EUROPEAN BANKING UNION, THREE YEARS ON
Miranda Xafa
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ABOUT THE PROJECT

The Central Banking and International Financial Regulation project is part of CIGI’s Global Economy Program. It analyzes the implications of domestic policies on global monetary and financial stability and the prospects for coordination and cooperation in the international regime.

The 2008 financial crisis produced major changes in monetary and financial regulatory practice. Unconventional monetary policy and macroprudential policy are two important developments in central banking that have significant impacts on the stability of the international system and the power, influence and authority of central banks. In international financial regulation, the strengthening of the Financial Stability Board after the financial crisis has important implications for the governance of global finance. CIGI’s research in this area aims to shed light on the policy goals and tools utilized by central banks and financial regulators after the crisis. Through this research stream, CIGI’s Global Economy Program intends to identify and research the key policy and governance issues facing central banks and financial regulators in the post-crisis world.

ABOUT THE AUTHOR

Miranda Xafa is a CIGI senior fellow. She is also chief executive officer of E. F. Consulting, an Athens-based advisory firm focusing on eurozone economic and financial issues. At CIGI, Miranda focuses on sovereign debt crises and drawing lessons from the Greek debt restructuring for future debt crises. From 2004 to 2009, she served as a member of the executive board of the International Monetary Fund in Washington, DC, where she had previously worked as a staff member. Miranda served as chief economic adviser to Greek Prime Minister Konstantinos Mitsotakis, from 1991 to 1993. From 1994 to 2003, she was a financial market analyst and senior expert at Salomon Brothers/Citigroup in London. Miranda holds a Ph.D. in economics from the University of Pennsylvania and has taught economics at the Universities of Pennsylvania and Princeton. She has published several articles and papers on international economic and financial issues.
EXECUTIVE SUMMARY

Banking union is the most important policy initiative to advance euro-area integration since monetary union started in 1999. It involves the transfer of authority over banking policy from the national level to a pan-European institution. Surrendering national sovereignty over banking policy was strongly resisted by euro-area members until the global financial crisis demonstrated that national authorities were ill-equipped to deal with ailing banks operating in today’s global markets. Nationalist banking policies aimed at protecting “national champions” in the banking sector explain both the buildup of risks in the run-up to the crisis and the difficulty of resolving it.

The onset of the global financial crisis in 2007 led to a reversal of cross-border banking flows that had increased after monetary union. The reversal was particularly marked in central and eastern European countries and in the euro area’s periphery, which were crisis-prone because of their large external deficits or fragile banking sectors. National supervisors responded to the crisis by ring-fencing assets in subsidiaries in order to avoid any cross-border fiscal transfers, leading to further fragmentation. Building a banking union with centralized supervision and resolution provided the necessary policy push to encourage a return to financial integration. Banking union also aimed at breaking the link between banks and sovereigns. During the crisis, banks in Ireland, Spain and elsewhere in Europe faced large recapitalization needs. National backstops used to recapitalize these banks caused a sharp increase in sovereign indebtedness and created a vicious circle between overindebted sovereigns and undercapitalized banks. Bail-in rules and a common bank-financed resolution fund have been agreed to ensure that taxpayer funding of bank bailouts would be minimized in the future.

Significant milestones in the process of building a more robust and resilient banking system in Europe already have been completed: the Single Supervisory Mechanism (SSM), led by the European Central Bank (ECB), was launched in November 2014 following the successful “comprehensive assessment” of the health of euro-area banks. And the Single Resolution Board (SRB), launched in January 2015, will be fully operational in January 2016, when the Single Resolution Fund (SRF), which allows for some burden sharing of banking losses, will become operational.

The banking union project is still at an early stage and it is too soon to tell whether it will achieve its goals. Even as the Greek crisis is unfolding, the tightening of sovereign credit spreads from mid-2012 peak levels indicates that market expectations of a euro-area breakup have receded. Agreement on a road map for banking union clearly played a role in easing market concerns by enabling the ECB to state that it would do “whatever it takes” to save
the euro; the ECB subsequently announced a massive firewall through a bond-buying program in the summer of 2012. The ECB’s price- and quantity-based indicators of financial integration show that the integration of European financial markets is increasing, although the indicators remain below their pre-crisis level. The improvement is due to the establishment of the banking union and non-standard monetary policy actions taken by the ECB in the past few years. Recent data showing that bank lending to the private sector is starting to recover, in line with the recovery of economic activity in the euro area, confirm that the worst is behind us.

INTRODUCTION

The debate on European banking union is far from new. Since the single market project was launched in the 1980s, the European Union (EU) has aspired to build a “single financial market” in which governments, private investors, non-financial corporations, financial firms and markets operate seamlessly across national borders. Presumably, some sort of banking union has always been at the core of this aspiration, but there was strong resistance to surrendering national sovereignty over banking policy to a supranational institution. It was ultimately agreed under stress, when the breakup of the euro was at stake. At the peak of the euro area’s debt crisis in June 2012, the EU heads of state or government agreed to create a banking union to complement the economic and monetary union and to centralize the application of EU-wide rules for banks in the euro area and beyond.1 The decision toward deeper integration marked a shift from “firefighting” through successive rescue packages for individual member states to addressing the systemic causes of the crisis. This shift in crisis management was the game-changer that is widely viewed as enabling the ECB to ease market tensions by committing to do whatever it takes to save the euro.

Banking union involves the transfer of authority over banking policy from the national to the European level. It is a major step in the economic and monetary integration of the European Union, and aims to end large taxpayer-funded bailouts and national policies that protect domestic banks at the expense of financial stability. Banking union encompasses institutional reform to improve the shock-absorbing capacity of the banking sector: stronger supervision at the EU level and a special resolution regime for systemically important banks with cross-border operations. Bank supervision has been delegated to the ECB, and an SRB with access to a bank-funded common backstop is being set up.

