

The politics of an asymmetric Banking Union

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Abstract

This paper takes stock of the first few years of the functioning of Banking Union by examining the politics an asymmetric Banking Union. It first explains why Banking Union was set up in an incomplete way. It then explains how and why this has resulted in asymmetric effects, beside the original intended effects. Finally, it teases out two coalitions that have shaped the configuration of Banking Union, they have been differently affected by it and are currently seeking to shape its completion. The paper also reflects on the supranational–intergovernmental dynamics in Banking Union and its various components.

1. Introduction

Banking Union was the main response of the European Union (EU) - to be precise, the euro area - to the sovereign crisis in the euro area periphery (Donnelly 2014; De Rynck 2015; Epstein and Rhodes 2016; Glöcker et al. 2016; Howarth and Quaglia 2016a; Schaffer 2016; Schimmelfennig 2016). Banking Union was supposed to ‘ensure financial stability’ by breaking the ‘doom loop’ between banks and sovereign, elevating the ‘responsibility for supervision to the European level’, and providing for ‘common mechanisms to resolve banks and guarantee customer deposits’ (Van Rompuy 2012). Yet, the Banking Union that was originally envisaged in 2012 is different from the one that was eventually set up between 2012 and 2014. This paper takes stock of the first few

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years of the functioning of Banking Union by examining the politics of an asymmetric Banking Union and its effects.

The argument is developed in three main steps. Section 2 explains why Banking Union was set up in an incomplete way: banking supervision was supranationalised by transferring it to the euro area level (with some caveats); resolution was supranationalised only to a limited degree, maintaining an intergovernmental component, as well as substantial responsibilities at the national level; a common deposit guarantee scheme was not set up, and a common fiscal backstop did not materialise.

Section 3 explains how and why this asymmetric configuration of Banking Union has produced some negative effects, beside the original intended effects. The ECB in the Single Supervisory Mechanism (SSM) directly supervises more than 120 significant banks, and the supervision of the remaining 6000 non-significant banks is in the process of being harmonised. By contrast, the Single Resolution Board (SRB) at the centre of the Single Resolution Mechanism (SRM) has not resolved one single bank and de facto there has been limited harmonisation of bank resolution practices amongst the member states. Indeed, the national authorities seem to be inclined to apply the 'Sinatra doctrine' in resolution by dealing with ailing banks in 'their own ways'.

Section 4 argues that two coalitions have shaped the configuration of Banking Union, they have been differently affected by it and seek to promote (or hinder) its completion. One coalition criticises the incompleteness of Banking Union and seeks to set in place the missing components. The other coalition points out the need of sorting out national banking problems first, before

considering any move towards the completion of Banking Union. This section also reflects on the supranational–intergovernmental-national dynamics in Banking Union and its various components.

2. The making of an incomplete Banking Union (2012-14)

In June 2012, the President of the European Council, the President of the Eurogroup, the President of the Commission and the President of the ECB, presented an interim report titled ‘Towards a Genuine Economic and Monetary Union’. The Van Rompuy (2012) report, which was also known as the Four Presidents Report, proposed what later became known as Banking Union. The project of Banking Union was subsequently endorsed by the European Council and the euro area summit in June 2012. The main objective of Banking Union was to break the ‘vicious circle’ between ailing banks and struggling sovereigns (Allen et al. 2013; Pisani-Ferry 2012).

For example, the member of the ECB Executive Board Jorg Asmussen (2012), pointed out that ‘several European countries face a vicious circle where weak domestic banks cause fiscal difficulties for governments, which in turn undermines public debt sustainability and further damages banks’. Subsequently, the ECB explicitly called for the creation of ‘a supervisory authority at the European level for systemically relevant financial institutions’ and ‘the creation of a pan-European resolution fund and a pan-European resolution authority’ (González-Páramo 2012). Indeed, the ECB and the Commission played a major role in flagging the problem of the ‘doom loop’, framing Banking Union - though this term appeared in the official policy debate in late 2013 - as the main response to the sovereign debt crisis (Epstein and Rhodes 2016; De Rynck 2015).

The main supporters of Banking Union were the member states in the euro area periphery, first and foremost Spain and Italy, which were hit by the sovereign debt crisis (Epstein and Rhodes 2016). The French government was worried by the fact that French banks were heavily exposed in Southern Europe and France would have been the next country, after Italy, to be at risk of financial contagion. The national authorities of these countries pointed out the need to move quickly to Banking Union. By contrast, the German authorities argued that timing was not the essence and that it was instead important to get the right institutional arrangements in place (Schäffer 2016).

