European University Institute

ROBERT SCHUMAN CENTRE FOR ADVANCED STUDIES

EUI WORKING PAPERS

RSCAS 2017/48
Robert Schuman Centre for Advanced Studies

The politics of an asymmetric Banking Union

Lucia Quaglia

European University Institute
Robert Schuman Centre for Advanced Studies

The politics of an asymmetric Banking Union

Lucia Quaglia

EUI Working Paper **RSCAS** 2017/48

ISSN 1028-3625

Printed in Italy, September 2017
European University Institute
Badia Fiesolana
I – 50014 San Domenico di Fiesole (FI)
Italy
www.eui.eu/RSCAS/Publications/
www.eui.eu
cadmus.eui.eu

Robert Schuman Centre for Advanced Studies

The Robert Schuman Centre for Advanced Studies (RSCAS), created in 1992 and directed by Professor Brigid Laffan, aims to develop inter-disciplinary and comparative research and to promote work on the major issues facing the process of integration and European society.

The Centre is home to a large post-doctoral programme and hosts major research programmes and projects, and a range of working groups and *ad hoc* initiatives. The research agenda is organised around a set of core themes and is continuously evolving, reflecting the changing agenda of European integration and the expanding membership of the European Union.

Details of the research of the Centre can be found on:
http://www.eui.eu/RSCAS/Research/

Research publications take the form of Working Papers, Policy Papers, Policy Briefs, Distinguished Lectures, Research Project Reports and Books.

Most of these are also available on the RSCAS website:
http://www.eui.eu/RSCAS/Publications/

Abstract

This paper takes stock of the first few years of the functioning of Banking Union by examining the politics an asymmetric Banking Union. It first explains why Banking Union was set up in an incomplete and asymmetric way. It then explains how and why this has resulted in asymmetric effects, beside the original intended effects. It is argued that two competing coalitions mainly driven by different economic interests have shaped the configuration of Banking Union and have been differently affected by it. The paper also reflects on the disjuncture (meaning, overlap and underlap) of competences between levels of governance and supranational–intergovernmental dynamics in Banking Union.

Keywords

Banking Union, SSM, SRM, EDIS, bank resolution

1. Introduction[*]

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

It is argued that two competing coalitions have shaped the configuration of Banking Union; they have been differently affected by it; and they have sought to promote (or hinder) its completion. One coalition, led by German policy-makers, has been keen to establish 'rules' (mainly, restrictions placed on the national authorities), but has been reluctant to set up common mechanisms for financial support, pointing out the danger of 'moral hazard' and the need to sort out national banking problems prior to the completion of Banking Union. The second coalition, led by French policy-makers, with the support of policy-makers from Italy and other 'periphery' member states, has been eager to establish common support mechanisms, but has been reluctant to abide by the new rules set up as part of Banking Union. This coalition has criticised the incompleteness of Banking Union with a view to setting in place the missing components. The result has been an incomplete and asymmetric Banking Union, which has produced asymmetric effects. Moreover, there is a disjuncture (meaning, overlap and underlap) of competences between levels of governance in Banking Union: national, euro area and EU.

The paper proceeds as follows. Section 2 outlines two competing coalitions, their members, their interests and their interactions. Section 3 explains how and why Banking Union was set up in an incomplete way: banking supervision was supranationalised by transferring it to the euro area level (with some caveats); resolution was supranationalised only to a limited degree, maintaining an intergovernmental component, as well as substantial responsibilities at the national level; a common deposit guarantee scheme was not set up; and a common fiscal backstop did not materialise. Section 4 explains how and why an incomplete Banking Union has produced some negative effects, beside the original intended effects. In particular, there has been limited harmonisation of bank resolution practices amongst the member states and the national authorities seem to be inclined to apply the 'Sinatra doctrine' by dealing with ailing banks in 'their own ways'. This has produced inconsistencies - a patchwork - across Banking Union. Furthermore, Banking Union has weakened the ability of the national authorities to deal with ailing banks, without sufficiently strengthening the capability of supranational authorities to do so.

2. Competing coalitions in Banking Union

This paper analyses the setting up and the functioning of Banking Union by taking an intergovernmental perspective, albeit considering also the role of supranational actors. Accounts that focus (not exclusively) on the preferences and the influence of the member states have been used to explain the construction of Economic and Monetary Union (EMU) (e.g.Dyson and Featherstone 1999, Moravcsik 1998), the functioning of EMU (e.g. Dyson 2000, Dyson 2008), the response to the

[*] This paper was written while Lucia Quaglia was a research fellow first at the BIGSSS (University of Bremen) and the Hanse-Wissenschaftskolleg (HWK) and then at the Scuola Normale Superiore (SNS), Florence. It was presented at the JMF alumni conference at the EUI in June 2017. I wish to thank the participants for their insighful comments.

sovereign debt crisis in the euro area (Fabbrini 2013; Schimmelfennig 2015), and the construction of Banking Union (Howarth and Quaglia 2016a). More generally, recent literature has pointed out the trend towards the 'new intergovernmentalism' in the EU (Bickerton, Hodson, Puetter 2015), albeit with considerable variations across policy areas. With reference to recent EU crises, Jones et al. (2016) have argued that intergovernmental bargaining leads to incomplete solutions based on the 'lowest common denominator', which deepen integration, but lay the seeds for subsequent crises in the EU. Over time, a new crisis builds up and the member states respond to it with solutions based on the lowest common denominator.

