

## **The Difficult Construction of European Banking Union: Introduction**

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Banking Union represents one of the most important developments in European integration since the launch of Monetary Union. Furthermore, the design of the Banking Union agreed between 2012 and 2014 was a messy compromise among European Union (EU) member states. It is not surprising then that Banking Union has sparked a lively academic debate and triggered an ever-growing number of publications from different disciplinary backgrounds. This edited volume is located at the intersection of two major waves of academic research on Banking Union.

The first wave of academic work focuses upon the economic rationale underpinning the supranationalisation of control over banking—regulation, supervision, support and resolution—and the political dynamics and legal issues that shaped the design of the Banking Union agreed. (For overviews, see Binder and Gortsos 2016; Busch and Ferrarini 2015; Castañeda, Mayes, and Wood 2016; Howarth and Quaglia 2013, 2014, 2016). This literature focuses upon Banking Union's foundational phase between 2012 and 2014 when the major

texts enshrining Banking Union in law were negotiated and adopted. The second stage of academic research analyses the functioning of the different elements of Banking Union. New research questions have been triggered by the—albeit limited—empirical evidence on the operation of the supranational supervision and resolution of banks. Contributions to this second wave of Banking Union-related research attempt to identify potentially dangerous lacunae and contribute to on-going reform debates. This edited volume brings together the work of sixteen scholars focused on the political, legal and economic debates surrounding the construction and operation of Banking Union, and its necessary reform.

A decade on since the outbreak of the worst international financial crisis since the late 1920s, the effective design of EU bank regulation, supervision, support and resolution remains hotly contested, in both academic and policy-making circles. European Banking Union still ranks very high on the European Union's reform agenda. Some reform proposals, such as the creation of the European Deposit Insurance Scheme (EDIS), have been placed on the backburner given German government concerns regarding the state of bank balance sheets in some euro area member states—and, specifically, bank holdings of nonperforming loans—and that incentives for future risk-taking have not been sufficiently reduced. Other reforms affecting all EU member states have met the determined opposition of a number of national governments and powerful bank interests, including the European Commission's proposal for a regulation on Bank Structural Reform, which was dropped by the Commission in late 2017. However, there are also a range of other legislative and institutional reforms designed to reinforce EU bank regulation and supervision which have either been proposed and / or adopted—and specifically the revised versions of the Capital Requirements Directive (CRDIV and V) and the Capital Requirements Regulation (CRR I and II) of 2013 and 2019 respectively.<sup>1</sup> The main objectives of these reforms to force banks to hold greater capital and liquid assets are to make banking

safer—and specifically to diminish the systemic effects of losses resulting from high risk bank activities—and to reinforce the ability of supervisory authorities to monitor effectively bank activity. The degree to which these reforms have achieved or will achieve their stated objectives remains a matter of considerable debate.

The first section of this volume includes three chapters that present different political science and political economy analyses of the move to supranationalise control over banking. The late David G. Mayes (2018, p. 132) compares the current state of affairs in Banking Union, that “reflects the political constraints and the path of history”, with a full-fledged optimum structure that might have emerged if Banking Union designers had had the opportunity to start from scratch. He contrasts a comprehensive structure of a banking union, taking the U.S. as an example, with the new European system with all its “omissions” and “inelegant features”. One important difference he identifies can be found in the key role that the U.S. Federal Deposit Insurance Corporation (FDIC) plays as a resolution agency with strong financial resources. There is no equivalent to be found in European Banking Union. Furthermore, Mayes points to the danger of the Banking Union “breaking up rather than reinforcing the EU” (p. 132). This is due to the new fault lines between euro-ins and euro-outs as Banking Union implies the exclusion of the most important financial centre in Europe: London. Risks to financial stability also stem from Banking Union’s Single Supervisory Mechanism (SSM) covering only banks as opposed to all major financial institutions—including insurers and shadow banks, the operation of which might undermine financial stability. Based on his assessment of risks and omissions in the Banking Union’s design, Mayes presents an agenda of what needs to be done to move Banking Union closer to a comprehensive structure. However, he notes his pessimism with regard to the willingness of politicians to embark on the road towards new reforms, without

the incentive of an immediate crisis. Hence, the “vulnerabilities from the incomplete union and the untested tools will remain” (Mayes, 2018, p. 140).