The UK, which was not part of the single currency and had a very internationalised rather than 'Europeanised' banking system, lacked an incentive to join Banking Union. The UK by and large supported the Banking Union project, but declared at the outset that it would not be part of it. For example, as early as the summer of 2011, the British Chancellor Osborne called for 'permanent changes' to stabilise the euro area in the medium and long term (*Financial Times*, 20 July 2011), arguing that there was a 'remorseless logic' for a banking and fiscal union in the euro area. The British authorities were however concerned about the 'side effects' of Banking Union, such as the potential formation of a euro area majority influencing EU financial regulation *tout court* (Schimmelfennig 2016). Hence, they demanded and achieved a voting reform of the European Banking Authority (EBA), whereby any decision by the Authority should be approved by a minimum number of member states outside Banking Union and thus effectively by a 'double majority' of member states inside and outside the Banking Union. However, the safeguard in the EBA will end once the number of non-BU member states is less than four (Ferran 2014).

Although Banking Union was to include all the countries in the euro area as well as the countries that decided and were able to opt-in, no country decided to opt in. Beside the UK, other non-euro member states were worried about their second-class status in Banking Union, with limited decision-making power as compared to euro area members and no access to ECB's funding (Schimmelfennig 2016). Furthermore, there was the concern that the ECB could be less prone to focus on the risks building in non-euro and smaller member states, not least because branches and subsidiaries of foreign banks could be systemic for the host, but not for the home country. Finally, banking nationalism in some central and eastern European countries played a role (Mero and Piroška 2016).

The ECB-centric SSM

The first component of Banking Union to be set up was the SSM (Alexander 2015; Ferran and Babis 2013; Ferran 2014; Salines et al. 2011). The final agreement reached at the December 2012 European Council foresaw that the ECB would be 'responsible for the overall effective functioning of the SSM' and would have 'direct oversight of the euro area banks'. This supervision, however, would be 'differentiated' and the ECB would carry it out in 'close cooperation with national supervisory authorities'. The regulation establishing the SSM also permitted the ECB to step in, if necessary, and supervise any of the 6000 banks in the euro area. The SSM applied only to the euro area member states and to the non-euro area member states that decide to join Banking Union.

The SSM eventually agreed involved a compromise on the distribution of supervisory power between the ECB and the national competent authorities. Direct ECB supervision – through joint supervisory teams – was to cover only those banks with assets exceeding €30 billion or those whose asset represented at least 20 per cent of their home country’s annual GDP. The thousands of smaller, so-called ‘less significant’ banks headquartered in the euro area would continue to be under the direct supervision of the national competent authorities, but according to increasingly harmonised rules and practices. This compromise of two-level supervision reflected above all the demands of the German government, which opposed transferring supervisory responsibilities for the country’s regional public savings banks (Sparkassen) and co-operatives to the ECB (Howarth and Quaglia 2016b).

The ‘hybrid’ SRM

In July 2013, the Commission proposed the establishment of the SRM, designed to complement the SSM (Veron and Wolf 2013). The initial proposal, supported by the French, Spanish and Italian governments, gave the Commission the final power to decide whether to place a bank into resolution and determine the application of resolution tools. However, the German government argued that the Single Resolution Board (SRB) should be given this power. Furthermore, the directive proposed the establishment of the Single Resolution Fund (SRF) financed by bank levies raised at the national level. The national compartments would then be pooled into a single fund. In this respect, the German government insisted on setting up the fund through an intergovernmental agreement among the participating member states (Howarth and Quaglia 2016a).

The ECB argued that the SRM was 'a necessary complement to the SSM, as the levels of responsibility and decision-making for resolution and supervision have to be aligned' (ECB 2013, p. 3). In November 2013, the ECB issued a 32-page opinion that the SRB should be, from the start, a single 'strong and independent' body, thus directly challenging the German position that the SRM should begin as a network of national authorities (*Financial Times*, 8 November 2013). The ECB President Mario Draghi pointed out that 'We should not create a Single Resolution Mechanism that is single in name only...I urge you and the Council to swiftly set up a robust Single Resolution Mechanism, for which three elements are essential in practice: a single system, a single authority, and a single fund' (*Bloomberg*, 16 December 2013). Michel Barnier, the EU Commissioner responsible for financial services, remained concerned that 'decision-making within the SRM [was] still too complex... What we are building is a single system and not a multi-storey intergovernmental network' (*The Telegraph*, 18 December 2013).