Building on this literature, this paper identifies two competing coalitions of member states that shared similar economic interests and articulated similar views concerning Banking Union. The arguments put forward by the two coalitions reflected long-standing debates between 'creditors' and 'debtors' countries in the EU (or 'saints' and 'sinners' as Dyson 2014 puts it). The interests of the member states had mostly to do with their fiscal positions, but also the overall 'health' of their national banking systems. Supranational actors, specifically, the European Commission and the European Central Bank (ECB), were instrumental in the construction of Banking Union (Epstein and Rhodes 2016) and favoured the supranationalisation of all its components, meaning the transfer of supervision, resolution and deposit protection from the national level to the Banking Union level. However, these supranational bodies were aware of what was (or not) politically feasible and of the need to strike a balance between the (different) preferences of the member states.

The first coalition, which was led by French policy-makers and included policy-makers from Italy and other countries in the euro area periphery, advocated the establishment of Banking Union quickly in order to deal with the sovereign debt crisis in the euro area periphery, as detailed in the following section. Policy-makers in these countries were keen to secure financial support mechanisms for ailing banks and sovereigns. In return, they were willing to accept the supranationalisation of banking supervision as well as new rules on bank resolution (first and foremost, the bail in). States in the periphery of the euro area shared similar interests: they had weak fiscal positions and several ailing banks, some of which, especially in Italy, had not been bailed-out during the height of the crisis and were subsequently penalised by the low economic growth in the euro area periphery (Hardie and Howarth 2013). These banks were interconnected to the rest of the national banking system and held considerable amounts of national government bonds, posing the risk of contagion that could undermine the confidence in the national banking system and its sovereign. Banking Union was therefore seen by policy-makers in the periphery of the euro area as a solution to the 'doom loop' banks-sovereigns (Veron 2012; Marzinotto et al. 2011). In Banking Union, national policy-makers in the periphery faced the issue of dealing with ailing banks within the new framework set up by Banking Union, in particular, the rules on private sector burden sharing and the bail-in, as explained in Section 4.

A competing coalition, which was led by German policy-makers and included policy-makers in Austria, Finland and the Netherlands (the last two with some caveats), was reluctant to set up Banking Union, especially mechanisms for financial support to (foreign) ailing banks and their sovereigns. The German authorities were particularly concerned about moral hazard - that is to say, not to provide incentives for 'risky' behaviour of sovereigns and banks - and legacies problems deriving from past supervisory forbearance (Schaeffer 2016). This coalition was therefore keen to supranationalise banking supervision for systemic banks – an important qualification for Germany and Austria, given the dual configuration of their national banking systems - but not resolution (except to a limited extent), deposit insurance and a common fiscal backstop (Howarth and Quaglia 2016a), as detailed in Section 3. Germany, Austria, Finland and the Netherlands shared similar interests: they had sound fiscal positions and were likely to be net contributors to any mechanism for financial support in Banking Union. Policy-makers in these countries were therefore keen to prevent moral hazard and to minimise the elements of Banking Union that could result in fiscal transfers from fiscally and financially stable member states to ailing member states. Moreover, Germany, Austria and to some extent the Netherlands and Finland, bailed out their banks in the aftermath of the international financial crisis, hence these banks were in a relatively good shape when Banking Union was set up (Hardie and Howarth 2013). In Banking Union, the new rules on resolution, especially the bail-in, were (at least on paper) easier to apply in these countries because there were fewer ailing banks, the new rules did not affect many retail bonds holders, and national (or associational) deposit guarantee schemes protected depositors above 100.000 euros, as elaborated in Section 4.

Germany was the largest economy in the euro area, it had a large current account surplus and a sound fiscal position. For these reasons, German policy-makers enjoyed a kind of veto power in the construction of Banking Union (Bulmer 2016; Bulmer and Patterson 2013), although one constrained by the threat of sovereign debt default in the euro periphery, contagion and euro area disintegration. Indeed, German policy-makers, like policy-makers in other euro area members, were concerned about the potential breaking up of the euro (Epstein and Rhodes 2016; Schimmelfennig 2015). As it had happened with reference to EMU, the German authorities agreed to Banking Union, but they had a strong 'imprint' in its construction, which was somewhat a 'lighter' version of that initially proposed in three main respects: resolution, deposit guarantee and fiscal backstop, as explained in the following section. Overall, Banking Union was built in an asymmetric way because different forces pulled in somewhat different directions. The effects of the functioning of Banking Union have not brought together the two coalitions, and the existing division has been reinforced, as explained in Section 4.