The onset of the global financial crisis in 2007 led to a reversal of cross-border banking flows in Europe, in particular to central and eastern European countries and to the euro area’s periphery, which were crisis-prone because of their large external deficits or fragile banking sectors. National supervisors responded to the crisis by ring-fencing assets in subsidiaries, leading to further fragmentation. To keep the benefits of both the single financial market and financial stability, a pan-European approach to bank supervision and resolution was needed to encourage integration. Building a banking union with centralized supervision and resolution provided the necessary policy push for a return to integration.

Two significant milestones in the process of building a more robust and resilient banking system in Europe have already been completed. The SSM, led by the ECB, started its work in November 2014. The SRB was launched in January 2015 and will be fully operational in January 2016, when the bank-financed SRF will become operational. It is clearly too soon to assess whether banking union has been successful, but not too soon to lay out the criteria by which it should be judged: the extent to which it reverses the fragmentation in Europe’s financial system and breaks the vicious circle between undercapitalized banks and overindebted sovereigns.

Even before completing the banking union, the European Commission has launched a public consultation on its vision for creating a “capital markets union” in Europe. (European Commission 2015). Compared to the United States, European businesses rely much more heavily on banks than on capital markets for funding. Deeper capital markets would help unlock more funding for investment, especially for small- and medium-sized enterprises (SMEs) and infrastructure projects. They would also help attract portfolio investment to the European Union from the rest of the world, and make the financial system more stable by broadening the range of funding sources. Creating a capital markets union involves establishing cross-border consistency in prudential standards, securities regulation, insolvency regimes, as well as in financial disclosure, infrastructure and taxation. A well-developed EU securitization market relying on transparent and standardized securitization instruments would increase the capacity of banks to lend by creating room in their balance sheets.

THE VICIOUS CIRCLE BETWEEN BANKS AND SOVEREIGNS

Before the global financial crisis erupted in 2007, countries in the European periphery (Portugal, Ireland, Greece and Spain — the PIGS) were enjoying stable growth, relatively low fiscal deficits and near-zero credit spreads. The financial crisis ended debt-financed consumer booms and burst housing bubbles resulting from the sharp decline in interest rates in the run-up to the euro’s launch in 1999, triggering deep recessions and raising fiscal deficits and

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1 EU countries outside the euro area may join the banking union if they so wish.
debt levels. In Portugal, Ireland and Spain, the problem arose from excessive private sector lending (largely mortgage lending), with losses socialized when the banks failed. In Greece (and Italy, to some extent), the origin of the problem was government profligacy of running unsustainable deficits funded by the banking sector during the boom years. By 2010, the PIGS were facing severe sovereign debt problems. The financial crisis thus morphed into a debt crisis that gradually engulfed the entire euro-area periphery.

The euro area’s initial policy response was to negotiate rescue packages as needed to address the funding needs of each individual country subject to agreement on reforms. Greece was the first to receive official financial assistance in May 2010, followed by Ireland in November 2010 and Portugal in May 2011. By the fall of 2011, the crisis had spread to Spain and Italy, whose borrowing costs had become prohibitive. As the crisis became systemic, the need for a comprehensive approach became apparent. Policy makers recognized that a common backstop, with shared risk, would be needed to break the negative feedback loop between banks and sovereigns. By the early spring of 2012, banking union came to dominate European economic policy discussions.

In late June 2012, the EU heads of state or government committed to a specific, time-bound road map for the achievement of a genuine Economic and Monetary Union (European Council 2012). This commitment permitted ECB President Mario Draghi to state in July that he would do “whatever it takes” to save the euro, which was interpreted as a pledge to provide a theoretically infinite backstop.2 Draghi’s statement and the subsequent announcement of a bond-buying program, known as OMT,3 in early August had an immediate impact in calming markets. Sovereign credit spreads tightened significantly in all peripheral countries (see Figure 1); however, corporate borrowing costs remained significantly higher in the euro-area periphery than in the core countries. This “balkanization” of the financial system partly stemmed from the perception that sovereigns in the periphery lack the fiscal backstop needed to address potential capital needs. Uncertainty about asset quality in bank balance sheets and national supervisory practices also contributed to fragmentation.

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2 Although perhaps not obvious at the time, subsequent statements by European policy makers reinforce the link between the EU summit decision to launch banking union in June 2012 and the OMT announcement a few weeks later (Van Rompuy 2014; Véron 2015).

3 The OMT program of euro-area sovereign bond purchases in the secondary market differed from its predecessor, the Securities Market Programme, in two important respects: it was subject to conditionality under an EU/IMF-supported program, and ECB bond purchases did not have seniority over private bondholders (ECB 2012).
froze, as banks were reluctant to take counterparty risk, giving rise to further fragmentation of the financial system. Uncertainty about asset quality in bank balance sheets impaired the transmission of monetary policy and restrained credit flows. Bank lending rates in the euro area’s periphery hit by the crisis remained elevated relative to those in the core countries, as banks’ funding costs were highly correlated with the credit quality of their sovereigns (see Figure 2).4

The inability of national (often nationalist) banking policies to deal with large and growing cross-border banking flows explains both the build-up of risks in the run-up to the euro-area crisis and the difficulty of resolving it. The financial crisis highlighted that national authorities were ill-equipped to deal with ailing banks operating across national borders. Past experience indicates that under a system of national banking policies, national interests will prevail in cross-border bank failures. National supervisory authorities opt for the lowest-cost solution for their domestic taxpayers, ignoring the wider risks for global financial stability. Moreover, local holdings of liquidity and capital are suboptimal relative to an integrated financial space where capital and liquidity are allocated where they reap the highest return. Distortions in the allocation of capital could hamper the proper functioning of the internal market for goods and services in Europe and adversely affect economic growth. Cross-border integration of banks in a single financial market leads to welfare gains as intensified competition brings down the cost of capital and allows an optimal allocation of capital to the most productive investments (Claessens, Herring and Schoenmaker 2010).