In March 2014, an agreement was reached on the establishment of the SRM. It was agreed that the ECB would be responsible for deciding whether or not a bank should be resolved, but the SRB could take this decision should the ECB decline to do so. The main decision-making power to enter a bank into resolution, the application of resolution tools and the use of the SRF was assigned to the SRB. As advocated by Germany, the Board would be responsible for the planning and resolution phases of cross-border banks and those directly supervised by the ECB, while national resolution authorities would be responsible for all other banks, except if a bank required access to the SRF. National authorities would also be responsible for executing bank resolution plans under the control of the SRB. In order to guarantee member state budgetary sovereignty, the SRB was

not empowered to require governments to provide extraordinary public support to any bank under resolution. The SRF, financed by bank levies raised at national level, would initially consist of national compartments that would be gradually merged over eight years (Alexander 2015).

The SRM regulation was adopted in conjunction with the Bank Recovery and Resolution Directive (BRRD), which harmonised resolution instruments and powers in the EU. Deliberately, the SRM regulation reproduced many provisions of the BRRD, narrowing down the room for manoeuvre in the national implementation of the directive. The BRRD and the SRM regulation introduced a new instrument in bank resolution, the bail-in, which became a game changer as it reduced substantially the need for public funding to bail out banks (Nielsen and Smeets 2017). Thus, the SRM would be 'fiscally neutral' (Eurogroup and Ecofin 2013, p. 1). Indeed, once the SRM regulation was proposed, the German government, supported by the Dutch, Austrian and Finnish governments, insisted on an earlier entry into force of the bail-in than the originally envisaged date in 2018. The start date was eventually moved forward to 2016 (*The Economist*, 14 December 2013).

The position of the German authorities needs to be elaborated further (see also Donnelly 2014; Epstein and Rhodes 2016; Schäffer 2016). Before the proposal for Banking Union was put forward, the German government had repeatedly pointed out the need to have the responsibility for supervision and resolution at the same level of governance, so as to avoid moral hazard. In other words, it opposed the idea of pooling national financial resources at the EU level to pay for the resolution of banks across the EU, which were not subject to common supervision. However, once the SSM was agreed, the German authorities remained reluctant to supranationalise bank

resolution for fear of past national supervisory forbearance and the legacy problems plaguing national banking systems. Furthermore, the German government — joined with the Austrian, Dutch and Finns — insisted that the funds of the European Stability Mechanism (ESM) could not be used to cover legacy problems, to be revealed by a comprehensive assessment of euro area banks by the ECB (Howarth and Quaglia 2016a), as elaborated below.

The missing EDIS

The missing component of Banking Union was what later became to be known as the European Deposit Insurance Scheme (EDIS) (see Gros and Schoenmaker 2014). In June 2012, the interim Van Rompuy (Four Presidents) report mentioned the need to set up a EDIS. According to the *Financial Times* (13 September 2012), the Commission had prepared a draft proposing a new agency, the European Deposit Insurance and Resolution Authority (EDIRA), which would control a new European Deposit Guarantee and Resolution Fund. The EDIRA would be financed through a regular levy on euro area banks and would become the ‘single resolution authority’ for Banking Union, replacing national deposit guarantee schemes. Due to German opposition, the proposal for the EDIRA was removed and the final Commission document ‘A Roadmap Towards Banking Union’ only discussed Deposit Guarantee Schemes (DGS) briefly (*Financial Times*, 13 September 2012). Hence, the final Van Rompuy report issued in December 2012 only made reference to the ‘Agreement on the harmonisation of national resolution and deposit guarantee frameworks, ensuring appropriate funding from the financial industry’ (Van Rompuy 2012, p. 4). In other words, by December 2012, any reference to the setting up of a EDIS had disappeared from the agenda for Banking Union, mainly because of German opposition.

The German government criticised a EDIS as an unacceptable step towards debt mutualisation. The coalition agreement between the Christian Democratic Union (CDU), the Christian Social Union (CSU) and the Social Democratic Party (SPD) explicitly rejected the idea (Koalitionsvertrag 2013: 94). German banking associations and individual banks feared that a EDIS would impinge upon their sectoral institutional protection schemes (*Handelsblatt*, 7 November 2012). Moreover, German banks feared that they would likely become net contributors to a EDIS — bailing out depositors in other euro area member states. By contrast, France and euro area periphery countries regarded a EDIS as the final pillar of Banking Union, necessary to sever the doom loop between banks and sovereigns, preventing deposit flights in countries hit by the sovereign debt crisis (*Reuters*, 11 September 2015). For example, the Italian authorities repeatedly pointed out that ‘coherence is needed between the centralisation of supervision and the management of financial difficulties’ (Szego 2013: 7, authors’ translation). Similarly, the Spanish government emphasized the need to agree the basis and the date for a EDIS to complete Banking Union (Rajoy 2013). However, these countries focused their efforts on the creation of the SRM (and SRF), on which there was a proposal under negotiation — rather than lobby for a EDIS, which was seen as a lost battle (Saccomanni 2013).