It is also worth noting an interesting historical parallel between EMU and Banking Union (Howarth and Quaglia 2015). Banking Union was the response to a crisis triggered by an incomplete EMU. Indeed, the architects of EMU – the central bank governors and expert members of the Committee for the study of economic and monetary union under the chairmanship of Commission President Jacques Delors – had advocated the transfer of prudential supervision to the supranational level to complement monetary union (1989, para. 32). However, the transfer of supervisory powers was postponed given the opposition of a number of national governments (Dyson and Featherstone 1999). Furthermore, during the negotiations leading to the Maastricht Treaty, some member states, first and foremost Germany, opposed a fiscal (or transfer) union for political and economic reasons. Politically, it was seen as a step too far, impinging upon a core area of national sovereignty. Economically, member states with sound fiscal positions, led by Germany, were concerned by the potential moral hazard that a fiscal union would bring about, and that they would end up financing countries that lacked sufficient fiscal discipline (Dyson and Featherstone 1999).

The result was the establishment of an asymmetric EMU, whereby monetary union did not include banking supervision and was not coupled by a full economic (fiscal) union (Dyson 2000; Verdun 1996). By 2012, in the context of a devastating sovereign debt crisis and the very real menace of the imminent collapse of the Spanish banking system, Spanish government default and euro area collapse, euro area governments agreed to Banking Union. Banking Union was presented as the completion of EMU, addressing a fundamental flaw in the design of EMU (Van Rompuy 2012). But even Banking Union was incomplete, without a fiscal backstop and a common deposit guarantee scheme.

3. The making of an incomplete Banking Union (2012-14)[1]

In June 2012, the President of the European Council, the President of the Eurogroup, the President of the Commission and the President of the ECB, presented an interim report titled 'Towards a Genuine Economic and Monetary Union'. The Van Rompuy (2012) report, which was also known as the Four Presidents Report, proposed what later became known as Banking Union. The project of Banking Union was subsequently endorsed by the European Council and the euro area summit in June 2012.

[1] This section draws on Howarth and Quaglia (2016a).

The main objective of Banking Union was to break the 'vicious circle' between ailing banks and struggling sovereigns (Allen at al. 2013; Pisani-Ferry 2012).

The main supporters of Banking Union were policy-makers in the member states in the euro area periphery, first and foremost Spain and Italy, which were hit by the sovereign debt crisis (*Financial Times*, 5 December 2012). French policy-makers were worried by the fact that French banks were heavily exposed in Southern Europe and France would have been the next country, after Italy, to be at risk of financial contagion. Policy-makers in these countries pointed out the need to move quickly to Banking Union. By contrast, German policy-makers argued that timing was not the essence and that it was instead important to get the right institutional arrangements in place (*Financial Times*, 6 December 2012). British policy-makers, given the fact that the UK was not part of the single currency and had a very internationalised rather than 'Europeanised' banking system, lacked an incentive to join Banking Union. The UK by and large supported the Banking Union project, but declared at the outset that it would not be part of it. For example, in the summer of 2011, the British Chancellor Osborne called for 'permanent changes' to stabilise the euro area in the medium and long term (*Financial Times,* 20 July 2011), arguing that there was a 'remorseless logic' for a banking and fiscal union in the euro area.

The ECB-centric SSM

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

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

The 'hybrid' SRM

In July 2013, the Commission proposed the establishment of the SRM, designed to complement the SSM (Veron and Wolf 2013). Most of the negotiations concerned the decision-making process in the SSM and the establishment of the Single Resolution Fund (SRF) financed by bank levies raised at the national level. The Commission, supported by French, Spanish and Italian policy-makers, wanted to be given the final power to decide whether to place a bank into resolution and determine the application of resolution tools. However, German policy-makers argued that the Single Resolution Board (SRB) should be given this power and insisted on setting up the SRF through an intergovernmental agreement among the participating member states (*Financial Times*, 8 November 2013.).

The ECB argued that the SRM was 'a necessary complement to the SSM, as the levels of responsibility and decision-making for resolution and supervision have to be aligned' (ECB 2013, p.

3). In November 2013, the ECB issued a 32-page opinion that the SRB should be, from the start, a single 'strong and independent' body, thus directly challenging the German position that the SRM should begin as a network of national authorities (*Financial Times*, 8 November 2013). Along similar lines, Michel Barnier, the EU Commissioner responsible for financial services, pointed out that 'we are building is a single system and not a multi-storey intergovernmental network (*The Telegraph*, 18 December 2013).

In March 2014, an agreement was reached on the establishment of the SRM. As advocated by German policy-makers, the SRB would be responsible for the planning and resolution of cross-border banks and those directly supervised by the ECB, while national resolution authorities would be responsible for all other banks, except if a bank required access to the SRF. Moreover, the SRF, financed by bank levies raised at national level, would initially consist of national compartments that would be gradually merged over eight years (Alexander 2015). The SRM regulation was adopted in conjunction with the Bank Recovery and Resolution Directive (BRRD), which harmonised resolution instruments and powers in the EU. The BRRD and the SRM regulation introduced a new instrument in bank resolution, the bail-in, which reduced substantially the need for public funding to bail out banks (Nielsen and Smeets 2017). Thus, the SRM would be 'fiscally neutral' (Eurogroup and Ecofin 2013, p. 1). German policy-makers, supported by the Dutch, Austrian and Finnish policy-makers, insisted on an earlier entry into force of the bail-in than the originally envisaged date in 2018. The start date was eventually moved forward to 2016 (*The Economist*, 14 December 2013).

