were unable to win complete exemption from the SSM, but the fact that their day-to-day supervision (and that of other smaller banks in the euro area) remains in the hand of national supervisors might still lead to distortions and inconsistencies. The interplay between national authorities, the SRB and other EU institutions in future resolution cases is a significant factor of uncertainty, which will probably be lifted only gradually. The legislative agenda remains unfinished, with harmonisation of capital regulation still incomplete, the Basel III accord imperfectly transposed, different national insolvency regimes for banks, and diverging accounting and auditing frameworks. The nostalgia for the old regime and the associated banking nationalism will linger for a long time. In a revealing comment, a leading German industrialist recently opined that *"we as a global company need a German-based global bank"*⁷³. Such feelings remain widespread across the euro area, especially in the larger member states. The geographical discrepancy between the banking union area and the EU, especially the special status of the UK which hosts Europe's leading financial centre, is another major source of complexity and uncertainty.

Most fundamentally, banking union without fiscal union is an inherently incomplete and potentially unstable combination. Monetary union

with banking union is more resilient than without it, but might still not be resilient enough in the face of future challenges. The bank-sovereign vicious circle remains present as long as no coherent fiscal framework exists at the European level, as the situation in Greece illustrates. The fact that deposit insurance remains national is fundamentally at odds with the very concept of banking union, but can only be changed with the implicit or explicit backing of a pan-European treasury, which does not currently exist. The belief that a structurally incomplete policy framework will lead to sufficient convergence might result in harmful complacency, as it did in the previous phase of monetary union without banking union in the 1990s and 2000s⁸⁴. For all its promises, banking union alone is insufficient to make the euro area sustainable over the long term, even though the time horizon at which this might result in a new crisis is inherently unpredictable.

Even the current incomplete union cannot be taken permanently for granted, and its continuation will require stamina and leadership from several key players. The new institutions of banking union, including the SSM and SRB, will need to be exemplary in terms of effectiveness, fairness, transparency and accountability, not to mention technical competence and integrity. They will need to navigate political constraints skilfully without compromising their basic policy principles. The first steps, including the comprehensive assessment of 2014, encourage cautious optimism. But even more difficult moments surely lie ahead.

The broader political challenge for the EU is to reconcile its vision of economic integration with a sustainable framework to define and defend the European public interest through adequate rules and institutions. In this respect, banking union marks a significant milestone for Europe, and an achievement worth acknowledging. But it is only one step in a longer journey.

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NOTES

- 1 This essay is a substantially revised and expanded version of the chapter titled 'The Economic Consequences of Banking Union' written by the author for the book *European Banking Union* co-edited by Danny Busch and Guido Ferrarini, and forthcoming in 2015 from Oxford University Press (OUP). The author is grateful to Professors Busch and Ferrarini and other participants in the OUP book project, and to his colleagues at Bruegel (especially Francesco Papadia and Guntram B. Wolff) and at the Peterson Institute for International Economics, for their insights and encouragements. Research assistance by Anish Tailor at the Peterson Institute is also gratefully acknowledged. Any errors or inaccuracies are the author's alone.
- 2 This mantra refers to a longstanding saying about the International Monetary Fund (IMF). See also Truman (2013), footnote 11.
- 3 A good example is the three-part analysis published by the *Financial Times* in May 2014 (Spiegel, 2014a to 2014c), in which banking union is only mentioned once and in passing.
- 4 See, among others, Cihak & Decressin (2007); Véron (2007); Decressin, Faruqee & Fonteyne (2007); Posen & Véron (2009); Véron (2011); Pisani-Ferry, Sapir, Véron & Wolff (2012); Beck (2012); Goyal et al (2013); Véron (2013a); Hellwig (2014); and Lannoo (2014).
- 5 An early attempt is in De Rynck (2015).
- 6 To the author's knowledge, the first publicly recorded mention of 'banking union' in the context of the European crisis is in Véron (2011) and followed a suggestion made by Maarten Verwey (European Commission) a few weeks earlier. The expression was subsequently adopted first by other scholars at Bruegel, then by journalists and policymakers, not least the International Monetary Fund. The first use in a public official document appears to be European Commission (2012).
- 7 The ultimate decision-making authority over the SSM resides with the ECB's Governing Council, in accordance with the Treaty on the Functioning of the European Union.
- 8 The non-SSM operations of the ECB moved to a new tower in late 2014. The SSM currently occupies commercial office space and is scheduled to move to the Eurotower, where the ECB used to be headquartered, following its ongoing refurbishment.
- 9 As of March 2015, these are Sabine Lautenschläger, the Board's Vice Chair who is also a member of the ECB's Executive Board, Ignazio Angeloni, Luc Coene, Julie Dickson and Sirkka Hämäläinen.
- 10 As of March 2015, these are Timo Löytiniemi (Vice Chair), Antonio Carrascosa, Mauro Grande, Joanne Kellermann and Dominique Laboureix.
- 11 ECB (2015b), section 3.10.

