

Banking Union in Nine Questions

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for the Interparliamentary Conference under Article 13 of the Fiscal Compact

Palazzo Montecitorio (Rome), 30 September 2014

This statement is prepared as a contribution to the conference's third session, "Completing the Banking Union and Financing the Real Economy". Its aim is to help form a collectively shared assessment of the EU's banking union project, its implementation so far, its possible future impact, and further policy initiatives that may be considered to complete or complement it. To facilitate reading, it is structured in questions & answers, with three questions on each of banking union's past, present, and future.

Given the statement's focus, the topical issues of EU bank structure reform and capital markets union are covered only superficially and primarily in their relationship with banking union, under question 9. The other issue on the session's agenda, microcredit, is not covered in this statement.

The Past

1. What is Banking Union?

The expression "banking union" started being widely used in the spring of 2012 in the European public debate (initially by Bruegel scholars, it appears), before it was picked up by public policymakers in the early summer of that year. In practice, banking union generally refers, depending on context, either to the process of transfer of authority over banking policy from the national towards the European level, or to the European banking policy framework resulting from that transfer process. In terms of actual policy decisions, the starting point of the process was the summit of euro area heads of state and governments on 28-29 June 2012, at the end of which leaders memorably declared "We affirm that it is imperative to break the vicious circle between banks and sovereigns" and announced the creation of the Single Supervisory Mechanism (SSM).

As of now, the foundation of banking union is made of two key pieces of EU legislation. The SSM Regulation of 15 October 2013 designates the European Central Bank (ECB) as the licensing authority for all euro area banks from 4 November 2014. The Single Resolution Mechanism (SRM) Regulation of 15 July 2014 creates a Single Resolution Board (SRB) in Brussels from 1 January 2015 and gives it a central role in the future management of crises involving banks directly supervised by the SSM. The SRM Regulation also entrusts the SRB with a Single Resolution Fund (SRF), the modalities of which are specified in a separate intergovernmental agreement that was signed on 14 May 2014 by 26 EU member states (all except Sweden and the UK) and is in the process of being ratified.

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Several other pieces of legislation also support the banking union by strengthening the European “single rulebook” for banks, even though their initial proposals by the European Commission predate the inception of banking union in late June 2012. These include the Capital Requirements Regulation (CRR) and fourth Capital Requirements Directive (CRD4) of 26 June 2013; the Deposit Guarantee Schemes (DGS) Directive of 16 April 2014; and the Bank Recovery & Resolution Directive (BRRD) of 15 May 2014.

Strictly speaking, banking union is neither part of Europe’s Economic and Monetary Union (EMU), nor of its Internal Market policy. The euro area crisis, and the identification in 2011-12 of the vicious circle between banks and sovereigns, was the trigger for the decisions made by euro area leaders on 29 June 2012. Correspondingly, the SSM Regulation is based on Article 127(6) of the Treaty on the Functioning of the European Union (TFEU), which is part of its chapter on Monetary Policy. However, the SRM Regulation is based on Article 114 TFEU, which makes it technically part of the Single Market body of legislation even though some member states are exempted from its scope.² Moreover, Article 7 of the SSM Regulation allows non-euro-area member states to join the banking union through so-called “close cooperation,” and it appears likely that several (though not all) such member states will do so in the next two years. As a result, the geographical scope of banking union, or “banking union area”, would be larger than the euro area but smaller than the EU. This geographical aspect echoes the broader hybrid nature of the banking union, somewhere between EMU and the Internal Market.

2. Why was banking union started?

Because the earlier framework, which combined national banking policy with European integration through the Internal Market and EMU, had failed to deliver financial stability and was increasingly likely to precipitate the breakup of the euro area.

For five years, from mid-2007 to mid-2012, member states tried to address the systemic fragility of their banking systems using national banking policy tools, with occasional moments of co-ordination such as the summits of 12 and 15 October 2008 at the height of the market turmoil following the collapse of Lehman Brothers. But their attempts were gripped by a collective action problem. For each national banking supervisory authority, the prudential mandate to ensure financial stability collided with the concern to protect and foster domestically-headquartered banks against their European competitors. The domestic banks’ interests were widely viewed as aligned with the national interest, under a pervasive mindset of “banking nationalism” which typically considers banks as instruments or even agents of government for the purpose of industrial policy (directed lending) and/or government financing (“financial repression”), and more generally as “national champions” that are somehow seen as better contributing to the countries’ common good than foreign-owned banking operations.

This legacy of banking nationalism, and more specifically its combination with uniquely European binding frameworks of cross-border market integration, goes a long way in explaining the build-up of excessive risk in the European banking system in the decade before the crisis, and then the inability to conduct the necessary but painful process of triage, recapitalization and restructuring in most member states during the first five years of crisis. It was also a major contributing factor to the

² The legal robustness of this exemption may be tested in court in the future.

provision by EU member states of excessive guarantees to their domestic banks, their overgenerous use of public money in successive bank bailouts, and their general inability (with the exception of Denmark in 2010) to impose market discipline on bank creditors, even in most cases subordinated ones.

The resulting high level of public support of domestic banks, combined with the simultaneous refusal to extend similar support to fellow member states as sovereign issuers (perhaps most noticeably expressed in the French-German declaration in Deauville on 18 October 2010), was a core driver of the bank-sovereign vicious circle of market contagion, which became increasingly evident through 2011 and was generally (and rightly) identified by European policymakers as a major source of instability in early 2012.