**Figure 2: SMEs — Real Corporate Lending Rates (in %)**


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4 The challenge of conducting a single monetary policy under financial fragmentation is clearly described in a speech by ECB chief economist Peter Praet: “The effects of weaker financial integration and, in extreme cases, the re-emergence of separate national markets have considerably impaired the transmission of monetary policy. In fact, monetary policy has ceased to convey balanced and homogeneous signals to the euro area economy as a whole” (Praet 2012).
authorities to which the national authorities would be subordinate. The proposed blueprint for the EU financial architecture consisted of a three-tiered structure: a systemic risk regulator at the “top” — the European Systemic Risk Board, responsible for macroprudential supervision and housed at the ECB, functional regulators in the “middle” — European Banking Authority (EBA), European Insurance Authority and European Securities and Markets Authority, and national regulators at the “bottom.” All these authorities were established prior to the June 2012 banking union decision. The report also called for the adoption of a common definition of regulatory capital in the European Union, a common regulatory rulebook and a common crisis resolution mechanism, but these were not established until after 2012.

Once the global crisis morphed into a debt crisis, the need to address remaining gaps in the financial architecture of the euro area became apparent. Closing the gaps was necessary in order to:

- **Break the link between banks and sovereigns by ensuring that taxpayer funding of bailouts is minimized.** The global financial crisis demonstrated the limitations of national banking policies in conjunction with overindebted sovereigns. During the crisis, banks in Ireland, Spain and elsewhere in Europe faced large recapitalization needs due to an overexpansion of balance sheets at a time when asset valuations were collapsing. National backstops used to recapitalize these banks caused a sharp increase in sovereign indebtedness and created a negative feedback loop between overindebted sovereigns and undercapitalized banks.

- **Reverse fragmentation by unifying bank supervision and resolution at a central level.** To preserve a single market for banking, an EU-wide approach to supervision and resolution was needed. The large cross-border banks would need to be supervised by a single regulator, and have access to the ECB and an EU-wide resolution authority in case of liquidity and solvency problems. To be credible, the resolution authority would need a fiscal backstop and a strong legal framework that provides the power to liquidate or resolve ailing banks in a timely and orderly manner on a EU-wide scale. The fiscal backstop should be based on _ex ante_ burden sharing between participating countries. The re-integration of the European banking system would also help restore the effectiveness of the ECB’s monetary policy by unblocking the credit and monetary transmission channels.

5 Initially, the EBA was a weak institution with no direct access to national supervisors’ data, giving rise to misleading stress tests results, which found Dexia bank solvent months before it collapsed in September 2011.

- **Set a clear pecking order on bank losses.** Since the collapse of Lehman Brothers in September 2008, supervisors felt compelled to recapitalize with public funds large banks that became insolvent, because they considered that the financial stability risks of liquidating a large and complex bank with cross-border activities would be too great. Between October 2008 and October 2011, the European Commission approved €4.5 trillion (37 percent of EU GDP) of state aid measures to financial institutions. This state aid averted massive banking failures and economic disruption, but imposed a huge burden on taxpayers and failed to address the issue of how to deal with large cross-border banks in trouble. Publicly funded bailouts give rise to moral hazard by generating expectations of government support.

The €10 billion rescue package for Cyprus in April 2013, funded by the European Stability Mechanism (ESM) and the IMF, became the catalyst for a new approach: Cyprus was forced to opt for bank bail-in, because an Irish-style bailout would have required a far bigger rescue package, which would be incompatible with sovereign debt sustainability. Moreover, spillover risks from Cyprus were much lower than they were for Ireland, as market participants perceived Ireland’s vulnerabilities to be similar to those of other euro-area peripheral economies, including Spain. The Cyprus bail-in was thus mandated by the size of the needed recapitalization and the perception that contagion risks were limited. What made the bail-in chaotic, however, was the lack of clarity on the hierarchy of claims (Xafa 2013). An initial plan to impose losses on depositors — including small depositors — in all Cypriot banks was replaced by the imposition of haircuts on creditors and large depositors only in two insolvent banks. An orderly resolution scheme must set clear rules on the future creditor pecking order, which should be known in advance by all parties. The possibility of suffering losses would provide an incentive to price risk correctly, ultimately protecting taxpayers.

The chaos associated with the Cyprus rescue showed how important it is to have clear procedures for loss sharing by shareholders, bondholders and, ultimately, depositors to deal with failing banks. Despite its trivial size, the Cyprus rescue package became a catalyst for new EU bank resolution rules. As a major component of future EU bank resolutions, bail-ins would help reduce the burden on taxpayers and avoid any associated cross-country fiscal transfers. The European Union has now agreed on a bail-in regime that would let bondholders and big depositors take a hit if a bank becomes insolvent.

Direct recapitalization of banks from the ESM is another means of severing the link between banks and sovereigns in cases where private capital is insufficient. Initially proposed before the Bank Recovery and Resolution Directive (BRRD) was agreed, it subsequently became
clear that the bail-in of private investors and the creation of a bank-financed SRF from 2016 has shifted the bulk of potential financing from the ESM to the banks themselves, including their investors and creditors. The direct recapitalization instrument (DRI) was finally approved by the ESM board of governors in December 2014 as a last resort when all other instruments, including the bail-in mechanism, have been applied, i.e., after bail-ins of at least eight percent of eligible bank liabilities. Accessing DRI also requires that the country’s fiscal position rules out indirect recapitalization from the ESM via the sovereign (ESM 2014).