Joachim Schild’s (2018) contribution looks at the protracted and conflict-ridden process of negotiations—notable for the absence of strong Franco-German leadership—that left important matters undecided: notably, European-level deposit insurance and a fiscal backstop for Banking Union. Germany and France, the key actors in the Banking Union negotiations, did not share a clear common purpose on any of the Union’s main elements. They did not set the agenda, nor did they submit influential joint proposals. Only on occasion could they provide a limited contribution to compromise building. This stands in stark contrast to the leading role of France and Germany in the negotiations resulting in the EMU provisions of the Maastricht Treaty. The explanation provided by Schild for this lack of joint leadership consists of three main elements. First, French president François Hollande’s made the political choice not to base the French approach to Banking Union on the familiar pattern of Franco-German pre-negotiations. Second, there were diverging assessments of Banking Union’s social purpose and benefits, with the French government presenting centralised fiscal support for ailing banks as a key *raison d’être* of a Banking Union whereas the German federal government proved unwilling to pay for the banking crises in euro area periphery countries. Third, the German government perceived the financial and political costs of Banking Union to be distributed asymmetrically and to its disadvantage.

David Howarth and Lucia Quaglia (2020) interrogate previous political science and European integration theoretical accounts of the move to and the design of EMU—neofunctionalism, intergovernmentalism and constructivism—evaluating their explanatory power with reference to Banking Union. The authors argue that the asymmetrical design of EMU generated a variety

of spill-overs and, hence, a neofunctionalist drive to supranationalise control over bank supervision and financial support for banks as part of the so-called ‘completion’ of EMU. However, intergovernmental negotiations informed by moral hazard and domestic political economy concerns explain the asymmetrical design of Banking Union agreed by national governments.

The five chapters of the second section of this edited volume examine more specifically the design and functioning of supranational bank supervision in the European Union. Three chapters focus upon the problematic operation of the EU’s two supranational supervisory bodies—the European Central Bank (ECB) and the European Banking Authority (EBA)—arguing the need for further reform. These chapters are representative of the changing research agenda on EU bank regulation and supervision in light of the empirical evidence that can be gathered despite the recent creation of the EBA and launch of the SSM. It is not surprising that the early operation of both the EBA and the ECB’s bank regulatory and supervisory roles has highlighted a number of practical problems and thorny existential questions. These chapters—in addition to others in this edited volume that examine the EBA and ECB—also suggest proposals for further reform.

In his contribution to this section, Jakub Gren looks at the coexistence of the ECB’s direct supervision of large and systemically important banks (approximately 120) and its indirect supervision of small and medium-sized banks via its oversight of the national supervisors’ legwork. Gren analyses the dynamic relations between the ECB and national competent authorities (NCAs) in banking supervision in terms of a principal-agent relationship. First, he looks at potential agency problems in this multi-level and decentralised setting of the ECB’s indirect supervisory competence. Then he goes on to identify six *ex ante* and *ex post* control

and accountability mechanisms at the ECB's disposal thanks to the SSM's supervisory legal framework. These mechanisms allow the ECB to steer and monitor the NCAs' exercise of their supervisory tasks. Gren's analysis shows that the *ex ante* controls are more prominent than the *ex post* controls such as staff relocation or direct takeover of supervision by the ECB since the latter would enter into legally and politically highly sensitive areas. However, the asymmetry between the ECB's supervisory apparatus (the principal) responsible for the oversight and the NCA supervisory apparatus (the agent) responsible for the actual supervision of small and medium-sized banks together with the soft, legally non-binding nature of the ECB's formulation of policy expectations on key areas of the NCA's prudential supervision casts some doubt as to the ultimate robustness of the current two-level and multi-actor system of ECB indirect supervision. Gren argues that the ECB is in a relatively weaker position in relation to the NCAs and may not always be able to guarantee their coherent and effective implementation of prudential supervision. Therefore, he suggests a strengthening of the ECB's position in relation to the NCAs in future Banking Union reforms and points to some concrete reform options as to how this reinforcement might be achieved.