To put it simply, there were two and only two options to break the bank-sovereign vicious circle: either on the sovereign side, or on the banking side. The sovereign-side option would have required “fiscal union” in the form of a potentially unlimited joint debt issuance capability, which would arguably have required some form of unlimited (if only contingent) joint revenue-raising capacity. This was widely discussed in 2011 but no basis for agreement was found, beyond the imposition of an EU straightjacket on national fiscal decisions, whose enforceability remains somewhat to be tested. As the bank-sovereign vicious circle intensified in the spring and early summer of 2012, this left banking union as the only remaining option to avoid the break-up of the euro area. This option entailed bidding farewell to banking nationalism, through the creation of a joint institutional framework that would dramatically alter policy incentives, and was therefore least favoured by most member states and their respective national banking communities. However, euro area break-up appeared as an even less palatable option, which explains the remarkable moment of decision on 28-29 June 2012.

3. Why is banking union incomplete?

Essentially, for the same reasons that delayed its inception for so long, in spite of compelling advocacy by analysts and experts that goes back to the negotiation of the Maastricht Treaty and even to the 1960s. The significant pooling of sovereignty that banking union represents was decided under duress, after all alternative options had failed. The ad hoc manner in which it was introduced (by contrast with, say, a treaty revision through an intergovernmental conference) made it impractical to bind all participants identically on a common vision. As an inevitable consequence, the implementation of banking union since mid-2012 has been incomplete and somewhat lopsided, alongside at least three dimensions.

First, not all EU member states are or will be in the banking union area. This was made unavoidable by the stance adopted by the United Kingdom in 2011, reversing earlier policy, and memorably summarized by Chancellor of the Exchequer George Osborne as the “remorseless logic” of policy integration in the euro area, a process which he suggested the UK would encourage but not participate in. As previously noted, the banking union area is likely to soon include some non-euro-area member states, but not all of them. Each of the non-euro member states has to weigh the cost of relinquishing sovereignty over banks against the benefits of banking union in terms of financial stability and market integration; the political, economic and financial drivers of this assessment are different in each of them. Even in the UK, there is scope for future (if not current) debate: in a report of its EU Committee published in February 2014, the UK House of Lords wrote that “It would be wise

not to close the door on the possibility of some level of [UK] participation in Banking Union in the future, in particular as a means of further promoting and shaping the Single Market in Financial Services and the UK's position within it."

Second, not all banks inside the banking union area are directly covered. At the insistence of the German government, most banks under EUR 30bn of total assets are not directly supervised by the ECB, even though it is the ECB that ultimately grants their banking license. These small banks, which are predominantly concentrated in Germany (as well as in Austria and Italy – together these three countries represent almost four-fifths of all small banks in the euro area, according to ECB data), also escape the authority of the SRM in crisis situations. Together they represent probably less than 15% of total euro area banking assets, but a much higher share in Germany and probably in Italy as well. While they do not appear to represent a systemic risk at this point, the regulatory asymmetry could lead to future risk concentrations in them that might be destabilizing for the entire system, as was the case with the US savings & loans in the 1980s or the Spanish savings banks (*cajas de ahorros*) in the 2000s. In addition, the existence of the EUR 30bn threshold might lead national supervisors to discourage necessary consolidation that would result in banks crossing this line and thus escaping their direct authority, Italy being a case in point.

Third, significant aspects of banking policy remain outside of the scope of banking union. The most obvious case is deposit insurance which, even after the harmonization brought forward by the DGS Directive, remains a national competence and thus a probable propagator of the bank-sovereign vicious circle in at least some systemic crisis scenarios, as was illustrated in Cyprus in early 2013. The same is true of resolution funding: in spite of gradual build-up and "mutualisation" of "national compartments", the SRF will remain too small and unwieldy to represent an adequate European-level resource in systemic banking crisis scenarios. An initial decision to allow the European Stability Mechanism (ESM) to recapitalize banks directly, which was announced on 29 June 2012, was then effectively reversed, and the likelihood of this possibility being activated in the future is low. Separately, consumer financial protection, the fight against money laundering, and other components of the regulation of bank conduct remain national competencies, even though some of these could be further harmonized through EU Internal Market legislation, as discussed below under question 9. The SRM itself is single in name only, with a complex and untested decision-making framework that preserves significant discretionary autonomy for national resolution authorities, as well as some legal risk given the departure from established Internal Market legislative patterns. By contrast, the SSM appears legally robust (even though it is being contested before Germany's Federal Constitutional Court) and represents a remarkably comprehensive transfer of authority to the ECB on those banks that it will supervise directly.

The Present

4. How effective has been the implementation of banking union decisions so far?

The above described initial legislative package that underpins Europe's banking union was adopted rather quickly: about a year from the European Commission's proposal to the publication in the Official Journal of the EU, for both the SSM and SRM Regulations. However, its initial implementation is still at an early stage. The SSM, which is headquartered in Frankfurt near the ECB but in a separate building, will assume direct supervisory authority over the euro area's 120 largest banking groups on

4 November 2014. The SRB will start operations in Brussels on 1 January 2015. The Comprehensive Assessment, a crucial element of the transition, is addressed separately under the next question.

The available indications, including the ECB's latest quarterly report on SSM implementation published in early August 2014, suggest that the deadline of 4 November is likely to be met in a broadly effective and orderly manner. The SSM's key decision-making body, the Supervisory Board, has been appointed (even though one of the four seats for ECB representatives remains vacant), as has been the Administrative Board of Review. Senior staff positions have been appointed months ago, and in total more than 550 recruitments had been made for the SSM by early July, with the new recruits coming from national supervisors (the majority), the ECB internally, and the private sector or other backgrounds. The SSM appears on track to reach its target of 1,050 staff shortly after the handover of authority on 4 November. As far as can be judged at this point, the individuals recruited under this process appear of high professional quality.

