Policy Contribution
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Executive summary

The European Union's banking union project started in mid-2012 in response to the euro-area crisis, with the goal of breaking the bank-sovereign vicious circle. The objective was also to restore private liability in banking and to move towards an integrated supranational market for banking services. For all the progress achieved in the past decade, particularly in banking supervision, these aims have not yet been accomplished.

This Policy Contribution analysis the deficiencies of the current framework and identifies possible responses, in line with three levels of reform ambition. We label these 'incremental' (broadening the scope for private-sector burden-sharing in future cases of bank failures), 'real' (effectively breaking the bank-sovereign vicious circle), and 'cosmic' (a single, seamlessly integrated banking market). European policymakers should set their sights on the second level, which we view as achievable within the current decade, requiring new EU legislation but no change to the European treaties.

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1 The banking nion projec

The great financial crisis and the euro-area crisis led to substantial reform of financial safety nets across Europe and – critically – to the introduction of supranational elements. Specifically, a supranational supervisor was established for the euro area, with competences and tasks depending on the systemic relevance of supervised credit institutions. A resolution mechanism was created to allow the frictionless resolution of large financial institutions. This resolution mechanism has been now complemented with a funding instrument.

For all the progress that has been achieved, the banking union remains unfinished, and has major deficiencies. The Eurogroup in June 2022 concluded a round of negotiations between EU countries by calling for further reform in the area of crisis management and resolution[1].

This Policy Contribution assesses the current and the desired state of the banking union project. The key underlying question is the level of ambition and how it matches with effective legal and regulatory tools. Two questions structure our evaluation:

- What would be a reasonable definition and rationale for a 'complete' banking union, and what legal reforms would be required to achieve it?
- Banking union is a case of a new remit for European Union-level policy that so far has been conducted on the basis of long-existing treaty stipulations, namely Article 127(6) of the Treaty on the Functioning of the European Union (for banking supervision) and Article 114 TFEU (for crisis management and deposit insurance). Could banking union be completed through secondary law, or is a more comprehensive overhaul of the legal architecture required to ensure legal certainty and legitimacy?

2 S a e of pla

Europe's banking union was a major component of the EU's policy response to the great financial crisis (GFC) of 2007-2009 and the euro-area crisis of 2010-2015. Its stated aim, pithily formulated at its inception in mid-2012[2] and expressed repeatedly afterwards, was to sever member states could no longer lean on domestic banks for concessionary financing conditions that ultimately exacerbate the bank-sovereign nexus.

Despite the original political vows (Van Rompuy, 2012) and notwithstanding specific proposals by the European Commission and academics, the banking union is far from complete. First, significant crisis-management competences remain at national level. Second, even where crisis-management competences have been centralised – in the resolution area – there efficient decision-making difficult, as special interests and their political backers have many places to turn to in their lobbying efforts.

2.2 The prana ional re ol ion frame ork ha no been applied in prac ice

The policy changes associated with the banking union, especially the BRRD and SRMR, were supposed to prevent bank bailouts by home-country authorities, including by making banking fragility less likely, by permitting national bailouts only in exceptional circumstances, and by ensuring that failed banks could be resolved without fiscal support and without creating a financial disaster. In turn, this was expected to prevent contagion from banks to sovereigns and from sovereigns to banks, and to facilitate the development of a pan-European banking market and the formation of pan-European banks, thus preventing the concentration of country-specific risk on the balance sheets of national banks. It was also meant to facilitate bank exit in overbanked economies.

By and large, these aims have not been realised. There have been few exits. The euro-area banking system remains fragmented, with banks exposed disproportionately to their national sovereigns. Solutions to banking problems remain predominantly national. With very few exceptions[5], the SRB-led resolution option has been circumvented in most recorded cases of ailing or failing banks, and national practices for dealing with banking crises have continued to diverge significantly. Thomas Huertas's famous quote still holds: global (or for our purposes here, European) banks are "*international in life, but national in death*"[6].

The EU crisis-management framework provides critical escape routes which allow supranational decision-makers (the SRB and the European Commission, which is formally involved in the resolution process) to shy away from implementing EU-level resolution schemes that would generate legal risks and might be perceived as not aligned with certain national interests. Admittedly, all banking authorities are confronted with a difficult balancing act between the ex-ante risk of imprudently committing public funds to the bailout of ailing banks, thereby creating moral hazard, and the ex-post risk of liquidating viable financial institutions, thereby destroying economic value. A problem specific to the EU is that the lack of a common fiscal capacity has helped tilt the balance towards a very harsh and arguably unrealistic bail-in regime, which in turn feeds incentives to avoid EU-level resolution and to keep banks and their crisis management under national control, in order to facilitate bailouts.

