

European Banking Union: Current Outlook and Short-Term Choices

statement by Nicolas Véron

Senior Fellow, Bruegel, and Visiting Fellow, Peterson Institute for International Economics
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The launch of Europe’s banking union on 29 June 2012 was arguably the European Union (EU)’s most consequential policy initiative since the start of its financial crisis in mid-2007. Banking union, defined as the transfer of banking sector policy from the national to the European level, is a highly ambitious project. Its completion will take many more years, but it is already changing the structures of the European financial system and has wide-ranging political implications. Its implementation to date, while protracted and far from straightforward, is broadly in line with the initial commitment.

As decided in June 2012, the first steps are the formation of a Single Supervisory Mechanism (SSM) within the European Central Bank (ECB) and its corollary, a comprehensive assessment of the euro area’s largest banks, generally referred to as its most critical component, the Asset Quality Review (AQR).¹ At this juncture, the prospects for the AQR and the establishment of the SSM to be successfully implemented before the end of 2014 are encouraging, even though the most difficult phase still lies ahead.

If this success is confirmed, it can be expected to improve the functioning of Europe’s banking system and its contribution to the broader economy. However, it cannot be expected to resolve the current European crisis entirely, as further efforts will be needed to address the EU’s severe institutional mismatches. Specifically, the bank-sovereign vicious circle, which has been correctly identified as a key factor of instability, cannot be eliminated without further progress towards fiscal and political union.

In the short term, the most critical policy choices are those that relate to the conduct of the AQR and its likely consequences in terms of bank restructuring in 2014 and early 2015, even though the legislative discussion on a future Single Resolution Mechanism (SRM) currently attracts more media attention.

Why a Banking Union? Origins and Early Impact

While analysts had advocated various forms of EU banking policy integration for years and even decades, the trigger for the June 2012 decision was the deterioration of market conditions for euro area sovereign debt that started in 2010 and accelerated in mid-2011, with the contagion then extending to large countries such as Spain and Italy (as well as French banks for a brief time in August 2011) and creating doubts about the sustainability of the euro itself. From an analytical standpoint, the characterization of the bank-sovereign vicious circle as a driver of instability became increasingly

¹ Following widespread practice, the acronym AQR is used here to designate the entire process which is formally referred to by the ECB as the Comprehensive Assessment.

accepted in the course of 2011. This in turn led to an acceleration of the policy debate on banking union in the spring of 2012,² culminating in the landmark euro area summit statement of 29 June. This starts with the words “We affirm that it is imperative to break the vicious circle between banks and sovereigns,” and goes on to establish the basis for the creation of the SSM.

Genealogy and significance of the June 2012 decision

The significance of this decision was not immediately clear and remains debated to a significant extent. An influential narrative is that banking union was decided as a default solution in the absence of a political consensus for fiscal union, including some form of pooled bond issuance without the hard size limits of the European Financial Stabilization Facility (EFSF) and its successor the European Stability Mechanism (ESM). Fiscal union was much discussed in the second half of 2011, but with limited results. In this narrative, banking union was a kind of Potemkin reform, erected to mask EU leaders’ inability to make progress towards fiscal union. It may be an improvement in the long-term policy architecture of the EU, but had no impact on the current crisis as it was not designed as a crisis management mechanism.³ In a starker version of this argument, the decisions made towards banking union so far are dismissed as insubstantial and inconsequential, and may even be harmful as a botched system may impair the credibility of the ECB.⁴