The ECB also appears to have been remarkably successful in enlisting the cooperation of national bank supervisors (in the SSM jargon, National Competent Authorities – these are national central banks, or practically arms thereof, in many but not all member states: in Germany for example, BaFin is autonomous from the Bundesbank). The transfer of authority over larger banks could have been a highly acrimonious process, but, in most countries at least, it appears to be occurring rather smoothly. The fact that so many of the SSM staff were recruited from national supervisors, starting with the French Chair and German Vice-Chair of the Supervisory Board, probably helps.

Also helpfully perhaps, the ECB may have chosen not to prioritize decisions on issues that could be divisive, but are not urgent. For example, the ECB appears unwilling to force an early decision about the impact of banking union on the composition of the Basel Committee on Banking Supervision, in which logic suggests that the ECB become a full member (it is currently an observer) but also that national authorities from Belgium, France, Germany, Italy, the Netherlands and Spain need no longer to be represented. Another example is the finalization of the centralized Risk Assessment System, a framework to score all supervised banks across different categories of risks, which was delayed from 2014 to 2015. As a consequence, the "supervisory risk assessment" that had been communicated as one of three pillars of the Comprehensive Assessment at its outset in October 2013, was later downgraded in importance and visibility. This delay may be due to technical or operational factors, but also possibly to the fact that different national supervisors defended different methodological choices, which would have had impact on the respective scores of banks from different member states. If a decision had been forced early, the high public visibility of the Comprehensive Assessment could have exposed discrepancies from previous national assessments that might prove unflattering for at least some of the authorities. On the whole, the ECB appears to have shrewdly temporised on the resolution of some potentially contentious dilemmas.

Another factor that fosters genuine cooperation within the SSM is that it provides an opportunity for national supervisors to become more independent and authoritative in their respective national environments. This is broadly what happened to national competition authorities in the early 2000s, through the strengthening of the network they form with the competition-policy arm of the European Commission: indeed, the precedent provided by European competition policy may have served as inspiration for the design of the SSM by the European Commission during the summer of 2012. As in competition policy, the ECB has been careful to preserve a significant operational role for

the national supervisors even as they lose ultimate decision-making autonomy. For the 120 banks it supervises directly, the “joint supervisory team” will include staff from the national supervisors as well as ECB supervisory staff – including the team’s head, who according to current SSM policy will be a citizen of another country than the one where the bank is headquartered. The decision by the ECB not to have its own permanent staff in the participating member states thus contributes to the empowerment of national supervisors in the system. In recent months, SSM Supervisory Board Chair Danièle Nouy has often repeated that the SSM design provides “the best of both worlds: the proximity of [national] supervisors to the banks, and some distance [from local political entanglements] for the [ECB’s] decision-making”. Beyond the rhetoric, this vision appears to have elicited buy-in from many of the participant authorities.

5. How credible will be the Comprehensive Assessment?

The Comprehensive Assessment is the transitional process provided for under Article 33(4) of the SSM Regulation, by which the ECB checks the health of all banks that come under its direct supervisory authority to make sure they still deserve their banking license. It consists of two components, an Asset Quality Review (AQR) and a stress test. The AQR was completed during the summer of 2014 and involved thousands of reviewers, mostly from national supervisors and large audit firms that they hired as consultants, which double-checked the valuation of a wide selection of asset portfolios on the banks’ balance sheets. The stress tests are currently being finalized under the auspices of the European Banking Authority (EBA) in London, since all EU member states, not only those from the euro area, are participating in them. The banks need to pass an 8 percent capital threshold under the baseline scenario, and a 5.5 percent threshold under the adverse stress scenario. If they don’t, they will have to quickly present plans to bridge the capital gaps in six months for shortfalls under the baseline scenario, and in nine months for shortfalls under the adverse scenario. The stress test calculations will take into account findings from the AQR under a process labelled “join-up” by the ECB. All results will be announced by the ECB in the second half of October, in anticipation of its assumption of supervisory authority on 4 November. There have been essentially no leaks so far about the AQR findings, a fact that may be related with the judgment made above about the quality of co-operation within the SSM so far.

On the face of it, the process should be more robust and credible than the ill-fated stress tests of July 2010 and July 2011, which gave clean bills of health to groups such as Allied Irish Banks, Bankia or Dexia that collapsed soon afterwards. Those past exercises did not include an AQR, and even more importantly, did not ensure adequate alignment between national supervisors and the EBA (or in 2010, its predecessor the Committee of European Banking Supervisors), in spite of the latter’s dedication and valuable efforts. There were strong incentives for weaker banks and their national supervisors to hide the proverbial skeletons in the cupboard from the EBA. By contrast in this year’s process, the ECB is the future supervisor, and will thus have access to all the information anyway, so that the incentives are much more skewed towards sharing the bad news upfront. However, there remain many concerns that the examination may not be as rigorous and impartial as it should be.

First, the ECB is new to the business of supervision and has had to go through a sharp learning curve. Even though many of its new staff have vast experience, as an institution it may shy away from contentious positions on key issues of accounting, recognition and valuation. The audit firms that support the AQR process have highly skewed incentives: each of the large audit networks may be

biased towards forbearance by the fact that it has many statutory audit clients among the banks that are reviewed, even though it may not review its own audit clients. Furthermore, the ECB will be understandably wary at the beginning not to create too many opportunities for banks or their shareholders to sue it in court, if they believe the accounting or valuation judgments that the ECB imposed on a bank were too harsh and thus created a financial damage.