Zdenek Kudrna and Sonja Puntcher Riekmann (2018) analyse the number of national options and discretions (O&Ds) in transposing and applying the new rules enshrined in the EU's single rule book that directs bank supervision in all twenty-eight EU member states. These O&Ds provide a source of fragmentation in that they allow a persistent level of regulatory differentiation in the EU's Single Market. The ECB's initiative to reduce O&Ds by way of harmonisation launched in 2016 only applies to the euro area's largest (significant) banks under its direct supervision. This intended reduction of O&Ds for these large banks will add de facto a twenty-ninth regulatory regime in addition to the twenty-eight national regulatory regimes which result from the differentiated use of national O&Ds by EU member states. Kudrna and

Puntscher Riekmann show that there is a systematic differentiation between the advanced market economies of the EU-15 and the emerging markets of the new post-communist member states. The latter attempt to stabilise their banking systems, heavily reliant on foreign capital, using available options and discretions to protect the capital and liquidity in local subsidiaries of foreign banking groups under their host supervision. These differences notwithstanding, the authors are relatively optimistic with regard to the prospects for O&D harmonizing reforms inside Banking Union.

Ute Lettanie (2019) looks at the manner in which the ECB fulfils its legal obligations enshrined in the SSM regulation to organise public consultations in cases where it makes use of its limited regulatory powers when acting as a prudential regulator. Lettanie asks whether the ECB gains in terms of legitimacy thanks to the openness, transparency, inclusiveness, efficacy and judicial accountability of its practice of consultation. She identifies the lack of feedback given by the ECB to those who participate in the ECB's consultation procedure, the low participation rate beyond the group of actors from the regulated sector and the weak judicial review as constituting the Achilles' heel of the ECB's consultation practice. Whereas she finds the openness and transparency standards to have been met, the judicial review *ex post* is still vague and the inclusiveness criterion is hardly fulfilled. The latter comes as no surprise as well-organised sectoral interest groups are overrepresented, as to be expected in terms of Mancur Olson's logic of collective action. Overall, improving the throughput legitimacy of the ECB's practice as a regulator turns out to be a crucial but complex challenge. The author then identifies several mechanisms to meet this challenge.

In his chapter, John-Paul Salter (2019) looks at the complex accountability structure surrounding the European Banking Authority (EBA), taking into account both formal-legal

accountability to political principals as well as more fluid and more contingent forms of accountability to peers. Are these forms of accountability complementary or constraining of the EBA's autonomy? According to Salter, the EBA is accountable to four sets of stakeholders: EU institutions, its fellow European supervisory authorities (the European Securities and Markets Authority and the European Investments and Occupational Pensions Authority), national competent authorities (NCAs) and market actors. The formal links to the European Parliament and the EBA's resource dependency on the NCAs create stronger EBA relations to these two types of actors compared to those with its fellow EU-level supervisory authorities and market actors. It is, above all, its resource dependency on the NCAs that limits the EBA's operational autonomy. This makes the maintenance of national specificities in regulatory regimes and supervisory practices more likely and suggests the need for reforms to the EBA's accountability structure in order to reinforce the harmonisation of supervisory standards in the EU.

In their chapter, Katalin M  r   and Dora Pirooska (2018) argue that reforms to Banking Union should be aimed at increasing the efficiency of the entire EU Single Market and enhancing the financial stability of all EU member states. They review European financial regulatory developments since the Maastricht Treaty with the aim of demonstrating that Banking Union represents a shift in the logic of regulation. The regulatory logic prior to the outbreak of the international financial crisis (from 2007) was driven by EU-wide integration and the subsidiarity concerns of member states. However, Banking Union focuses only on the euro area and it is driven by the logic of saving the euro and cutting the vicious circle between governments and domestic banks. The authors show that non euro area central and eastern European (CEE) member state governments demand a return to the old logic of financial regulation. Acknowledging that nationalist, illiberal political forces in power in the CEE member states are not likely to surrender regulatory authority, they argue that it is in the interest



of all EU member states to accommodate non euro area CEE member states and that this accommodation must also reflect the subsidiary demands of CEE member state governments. Using the example of macroprudential regulation, Mérő and Piroska propose a number of reform options that—with a return to the old logic—could result in the better functioning of the SSM.