This dismissive narrative of banking union, however, underplays the centrality of banking system fragility in the unfolding of the European crisis.⁵ The European banking sector has been in a continued state of weakness since mid-2007, well before the first concerns about Greek debt sustainability in late 2009. Doubts about bank strength, including in so-called core member states such as France and Germany, were a prominent driver of policy reactions to adverse market developments in the early phase of the sovereign debt crisis in 2010. Moreover, this very banking fragility, which was complacently blamed on an exogenous trigger (the US subprime crisis) by most policymakers for a number of years, was actually caused by the uncontrolled balance sheet expansion and risk accumulation by European banks in the decade preceding the crisis, itself enabled by weak supervision under the guise of favouring the emergence of national banking champions in an increasingly integrated European financial system. In this alternative narrative, banking union is less a sideways manoeuvre to avoid the impasse on fiscal union than a logical consequence of the bankruptcy of banking nationalism as a driver of member states’ financial sector policies.⁶

Banking nationalism enabled the build-up of systemic risk when market conditions were supportive; prevented an early resolution of the banking crisis when it erupted; and resulted in excessive use of public money in successive bank bailouts whenever a bank’s weakness had become impossible to

² To the author’s best knowledge, the expression “banking union” was first introduced by an unidentified analyst in the fall of 2011. The author started using it in December 2011, and it became part of the mainstream EU policy language in April 2012. It was officialised in a formal European Council statement in June 2013.

³ This view has been articulated, among others, by Angel Ubide, “How to Form a More Perfect European Banking Union,” Peterson Institute for International Economics Policy Brief PB13-23, October 2013; and Thorsten Beck, “Banking union for Europe – where do we stand?” in *VoxEU.org*, 23 October 2013

⁴ See e.g. Gene Frieda, “A weak EU banking union risks deflation,” *Financial Times*, 10 December 2013

⁵ On the role of banks in the unfolding of the euro area crisis, see also Vitor Constâncio, “The European crisis and the role of the financial system,” Speech at the Bank of Greece in Athens, 23 May 2013.

⁶ This alternative narrative is elaborated in Nicolas Véron, “Banking Nationalism and the European Crisis,” keynote address at the European Private Equity and Venture Capital Association (EVCA)’s 30th Anniversary Symposium in Istanbul, 27 June 2013, available at <http://piie.com/publications/papers/veron20130627.pdf>.

dissimulate. Particularly since the late 1990s, banking nationalism was incentivized by the coexistence of national banking policy frameworks with EU financial market integration. When failure became too evident to deny, the choice was a stark one: banking policy integration, or bidding farewell to market integration. In June 2012 European leaders chose banking policy integration. After that, there was no way back.

A parallel question relates to the role of the decision to initiate banking union in the reversal of the deterioration of market conditions during the second half of 2012. This trend reversal was followed by a remarkable normalization of sovereign debt markets that has continued until now, in spite of significant policy shocks such as the botched treatment of the Cypriot crisis in March 2013. Two other major developments happened shortly afterwards: the announcement by the ECB that it would be willing to buy sovereign bonds of a euro area country under stress if certain conditions are met, signalled by ECB President Mario Draghi in late July 2012 and formalized with the presentation of the ECB's Outright Monetary Transactions (OMT) program in September; and a determination by German Chancellor Angela Merkel that Greece would not be forced to exit the euro area, which appears to have been formed during the summer and had become evident at the time of her visit to Athens in early October 2012.

It is difficult to disentangle the respective effects of banking union, OMT, and reassurance against Greek exit on the reversal of market trend and "positive contagion" that ensued. However, even if the succession in time does not imply causality, there are strong indications that the commitment of political leaders on banking union was a key factor in the ECB's decision to announce OMT. If such is the case, and even as the OMT announcement clearly had the most direct influence on market participants' perceptions and behaviour, then the decision to embark on banking union in late June can be seen as the true turning point of at least this phase of the European crisis.