### THE LEGAL FOUNDATION OF BANKING UNION

Four key pieces of legislation constitute the legal foundation of banking union:

- **EU Regulation No 1024/2013**, which confers to the ECB the task of prudential supervision of credit institutions;
- **EU Regulation No 806/2014**, which establishes the Single Resolution Mechanism (SRM), an SRB and an SRF. The specific features of the SRF are set out in an intergovernmental agreement signed by all EU countries (except the United Kingdom and Sweden) on March 14, 2014;
- **EU Directive 2014/59 (the BRRD)**, the single rulebook for the resolution of EU banks and large investment firms; and
- **EU Directive 2014/49**, which harmonizes the key features of national deposit guarantee schemes.

### Table 1: Legal Foundation of Banking Union

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<tr>
<th>SSM</th>
<th>EU Regulation 1024/2013</th>
<th>October 15, 2013</th>
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<tr>
<td>SRM</td>
<td>EU Regulation 806/2014</td>
<td>July 15, 2014</td>
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Source: Author.

The BRRD harmonizes and upgrades the tools for dealing with bank crises across the European Union. Banks will be required to prepare recovery plans to overcome financial distress, while authorities will lay out plans to resolve failed banks in a way that avoids taxpayer bailouts. The SRB is equipped with comprehensive powers and tools to restructure failing banks, allocating losses to shareholders and creditors according to a clear pecking order. The plan is similar to the 2013 Cyprus rescue, where uninsured depositors at two banks took large hits to save the country from bankruptcy.

Finally, the Deposit Guarantee Schemes Directive (DGSD) aims to harmonize EU rules on deposit protection, including coverage and payout arrangements. With pre-funded guarantee schemes in each member state, the directive seeks to ensure that depositors will benefit from a guaranteed coverage of €100,000 in case of bankruptcy, backed by funds to be collected in advance from the banking sector. In case of insufficient *ex ante* funds, the Deposit Guarantee Scheme (DGS) would collect immediate *ex post* contributions from the banking sector and, as a last resort, the DGS would have access to loans from public or private sources. The directive is only a first step toward common EU deposit insurance, since a common backstop is not envisaged.

Together with the Capital Requirements Directive IV, which implements the Basel III capital requirements, the BRRD and the DGSD constitute the single rulebook for EU financial services. The single rulebook aims to provide a single set of harmonized prudential rules that

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11 The Basel Committee on Banking Supervision develops global regulatory standards on bank capital adequacy. Following the financial crisis, the Basel Committee has reviewed its capital adequacy standards to significantly reduce the probability and severity of banking crises in the future. Basel III is the outcome of that review, labelled “III” because it is the third configuration of these standards. Group of Twenty (G20) leaders endorsed Basel III rules at their Seoul summit in November 2010. See Basel Committee on Banking Supervision (2010).
must be adhered to by financial institutions throughout the European Union. It ensures the uniform application of Basel III in all EU member states, thus establishing a level playing field and contributing to a more effective functioning of the single market.

**STRUCTURE OF THE EUROPEAN BANKING INSTITUTIONS**

Banking union has two key pillars: the SSM, which transfers the supervision of banks in the euro area and other participating countries to the ECB; and the SRM, which allows bank resolution to be managed rapidly and effectively. The SRM includes an SRB and an SRF. The first pillar (SSM) has been in place since November 4, 2014, and the second pillar (SRM) entered into force on January 1, 2015, and will be fully operational starting January 2016. A third pillar, deposit insurance, has been “harmonized” through common rules, but remains a national responsibility.

The SSM works closely with national supervisory authorities to ensure that the largest, systemically important banks comply with EU banking rules, and to address any capital shortfall early on. Smaller banks are also subject to EU rules, but continue to be supervised by national authorities.

The SRM will ensure that if a bank faces serious difficulties, its resolution can be managed efficiently with minimal costs to taxpayers. It has been given clear rules for cross-border bank resolution, a bail-in order similar to the template used by the Federal Deposit Insurance Corporation (FDIC) to wind down failing US banks. Shareholders and creditors, and after that the SRF, would cover the cost of failing banks instead of taxpayers as in the past. Losses would first be handed to a bank’s shareholders, then junior bondholders, followed by senior bondholders, with uninsured depositors the last in line to take a loss if a bank fails. Only after losses amounting to eight percent of bank assets are absorbed by shareholders and creditors, would the SRF cover the remaining costs of a failing bank.

The SRM implements the BRRD. In the event a cross-border bank fails, the BRRD ensures that a bank’s critical functions can be rescued while the costs of restructuring and resolving failing banks are borne by the bank’s owners and creditors and not by taxpayers. The BRRD also set up national resolution funds, which will be replaced by the SRF as of January 2016.

The SRB is the European resolution authority for the banking union and the key decision-making body for the SSM. In collaboration with the national resolution authorities of participating member states, its mission is to ensure an orderly resolution of failing banks with minimal costs for taxpayers and to the real economy. It became operational as an independent agency of the European Union based in Brussels on January 1, 2015 and started working on developing resolution plans for credit institutions. The five-member board, selected by the European Parliament, will carry out the resolution of failing banks and will be in charge of the SRF. It will be fully operational, with a complete set of resolution powers, from January 1, 2016. In the event resolution costs exceed €5 billion, a 19-member board consisting of euro-area country representatives needs to be consulted.

The SRF is a pool of money that has been set up to ensure that funding support is available while a credit institution is being restructured. The SRF will be funded exclusively through contributions from banks in participating countries. The modalities of the fund are set out in a separate intergovernmental agreement that was signed on May 21, 2014 by 26 EU member states (all except Sweden and the United Kingdom, which have an opt-out from the euro area) and is in the process of being ratified. The Fund will be operational in 2016 with an eventual target funding level of €55 billion, equivalent to one percent of covered deposits in the participating countries, to be reached over eight years. During the transition, the fund will comprise national compartments that will progressively merge into a single, fully mutualized fund, with 40 percent of the funds available to all participating countries from the first year. Regarding burden sharing, the initial proposals from the European Commission seemed to lean heavily on France’s big banks while favouring the hundreds of small- and medium-sized banks in Germany and Spain. The deal finally reached by finance ministers on December 9, 2014 aimed to ensure that French and German banks would each contribute about €15 billion to the €55 billion fund. The SRF has been set up by intergovernmental treaty, outside the EU legal framework (the *acquis communautaire*), which implies that will not be under the control of the European Commission and the Parliament.