Second, there might be conflicts between the ECB's supervisory function and its broader macroeconomic, monetary policy and financial stability responsibilities. Some of the Eurosystem's national central banks have taken significant financial risks under Emergency Liquidity Assistance (ELA) decisions, and may incur losses in some bank restructuring scenarios that could follow the identification of large capital gaps. More broadly, the ECB may be concerned that the disclosure of large capital shortfalls may trigger systemic financial instability, and perhaps even reactivate the vicious circle between banks and sovereigns. Even in the absence of systemic risk, the need for banks to deleverage to meet capital requirements may further depress an already lacklustre European economy.

Third, the ECB may be affected by institutional constraints. Disclosing hitherto unidentified capital shortfalls in euro area banks, especially if these result from lower asset valuations resulting from the AQR, will embarrass these banks' national supervisors, even as the ECB is doing its utmost to enlist their constructive cooperation as noted under the previous question. Depending on which countries such banks are from and on the particulars of each bank case, it may also embarrass ECB officials who were involved in national bank supervision until a relatively recent date, a group that includes the Chair and Vice-Chair of the SSM Supervisory Board, many SSM staff, as well as the President and Vice-President of the ECB itself. More generally, harsh Comprehensive Assessment results may be contentious in some euro area countries, and contribute to negative perceptions of the SSM in those countries that the ECB, while statutorily independent, may wish to avoid.

None of this means that the Comprehensive Assessment's credibility is fatally compromised. The ECB's leadership is aware of how much it has at stake in this process, and has healthy incentives not to compromise its reputation out of specific practical or political concerns such as the ones described above.

Even so, however, the success or failure of the Comprehensive Assessment is likely to remain a somewhat ambiguous issue in the immediate aftermath of the announcement of its results. To be sure, useful new indications will be available when these results are published next month. The aggregated capital gap which will certainly be the most watched headline number from the process, even though it is not necessarily the most significant. But only time will tell how rigorous the ECB will really be in comparison with the national supervisors it replaces.

As earlier suggested, even where the AQR has led to uncovering inadequate practices, the ECB will probably shy away from imposing accounting restatements on banks except in the most egregious cases. But in many more cases, it could ask the banks to change their future accounting and valuation practices, perhaps starting with the financial statements as of 31 December 2014 which will be disclosed in the first quarter of 2015. Some balance sheet corrections may take even longer and extend to a later date in 2015, depending on bank-specific considerations and on the ECB's own firmness of judgment. In other terms, and even assuming that the ECB is suitably rigorous, the AQR's consequences may unfold over a relatively long period of time before a comprehensive assessment

of the Comprehensive Assessment can be made. This protracted transition will entail significant communication challenges. The ECB will be inevitably be criticized for not having forced all the painful adjustments at the outset, rather than assuming some of the “legacy” of lax supervision on its own account. But it is difficult to see how it could avoid such an awkward sequence.

6. Does banking union contribute to resolving the Eurozone crisis?

There are two broad ways to look at this question, both of them relevant. One is whether and how banking union may have contributed to the “positive contagion” that has led to considerably lower sovereign interest spreads and costs since mid-2012; and the other is whether and how banking union may be contributing to restoring trust in European banks, reversing the fragmentation of the euro area financial space, better capital allocation, and better monetary policy transmission.

On the first dimension, it is increasingly clear (though not yet a matter of universal consensus) that the banking decisions of 29 June 2012 were the critical enabler of the memorable announcement four weeks later by ECB President Mario Draghi that “Within our mandate, the ECB is ready to do whatever it takes to preserve the euro – and believe me, it will be enough”, and of the Outright Monetary Transactions (OMT) program that was subsequently announced by the ECB in September. Of course, as an independent institution, the ECB cannot formally acknowledge a causal link between a decision made by national political leaders and its own policy initiatives. Nevertheless, in a speech in Brussels on 10 June 2014, European Council President (and thus chair of the landmark summit of 28-29 June 2012) Herman Van Rompuy remarked 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; he himself said to me, during that Council, that this was exactly the game-changer he needed.” In an interview in the Dutch daily *Volkscrant* on 13 April 2014, Mario Monti, who was the Italian Prime Minister at the time of the 2012 summit, similarly noted that “Mr Draghi had been able to say [what he said in London] because he had received the political support of the leaders” during the late-June summit.

Mr Draghi himself has hinted at the same link in various speeches in 2012 and 2013, noting the unique quality of the same June summit in terms of European leaders coming together on a joint constructive vision, and describing OMT as a “bridge” to a destination towards which “the establishment of the SSM is a key step”. Not only was the decision to start banking union a show of unity and solidarity; it was also a vote of confidence in favor of the ECB itself, through the choice of Article 127(6) TFEU as the legal basis for the future SSM, for which Mr Draghi appears to have argued personally during the summit.

The OMT announcement is widely seen as the key turning point of the crisis from a sovereign debt market perspective. It put an end to the near-panic of the early summer of 2012, and started the phase of “positive contagion” that has extended until now. It is therefore not an exaggeration to infer that the banking union decision of 29 June 2012 was the trigger to the resolution of the most acute phase of the euro area crisis.