The position of the German authorities needs to be elaborated further (see also Donnelly 2014; Epstein and Rhodes 2016; Schäffer 2016). Before the proposal for Banking Union was put forward, German policy-makers had repeatedly pointed out the need to have the responsibility for supervision and resolution at the same level of governance, so as to avoid moral hazard. In other words, they opposed the idea of pooling national financial resources at the euro area level to pay for the resolution of banks across the euro area that were not subject to common supervision. However, once the SSM was agreed, the German authorities remained reluctant to supranationalise bank resolution for fear of past national supervisory forbearance and the legacy problems plaguing national banking systems. Furthermore, German policy-makers — joined with the Austrian, Dutch and Finns — insisted that the funds of the European Stability Mechanism (ESM) could not be used to cover legacy problems, to be revealed by a comprehensive assessment of euro area banks by the ECB (Howarth and Quaglia 2016a), as elaborated below.

The missing EDIS

The missing component of Banking Union was what later became to be known as the European Deposit Insurance Scheme (EDIS) (see Gros and Schoenmaker 2014). In June 2012, the interim Van Rompuy (Four Presidents) report mentioned the need to set up a EDIS. According to the *Financial Times* (13 September 2012), the Commission had prepared a draft proposing a new agency, the European Deposit Insurance and Resolution Authority (EDIRA), which would control a new European Deposit Guarantee and Resolution Fund. Due to German opposition, the proposal for the EDIRA was removed from the final Commission document 'A Roadmap Towards Banking Union' (*Financial Times*, 13 September 2012). Hence, the final Van Rompuy report issued in December 2012 only made reference to the 'Agreement on the harmonisation of national resolution and deposit guarantee frameworks, ensuring appropriate funding from the financial industry' (Van Rompuy 2012, p. 4).

German policy-makers criticised a EDIS as an unacceptable step towards debt mutualisation. The coalition agreement between the Christian Democratic Union (CDU), the Christian Social Union (CSU) and the Social Democratic Party (SPD) explicitly rejected the idea (Koalitionsvertrag 2013: 94). German banking associations and individual banks feared that a EDIS would impinge upon their sectoral institutional protection schemes (*Handelsblatt*, 7 November 2012). Moreover, German banks feared that they would likely become net contributors to a EDIS — bailing out depositors in other euro area member states. By contrast, policy-makers in France and in the euro area periphery regarded the EDIS as the final pillar of Banking Union, necessary to severe the doom loop between banks and sovereigns (*Reuters*, 11 September 2015). For example, the Italian authorities repeatedly pointed out that 'coherence is needed between the centralisation of supervision and the management of financial difficulties' (Szego 2013: 7, authors' translation). The ECB regarded the EDIS as an important component of Banking Union, but one that could be implemented at a later date, as pointed out by ECB Vice President Vitor Constâncio (2014).

The issue came back on the policy agenda in June 2015, when EU leaders — including ECB president Mario Draghi and Commission President Jean-Claude Juncker — endorsed the creation of the EDIS in the so-called 'Five Presidents' Report' on the future of the euro. In the autumn of 2015, the Commission proposed the EDIS for bank deposits in the euro area as 'the third pillar of the Banking Union' (Commission 2015). The Commission proposal would, as a first step, involve the establishment of a mandatory 'reinsurance' scheme that would 'contribute under certain conditions when national deposit guarantee schemes are called upon', thus in effect act as a backstop to national deposit guarantee schemes (Commission 2015).

This initiative took place despite explicit German opposition. The German finance minister, Wolfgang Schäuble argued that there was a 'moral hazard problem': 'as soon as you share risk, the decisiveness to reduce risk is lessened' (*Financial Times*, 8 December 2015). His concern was that 'German taxpayers' will have to 'foot the bill' (*Financial Times*, 10 September 2015). German policy-makers also had good reason to fear that a number of member states would have difficulty meeting the target level for ex ante contributions from banks to national deposit guarantee schemes agreed in the 2014 revised directive (Howarth and Quaglia 2016a). As in the case of the creation of the SRF, the discussion on the creation of a EDIS pitted countries expected to make net contributions to common rescue funds — either from taxpayers or from banks — against those that expected to be the principal recipients (Donnelly 2014). In order to make progress on the EDIS and overcome German opposition, the European Commission proposed that savings and cooperative banks be exempted from having to contribute to the EDIS (*Reuters*, 2 November 2015).

The lack of a common fiscal backstop

Finally, the credibility of the SRM/SRF and the EDIS was linked to the possibility of accessing a common fiscal backstop. Given unanimity rules on the use of the ESM, German policy-makers enjoyed a veto on any decision to engage in direct bank recapitalization. Under the rules established for the direct recapitalization of banks, euro area member states agreed that a bank's creditors should absorb 'appropriate' losses before ESM funds could be accessed. These appropriate losses were defined by the BRRD's rules on the bail in. Moreover, ESM rules required a bank's home government to contribute at least twenty per cent of the recapitalization (initially) and then ten per cent from 2017. German policy-makers — joined by the Austrian, Dutch and Finns — insisted that ESM funds could not be used to cover legacy problems. Hence, the fiscal backstop did not materialize. However, as noted by the ECB's Executive Board member Peter Praet (2016) 'In the future it will be necessary to create a common fiscal backstop to ensure that the SRF has sufficient resources to support the resolution measures taken by the Single Resolution Board'.