The ECB regarded a EDIS as an important component of Banking Union, but one that could be implemented at a later date. The ECB Vice President Vitor Constâncio (2014) argued that ‘From a central bank perspective, the establishment of a common deposit insurance scheme is of less urgency than the other components of a Banking Union. Still, it is an important element that that should be pursued later, as it will be important to fend off bank runs on cross-border banks,

thereby enhancing trust in the European banking sector'. Indeed, a EDIS came back on the policy agenda in June 2015, when EU leaders — including ECB president Mario Draghi and Commission President Jean-Claude Juncker — endorsed the creation of a EDIS in the so-called 'Five Presidents' Report' on the future of the euro. In the autumn of 2015, Commission Vice President, Valdis Dombrovskis, pledged the launch of draft legislation by the end of 2015 as part of a broader policy package he unveiled designed to reinforce the euro (*Financial Times*, 21 October 2015). The Commission proposal would, as a first step, involve the establishment of a mandatory 'reinsurance' scheme that would 'contribute under certain conditions when national deposit guarantee schemes are called upon', thus in effect act as a backstop to national DGS (*Financial Times*, 10 September 2015).

These initiatives took place despite explicit German opposition. The German finance minister, Wolfgang Schäuble argued that it was unacceptable that the 'backstopping of depositors [could] become an excuse for banks to behave irresponsibly, potentially leaving German taxpayers to foot the bill' (*Financial Times*, 10 September 2015). For Schäuble, 'There [was] a moral hazard problem. As soon as you share risk, the decisiveness to reduce risk is lessened. That is what happened over the past few years' (*Financial Times*, 8 December 2015). The German government also had good reason to fear that a number of member states would have difficulty meeting the target level for ex ante contributions from banks to national DGS agreed in the 2014 revised directive. The likelihood existed that a EDIS would be created even though some member states had very little in the way of ex ante funds (Howarth and Quaglia 2016a). In September 2015, the German government produced a non-paper which pointed out several necessary steps forward to make Banking Union a success, without mentioning a EDIS (Federal Government 2015). In order to make

progress on the EDIS and overcome German opposition, the European Commission proposed that savings and cooperative banks be made exempt from having to contribute to the Common DGS (*Reuters*, 2 November 2015).

As in the case of the creation of the SRF, the discussion on the creation of a EDIS pitted countries expected to make net contributions to common rescue funds — either from taxpayers or from banks — against those that expected to be the principal recipients (Donnelly 2014). Germany worried about being the main contributor to the proposed scheme and having to guarantee the deposits of banks in other Banking Union countries, which would have been a form of fiscal transfer (Schimmelfennig 2015). By contrast, France and other periphery countries supported a EDIS, but focused their efforts on the SRM. The ECB regarded a EDIS as an important component of Banking Union, but that could be implemented later on (Constacio 2014). The Commission also supported the idea of a EDIS, as suggested by its proposal for the setting up of EDIRA. However, the different configuration of existing national DGS, which in turn were linked to the different configuration of national banking systems, would have made full harmonization extremely complex.

The lack of a common fiscal backstop

Finally, the credibility of the SRM/SRF and a EDIS was linked to the possibility of accessing a common fiscal backstop. In the construction of Banking Union, the European Stability Mechanism (ESM) was supposed to act as the fiscal backstop. The European Council (2013) agreed that the SSM would allow the ESM to recapitalize banks in difficulties directly and a total of €60 billion was

allocated to the ESM to fund to bank recapitalisation. At German insistence, all ESM bailouts were to be based on strong conditionality and were to be repaid by either the banks or the government of the banks' home member state (*Financial Times*, 15 October 2013). Given unanimity rules, the German government enjoyed a veto on any ESM decision to engage in direct bank recapitalization. Under the rules established for the direct recapitalization of banks, euro area member state governments agreed that a bank's creditors should absorb 'appropriate' losses before ESM funds could be accessed. These appropriate losses were defined by the BRRD's rules on the bail in. Moreover, ESM rules required a bank's home government to contribute at least twenty per cent of the recapitalization (initially) and then ten per cent from 2017. The German government — joined with the Austrian, Dutch and Finns — insisted that ESM funds could not be used to cover legacy problems, to be revealed by a comprehensive assessment of euro area banks by the ECB. Hence, the fiscal backstop did not materialise. However, as noted by the ECB's Executive Board member Peter Praet (2016) 'In the future it will be necessary to create a common fiscal backstop to ensure that the SRF has sufficient resources to support the resolution measures taken by the Single Resolution Board'.