**THE “COMPREHENSIVE ASSESSMENT”**

The first step toward an SSM was the “comprehensive assessment” of the systemically important European banks conducted in 2014. The goal of the assessment, which was jointly undertaken by the ECB, the EBA and national supervisors, was to identify and address any remaining vulnerabilities in the EU banking system. It contained both an Asset Quality Review (AQR) to ensure that assets are correctly valued under uniform standards, and a stress test to make sure banks can withstand further shocks. The stress tests were conducted by the EBA in London, since all EU member states, not only those from the euro area, were required to participate. The exercise provided the impetus for a much-needed diagnosis and repair of bank balance sheets, a process that was far less advanced than it should be several years after the global financial crisis.
broke out. The tests were by far the most thorough and comprehensive ever undertaken since the start of the crisis. A repeat of earlier blunders involving Anglo Irish, Bankia and Dexia banks, which collapsed within months of receiving a clean bill of health, appears unlikely.

The comprehensive assessment was successfully concluded in late October 2014, highlighting the progress made toward solvency and health of the euro area’s banking system (ECB 2014a). The 130 credit institutions included in the exercise (the “participating banks”) had total assets of €22 trillion, which accounts for 81.6 percent of total banking assets in the SSM. The exercise was based on the Capital Requirements Regulation (CRR) and Directive. The AQR required banks to have a minimum Common Equity Tier 1 (CET1) ratio of eight percent, which would apply during the transition to a tougher standard of 5.5 percent, referred to as the “fully loaded CET1,” to be reached in 2017.

The results can be briefly summarized as follows:

• The comprehensive assessment found that 25 banks failed the test, with a total capital shortfall of €25 billion at the end of 2013, arising roughly equally from asset revaluations and the stress test component.

• In anticipation of the comprehensive assessment, banks had already raised €57 billion in 2014, ahead of the October 26, 2014 deadline. After taking into account this capital-raising effort, only 13 banks had to raise €10 billion of additional capital to meet the requirements. The ECB will lean on these banks to raise the required capital based on approved recapitalization plans. Their shareholders should clearly not expect large dividend payments in the coming years.

Although the “fully loaded CET1” standard would only apply from 2017 onward, the comprehensive assessment published the results based on the tougher standard in order to provide forward guidance to banks. The new CET1 standard rules out various accounting rules used to minimize capital requirements, such as deferred tax assets (DTAs), which essentially constitute a fiscal transfer to the banks. As noted by the ECB, DTAs, whether they rely on future profitability of banks or not, reduce the need for new capital and create new liabilities for the government, contributing to the vicious circle between banks and sovereigns that the banking union was set up to end. The results of the fully loaded CET1 standard indicate that its adoption would add €126 billion to capital needs. The adverse scenario in the EBA stress tests (EBA 2014a) illustrates the size of the adjustment banks will need to deal with when the new capital standard comes into effect.

Following the successful conclusion of the comprehensive assessment, the SSM, with the ECB at its helm, took over the supervision of approximately 120 systemic banks on November 4, 2014. Smaller banks, with less than €30 billion in total assets, continued to be nationally supervised (ECB 2014b).

In early April 2015, SSM Chair Daniele Nouy said she might need the European Parliament’s support to close loopholes in EU bank capital rules that provide countries leeway to pursue their own versions of some regulations. National flexibility creates big differences in the definition of capital, for example, in the treatment of deferred tax credits (DTCs). The EU Commission is reportedly collecting evidence on legislative changes that permit DTAs to be transformed into DTCs in banks in Greece, Italy, Portugal and Spain to assess whether they constitute state aid. Because they are contingent on future profits, the CRR does not count DTAs as capital. By contrast, DTCs constitute a claim regardless of whether the bank makes a profit or a loss. Insofar as they represent a potential liability for the state, DTCs go against the objective of severing the link between banks and sovereigns.

**MONETARY POLICY INITIATIVES TO REVERSE FRAGMENTATION**

Restoring confidence in the asset quality and capital adequacy of banks would certainly contribute to a reversal of fragmentation. Recent monetary policy initiatives launched by the ECB would promote the same goal, although they are not directly targeted at banking union objectives.

• To promote the flow of credit, in early June 2014 the ECB launched targeted long-term refinancing operations (TLTROs) to support term funding. Loans provided under this facility are linked to each bank’s lending to the non-financial private sector. The loans have a four-year tenor and a fixed interest rate linked to the ECB’s rate on main refinancing operations, providing significant incentives for banks to use the facility.

12 In her first major speech as IMF managing director, Christine Lagarde (2011) warned in Jackson Hole, Wyoming in August 2011 that “[European] banks need urgent recapitalization. They must be strong enough to withstand the risks of sovereigns and weak growth. This is key to cutting the chains of contagion. If it is not addressed, we could easily see the further spread of economic weakness to core countries, or even a debilitating liquidity crisis. The most efficient solution would be mandatory substantial recapitalization — seeking private resources first, but using public funds if necessary. One option would be to mobilize EFSF or other European-wide funding to recapitalize banks directly, which would avoid placing even greater burdens on vulnerable sovereigns.” The speech was not well received in Europe, with a European Commission spokesperson saying that “European banks are much better capitalized than they were even a year ago” (Spiegel 2011).
• To end deflation and restore confidence in southern Europe’s debt sustainability, in early March 2015 the ECB embarked on a major expansion of its balance sheet through quantitative easing (QE). QE aimed at returning to the ECB’s inflation target of “below, but close to, 2% over the medium term” and narrowing sovereign credit spreads. In contrast to TLTROs, which depends on take-up by banks, QE would provide the ECB direct control over the expansion of its balance sheet. To the extent that it includes asset-backed securities and corporate bond purchases (and indirectly through sovereign bond purchases), QE would help reduce the cost of capital to firms.