The AQR and its implications

This role of banking union in enabling OMT would be enough to dismiss the critique that it has not contributed effectively to managing the current crisis. However, there is a separate and perhaps equally important impact, which many observers did not immediately identify. The creation of the SSM made it inevitable that all banks would be submitted to a simultaneous balance sheet assessment, before the actual transfer of supervisory authority to the ECB. This would "reset" the supervisory evaluation of their capital strength, as the ECB should not take over supervision of banks that it would consider insolvent. This is the process generally referred to as AQR, even though in addition to the asset quality review itself, it also includes what the ECB calls a supervisory risk assessment, and a stress test coordinated by the European Banking Authority (EBA) and covering banks from all EU member states. The comprehensive assessment is defined by Article 33(4) of the EU legislative text establishing the SSM, or "SSM Regulation."⁷ This article on transitional provisions was present from the first version published by the European Commission in September 2012, but its true importance was acknowledged by most analysts only gradually over the course of 2013. Article 33 also implies that the AQR and stress test should be completed before the assumption of direct supervisory authority by the ECB on 4 November 2014, unless the ECB itself decides to delay this deadline.

⁷ Council Regulation (EU) No. 1024/2013 of 15 October 2013, conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

The AQR thus can be expected to force a process of triage, recapitalization and restructuring that has been proved by past experience to be the surest way to resolve a systemic banking crisis, especially in a developed-economy environment.⁸ The context of this review is fundamentally different from the stress tests of 2009 and 2010, coordinated by the Committee of European Banking Supervisors (CEBS), and of 2011, coordinated by its newly formed successor, the EBA. These earlier stress tests are widely seen as policy failures, as they gave a clean bill of health to banks that collapsed shortly afterwards. But none of them included an AQR, which is the core of this year's assessment. By contrast to the CEBS and EBA, the ECB has direct relationships with the reviewed banks, direct access to all supervisory information, wide legal authority to request information from both the banks and national supervisory authorities, and the ultimate ability to revoke a bank's license after the handover on 4 November 2014. Moreover, all euro area member states have a stake in the credibility of the ECB as a monetary authority, which had no equivalent with the CEBS and EBA. The AQR process, of course, implies subsequent restructuring of "problem banks" that would be exposed as severely undercapitalized in its aftermath, a set of decisions which belongs to individual member states within the EU legal framework (including state aid rules), a crucial point which is discussed more at length in the last section of this statement. This explains why the AQR's robustness cannot yet fully be taken for granted. But in any event, it will be significantly more robust than the European stress tests of 2009, 2010 and 2011.

If credible, the AQR and subsequent restructuring of problem banks could have a transformative and highly positive (if not painless) impact on the European banking system. It holds the promise of a gradual return of trust, as "legacy" losses, related to past risk management mistakes and supervisory forbearance, would be crystallized, publicly disclosed, and adequately addressed. Following this, banks would be under much less suspicion of keeping "skeletons in the closet" than has ever been the case since 2007, both from the investor community and from each other. This would allow for a return of bank funding markets to more normal conditions, and for a gradual removal of the ECB's extraordinary intervention policy, known as fixed-rate full allotment and in place since mid-October 2008.⁹ This in turn may put an end to the current dysfunctional credit allocation in the euro area, in which credit conditions, especially to households and smaller companies, remain adverse in so-called periphery countries even as sovereign spreads have sharply declined. In other terms, a successful AQR is a key condition for a reversal of the fragmentation of the euro area financial system, which currently acts as a major drag on growth and employment in the periphery and beyond.

Early impact of banking union

The AQR process is still in its early phase, and it is too early to form a firm judgement of its future success. However, the banking union process is already having an impact. As argued above, it is likely to have played a major role in the dramatic reversal of market perception about the sustainability of the euro area in the second half of 2012, initiating a trend that has been sustained until now.

The SSM Regulation establishes a robust and unambiguous legal basis for the ECB's supervisory authority. Its final version, adopted in October 2013, is not a complex compromise that leaves

⁸ This point is developed in Adam Posen and Nicolas Véron, "A Solution for Europe's Banking Problem," Peterson Institute for International Economics Policy Brief PB09-13, June 2009.