3. The functioning of an asymmetric Banking Union

In the short term, the setting up of Banking Union – together with the pledge of the ECB to 'do whatever it takes to save the euro' - were successful in stopping the sovereign debt crisis in the euro periphery. In 2014, three SSM milestones were reached. First, the ECB published a list of 128 banks subject to direct ECB supervision. The thousands of smaller, so-called 'less significant' banks headquartered in the euro area would continue to be under the direct supervision of national

competent authorities, according to increasingly harmonised rules and practices. Second, the ECB endorsed the SSM Supervisory Manual and published a Guide to Banking Supervision, which had been drawn up by a task force consisting of ECB staff and experts from the national competent authorities (ECB 2014a). Third, the ECB published its comprehensive assessment of the banks subject to its direct supervision (ECB 2014b). This comprehensive assessment consisted of the ECB's assets quality review (AQR) and the EBA's stress tests.

The AQR involved over 6000 ECB and national competent authorities officials reviewing 800 portfolios, amounting to more than 57 per cent of the risk-weighted assets of the 128 banks examined (see Gren et al. 2015 for further details). Crucially, the AQR significantly improved the transparency and comparability of bank data across the then 18 euro area Member States plus Lithuania (which joined at the start of 2015). The AQR harmonised the definition of non-performing loans and uncovered hidden losses. In doing so, the ECB found massive shortfalls – €136 billion – in the loans that banks and national regulators classified as non-performing (i.e. bad). This figure amounted to 15 per cent more than the total previously announced by the national competent authorities. As for the EBA's stress test, 24 banks failed with a capital shortfall under the adverse scenario of €24.6 billion. Amongst the 24 (14 after earlier capital-raising in 2014) banks that failed the comprehensive assessment Italian and Greek banks were the most exposed, with, respectively, nine and four failing, followed by three Austrian banks and two from each of Cyprus, Slovenia and Spain. A Portuguese bank failed the tests later on. Italian banks, which were responsible for a quarter of the total over-valued assets, were hit particularly hard by the harmonised definition of nonperforming loans.

Overall, the harmonisation of rules and practices in supervision has taken place in Banking Union (see Gren et al. 2015). One of the first priorities of the Supervisory Board of the SSM has been to promote the harmonised implementation of options and national discretions in the EU banking rule book, so as to create a level playing field in the euro area (Praet 2016). It is an ongoing process that has started by focusing on significant banks, whereas divergence in the supervision of less significant banks at the national level will continue in the immediate future, given very different national institutional and regulatory frameworks. However, harmonisation will gradually take place in the long term for these small banks.

The SRB was set up as an EU agency in 2015, but it has not been used yet to resolve banks. In December 2014, the Council of Ministers reached a political agreement (compromise) on the implementing Regulation determining the contributions to be paid by banks to the SRF (Council 2014). Banks in France and Germany, the two biggest euro area economies, would contribute the bulk of the SRF's financial resources (€55 billions), with each country's banking sector set to pay just under €15.5 billion by the end of 2023. Italy, the third biggest euro area economy, would contribute €5.8 billion, Spain €5.4 billion and the Netherlands €4.2 billion (*Reuters*, 18 December 2014). Smaller banks — broadly defined as those with total assets of up to €1 billion — would pay a lower flat contribution rate. To date, the SRF has not been used.

Despite the functioning of the SRM and the entry into force of the BRRD, resolution practices have continued to differ in Banking Union. Indeed, there has been a considerable variation in the way in which the national authorities have dealt with ailing banks, in particular concerning the important question of 'who pays' (Mayes 2004). In certain cases, such as Austria and Greece, subordinated

and senior creditors were bailed-in, with some compensation for state guarantee in Austria. In other cases, such as Portugal, selected senior (foreign) creditors were bailed-in. In other cases, such as Italy, subordinated creditors were bailed-in and some retail investors were then partly compensated by the state. Moreover, healthy Italian banks were involved in a private sector bail-out orchestrated by the public authorities. In several cases, precautionary recapitalisation was used to get around the bail-in and to avoid the SRB's involvement.