**BAIL-IN RULES**

If a bank proves unable to raise capital for its capital ratio to reach the required level, bail-in rules or conversion of subordinated debt to capital must be applied before recourse to public support under EU state aid rules. The bail-in and resolution functions of the SRM would apply in all EU member states from January 1, 2016. The bail-in tool of the BRRD will enable resolution authorities to write down or convert into equity the claims of a broad range of creditors. This tool will be essential to achieve orderly resolution without exposing taxpayers to losses, while ensuring continuity of critical functions to avoid any disruption in the financial system. The order in which creditors, after shareholders, would be affected by a bail-in has now been agreed: subordinated liabilities; unsecured and non-preferred liabilities; and preferred liabilities. Covered deposits up to €100,000 are excluded from bail-in, but the national DGS would step in and make a contribution for covered deposits if needed.

Here is where the exemptions begin. In exceptional circumstances, the BRRD allows resolution authorities to exclude or partially exclude other liabilities if it is not possible to bail them in within a reasonable time, it is strictly necessary to achieve the continuity of critical functions and core business lines, it is strictly necessary to avoid giving rise to widespread contagion, or if bailing them in would cause a destruction of value such that the losses borne by other creditors would be higher than if these liabilities were excluded from the bail-in. However, in order to avoid having the exemptions abused to shield creditors from losses, the resolution fund cannot be used, as a general rule, to cover any excluded liabilities until an amount of at least eight percent of the total liabilities of the ailing bank have been bailed in. Beyond this, resolution funds could assume five percent of the losses. Public funds could either be provided to give limited backup support to the resolution fund at this point or, in extraordinary circumstances, directly to cover losses after the five percent contribution from the resolution fund.

In order to make sure that there are sufficient liabilities to bail in at the point of resolution, the resolution authorities will, in consultation with the supervisors, determine a minimum requirement for own funds and eligible liabilities (MREL) for bail-in for each bank. The MREL is determined as a percentage of total liabilities with which banks must comply. For most EU banks, the work to determine MREL levels and to develop resolution plans started in January 2015, when both the BRRD and the SRM regulation entered into force. For the global systemically important banks under the G20/Financial Stability Board’s agenda to end the too-big-to-fail (TBTF) problem, preliminary results were discussed at the FSF’s Brisbane summit in November 2014 (FSB 2014). G20 leaders endorsed proposals to end TBTF in the banking sector. Once implemented, these proposals will play an important role in enabling globally systemic banks to be resolved without recourse to public subsidies and without disruption to the wider financial system.

While the bail-in rules were being negotiated, both the European Commission and the ECB supported a bail-in order similar to the template used by the FDIC to wind down failing US banks, with uninsured depositors the last in line to take a loss if the bank fails. But opinion remained divided on this point, as well as over how much flexibility countries should have in exempting uninsured depositors, such as pension funds, and senior creditors from losses. The Netherlands, one of the four triple-A-rated euro-area countries, backtracked from its earlier position that all creditors be liable when a bank fails, following the nationalization in February 2014 of SNS Reaal NV, in which the government shielded senior bondholders to prevent a surge in funding costs for other Dutch banks.

The SRM’s decision-making process to resolve a failing bank has been streamlined relative to initial plans, but remains quite complex. In most cases, the procedure will start with the ECB notifying to the SRB, the European Commission and the relevant national resolution authorities that a bank is failing. The ECB will then adopt a resolution scheme, including the relevant resolution tools and any use of the SRF, if needed. Before the board adopts its decision, the commission will assess its compliance with state aid rules. Only if the commission significantly modifies the amount of resources drawn from the SRF,
or contests the public interest in resolving the bank, would its decision be subject to approval or objection by the European Council. If the council or the commission objects to the resolution scheme, the board would have to amend it.

THE “INS” AND “OUTS” OF BANKING UNION

The coexistence between the single market and the banking union raise issues of jurisdictional domain, since the BRRD and the single rulebook relate to the European Union as a whole, while the SSM and SRM are specific to the euro area, even though they are open to any EU member state that wants to join. Indeed, as discussed above, all EU countries besides the United Kingdom and Sweden signed the intergovernmental agreement on the transfer and mutualization of contributions to the SRF, an essential part of the SRM. The United Kingdom and Sweden (the two members with a permanent opt-out from euro adoption) took the view that banking union was the sole province of the single currency and chose not to be a signatory in the intergovernmental agreement on the SRF. The other seven EU members that remain outside the euro area (Bulgaria, Croatia, Czech Republic, Denmark, Hungary, Poland and Romania) viewed their participation as a means of ensuring that there is a level playing field between participants and non-participants, and effective cooperation between their respective banking authorities. Though neither a euro-area member nor a signatory, the United Kingdom is the financial centre of Europe and, understandably, feels it should be closely involved in decisions affecting Europe’s financial system. Other non-euro-area EU members also wish to remain engaged in European coordination of financial services rules. Denmark is likely to be the first non-euro area country to join banking union. But issues of representation arise: for example, how can the interests of non-euro-area members who wish to join the banking union be served, if they have a voice in the ECB Supervisory Board but not in the ECB Governing Council? What about the interests of the “outs,” the United Kingdom and Sweden, who will join neither the euro area nor banking union? These concerns gave rise to a modification of voting procedures within the EBA to double-majority voting, whereby a majority is needed among both euro-area and non-euro-area countries for a decision to pass. The EBA has undertaken the role of mediating any cross-border supervision and resolution issues that may arise, and ensuring that regulatory arbitrage is avoided.