Overall, Banking Union was set up in timely fashion between 2012 and 2014. However, it was incomplete and asymmetric in three main respects. First, member states governments retained their vetoes on the mutualisation of national funds and an important say on the use of resolution funds in the SRM. A rather 'complex' compromise was reached concerning the resolution process in the SRB. Moreover, resolution mostly remained a national matter. De facto, the SRB has so far resolved only one bank. Second, the EDIS was not set up. Third, no common fiscal backstop was established.

4. The functioning and the effects of an asymmetric Banking Union

In the short term, the setting up of Banking Union – together with the pledge of the ECB to 'do whatever it takes to save the euro' - were successful in stopping the sovereign debt crisis in the euro periphery. In 2014, three SSM milestones were reached. First, the ECB published a list of 128 banks subject to direct ECB supervision. The thousands of smaller, so-called 'less significant' banks headquartered in the euro area would continue to be under the direct supervision of the national competent authorities, according to increasingly harmonised rules and practices. Second, the ECB endorsed the SSM Supervisory Manual and published a Guide to Banking Supervision, which had been drawn up by a task force consisting of ECB staff and experts from the national competent authorities (ECB 2014a). Third, the ECB published its comprehensive assessment of the banks subject to its direct supervision (ECB 2014b). This comprehensive assessment consisted of the ECB's assets quality review (AQR) and the EBA's stress tests.

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

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

The SRB was set up as an EU agency in 2015 and so far it has resolved one bank. In December 2014, the Council of Ministers reached a political agreement on the implementing Regulation determining the contributions to be paid by banks to the SRF (Council 2014), whereby banks in France and Germany, the two biggest euro area economies, would contribute the bulk of the SRF's financial resources (€55 billions), followed by Italy, the third biggest euro area economy (*Reuters*, 18 December 2014). Smaller banks — broadly defined as those with total assets of up to €1 billion — would pay a lower flat contribution rate.

Despite the functioning of the SRM and the entry into force of the BRRD, resolution practices in the member states have continued to differ in Banking Union. Indeed, there has been a considerable variation in the way in which the national authorities have dealt with ailing banks, in particular concerning the important question of 'who pays' (Mayes 2004). In certain cases, such as Austria and Greece, subordinated and senior creditors were bailed-in, with some compensation concerning the state guarantee in Austria. In other cases, such as Portugal, selected senior (foreign) creditors were bailed-in. In Spain, the SRB intervened for the first time to resolve a bank that was later taken over by a larger bank. In Italy, there was a gamut of cases: subordinated creditors were bailed-in and some retail investors were then partly compensated by the state; healthy banks were involved in a private sector bail-out orchestrated by the public authorities; precautionary recapitalisation was used to get around the bail-in and to avoid the SRB's involvement; finally banks were liquidated by the national authorities according to national law, and were later acquired by a larger bank.

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

In Portugal, the resolution of *Novo Banco* (former Banco Espiritu Santo), involved the selective bail-in of some of senior (foreign) creditors for approximately €2 billion. Although Novo Banco had about €5.4 billion of senior debt, only 5 tranches of it, mostly held by institutional investors, were wiped out, triggering a set of legal proceedings initiated by the creditors hit by the bail in (World Bank 2016). In Spain, the rural bank *Bantierra* received financial support in 2012, 2013 and 2015 from the insolvency fund of the Spanish Association of Rural Banks, which is the largest cooperative group in Spain. In March 2017, Bantierra received a further capital injection of €328 million from the Association, while the Banco de Espana considered a solution similar to the Atlas fund set up in Italy and discussed below (*El Mundo*, 5 March 2017). In June 2017, the ailing *Banco Mare Nostrum*, which was state owned, following the bail-out and merger of several cajas, was acquired by Bankia, which was the biggest bank in Spain, resulting from the mergers of several cajas that had been bailed-out (*Reuters*, 27 June 2017). In July 2017, the SRB resolved the Banco Popular: shareholders and bondholders suffered losses and the bank was later acquired by Santander for a relatively low price. In the deal, Santander benefitted from tax exemptions granted by the Spanish authorities. A compensation scheme in the form of new bonds was offered to retail investors who had bought shares and subordinated bonds of the Banco Popular (*Global Capital*, 18 July 2017).

In Italy, four small banks (Banca Marche, Cassa di risparmio di Ferrara, Popolare Etruria e CariChieti), were resolved in late 2015. Junior subordinated creditors were bailed-in and later some retail investors were partly compensated by the state. In early 2016, a state guarantee scheme on banks' non-performing loans was set up, and a new state-sponsored bank-financed fund (Atlas 1) was created to buy tranches of non- performing loans. Atlas also acted as the underwriter of last resort for the precautionary recapitalisation undertaken by two ailing banks in the Veneto region, which had failed the ECB's comprehensive assessment (*Sole 24 Ore*, 8 April 2016). In the summer of 2017, the fund Atlas 2 was set up to help dealing with the problems of the Monte dei Paschi di Siena, which had been the largest bank to fail the ECB's comprehensive assessment. Eventually the preventive recapitalisation of the MPS with public money was carried out in June 2017, accompanied by burden sharing for shareholders and junior debt holders, with some compensation for retail investors. In June 2017, the two ailing banks of the Veneto region, which were under the direct supervision of the ECB in SSM, were declared no longer viable. The SRB decided not to intervene and these banks were liquidated by the Italian authorise according to the Italian insolvency law. The Italian authorities de facto avoided or side-stepped the application of the new EU rules prohibiting the bail out and prescribing the bail in.