The following is a bird's eye view of cases of recovery and resolution that have taken place in Banking Union.² In Austria, the *HETA* was resolved between 2015 and 2016 with the full bail-in of subordinated debt, the bail-in of senior debt with a haircut of 54%; and an out of court settlement by the Carinthia Compensation Payment Fund to partly compensate creditors whose bonds were covered by state guarantees. The State of Carinthia and the Austrian government contributed to the Compensation Fund. In Greece, the *Panellinia Bank* was resolved in 2015 by transferring selected assets and liabilities to Piraeus Bank. The equities were bailed-in, and there was no outstanding subordinated debt at that time. In the resolution of the *Cooperative Bank of Peloponnese*, shareholders and remaining liabilities were bailed-in, and deposits were transferred to the National Bank of Greece by using the Greek resolution fund (World Bank 2016).

In Portugal, the resolution of *Novo Banco* (former Banco Espirito Santo), involved the selective bail-in of some of senior (foreign) creditors for approximately €2 billion. Although Novo Banco had about €5.4 billion of senior debt, only 5 tranches of it, mostly held by institutional investors, were wiped out, triggering a set of legal proceedings initiated by the creditors hit by the bail in (World

² The following case studies are partly drawn from World Bank (2016) and are part of a joint project with Manuela Moschella on 'who pays for bank resolution'.

Bank 2016). In Spain, the rural bank *Bantierra* received financial support in 2012, 2013 and 2015 from the insolvency fund of the Spanish Association of Rural Banks, which is the largest cooperative group in Spain. In 2017, Bantierra received a further capital injection of €328 million from the Association, while the Banco de Espana considered a solution similar to the Atlas fund set up in Italy and discussed below. Also in Spain, in March 2017, there were plans to merge the ailing *Banco Mare Nostrum*, which was state owned, following the bail-out and merger of several cajas and Bankia, which was the biggest bank in Spain, resulting from the mergers of several cajas that had been bailed-out.

In Italy, four small banks (Banca Marche, Cassa di risparmio di Ferrara, Popolare Etruria e CariChieti), were resolved in late 2015. Junior subordinated creditors were bailed-in and later some retail investors were partly compensated by the state. A state guarantee scheme on banks' non-performing loans was set up, and a new state-sponsored bank-financed fund (Atlas 1) was created to buy tranches of non-performing loans. In 2016, Atlas also acted as the underwriter of last resort for the precautionary recapitalisation undertaken by two ailing banks in the Veneto region, which had failed the ECB's comprehensive assessment. Finally, there was the preventive recapitalisation of the Monte dei Paschi di Siena, which had been the largest bank to fail the ECB's comprehensive assessment. To this end, the fund Atlas 2 was set up in Italy.

On the one hand, the Sinatra doctrine in dealing with ailing banks was a political necessity, given the political salience of bank resolution and the different configurations of national banking systems. On the other hand, the BRRD and SRM were supposed to harmonise national frameworks and practices concerning bank resolution, but this has happened only to a limited extent in

Banking Union. The current patchwork has implication for the levelled playing field for banks and their creditors (including bond holders and depositors) across countries. It is also potentially detrimental to financial stability given the difficulty of resolving cross-border banks if national specificities persist.

Furthermore, an incomplete Banking Union has revealed the structural difficulty of breaking the 'doom loop'. A clear example was the ECB's comprehensive assessment, which highlighted that several banks suffered from non-performing loans. Whereas in the past, national supervisory forbearance was a common practice, this was no longer possible under the supervision of the ECB in the SSM. In certain cases, such as the Monte dei Paschi di Siena, the viability of the bank was at risk.³ Yet, bank resolution remained to a large extent a national matter, but was complicated by the entry into force of the bail-in rules because the debt of ailing banks was mostly owned by financial institutions and in some cases retail investors in the same country, especially in the euro area periphery. Consequently, there was the danger of contagion effects within national banking systems, re-igniting the doom loop that Banking Union was supposed to stop.

Overall, the supranationalisation of only one component of Banking Union, namely, supervision, but not resolution and deposit guarantee, as well as the absence of a common fiscal backstop, has produced negative effects in the euro area periphery. Although the problem of ailing banks mostly resulted from past legacies and would have existed within or without Banking Union, the ECB-led supervision in the SSM exposed these banking problems more starkly. Yet, an incomplete Banking

³ The situation in Italy was complicated by the fact that subordinated and senior bank debt was also owned by small savers who were not aware of the risk that this debt carried.