CONCLUDING REMARKS

Rapid progress has been made toward establishing banking union, with the ECB already fully functional as the single supervisor and the SRB in place, although without executive power until the SRF becomes operational in 2016. The project is still at an early stage, and it is too soon to tell to what extent it is achieving its goals. What is clear is that the market perception that the euro area could break apart has been reversed, as is obvious from the massive tightening of sovereign credit spreads from near-peak levels since mid-2012 (with Greece remaining an outlier). Agreement on banking union clearly played a role in easing market concerns by enabling the subsequent announcement of a massive firewall by the ECB’s “whatever it takes” statement and OMT announcement in the summer of 2012, which marked the beginning of spread tightening. The ECB’s recent decisions to provide targeted funding for SMEs and to substantially expand its balance sheet by embarking on sovereign QE should contribute to reversing fragmentation. The latest ECB financial integration report (ECB 2015) shows improvements in the integration of all four (money, credit, bond and equity) market segments. Price and quantity-based indicators of financial integration show that, although still worse than before crisis, the integration of European financial markets has significantly improved. The report attributes the improvement to the prospect of the establishment of the banking union and non-standard monetary policy actions taken by the ECB. Recent data showing that bank lending to the private sector is starting to recover, in line with the recovery of economic activity in the euro area, also indicate that the worst is behind us (see Figure 3).

Figure 3: Euro-area Bank Lending to Non-financial Private Sector (% change year over year)

Source: ECB.

15 See Bloomberg (2015). The Danish experience illustrates the need for a harmonized approach across the European Union to ensure a level playing field. At the peak of the banking crisis in 2010, Denmark was the first EU country to force senior creditors to take a hit when two of its banks failed (Amagerbanken and Fjordbank Mors). As a result, Danish banks were viewed as benefiting less than their competitors from an implicit government guarantee, and they were penalized by rating downgrades and a hike in funding costs. Although the bail-in decision was sound, the market response can be negative when member states implement such policies alone and unexpectedly.
Uncertainty remains about how the banking union would function in practice, in areas where policies are still untested or where transition to full banking union is incomplete. As noted by Nicolas Véron (2014), “the ad hoc manner in which [banking union] 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.” At present, the implementation of banking union is only partial, insofar as:

- It focuses on the euro area rather than the entire European Union, which could give rise to a fracture in the single market for banking services if supervisory convergence and common resolution practices are not fully achieved. The EBA, mandated to foster sound supervision and to drive supervisory convergence across the European Union, has recently issued detailed guidelines (2014b) and called on policy makers to accelerate the harmonization of supervisory frameworks across the European Union.

- Supervision of less-significant institutions remains the responsibility of national supervisory authorities. While it seems appropriate for the ECB to focus on the systemic banks, regulatory arbitrage could lead to the build-up of risky assets in small banks that remain below the ECB radar. Although small, the Spanish savings banks (cajas de ahorros) and the German Landesbanken required the injection of significant public funds to remain viable after the onset of global financial crisis.

- Deposit insurance remains a national responsibility that may collide with fiscal capacity, as in the case of Cyprus in 2013.

**Supervision**: The ECB took over bank supervision just two years after it was designated single supervisor by European leaders. The comprehensive assessment provided a major boost to confidence in European banks by strengthening balance sheets, enhancing transparency and assuring that banks were soundly capitalized. By uncovering capital shortfalls, the ECB already has demonstrated that it is more rigorous than the national supervisors it replaced. But gaps in supervision remain: First, the issue that has arisen regarding DTCs illustrates the need for further harmonization of capital rules. Second, breaking the vicious circle between banks and sovereigns is unlikely while banks hold a large proportion of the bonds of their sovereign. The SSM has not, so far, imposed explicit limits on the share of bank assets that can be invested in bonds of their own sovereign, but this is an idea worth considering now that sovereign QE provides a bid to the market and interest rates are at an all-time low (Wolff 2015).

While the supervisory role of ECB is firmly established, its resolution function remains untested. Under Comprehensive Assessment, no banks were deemed unviable and required to shut down, although some banks were required to raise additional capital. While the assessment was still underway, two banks (Banco Espirito Santo and Volksbanken) were already being restructured under the supervision of national authorities in Portugal and Austria respectively. The ECB’s willingness to force such restructuring or closures in future, free of political interference, remains to be seen, especially after the transition to tougher capital requirements in 2017.

**Fragmentation**: Now that the ECB has taken over supervision of systemic banks, the expectation is that it will put an end to national ring-fencing of capital and liquidity imposed by national supervisors that has contributed to financial fragmentation. Ultimately, the interference by national authorities in the allocations of capital and liquidity across subsidiaries located in different countries needs to stop, otherwise cross-border operations will continue to be hampered, perpetuating financial fragmentation. However, it is too soon to assess whether fragmentation has receded. Useful new information will be provided when the trend in cross-border holdings of bank assets post-2014 can be discerned. Although not specifically targeted at fragmentation, sovereign QE could, in principle, help reduce corporate borrowing costs in the periphery, but this objective is unlikely to be achieved through the limited risk pooling inherent in the current scheme.

**Bank resolution**: The final agreement reached in the European Parliament in March 2014 improved earlier proposals by streamlining the decision-making process when a bank is failing and by accelerating the mutualization of national compartments of the SRF, with 40 percent of the funds available to all participating countries needs to stop, otherwise cross-border operations will continue to be hampered, perpetuating financial fragmentation. However, it is too soon to assess whether fragmentation has receded. Useful new information will be provided when the trend in cross-border holdings of bank assets post-2014 can be discerned. Although not specifically targeted at fragmentation, sovereign QE could, in principle, help reduce corporate borrowing costs in the periphery, but this objective is unlikely to be achieved through the limited risk pooling inherent in the current scheme.

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16 Though not directly responsible for the supervision of smaller banks, the ECB retains the prerogative to step in if needed, including through onsite inspections. The ECB is entrusted with oversight responsibility to ensure that supervisory requirements on all credit institutions covered by the SSM are consistent. See ECB (2014b).