On the second dimension, and as noted under the previous question, it is still too early to opine on the success of the ECB’s Comprehensive Assessment, and the hoped-for return of trust in the European banking sector. That said, the transition towards the establishment of the SSM and the

AQR appears to have already encouraged many banks to write down their doubtful assets and to raise equity. There are also early indications that the fragmentation of financial conditions across national borders inside the euro area has started to go into reverse. But for all the ECB's efforts to ensure that banks would anticipate on any future requirements for additional capital, the impact of the Comprehensive Assessment on banks' behaviour and structure is still predominantly a question about the future – and it will not even be immediately clear on the day the results are announced.

Once in the supervisory driving seat in November, the ECB can safely be expected to put an end to the national ring-fencing of capital and liquidity that has been imposed by national supervisors in the euro area over many banks in their jurisdiction, including domestic subsidiaries of non-domestic banking groups. Such ring-fencing is most often not publicly acknowledged by supervisory authorities, but it has been a widespread practice over the past three or four years, and a severely damaging one for the euro area, even though it was understandable (and even defensible) from a national institutional perspective. Ending it will make a significant contribution to the de-fragmentation of the financial space in the banking union area.

Furthermore, the ECB as a supervisor is likely to gradually dismantle one of the key components of the bank-sovereign vicious circle, namely the large home bias in sovereign-debt portfolios held by banks, especially medium-sized and unlisted ones. It is not unusual that banks would hold the equivalent of more than half of their core regulatory capital in bonds issued by their home-country government, with the consequence that a weakening of sovereign credit directly triggers a deterioration of the banks' solvency if the bonds' value is marked to market. The reasons for this home bias have not been analysed to a point of consensus. They are likely to combine a degree of financial repression (or "moral suasion" by home-country authorities to support the government's financing by buying its debt), behavioral asymmetries, and anticipation of a positive if small risk of euro area break-up. Unlike domestic national supervisors, the ECB can be expected to impose increasingly low exposure limits on such linkages and to encourage banks to diversify their sovereign-debt portfolios and reduce their home bias. This stance would arguably be preferable to the oft-discussed option of imposing positive risk weight on sovereign-bond portfolios in regulatory capital calculations, as the latter could reinforce the bank-sovereign linkage, at least in the current absence of a well-functioning fiscal union. The transition will need to be managed carefully, because the dismantling of the home bias could result in temporary imbalances between supply and demand in some sovereign debt market segments. But the persistence of benign borrowing conditions for euro area member states suggests that such transitional challenges should not be insurmountable.

In sum, banking union has already made a massively positive contribution to crisis management by enabling the ECB's OMT program and the ensuing sovereign-debt market reversal and "positive contagion" of the past two years. It is likely to trigger a gradual de-fragmentation of the European financial space through the ECB's future supervisory actions. Whether it will reinstate trust in the area's banks, and thus remove the current tension in credit supply which contributes to the general economic anaemia of the euro area (even though it is not its only cause), depends chiefly on the still-to-be-observed outcome of the Comprehensive Assessment and its aftermath.

The Future

7. What bank restructuring may follow the Comprehensive Assessment?

The extent of banking sector restructuring that may be triggered by the Comprehensive Assessment, whether immediately in late 2014 or with delayed effect in 2015 and beyond, depends of course on the findings of the assessment and on the policy and individual choices that will be made by the ECB. The baseline scenario here is that the impact will be significant enough that there will be at least some restructuring activity in the next months and quarters.

Both the legislation and the practices associated with bank restructuring in the EU are in a phase of rapid change. Until the crisis, most EU member states (unlike the US) had no special resolution regime for banks, and most bank failures, except in isolated cases of fraud in relatively small banks, were addressed through government-funded bailouts of all creditors, often accompanied by partial or complete nationalization. This pattern largely held in the early years of the crisis and until 2012, the only exceptions in the EU being some instances of bail-in of junior creditors in Ireland, and to a lesser extent in the UK, as well as a more robust experience of resolution involving burden-sharing by senior unsecured creditors and uninsured depositors of two medium-sized Danish banks in 2010. However, from 2010 to 2012, public opinion and policy discussions turned sharply against government-funded bailouts, at least in principle and in most member states.

Since 2009, a number of member states have passed legislation creating a special resolution regime for banks and a bank resolution authority, and enabling the latter to impose losses to various degrees upon various categories of claim holders. These arrangements are being streamlined with the entry into force of the Bank recovery and Resolution Directive (BRRD) from 1 January 2015, at which time all member states are supposed to have transposed it into national law. The same date will mark the start of application of the Single Resolution Mechanism (SRM), with the SRB operational in Brussels – its leadership is expected to be announced in late 2014. One year later, on 1 January 2016, the entry into force of bail-in provisions of the BRRD will severely restrict the discretion of authorities to bail-out senior creditors. As for junior creditors, the possibility of their bailing-out by public authorities has already been considerably restricted by new European Commission rules on state aid control that entered into force in August 2013. In summary, the current applicable framework generally imposes losses on the subordinated creditors (as well as the shareholders and preferred or hybrid capital holders) of failing banks, and will impose losses on senior unsecured creditors (and in the worst cases, possibly also on uninsured depositors) from 2016 onwards.

Practices have broadly followed this evolution of the legislative framework, with some lags and hiccups. Several member states have effectively transferred public funds to banks through variously stealthy initiatives such as guarantees (recently reported by the media on Germany's HSH Nordbank), abandonment of future lawsuits (in France with Dexia, also according to media reporting) or tax claims (known as deferred tax assets, in several Southern European countries), or publicly-triggered revaluation of assets held by banks such as shares in Banca d'Italia. Conversely, in Cyprus in early 2013, the Troika of the European Commission, ECB and International Monetary Fund imposed a framework in which all creditors and uninsured depositors of failing banks were bailed in as a condition for sovereign assistance, following an ill-fated earlier plan that would have imposed losses on all depositors of all banks in the country. But in many recent cases, including Spanish banks since 2012, SNS Reaal in the Netherlands in 2013, and Banco Espírito Santo in Portugal in mid-2014, the

general pattern has been the one in which shares lose all or almost all their value, subordinated debts are written down or forcibly converted into equity capital, and all senior debts and deposits are protected, in compliance with the 2013 state aid rules.