Union does not make their solution easier. Some people would argue that a larger SRF, an EDIS and a fiscal backstop are not necessary, given the bail-in rules, which are supposed to reduce the need for common rescue funds — either from taxpayers or from banks — to deal with ailing banks. However, the bail-in is often politically controversial and judicially contested, especially if retail investors are affected (as in the case of Italy), or creditors are selectively bailed-in (as in Portugal), or there are state guarantees (as in the Austrian case). Moreover, the bail-in of bank creditors could have contagion effects, triggering the doom loop in the periphery.

As pointed out by the ECB's Executive Board member Praet (2017) 'While supervisory decisions are taken at European level, the relevant risk-sharing mechanisms such as deposit insurance schemes are still at national level. Supervision is common, but the consequences of potential bank failures are still predominantly national...Both supervisory responsibility and the fiscal backstop need to be at European level, to underpin durably confidence in the area-wide financial system.... For the same reason, it will also be necessary the establishment of a EDIS, with a credible backstop'. However, important political roadblocks on the road to full Banking Union remains and are part and parcel of long standing debate in European economic governance, as elaborated in the following section.

4. Competing coalitions and political dynamics in Banking Union

Overall, the Banking Union that was eventually agreed and subsequently set up was somewhat a 'lighter' version of that initially proposed in three main respects: resolution, deposit guarantee and fiscal backstop. First, member states governments retained their vetoes on the mutualisation on

national fund and an important say on the use of resolution funds in the SRM. A rather 'complex' compromise was reached concerning the resolution process in the SRB. Moreover, resolution mostly remained a national matter. De facto, the SRB has so far not resolved a bank. Second, an EDIS was not set up. Third, no common fiscal backstop was established. Banking Union was built in an asymmetric way because different forces pulled in somewhat different directions, reflecting a long standing debate between 'creditors' and 'debtors' countries in the EU (or 'saints' and 'sinners' as Dyson 2014 puts it). It also reflected the coexistence of supranational and intergovernmental dynamics in European economic governance (Bickerton et al. 2015; Dehousse 2014; Fabbrini 2015; Schimmelfennig 2015; Niemann and Ioannou 2015).

The Commission and the ECB supported the construction of Banking Union and favoured the supranationalisation of all its components, meaning the transfer of supervision, resolution and deposit protection from the national level to the Banking Union level. However, these supranational bodies were aware of what was (or not) politically feasible and of the need to strike a balance between the (different) preferences of the member states. A coalition led by France, and including Italy, Spain and other countries in the euro area periphery, was keen on securing financial support mechanisms for ailing banks and sovereigns. In return, they were willing to accept the supranationalisation of banking supervision.

A coalition led by Germany and including, Austria, Finland and the Netherlands (the last two with some caveats) was reluctant to provide financial support to (foreign) ailing banks and their countries. The German authorities in particular were concerned about moral hazard - that is to say, not to provide incentives for 'risky' behaviour of sovereigns and banks - and legacies problems

deriving from past supervisory forbearance. This coalition was therefore keen to supranationalise banking supervision for systemic banks – an important qualification for Germany and Austria, given the dual configuration of their national banking systems - but not resolution (except to a limited extent), deposit insurance and a common fiscal backstop.

On the one hand, Germany was keen to minimise the elements of Banking Union (such the SRF and a EDIS) that could result in fiscal transfers from fiscally and financially stable member states to ailing member states. Indeed, Germany was the largest economy in the euro area, it has a large current account surplus and a sound fiscal position. Thus, it would be the main net contributor to the support and resolution mechanisms of Banking Union. On the other hand, German banks were exposed in the EU periphery, and Germany, like the other euro area members, was concerned about the potential breaking up of the euro (Epstein and Rhodes 2016; Schimmelfennig 2015). Germany enjoyed a kind of veto power in the construction of Banking Union (Bulmer 2016; Bulmer and Patterson 2013), although one constrained by the threat of sovereign debt default in the euro periphery, contagion and euro area disintegration.

The effects of the first few years of the functioning of Banking Union have not brought together the two coalitions, and the existing division has been perpetuated. States in the periphery of the euro area have several ailing banks, several of which were not bailed-out during the height of the crisis and were subsequently penalised by the low economic growth in the periphery. These banks are interconnected to the rest of the national banking system and hold considerable amounts of national government bonds, posing the risk of contagion that can undermine the confidence in the national banking system and its sovereign. The national authorities in these countries face the

issue of resolving ailing banks, sometimes hitting domestic retail investors through the bail-in. At the same time, these countries are constrained by EU rules on state aid and resolution (in particular, the bail-in). Furthermore, the weak fiscal position of these periphery countries could trigger a doom loop in case of public bail out.