- 12 Article 127(6) served as a basis for the creation of the European Systemic Risk Board in 2011.
- 13 Most EU member states, unlike the US, had no special resolution regime for banks before 2008. Many of them created such regimes in the wake of the crisis, which are now being modified through the transposition of the BRRD.
- 14 ECB (2014c), page 16.
- 15 This remark applies among others to Cihak and Decressin (2007), Véron (2007), Posen and Véron (2009) and Fonteyne *et al* (2010).
- 16 House of Lords (2014).
- 17 Nouy (2015a).
- 18 Author's calculations and estimates based on ECB (2015a).
- 19 ECB (2015a). A breakdown by assets, which would be more relevant for purposes of economic analysis, has not yet been made available by the ECB.
- 20 Draghi (2012a).
- 21 Véron (2013).
- 22 Euro-Area Summit Statement, Brussels, 29 June 2012, https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf.
- 23 Lagarde (2012). See also Cihak and Decressin (2007), Decressin *et al* (2007) and Fonteyne *et al* (2010).
- 24 See also Dübel (2012).
- 25 See eg Fidler, Steinhauser & Walker (2012).
- 26 Matussek and Buergin (2011).
- 27 Van Rompuy (2014).
- 28 Interview with Mario Monti, *de Volkskrant*, 13 April 2014.
- 29 Draghi (2012b).
- 30 Draghi (2013).
- 31 ECB (2015b), foreword by Mario Draghi.
- 32 *Market News International*, 'Merkel: No Retroactive Direct Bank Recapitalization by ESM', 19 October 2012.
- 33 *RTE News*, 'Michael Noonan admits mixed messages from Germany over bank recapitalisation', 19 October 2012.
- 34 Goldstein and Véron (2011).
- 35 The ensuing developments were complex. Governor Fazio resigned after the wiretapping of his phone conversations with Italian financiers suggested 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.

- 36 Denmark provided a notable exception to that pattern, as it allowed two mid-sized banks to fail in 2010 with losses to senior creditors and unsecured depositors.
- 37 See Véron (2013b).
- 38 This much-quoted formulation appears to have been used first in Huertas (2009), in spite of its frequent attribution to the former Governor of the Bank of England, Mervyn King.
- 39 Dombret (2015).
- 40 ECB (2015b), section 2.3.1.
- 41 Nouy (2015a).
- 42 Draghi (2015b).
- 43 ECB (2014c), page 15.
- 44 The Comprehensive Assessment included 130 banks. The list essentially overlaps, but is not identical, with that of 123 significant institutions as per ECB (2015a).
- 45 ECB (2014b and 2015b).
- 46 Nouy (2015a). See also Nouy (2014b).
- 47 BCBS (2014).
- 48 Draghi (2015a).
- 49 Chopra and Véron (2014).
- 50 EBA (2014), Appendix 1. That list is based on capital levels as of end-2013. It includes, among others, all Cypriot, Greek and Irish banks included in the test, and all Slovenian banks but one; three Austrian Banks including Raiffeisen Zentralbank, four German banks including DZ Bank, HSH Nordbank and WGZ bank (note: Landesbank Baden-Württemberg was too close to the threshold to assess whether it passed or failed the test on this measure); nine Italian banks including Monte Paschi Siena, Carige and several Banche Popolari; and BCP and Caixa Geral de Depositos in Portugal.
- 51 Gandrud and Hallerberg (2014).
- 52 Lautenschläger (2014). See also ECB (2015b), section 3.8.3.
- 53 The trend is documented in ESRB (2015).
- 54 Nouy (2014a), Table 1.
- 55 Cited in Taylor (2011).
- 56 See Arons (2015) for an in-depth discussion.
- 57 See Mussler (2015). Somewhat ironically given other aspects of the German debate on moral hazard, the article reports that a common fund of the German banking association will reimburse creditors for an amount in the hundreds of millions euro *“in order not to damage the reputation of Germany as a place to do financial business”* (author's translation), and may be ready to absorb up to five billion euro in future costs of winding down the bank.
- 58 ESRB (2015).

- 59 Nouy (2015b).
- 60 Johnson (2015).
- 61 See Merler (2014).
- 62 See eg Lagarde (2012), Goyal *et al* (2013).
- 63 See Cihak and Decressin (2007), and also Arons on court arrangements (2015).
- 64 Gordon and Ringe (2015).
- 65 ECB (2014a), Statistical Annex, table 2.
- 66 The argument is also made by Coeuré (2014).
- 67 See Gould (2015).
- 68 ECB (2014a), Statistical Annex, table 2.
- 69 Balazs (2013)
- 70 See ESRB (2014).
- 71 Juncker (2014).
- 72 Coeuré (2014).
- 73 European Commission (2015).
- 74 Véron and Wolff (2015).
- 75 These points are also made in Coeuré (2014), based on prior studies on Europe and the US.
- 76 Nouy (2015b).
- 77 Brunnsden (2015).
- 78 See in particular ECB (2015b), section 3.9.
- 79 Anderson (2014).
- 80 Merler and Véron (2014).
- 81 Black (2015).
- 82 FSB (2014).
- 83 Kurt Bock, CEO of BASF, referring to Deutsche Bank and cited in Comfort and Jennen (2015).
- 84 Pill (2014).

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EUROPE'S RADICAL BANKING UNION

by
Nicolas Véron

Banking union, or the pooling by euro-area countries of their main instruments of banking-sector policy, is the mostly unheralded success of an otherwise lopsided sequence of crisis management by the European Union. This essay argues that banking union was the decisive factor behind two major developments that prevented a break-up of the euro area at the peak of market instability in mid-2012: the announcement by the European Central Bank of its Outright Monetary Transactions programme; and the shift of European policy preferences from public bailouts of failing banks towards 'bail-ins' in which private-sector creditors suffer most of the cost of future bank restructurings.

This is only the beginning. If implementation does not deviate from its promising start, banking union can lead to the restoration of trust in Europe's banks, the elimination of differences in financial conditions across intra-European borders, the emergence of an integrated, more diverse and more resilient European financial system, and a new institutional balance that might reinforce Europe's position in global financial policy discussions.

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