The same pattern is likely to apply to the bank restructurings that may take place between now and end-2015, before and after the entry into force of the BRRD and SRM on 1 January 2015. In principle, to increase financial discipline and mitigate moral hazard, authorities should go further and force financial participation of senior unsecured creditors as a precondition for any use of public money. But in practice, unfortunately, these considerations are likely to be overruled by caution about systemic stability, contagion, and the public controversy that may accompany them, as well as the legal risk associated with imposing losses on claimants. Furthermore, it would be difficult to impose consistent senior-debt bail-in practices across member states, in the absence of applicable EU legislation; and inconsistent behaviour may lead to a return of the bank-sovereign vicious circle, especially if there is a risk of investors' perception being of "bail-out in the North and bail-in in the South". Government-funded bailouts may stir renewed political controversy in some cases, but not necessarily if they are seen as accompanied by accountability on the part of the banks' managers, shareholders, and supervisors who may have failed to identify the problems early enough, as has been at least partly the case in Portugal with Banco Espírito Santo. Finally on this, it is unlikely that the public financing requirements associated with the repayment of senior creditors would be such that they would lead to a marked deterioration of sovereign credit, and the baseline expectation is that the current benign conditions for government funding across the euro area will not deteriorate dramatically. If this expectation was disproved, one may assume shifts in response in the euro area policy stance, which could prevent a propagation of sovereign credit risk perception as was observed in 2011-12.

A further shortcoming of the current arrangements for bank restructuring is the fact that banks and banking assets that come under public ownership are generally managed on an ad hoc manner, without any observable cross-border synergies in spite of the political commitment to banking union. It is clear at this stage that member states are unwilling to agree on any mutualisation of resolution funding within the euro area before the gradual build-up of the SRF starting in 2016: specifically, any public cost of resolution in 2014 and 2015 is seen in several Northern European countries as corresponding to the national "legacy" of prior lack of prudence, and is therefore to be covered by national budgets. This powerful legacy narrative is also why the commitment to use the ESM for direct bank recapitalization, made at the euro area summit on 29 June 2012, was never acted upon and appears unlikely to ever be. Even so, however, it would be possible and beneficial to pool the management of publicly-owned legacy assets across the banking union area and entrust it to a single joint agent, or asset management company. Needless to say, such a joint asset management company should be subject to proper checks and balances in terms of its appointments, mandate, governance and accountability. It would manage assets and operations on behalf of the relevant member states and on their separate accounts, with no mutualisation of financial liability or upside potential, but with potentially powerful synergies in terms of operating cost, financial bargaining position, and sheer professional competence.³

³ A compelling case for such an arrangement was made by Hans-Jürgen Walter, a consulting partner at Deloitte who has advised several national "bad banks", at a conference in Frankfurt in late 2013 – presentation available at http://www.malekigroup.com/images/2013EFW/Rede2013/Hans_Juergen_Walter.pdf. See also

Ultimately, bank restructuring driven by public authorities is always a politically charged endeavor, and country-specific and bank-specific considerations can be expected to play important roles. Nationalism is also sure to be a factor. But in a banking union, restricting the purchase of failed banks, even iconic ones whose name resonates with public opinion, to national buyers would be inconsistent and damaging. Not only should banks from other countries (including, with proper vetting, from outside the EU) be allowed to engage in cross-border acquisitions; also under the condition of appropriate vetting and oversight, private equity firms should also be welcomed to play their part in forthcoming restructuring, as they have usefully done in the recent past both in Europe, for example with Bawag in Austria and IKB in Germany, or in other parts of the world, for example in Japan and Korea.

8. How could banking union impact Europe's financial landscape over the medium term?

Beyond the phase of restructuring that may follow the Comprehensive Assessment subject to the latter's findings and ECB choices, one can anticipate that banking union will significantly reshape European finance. It would be foolish to try to make deterministic forecasts, because the changes will be path-dependent and subject to numerous drivers, many of them unquantifiable. What is attempted here is to identify trends or issues that are likely to materialize, based on past developments, current legal and operational policy frameworks, political realities, and individual judgment. However, no prediction in regard to the future is ventured.

The ECB will vocally encourage cross-border consolidation among European banks, as it has already started to. The emergence of genuine pan-European banking groups, beyond existing pioneers such as BNP Paribas, Santander or UniCredit, appears to be viewed by the ECB as important to foster broader cross-border financial system integration, with multiple economic benefits that may include better resilience against asymmetric risk, more efficient capital allocation, and better transmission of monetary policy through the banking system. It could also gradually result in a powerful interest group that may call public decision-makers to accelerate the harmonization of regulatory and supervisory frameworks, possibly resulting in mutually reinforcing dynamics of market integration and policy integration. While the banking industry is highly concentrated in several euro area member states, including large ones such as France, it remains rather fragmented seen from a European perspective. In terms of systemic risk, the ECB's judgment at this point appears to be that the drawbacks of creating more systemically important banks would be more than offset by the benefits of cross-border consolidation, especially as many banks simultaneously shed assets and deleverage their balance sheets.