For bail-in to fully develop its influence on creditor behaviour, the logic of the BRRD needs to be revisited. Under the BRRD framework, putting an ailing bank into resolution entails applying a stringent 8 percent minimum private sector loss-bearing requirement[7]. To escape that strict discipline, supervisors and resolution authorities can either muddle through (supervisory forbearance) or send the bank into liquidation under normal (national) insolvency procedures, which vary significantly across member states. Both alternatives to resolution allow for rather generous injections of public funds instead of bailing-in investors thrurd82.ch62022.-1.444 2eth(6-37./Span ActualText EFF2002 BDC (-37.EMC 1.001)0 thr)F)1rb-8ma9iculaa

Further down the line, if a bank has been deemed to be failing or likely to fail, the SRB can deny a public interest and thus avoid triggering resolution, if it determines that the resolution objectives laid down in Art. 31(2) of the BRRD and Art. 14(2) of the SRMR, respectively, can also be achieved in a proportionate manner under normal insolvency proceedings (BRRD, Art. 32(1)(c) and (5); SRMR, Art. 18(1)(c) and (5)). In both instances, the European legal framework relies on standards that are too vague, concede significant leeway to supranational authorities in determining the scope of the European resolution regime, and ultimately defeat the proclaimed objective of avoiding bailouts.

To date, only three troubled institutions have been judged to meet the conditions for supranational resolution. The economically most significant case remains Banco Popular Español, which was taken over in June 2017 by Santander for the symbolic price of one euro. As a result of the takeover, which provided a potent private-sector backstop[9], there was no need to enter into the more contentious parts of the resolution framework, including the write-down of either subordinated or senior unsecured debt[10]. Yet, even in this relatively straightforward case, more than 100 cases of aggrieved capital holders were brought to local and European courts.

The litigious nature of resolution with bail-in (Avgouleas and Goodhart, 2015) also highlights another reason why the supranational resolution framework is not applied in practice, even though EU-level resolution would be efficient from a welfare point of view. The 'no creditor worse off' principle, enshrined in SRMR, Art. 14(1)(g), 29 and BRRD, Art. art. 34(1)(g), 73, requires resolution authorities to make sure they pick resolution schemes and actions that do not impose greater losses on bailed-in creditors than these would have incurred in normal (national) insolvency proceedings. The uncertainty introduced by the no creditor worse off principle, which requires resolution to be compared with a hypothetical insolvency procedure, has contributed to a fear among many responsible authorities, particularly the SRB, that they could overstep their mandates, rendering true bail-in a risky endeavour from the perspective of resolution authorities. There may always be a counterfactual, deemed achievable by some court, that supports the view of an infringement of creditor rights, which in turn may lead to reputational damage and even liability. As a consequence, regulators face additional incentives to avoid harsh bail-ins.

As a result, normal (national) insolvency proceedings have continued to apply to the large majority of small and medium-sized banks. This leads to an uneven playing field for investors across countries, and significant variation in funding conditions for banks even within the banking union. The various options for injecting public funds into non-viable institutions can lead to zombie banks and put a drag on credit-funded growth.

Even if the SRB could get its way, it may lack the financial firepower to interfere with the business model of large banks in resolution, because of impending liquidity and subsequent solvency risks. Th036rit(erdicr)15.1 (e)-2.9 cut ccness toceintral bans mnhey not a s cieinply large nsalblacrstat could proideh the6cmitall and liquiditycrequired to(s)2 ((a)5 (bilus)-4 (e(an(aitin)4 (g)TJ0

2.3 The bank- o ereign ne ha no been addre ed

There is still a strong home bias among financial institutions in their sovereign bond holdings across the euro area, a bias that is stronger in countries with higher debt/GDP levels. This compounds the above-described biases in the BRRD towards national solutions that further exacerbate the bank-sovereign link.

Over the past decade, different proposals have sought to address the home bias. One idea is to introduce positive risk weights for all sovereign-bond holdings of banks, as is already required for holdings of non-OECD sovereign bonds. But, aside from the fact that there is no global consensus about them, such risk weights might introduce cliff-edge effects for countries that are about to be downgraded, and where such a downgrade could trigger a substantial increase in risk weights. This problem would arises not only in a transition period but would be a permanent feature of a credit-risk-centric approach to regulatory treatment of sovereign exposures. Concentration limits or, to avoid other cliff effects, sovereign concentration charges, have therefore been suggested as alternative, together with transition arrangements (eg Bénassy-Quéré *et al*, 2018). Because they are tailored to the unique circumstances of a monetary union, such concentration charges, if properly calibrated in order to constrain exposures to individual euro-area countries but not aggregate euro-area sovereign exposures, would not introduce competitive distortions between euro-area banks and their global peers.

Limiting the home bias in sovereign bond holdings and thus the exposure of banks to their home-country government, can reduce the effect that sovereign fragility has on banks' balance sheets. Conversely, the effect of bank fragility on sovereign debt sustainability can only be addressed by supranationalising the resolution process and countering the national bias in favour of bailouts.