The four chapters of the third section of this volume focus upon the problematic design and operation of the Single Resolution Mechanism. In his second contribution to this volume, David G. Mayes (2018) explores the problems the EU and the Single Resolution Board (SRB) face in trying to implement a credible system for resolving banks without the use of taxpayer funds as a key part of Banking Union, with the aim of avoiding the doom loop between indebted banks and indebted sovereigns. Mayes argues that without clear examples of how the system works in practice it is very difficult to provide convincing evidence of what will happen given the large number of options for bailing in, the continuing predilection for bailing out in some countries and the lack of fiscal backstop to help tackle general threats to financial stability.

Analysing the divergent preferences of member state governments sheds light on the origins of the, often messy, compromises and complicated institutional setups characterizing the current design of Banking Union, including the decision-making process to resolve banks. Ioannis Asimakopoulos' (2018) contribution to this volume examines the use of international law—instead of EU law—in the establishment of the Single Resolution Fund (SRF). He points to the legal implications of this political choice to make use of an international agreement instead of Union law, and notably the weak enforceability of the arrangements on the SRF. The use of international law, successfully advocated by Germany, allowed the largest euro area member states—first and foremost Germany—to retain control both of the setup and the use of the SRF.

Opting for an international agreement for the provisions on the transfer of national funds to the SRF sidestepped the European Parliament and gave the largest national contributors to the fund a veto power during the negotiations. The same holds true for the future potential use of ESM funds for direct bank recapitalisation in case the SRF resources turn out to be insufficient. According to Asimakopulos (p. 129), this provides an example of “nationalised European Integration” “since economically stronger countries can fully control and influence resolution procedures and structural measures taken in poorer countries for the sake of integration” in case ESM conditionality applies.

The third chapter in this section focuses upon European level financing of bank resolution and specifically the debate over the creation of a common financial backstop for the Single Resolution Fund (SRF). Florian Brandt and Matthias Wohlfahrt (2018) identify four main principles in statements by national ministers of finance which must be respected in the design of a future backstop in order to ensure a sufficiently large coalition of support among member state governments (Brandt and Wohlfahrt, 2018). These principles include fiscal neutrality in the medium term; that the backstop be an instrument of last resort in order to minimise any recourse to public funds; the equivalent treatment of all current and future Banking Union member state banking sectors; and the assurance that no costs will occur for non-Banking Union member states. The authors argue that taking these principles into account significantly restricts the possible designs for and available providers of a future common backstop.

Shawn Donnelly’s (2018) contribution to this section evaluates the first experiences with the implementation of resolution rules and the working of new resolution institutions. Donnelly’s chapter sheds light on a weak spot of Banking Union, specifically the possibility open to member states—here, Italy and Portugal—to circumvent the application of bail-in rules and

instead continue to bail out banks using taxpayers' money. Donnelly underlines the leeway available to member states and their competent authorities to bail out national banks and to keep them under national control and ownership. They can also count on an accommodating stance of the Commission. This stance has, according to Donnelly, far reaching consequences as it “means fewer resolutions than originally envisaged, continued state aid and poor prospects for a [SRM] with full supranational powers” (p. 160). The available evidence so far as to how the Commission applied the rules when it allowed the Italian and Portuguese governments to bail out troubled banks testifies to a roll back of the agreed principle of bailing-in private investors. Hence, the “doom loop between banks and sovereigns persists” in Italy and Portugal (Donnelly, 2018, p. 167).

The fourth section of this edited volume includes four chapters examining additional setbacks that have undermined a coherent and sustainable Banking Union, notably the failure to agree upon the creation of a European Deposit Insurance Scheme (EDIS) and EU-level legislation on bank structural reform. In their contribution to this section, David Howarth and Lucia Quaglia (2018) demonstrate that the difficulties facing the construction of an EDIS owe to the weakness of the previously agreed harmonisation of national DGS in the 2014 directive.<sup>2</sup> The German government refused to accept the development of an EDIS. Publicly, German ministers expressed concern for the creation of a moral hazard that common funds would create for banks in those participating countries that had weak banking systems—notably in the euro area periphery. Howarth and Quaglia argue that to understand fully German moral hazard concerns it is also necessary to look beyond the ideational—notably concerns stemming from German Ordo-liberalism—and focus on the existing national institutional arrangements that the German government sought to protect. German moral hazard concerns stemmed from the fear that well-funded German DGS—especially those of small savings and cooperative banks—could be

tapped to compensate for underfunded (and largely ex post funded) DGS in other member states. This failure to harmonise schemes beyond a low minimal standard can be explained through an analysis focused on national systems. Different national DGS stemmed from the different configuration of national banking systems, the longstanding relationships among national banks and well-entrenched regulatory frameworks. Thus, to overcome German opposition to the creation of the EDIS, the further reinforcement of national schemes appears necessary.