A separate though related question is about smaller, local banks. These are currently very unequally distributed across Europe. In the ECBs' classification, the euro area's 120 "significant" banking groups are scattered across all member states, but the other 3,532 "less significant" banks are overwhelmingly concentrated in Germany, Austria and Italy (see also question 3). One could hope that the future trend might point in the opposite direction: a concentration of larger banks in a smaller number of larger, specialized and better globally integrated financial centers, and the emergence of more local banks in parts of Europe where they are currently scarce and could usefully help finance local activities and development. In the US, many recently created "de novo" banks

Adam Posen & Nicolas Véron, "A Solution for Europe's Banking Problem", Bruegel and Peterson Institute, June 2009.

replace failed or consolidated banks at the local level, and contribute to the country's economic vibrancy. In Europe, by contrast, very few banks have been created de novo during the last hundred years, and those local banks that exist generally trace their roots to the 19th century. The ECB's justifiable calls for consolidation should thus be counterbalanced by policy efforts to facilitate market entry into regional and local banking markets.

As analysed under the previous question, the future framework for bank resolution and crisis management, which emphasizes market discipline and financial crisis burden-sharing by creditors, is largely untested and thus likely to go through a protracted period of adjustment, the pace of which will obviously depend on the frequency of future financial crises. At this point, it is difficult for investors and analysts to anticipate how the BRRD's framework for the bailing-in of senior debt will play out in practice. While the EU has made considerable progress in recent years, not least thanks to banking union, on the road towards better market discipline in the banking sector, this journey remains far from complete.

Banking union may also have impact on broader structures of Europe's financial system, and contribute to its rebalancing away from its current overreliance on bank intermediation. Under the previous regime, national authorities favoured the expansion of banks over that of non-bank intermediaries and disintermediated credit markets, and occasionally even repressed the latter with burdensome regulation. But the ECB has already signalled that it would instead favour a more diversified system, in which these alternative channels would play a bigger role. This is also a way to instil more market discipline, as inefficient banks can more easily be replaced by other providers of credit, as was observed in the US when domestic banks were in a phase of deleveraging in 2009-11. The current emphasis on developing Asset-Backed Securities (ABS) markets, which is immediately motivated by monetary policy considerations, may thus be the shape of larger things to come.

The SSM itself is likely to become increasingly cohesive and integrated, as it is likely to establish career paths that would alternate periods of service at the Frankfurt headquarters with time spent in the national regulators, thus gradually building up a shared culture and pool of experience. This, of course, crucially depends on the establishment and maintenance of trust between the ECB and the national supervisory authorities. As indicated above under question 4, initial indications in this respect are encouraging, but it remains far too early to make a definitive judgment. Some tensions between the ECB and national supervisors may be simmering and escalate publicly in some future development, as has been to a certain extent the case in monetary policy between the ECB and the Bundesbank. Nevertheless, significant advances are likely over time. For example; the creation of consistent systems for the aggregation of supervisory data and banking and credit statistics, if accompanied by a suitable effort of public disclosure, could bring unprecedented transparency to the European financial system and significantly enhance the ability of researchers and analysts to understand it.

A modicum of success in its internal build-up and initial learning curve may rapidly bring the SSM to a situation of prominence, both internally within the EU and externally vis-à-vis global peers. This would entail additional scrutiny. It could also bring it considerable heft in international discussions, for example in the Basel Committee – whose membership, as previously noted, must still evolve to take into account the new reality of banking union – and the Financial Stability Board. In particular, the ECB is likely to be increasingly benchmarked against the US Federal Reserve, not only as a central

bank but also as a financial supervisor. This may incentivize it to dramatically enhance its transparency about supervisory entities compared to Europe's current national supervisors, a development which if it happens should be wholeheartedly welcomed.⁴

9. What additional legislation may be needed?

The initial legislative package described under question 1 appears to provide a workable basis for the inception of banking union, but it is most definitely not the final word of it. Many significant further adjustments will be required in the future, some of them more urgent than others.

To start with, the "single rulebook" is a misnomer. While some rules are harmonized, much of the legislation that the SSM and the SRB will have to enforce, from 4 November and 1 January respectively, differs from one member state to another, and incidentally is also subject to judicial review by national not European courts. There are awkward overlaps between the SSM's supervisory mandate and other banking rules enforced by national authorities, e.g. on conduct of business, consumer protection, suitability of bank executives and owners (the "fit and proper person" test), the fight against money laundering and the financing of terrorism, to name only a few. In one glaring case of inconsistency, both France and Germany passed new laws in 2013 on bank structure reform, in conspicuous neglect of their commitment to a single rulebook and the banking union that had already been initiated at that time. The European Commission in January 2014 put forward a proposal for umbrella EU legislation on this, but it still does not guarantee sufficient cross-border consistency. The issue of separation of activities within banking groups is beyond the scope of this statement, but should be dealt with in a manner that ensures full harmonization within the banking union area, and arguably also with non-banking-union-area countries inside the EU to meet the objectives of the internal market.