2.4 Wh do na ional in ere con in e o r mp E ropean idea ?

Why has the banking union not lived up to expectations? The short answer is that the regulatory and institutional architecture that was first put in place between 2013 and 2015, and has been lightly amended since, is still not powerful enough to offset a national bias that dominates banking sector policy. Most member states still wish to maintain control over their banking systems, limit cross-border exposures to liquidity needs in times of crises, protect national or regional banks against foreign competitors, and leverage their domestic banking systems to facilitate government financing in times of stress. Despite the successful adoption of common rules and standards, pivotal responsibilities in bank crisis management still remain at national level. It should also be recalled that the reform package enacted in 2013-2014 is not yet fully implemented. In particular, the minimum requirements for own funds and eligible liabilities (MREL), which compel banks to build up sufficient loss-absorbing capacity, will only become fully loaded in 2024, in the meantime leaving the available private-sector funding for resolution uneven across member states.

within the SSM. At the SRB, structures that lend member states' representatives a dominant role in critical supranational decision-making are in place when individual cases are considered (Tröger and Kotovskaya, 2022). Home member-state representatives have strong incentives to make themselves heard, form coalitions and organise opposition to supranationally devised draft decisions precisely because, if a bank is in default, the home fiscal authority is the party ultimately liable for uncovered losses[11].

2.5 The re l : fragmen a ion ri k and fragmen ed nancial er ice along na ional line

The result is a regime in which resolution and liquidation are either avoided or happen under national rules. This continued de-facto national responsibility undercuts the intent of the BRRD and SRMR and stands in the way of the objective of creating a single banking market. There are recurring instances of regulatory 'ringfencing' along national borders, even though such decisions are not necessarily made public. A prominent example was the application of the ECB's recommendation for restrictions on profit distributions during the COVID-19 pandemic on the national (ie subsidiary) level, rather than EU or group level, in several EU countries. In some instances, national competent authorities restricted cross-border upstream transfers even within the EU, which were permissible under the ECB's recommendation that applied on the consolidated level (ECB, 2021)[12]. These interferences with free capital flows within the single market were justified by national authorities on the basis that fiscal support measures (which benefitted banks at least indirectly) were taken at national rather than European level.

The consequence is that even within the banking union, the market for financial services remains fragmented along national borders, with very few cross-border mergers and very limited cross-border competition. Banks therefore continue to concentrate risk at the national level, perpetuating a major vulnerability of the euro area that banking union was meant to remedy.

3 Op ion for reform

Reform options should relate back to the objectives the banking union project was intended to address:

- First, the repeal of implicit government guarantees and the return of private liability in banking;
- Second, breaking the bank-sovereign nexus which, in crisis situations, turns into a vicious circle that was revealed in 2011-2012 to be an existential threat to the euro area;
- Third, moving closer to a genuine single European banking market with its advantages in terms of credit allocation and value-for-money for firms and households.

Banking union reform could thus have three different possible levels of ambition.

First, we acknowledge that the round of Council negotiations that came to a close in June 2022 has endorsed a plan to improve the crisis-management and deposit-insurance framework while not attempting, at this stage at least, to further reduce the bank-sovereign vicious circle. While we are unsure to what extent the former can be achieved effectively without the latter, we take the plan seriously and characterise it as an 'incremental deal'.

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Second, we outline what we view as an achievable 'real deal' that would break the bank-sovereign vicious circle, even though it would not eliminate all national idiosyncrasies that contribute to the fragmentation of European banking markets across national borders.

Third, we sketch a vision of full market integration, which we view as desirable but much more distant and long-term, and therefore label as the 'cosmic deal'.

3.1 The incremen al deal: Impro e he cri i -managemen and depo i - in rance frame ork

A first approach would be to adjust the legal and regulatory framework to improve the effectiveness of crisis management, alongside better supervision, and to establish resolution as general practice in cases of failing or likely to fail banks. This approach is explicitly intended to match the plan alluded to in the Eurogroup statement of 16 June 2022. It consists of six recommendations.

1. Extend the crisis-management framework, as developed in the SRMR and the BRRD, to

all deposits beyond the MREL, eliminating the differentiated levels of seniority among

The three levels of ambition we identify do not represent mutually-exclusive reform trajectories, but correspond to different presumed timelines. The 'incremental deal' may be achievable in the course of the current EU parliamentary term, but is not sufficient to address the challenges revealed during the euro-area crisis. The 'real deal' is what we strongly advocate, while being aware that – unless precipitated by a new crisis – it will not be seriously considered by policymakers before the mid-2020s at the earliest. The 'cosmic deal' will remain aspirational for the foreseeable future, but some of the reforms on the way to the deal may not be.

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