In his chapter, Shawn Donnelly (2018) explains the failure to agree the creation of the EDIS in terms of competing advocacy coalitions focused on the link between the EDIS and two incompatible areas: risk reduction measures versus increased public backstops and state aid. On the one hand, Germany and the Netherlands, with the aim of minimising potential costs, pushed for wide-ranging risk reduction measures—specifically the reduction of the sovereign debt holdings of Southern European banks. On the other hand, Italy pushed for greater public backstops and state aid. Unable to break the deadlock in the Council between these two positions, euro area member states awaited international (Basel Committee) guidance on how to deal with sovereign risk exposures in its 2017–2018 work programme.

In her chapter, Cerrone (2018) provides an assessment of the reform of national DGS required by the DGS directive adopted in 2014 and, in her view, the necessary evolution of national DGS towards an EDIS. She argues in favour of further reforms to national DGS and, specifically, the adoption of risk pooling and the improved calculation of bank risk-based contributions. She also argues that the move from national DGS to the EDIS is essential to efforts to bolster customer confidence in their banks.

Finishing off this volume, the chapter by Vanessa Endrejat's and Matthias Thiemann (2019) examines how the European Commission watered down its own proposal for Bank Structural Reform (BSR). The initial proposal aimed at making banks more resilient and facilitating their resolvability through the separation of riskier trading activities from deposit-taking. The Commission framed the BSR as a balancing act between financial system stability on the one hand and market liquidity and growth on the other hand. Shifting its emphasis increasingly towards growth in order to bolster flagging support for the reform, the Commission finally dropped its proposed regulation altogether in October 2017. Focusing on the European Commission's regulatory discourse, Endrejat and Thiemann retrace the Commission's discursive framing of structural reform in terms of the benefits of market making, liquidity and growth in the context of a supposed stability-growth trade off. The authors argue that this Commission effort to get the balance right undermined progress on the draft legislation.

There are numerous other reform possibilities that are not examined in this volume. These include, notably, a range of possible reforms to improve both the efficiency and effectiveness of the SSM and the SRM—and specifically the efficient functioning of the SRB on resolution matters in moments of crisis that require quick decision-making. There are additional potential reforms to improve the (parliamentary) accountability of the ECB, the SSB and the SRB, on bank supervision and resolution issues respectively. Furthermore, there remain a range of possible reforms to the collection of EU rules on banking that are the subject of major ongoing debates among member states and EU institutions, although some—notably bank structural reform—have been pushed off the agenda for the time being. Taken together, the chapters of this edited volume provide us with a nuanced picture of Banking Union's construction problems, lacunae, and governance structure design faults. Banking Union resembles an unfinished cathedral. Given its problematic architecture, there remain important stability risks.

The chapters of this edited volume discuss a range of potential Banking Union reforms and, more generally, seek to stimulate questions for future research on EU bank regulation and supervision. By shedding light on a number of difficult issues facing the design and operation of EU supranational regulation and supervision, this edited volume seeks to provide a contribution that is helpful to both academics and policy makers. Policy evaluation, policy learning and reflections on a new cycle of reforms are ongoing—as demonstrated by the controversial proposals on the creation of an EDIS combined with additional necessary reforms presented by German Finance Minister Olaf Scholz in November 2019 (Scholz 2019).

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## Notes

<sup>1</sup> “Directive 2013/36/EU of the European Parliament and of the Council,” of 26 June 2013, “on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC; available at: <https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0338:0436:EN:PDF>.

“Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Text with EEA relevance; available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32013R0575&from=EN>.

“Directive 2019/878/EU of the European Parliament and of the Council”, of 20 May 2019, “amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures”; Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019L0878&from=EN>. “Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012; available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R0876&from=BG>

<sup>2</sup> “Directive 2014/49/EU of the European Parliament and of the Council”, of 16 April 2014, on deposit guarantee schemes”; available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32014L0049&from=en>

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