Three main reflections concerning the effects of an incomplete and asymmetric Banking Union are in order. First, the Sinatra doctrine in dealing with ailing banks was a political necessity, given the political salience of bank resolution and the different configurations of national banking systems. In Italy, many junior and senior bank bonds were hold by retailers - this made the bail very difficult from a political point of view. Yet, the BRRD and SRM were supposed to harmonise national frameworks and practices concerning bank resolution. The current 'patchwork' has implications for the levelled playing field for banks and their creditors (including bond holders and depositors) across countries. It is also potentially detrimental to financial stability, given the difficulty of resolving effectively and in a timely manner cross-border banks, if national specificities persist.

Second, the supranationalisation of only one component of Banking Union, namely, supervision, the partial supranationalisation of resolution, as well as the absence of the EDIS and the common fiscal backstop, have produced negative effects in the euro area periphery. Although the problems of ailing banks mostly resulted from past legacies and would have existed within or without Banking Union, the ECB-led supervision in the SSM exposed these banking problems more starkly. A clear example was the ECB's comprehensive assessment, which highlighted that several banks suffered from non-performing loans. Whereas in the past, national supervisory forbearance was a common practice, this was no longer possible under the supervision of the ECB in the SSM. In certain cases, such as the Monte dei Paschi di Siena, the viability of the bank was at risk. Bank resolution remained to a large extent a national matter, but it was complicated by an incomplete Banking Union. German policy-makers would argue that a larger SRF, the EDIS and the fiscal backstop are not necessary, given the bail-in rules, which are supposed to reduce the need for common rescue funds — either from taxpayers or banks — to deal with ailing banks. However, the bail-in is often politically controversial and judicially contested, especially if retail investors are affected (as in the case of Italy), or creditors are selectively bailed-in (as in Portugal), or there are state guarantees (as in the Austrian case).

Moreover, the bail-in of bank creditors could have contagion effects, triggering the doom loop in the periphery. Indeed, an incomplete Banking Union has revealed the structural difficulty of breaking the 'doom loop' in the euro area periphery. Following the entry into force of the bail-in rules and given the fact that in the euro area periphery the debt of ailing banks was mostly owned by financial institutions and in some cases retail investors in the same country, there was the danger of contagion effects within national banking systems. Furthermore, banks in the euro area periphery also had considerable amount of public debt of their national government on their balance sheets, hence there was the risk of re-igniting the doom loop that Banking Union was supposed to stop.

Third, an incomplete Banking Union seems to make more difficult - to be precise, more time-consuming, less cost-effective for the public finances and the private sector, and more socially disruptive - to deal with banking crises or the failures of individual banks. This is because some competences no longer belong to the national authorities, they have been transferred to different authorities at the euro area level (the ECB-SSM and the SRB) and EU level (the Commission) – these authorities sometimes act in a poorly coordinated way. In a nutshell, the ECB decides whether a bank under its direct supervision is 'failing or likely to fail'. The SRB is in charge of resolving banks whose resolution is in the 'public interest'. Other failing banks are liquidated by the national authorities according to national law. The Commission monitors the use of state aid, its effects on competition as well as the application of rules on private sector burden-sharing. Yet, the political responsibility for ailing banks remains at the national level, and so does the fiscal capacity to bail out banks, subject to EU rules.

In practice, there is a misalignment of competences and incentives between authorities and levels of governance in Banking Union. There seems to be a power vacuum that de facto strengthens big (solid) banks, making them pivotal players in order to deal with other ailing banks in the system. Intesa in Italy and Santander in Spain were the most notable examples. This happens because big (solid) banks have considerable financial firepower, partly as a consequence of Banking Union and financial integration in the EU more generally. At the same time, the national authorities are weaker - they have fewer powers and competences - following the setting up of Banking Union. Yet, the EU authorities have not been sufficiently strengthened to compensate for the competences lost by the public authorities at the national level. Timely coordination concerning the management of ailing banks is already difficult at the national level because different authorities with different incentives are involved. The process is even more difficult when powers and competences are split across levels of governance, but the political responsibility mostly remains national.