One specific aspect of this follow-up work will have to be about accounting and auditing, which play an important role in banking supervision. The SSM will be in the awkward position of relying on different audit firms regulated by different audit authorities for each of the cross-border banks it supervises. These firms are typically members of a single international audit network – though not universally so, e.g. with the French system of joint audit which implies that not all the audit work is carried out by one single firm. But practitioners know well that most of these networks are unable to enforce strict consistency across their national component partnerships, including on critical issues such as the implementation of International Financial Reporting Standards (IFRS). For listed banks, the enforcement of IFRS reporting by securities regulators (or separate ad hoc bodies, like in Germany) is also a national competency which entails some divergence among member states, in spite of the best efforts deployed by the European Securities and Markets Authority (ESMA) to foster coordination and convergence. Furthermore, IFRS are mandatory in the EU only for consolidated financial statements of issuers of public securities, a category that does not encompass all banks directly supervised by the ECB, let alone all smaller banks which will rely on the ECB for their banking license. Many of these, especially in Germany, only produce accounts in national accounting standards. This raises serious questions about comparability within the SSM. Further harmonization is likely to be needed in this area, including renewed discussions about the creation of a single

⁴ See on this issue Christopher Gandrud and Mark Hallerberg, "Supervisory Transparency in the European banking union", Bruegel, January 2014.

European authority for audit regulation, and the transfer of responsibility for the enforcement of IFRS from national securities authorities to ESMA.

With the entry into force of banking union, new concerns are also likely to emerge about the fact that entities that have similarities with banks, in terms of systemic risk and internal market impact, remain subject to national oversight and crisis management responsibility. This is particularly true of financial infrastructure firms and especially of central counterparties (or CCPs, also referred to as clearing houses outside the EU), which remain outside the supervisory scope of the SSM and raise additional questions in terms of the integrity of the single market.⁵ Similar concerns could emerge about insurance companies, especially insurance arms of banking groups, that remain supervised at a national level and cannot be brought under the authority of the SSM given a specific exemption in article 127(6) TFEU. The concerns about insurers may not materialize for some time, but those about CCPs could become rapidly more pressing, especially as the EU is committed to imposing central clearing of many derivative transactions in the very near future.

Another piece of unfinished legislative business related to banking union is about bank insolvency. Special resolution regimes are defined as an alternative to court-ordered insolvency. The general principle is of “no creditor worse off” in the resolution scenario than if the bank had gone through ordinary insolvency. Thus, and strictly speaking, there can be no genuine single resolution regime for credit institutions in the banking union area, as long as they are subject to insolvency frameworks that differ widely from one member state to another. The solution should be the introduction of a European insolvency regime administered by a European court, whose scope may be limited to the larger credit institutions directly supervised by the ECB. This would be a significant challenge from a legal and political perspective, but a necessary one to complete the banking union and prevent regulatory arbitrage. Whether it is possible within the current EU treaty arrangements may not be a matter of consensus among legal scholars.

Even more tangled from a political standpoint, and significant in terms of European financial integration, is the issue of how banking and other financial activities are being taxed by individual member states. Beyond the highly visible debate on the introduction of a financial transactions tax, this includes, crucially, the taxation of financial investments and savings products as well as other taxes and levies that affect banks and other financial markets participants, among them the future contribution of banks to the Single Resolution Fund. This is obviously a matter of national sovereignty, and the EU’s subsidiarity principle must apply. Nevertheless, the banking union may highlight various harmful distortions and opportunities for tax evasion that could require corrective action, both at the national level and through EU-level harmonization.

Furthermore, the global leadership which will be bestowed by banking union upon the ECB as a bank supervisor, as suggested under the previous question, may lead to its advocacy of a better alignment of the EU with global standards. The EU legislation on bank capital, leverage and liquidity (CRR and CRD4) is not fully compliant with the international Basel III accord, in contrast with the earlier Basel II accord which the EU had championed in the 2000s but was later found inadequate and in need of drastic revision in the financial crisis. Changes to the existing EU legislation may thus be needed in this area as well.

⁵ The British Treasury has sued the ECB twice, in 2011 and 2012, about its policy regarding the location of CCPs that clear euro-denominated products. The two cases are still ongoing.

Many of these themes – prudential standards, securities regulation and financial disclosure, financial infrastructure, insolvency reform, conduct-of-business regulation and consumer financial protection, and the taxation of financial activities – are prominently on the EU policy agenda under the new European Commission focus on creating a “capital markets union”. The capital markets union concept was announced by Commission President Jean-Claude Juncker on 15 July 2014, and since included in the portfolio title of Commissioner-designate Jonathan Hill. This agenda provides a welcome opportunity to accelerate reform in areas where it is needed, while putting emphasis on legitimate concerns about the integrity of the single market and the risk of harmful divergence, in particular between the UK and the banking union area.

Finally, the banking union framework will inevitably be reviewed, and hopefully strengthened, whenever the EU treaties are next revised in the future. Issues that would be on the agenda in this context could include the relationship between bank supervision and monetary policy within the ECB, possibly going the full way towards the institutional separation of the SSM from the ECB; the strengthening of the SRB’s discretionary authority by giving it a specific basis in the treaty;⁶ and the possibility of expansion of SSM authority over areas that may include conduct-of-business regulation and insurance supervision. A future treaty revision agenda may also include broader reform of the fiscal framework in the euro area or banking union area or EU, with related challenges of political representation and accountability of EU institutions, which may in turn pave the way for more integration of resolution funding and deposit insurance. The time horizon for this, of course, depends on numerous and complex political developments, and cannot be predicted at this point.

⁶ This suggestion holds even as the scope for discretionary decision-making by the SRB, an agency established on the basis of Article 114 TFEU, has been effectively widened by the recent decision of the European Court of Justice, Case C-270/12 *UK vs Council and European Parliament*, which updates the so-called *Meroni* doctrine. See e.g. the analysis by René Repasi, <http://www.sven-giegold.de/wp-content/uploads/2014/01/Assessment-ECJ-Case-C-270-12-and-relevance-for-the-SRM1.pdf>.