17 In the ongoing Greek crisis, the ECB has imposed a limit on the stock of Treasury bills that banks can hold in order to avoid monetary financing of the deficit through the Exceptional Liquidity Assistance facility on which banks rely for funding.

18 Even though the ECB has no resolution function, per se, it can trigger a resolution process by withdrawing a bank’s license.

19 The ECB will only hold 20 percent of bond purchases under QE on its own balance sheet, i.e., the de facto mutualization of risk is limited.
countries from year one.\textsuperscript{20} It remains to be seen whether the decision-making process to resolve a failing bank can be completed over a weekend, and whether it will be subject to political interference. While a simpler, more streamlined approach is preferable, creating a separate entity with full responsibility to decide on bank resolution, relying on significant own resources, would require a treaty change. The chosen approach was thus circumscribed by the need to work within the constraints of the existing Treaty on the Functioning of the European Union. Also, the eight-year transition period to full mutualization remains too long. With an eventual size of €55 billion, the SRF may prove insufficient in a systemic crisis. To be credible, the resolution authority would need a fiscal backstop, but the ESM can only lend to sovereigns, not to the SRF. It can recapitalize banks directly (DRI), but only under very strict conditions: bail-in of eight percent of eligible liabilities, with an additional five percent funded by the SRF and access to DRI dependent on the sovereign’s fiscal position. Enabling the ESM to provide a truly common backstop by lending to the SRF would require changing the treaty that established the ESM — a cumbersome process. Like the SRF, the ESM was set up through an intergovernmental agreement, with member states retaining veto power over any subsequent changes. The absence of a common fiscal backstop that can be quickly deployed in a systemic crisis constitutes a gap in the structure of the resolution authority. As noted by the IMF (2014), the availability of such a backstop could reduce the likelihood that it would be used.

The agreement on the SRM was a compromise between the original German vision of coordinated national resolution schemes and a system with shared euro-area risk from the outset. The impact of the agreement on bank-sovereign links and fragmentation are thus likely to appear only gradually over time.

**Bail-in:** While the bail-in principle has been firmly agreed, how the bail-in provisions will be applied in practice remains to be seen. Some deviations from agreed principles to carve out some creditors appear reasonable: for example, local governments holding subordinated debt who would need to be bailed out after being bailed in, or exemptions from bail-in to avoid possible contagion through cross-holdings of bonds by banks. However, the exemptions are broad enough to permit significant discretion. The Dutch experience with the nationalization of SNS Reaal NV in February 2014, in which the government shielded senior bondholders to prevent a surge in funding costs for other Dutch banks, suggests a “hybrid” approach toward failing banks. Under this approach, taxpayer funding may be used to avoid spooking senior bank creditors to the point that wholesale funding becomes unavailable at a fair price. Member states may thus seek some discretion on how to treat various creditors, casting doubt on whether a single EU rulebook will ultimately be established. Work is also ongoing at the newly appointed SRB to ensure sufficient loss-bearing capacity at each systemically important bank by setting an MREL for bail-in. The results of this exercise are pending. Legal issues also remain on the cross-border enforceability of bail-in. The FSB has proposed high-level principles that would guide the drafting of such contractual clauses in debt instruments to ensure enforceability (FSB 2014).\textsuperscript{21}

As discussed, the need to identify alternative sources of financing at a time when banks are deleveraging gave impetus to initiatives for “capital markets union” in Europe. This objective figures prominently among the priorities of Juncker’s presidency of the European Commission. As the ECB has stressed (Coeuré 2014), a single market in capital is essential in a monetary union to ensure its efficient allocation and to provide a cushion against local shocks through diversification. Moreover, the shortage of liquid private financial assets hampers the ECB’s efforts to ease monetary conditions through QE. In the euro area’s bank-dominated financial system, the market for corporate bonds and securitized bank assets is small, leaving sovereign bonds the only viable option for large-scale purchases. The ECB is working on identifying “high-quality” assets that could be securitized. Assuming securitized bank loans can be sufficiently standardized, they would open up new sources of cheap funding to small- and medium-sized businesses by broadening the investor base to include institutional investors while freeing up space in bank balance sheets for new lending. But much work lies ahead to achieve cross-border consistency in prudential standards, securities regulation and financial disclosure, financial infrastructure, insolvency regimes and the taxation of financial activities.

\textsuperscript{20} Under the European Council’s proposal tabled in December 2013, the transition period to a common backstop would last 10 years and the decision-making process was tedious. In principle, decisions would be made by the five-member executive board of the SRM, but if certain limits were breached, a plenary session would be called and, if needed, the European Council. It is unlikely that this process could be completed over a weekend, which would be required to avoid a bank run and market turbulence. The European Parliament considered the European Council’s proposal to be too complex and inadequately funded.

\textsuperscript{21} A recent CIGI paper (Schwarcz 2014) argues that a resolution regime based on contractual approaches has limited utility because its enforceability is questionable even if it binds parties that contractually agree to the regime. The paper argues that a statutory approach to a resolution regime would be much more effective in achieving financial stability. In designing such a regime, at least two goals should be recognized: enabling systemically important financial firms to achieve a successful resolution, and protecting financial markets whose collapse could be systemically risky. The FSB proposals focus primarily on the first goal; they should be broadened to also take into account the second goal.
To conclude, banking union is a big step toward promoting financial stability and supporting growth in the euro area. The comprehensive assessment already has helped reinstate trust in euro-area banks, as is obvious from the fact that long-term refinancing operations are being repaid and interbank market has begun to function. But bank resolution remains untested, so it is too early to draw any conclusions. The ultimate test of whether banking union has worked is whether it will succeed in reversing the fragmentation in Europe’s financial system and breaking the vicious circle between banks and sovereigns. Even though these would be no mean achievements, much more work lies ahead to establish a truly integrated financial market in the European Union.

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