As pointed out by the ECB's Executive Board member Praet (2017) 'While supervisory decisions are taken at European level, the relevant risk-sharing mechanisms such as deposit insurance schemes are still at national level. Supervision is common, but the consequences of potential bank failures are still predominantly national…Both supervisory responsibility and the fiscal backstop need to be at European level, to underpin durably confidence in the area-wide financial system…. For the same reason, it will also be necessary the establishment of a EDIS, with a credible backstop'. The most penalised by the disjuncture deriving from an incomplete Banking Union and the most affected by its undesirable effects mentioned above are countries in the periphery of the EU, which have several ailing banks as well as banking systems in a bad shape. Hence, a coalition led by policy-makers in France, Italy (which, given its banking problems, has been very vocal on this, see *Politico*, 2 October 2016, *Euronews*, 5 May 2016, Rossi 2016, Visco 2016) and Spain has called for the completion of Banking Union, with some support from the Commission and the ECB. Yet, some of these countries, notably, Italy, have side-stepped the rules of Banking Union, making the concerns of German policy-makers more justifiable and the completion of Banking Union more difficult.

Conclusion

Banking Union was a radical initiative to stabilise euro-periphery national banking systems exposed directly to rising sovereign debt loads and the growing risk of default – the 'sovereign debt-bank doom loop' – and to reverse the fragmentation of European financial markets. Banking Union was supposed to set in place a 'risk-sharing framework for the member states, which would allow costs of resolution to be spread across the euro area, contributing to breaking the bank-sovereign doom loop' (Draghi 2014). In the short term, Banking Union succeeded in stopping the sovereign debt crisis in the euro area, even though the doom loop was not severed and financial fragmentation across the member states remained. In the medium term, the incomplete Banking Union had asymmetric effects, promoting the supranationalisation of supervision, but not of resolution and deposit insurance. Consequently, in Banking Union there has been a limited convergence of resolution practices across countries – a sort of Sinatra doctrine in dealing with ailing banks – as well as limited risk-sharing arrangements. The asymmetric Banking Union and its effects pose considerable economic and political risks to the project. However, different national interests and political sensitivities hinder progress towards a full Banking Union, making for a 'bumpy road' ahead.

References

Alexander, K. (2015) 'European Banking Union: A Legal and Institutional Analysis of the Single Supervisory Mechanism and the Single Resolution Mechanism', *European Law Review*, 40 (2): 154-187.

Allen, F., Carletti, E., and Gray, J. (2013) *Political, Fiscal and Banking Union in the Eurozone?,* FIC Press, Philadelphia.

Asmussen, J. (2012) 'Key issues about the crisis and the European response', Speech, 20 April 2012.

Bickerton, C., Hodson, D. and Puetter U. (eds) (2015) *The New Intergovernmentalism*, Oxford University Press, Oxford.

Bulmer, S. (2014) 'Germany and the Eurozone Crisis: Between hegemony and domestic politics', *West European Politics*, 37 (6): 1244-1263.

Bulmer, S., and Paterson, W. E. (2013) 'Germany as the EU's Reluctant Hegemon? Of Economic Strength and Political Constraints', *Journal of European Public Policy*, 20 (10): 1387-1405.

Committee for the Study of Economic and Monetary Union (1989) *Report on Economic and Monetary Union in the European Community (Delors Committee Report)*, Brussels: CEC.

Constâncio, V. (2014) 'Banking Union and European integration', Speech at the OeNB Economics Conference, Vienna, 12 May.

De Rynck, S. (2015) 'Banking on a Union: The politics of changing Eurozone banking supervision', *Journal of European Public Policy,* 23 (1): 119-135.

Donnelly S. (2014) 'Power Politics and the Undersupply of Financial Stability in Europe', *Review of International Political Economy*, 21 (4): 980-1005.

Draghi, M. (2014), Speech, https://www.ecb.europa.eu/press/key/date/2014/html/sp140212.en.html

Dyson, K.H. (2014) *States, Debt, and Power. 'Saints' and 'Sinners' in European History and Integration,* Oxford University Press, Oxford.

Dyson, K. (ed.) (2008) *European States and the Euro*, Oxford University Press, Oxford.

Dyson, K. H. (2000) *The Politics of the Eurozone*, Oxford University Press, Oxford.

Dyson, K., & Featherstone, K. (1999) *The Road to Maastricht, Negotiating Economic and Monetary Union*, Oxford University Press, Oxford.

Epstein, R. and Rhodes, M. (2016) 'The political dynamics behind Europe's New Banking Union', *West European Politics,* 39 (30): 415-37.

Euro Group (2013) *Statement of Eurogroup and ECOFIN Ministers on the SRM backstop,* 18 December.

European Central Bank (2014a) Asset Quality Review: Phase 2 Manual, March, Frankfurt.

European Central Bank (2014b) Guide to Banking Supervision, November, Frankfurt.

European Central Bank (2013) *Banking Structures Report*, November, Frankfurt.

European Commission (2015) *Proposal for a EDIS*, https://ec.europa.eu/info/publications/commission-proposal-european-deposit-insurance-scheme-edis_en

Fabbrini, S. (2013) 'Intergovernmentalism and Its Limits: Assessing the European Union's Answer to the Euro Crisis', *Comparative Political Studies*, 46 (9): 1003-1029.

Federal Government (2015) *The EMU Needs a Stronger Banking Union, but Must Get it Right*. Non paper, 8 September, on file with the authors.

Ferran, E., and Babis, V. (2013) 'The European Single Supervisory Mechanism', *Journal of Corporate Law Studies*, 13: 255-285.