Germany, Austria and to some extent the Netherlands and Finland, bailed out their banks in the aftermath of the international financial crisis, hence these banks are in a relatively good shape. The bail-in is (at least on paper) easier to carry out in these countries because it does not affect many retail bonds holders and national (or associational) DGS protect depositors above 100.000 euros. Finally, these countries have sound fiscal positions and are likely to be net contributors to the SRF, the ESM, the would-be EDIS, the would-be fiscal backstop and other types of EU mechanisms for financial support. Hence, the national authorities want to prevent moral hazard and avoid anything resembling fiscal transfers in Banking Union.

Banking Union also invites a reflection on the role of crises in pushing forward EU integration, sometimes 'by stealth' (Meny 2014) and draws attention to the supranational- intergovernmental dynamics in EU economic governance (Fabbrini 2015, Jones et al 2016). Fabbrini (2015) points out 'a dual constitution, supranational in the single market's policies and intergovernmental in (among others) economic and financial policies', noting that the EU's response to the sovereign debt crisis has mainly been 'defined and implemented on the basis of the intergovernmental constitution of the EU'. This contributes to explaining the lack of progress in the cases of a EDIS and fiscal backstop, which met strong opposition by powerful governments. However, some components of Banking Union, notably the SSM, are strongly supranational. Jones et al. (2016) develop the

concept of 'failing forward', whereby intergovernmental bargaining in the EU leads to incomplete solutions based on the 'lowest common denominator', which deepen integration, but lay the seeds for subsequent crises. Over time, a new crisis builds up and the member states respond to it with solutions based on the lowest common denominator. These political dynamics apply to the construction of Banking Union, which was the response to a crisis triggered by an incomplete EMU.

Indeed, the architects of EMU – the central bank governors and expert members of the Committee for the study of economic and monetary union under the chairmanship of Commission President Jacques Delors – had advocated the transfer of prudential supervision to the supranational level to complement monetary union (1989, para. 32). However, the transfer of supervisory powers was postponed given the opposition of a number of national governments (Dyson and Featherstone 1999) and the result was an incomplete EMU. Furthermore, during the negotiations leading to the Maastricht Treaty, some member states, first and foremost Germany, opposed fiscal (or transfer) union for political and economic reasons. Politically, it was seen as a step too far, impinging upon a core area of national sovereignty. Economically, member states with sound fiscal positions, led by Germany, were concerned by the potential moral hazard that a fiscal union would bring about, and that they would end up financing countries that lacked sufficient fiscal discipline (Dyson and Featherstone 1999). The result was an asymmetric nature of EMU, whereby monetary union did not include banking supervision and was not coupled by a full economic (fiscal) union (Dyson 2000, Verdun 1996).

By 2012, in the context of a devastating sovereign debt crisis and the very real menace of the imminent collapse of the Spanish banking system, Spanish government default and euro area collapse, euro area governments agreed to supranationalise banking supervision (Gren et al. 2015), but not on other components of Banking Union. Banking Union was presented as the completion of economic and monetary union (EMU), addressing a fundamental flaw in the design of EMU (Van Rompuy 2012). But even Banking Union was incomplete, without a fiscal backstop and a European Deposit Insurance Scheme.

Conclusion

Banking Union was a radical initiative to stabilise euro-periphery national banking systems exposed directly to rising sovereign debt loads and the growing risk of default – the ‘sovereign debt-bank doom loop’ – and to reverse the fragmentation of European financial markets. Banking Union was supposed to set in place a ‘risk-sharing framework for the member states, which would allow costs of resolution to be spread across the euro area, contributing to breaking the bank-sovereign doom loop’ (Draghi 2014).⁴ In the short term, Banking Union succeeded in stopping the sovereign debt crisis in the euro area, even though the doom loop was not severed and financial fragmentation across the member states remained.

In the medium term, the incomplete Banking Union had asymmetric effects, promoting the supranationalisation of supervision, but not of resolution and deposit insurance. Consequently, in Banking Union there has been a limited convergence of resolution practices across countries - the

⁴ <https://www.ecb.europa.eu/press/key/date/2014/html/sp140212.en.html>

so-called Sinatra doctrine in dealing with ailing banks – as well as limited risk-sharing arrangements. The asymmetric Banking Union and its effects pose considerable economic and political risk to the project. However, different national interests and political sensitivities hinder progress towards a full Banking Union, making for a ‘bumpy road’ ahead.

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