Glöckler, Lindner, J. & Salines M. (2016) 'Explaining the sudden creation of a banking supervisor for the euro area', *Journal of European Public Policy*, 24 (8): 1135-1153.

Gonzalez-Paramo, J.M. (2012) 'Completing the euro project: The day after tomorrow', Speech, 18 May.

Gren, J., Howarth, D., and Quaglia, L. (2015) 'Supranational Banking Supervision in Europe: The Construction of a Credible Watchdog', *Journal of Common Market Studies*, 53 (S1): 181-199.

Gros, D., and Schoenmaker, D. (2014) 'European Deposit Insurance and Resolution in the Banking Union'. *Journal of Common Market Studies*, 52(3): 529-546.

Jones, E., Kelemen, D., Meunier S. (2016) 'Failing forward? The Euro crisis and the incomplete nature of European integration', *Comparative Political Studies* 49 (7): 1010-1034.

Koalitionsvertrag (2013) 'Deutschlands Zukunft gestalten Koalitionsvertrag zwischen CDU, CSU und SP', *18. Legislaturperiode*.

Howarth, D. and Quaglia, L. (2016a) *The Political Economy of Banking Union,* Oxford University Press, Oxford.

Howarth, D. and Quaglia, L. (2016b), 'Internationalized Banking and National Preferences on European Central Bank Supervision', *West European Politics* 39 (3): 438-461.

Howarth, D. and Quaglia L. (2015), 'The political economy of the euro area's sovereign debt crisis: Introduction', *Review of International Political Economy,* 22 (3): 457-484.

Mayes, D. G. (2004) 'Who Pays for Bank Insolvency?', *Journal of International money and Finance*, 23 (3): 515-551.

Marzinotto, B., Pisani-Ferry, J. and Wolff, G. (2012) 'An action plan for Europe's leaders', *Policy Contribution,* 2011/09, Bruegel.

Moravcsik, A. (1998) *The Choice for Europe,* Cornell University Press.

Nielsen, B., & Smeets, S. (2017) 'The role of the EU institutions in establishing the banking union. Collaborative leadership in the EMU reform process', *Journal of European Public Policy,* http://dx.doi.org/10.1080/13501763.2017.1285342.

Pisani-Ferry, J. (2012) 'The Euro Crisis and the New Impossible Trinity', *Bruegel Policy Contribution* 2012/01.

Praet, P. (2017) 'Remarks', Rome, 24 January 2017,http://www.bis.org/review/r170125c.htm

Rossi, S. (2016) 'Speech: The Banking Union in the European integration process', CUOA Business

School, Altavilla Vicentina, 7 April.

Saccomanni F. (2013) *Letter of Italian Finance Minister Saccomanni to the other finance minsters*. 13 December.

Salines, M., Glöckler, G., and Truchlewski, Z. (2012) 'Existential Crisis, Incremental Response: the Eurozone's Dual Institutional Evolution 2007-2011', *Journal of European Public Policy,* 19 (5): 665-681.

Schaffer, D. (2016) 'A Banking Union of Ideas? The Impact of Ordoliberalism and the Vicious Circle on the EU Banking Union', *Journal of Common Market Studies*, 54 (4): 961–980.

Schimmelfennig, F. (2016) 'A Differentiated Leap forward: Spillover, Path-dependency, and Graded Membership in European Banking Regulation', *West European Politics*, 39 (30): 483-502.

Schimmelfennig, F. (2015) 'Liberal intergovernmentalism and the euro area crisis', *Journal of European Public Policy* 22(2): 177–95.

Schoenmaker, D. (2013) *Governance of International Banking: The Financial Trilemma,* Oxford University Press, Oxford.

Szego, A. (2013) *Senato della Repubblica*: *Esame degli atti comunitari Proposta di direttiva sui conti di pagamento e Proposta di Regolamento sul Sistema Unico di Risoluzione* https://www.bancaditalia.it/pubblicazioni/interventi-vari/int-var-2013/Audizione-Szego-17-10.pdf accessed on 4 December 2015.

Valiante, D. (2014) 'Framing Banking Union in the Euro Area: Some Empirical Evidence', *CEPS Working Document* 388.

Van Rompuy, H. (2012) *Towards a Genuine Economic and Monetary Union,* [Four Presidents report], Brussels.

Verdun, A. (1996) 'An "Asymmetrical" Economic and Monetary Union in the EU: Perceptions of Monetary Authorities and Social partners?', *Journal of European Integration*, 20 (1): 59-81.

Veron, N. (20012) 'Europe's Single Supervisory Mechanism and the long journey towards Banking Union', October.

Véron, N., and Wolff, G. B. (2013) 'From Supervision to Resolution: Next Steps on the Road to European Banking Union', *Bruegel Policy Contribution,* 2013/04.

Visco, I. (2016) Speech: the State of the Union , Florence, 5 May 2016

World Bank (2016) *Bank resolution and 'bail'in' in the EU: selected case studies pre and post BRRD.*

Author contacts:

Lucia Quaglia
University of Bologna
Department of Political Science
Via dei Bersaglieri 6
40125 Bologna
Italy
Email: lucia.quaglia@unibo.it