⁹ Several months will be needed after the announcement of AQR results for the ECB to be reassured that it can remove this protective policy, which may be why the ECB announced last November that it would keep the fixed-rate full allotment policy until at least mid-2015.

ultimate responsibilities unclear, in sharp contrast to current discussions about the SRM as further elaborated in the next section. On the contrary, it provides clear lines of accountability and a governance framework which is likely to be effective. This is despite the awkwardness of making it open to non-euro area member states of the EU while subordinating it to the statutory bodies of the ECB, especially the Governing Council, as defined by the Treaty on the Functioning of the European Union and which grant exclusive governance rights to euro area countries. The ECB's supervisory authority extends to all banks headquartered in the corresponding geographical scope (or "banking union area"), namely all euro area countries plus other EU member states that may voluntarily join the SSM, as could be the case of Denmark and/or some Central European countries.¹⁰ There are initial exemptions for smaller banks with a balance sheet total under EUR 30bn, a category that includes most German saving banks and cooperative banks, but the ECB can later choose to supervise them directly as well. Because of unexpected roadblocks in the legislative process in 2013, the date of transfer of supervisory authority to the ECB was delayed in comparison to the one initially contemplated, from March to November 2014, but this delay may have been inevitable anyway given the logistical and operational complexity of the AQR.

On one important aspect, however, some initial expectations about the implementation of banking union have not been met. The summit statement of 29 June 2012 included a convoluted sentence that read "When an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalize banks directly." This led many observers to anticipate that "ESM direct recapitalization" could provide a form of European-level "backstop" in the period covering the AQR and its immediate aftermath. But subsequent developments have proved that this sentence had to be read literally, implying that no direct recapitalization by the ESM would be possible before the SSM is "established and effective," i.e. some time after the AQR and subsequent bank restructuring, if at all. This is a direct consequence of the political potency of the "legacy" argument in several Northern European countries including Germany, according to which there should be no European-level mutualisation of the public cost of past supervisory failures that have occurred at the national level. As a consequence of this argument, breaking the bank-sovereign vicious circle is made more difficult; and the restructuring of problem banks following the AQR, as it cannot rely on direct resources from the European level, is made more politically painful.

Nevertheless and contrary to some claims, the absence of a European backstop does not make such restructuring impossible, or even necessarily disruptive in terms of sovereign debt markets stability. Whatever bank restructuring may be needed as a consequence of the AQR will be financed by three tiers of resources. First, financial losses will be taken by junior creditors, according to European Commission state aid rules in force since August 2013, and possibly by senior creditors as well, depending on individual member states' decisions as elaborated in the last section of this statement. Second, relevant member states may intervene financially, providing what the current jargon refers to as national backstops. Third, if this intervention puts a member state at risk of losing market access, it may rely on financial assistance from the ESM along the lines of the Spanish programme in 2012, which was specifically designed for the purpose of banking system repair and appears to have been broadly successful. Even under pessimistic assumptions about capital gaps that may be

¹⁰ On the corresponding choices see Zsolt Darvas and Guntram Wolff, "Should non-euro area countries join the single supervisory mechanism?" Bruegel Policy Contribution 2013/06, March 2013.

uncovered in problem banks and could not be met from market investors on a going-concern basis, most member states should be able to provide adequate backstops if market conditions remain broadly benign, as they currently are. Under the same assumptions, those member states that may require ESM assistance, if any, are likely to be few in number and rather small in size, with the implication that current ESM resources should be sufficient. Of course, things would be different if sovereign debt market conditions were to deteriorate dramatically in the next months, a scenario that cannot be entirely ruled out. But if this were to be the case, the experience of 2012 suggests that euro area member states would be willing to collectively adapt their policy stance to the changed environment, and to introduce further assistance mechanisms. As a consequence, the absence so far of a European backstop for bank restructuring does not condemn the AQR process to complacency.

Indeed, market sentiment about the AQR has shifted significantly in the past few months. In September 2013, the prevailing sentiment among investors was widespread cynicism, with the anticipation that the obstacles to a robust process that were observed in 2010 and 2011 would again prevent the results from being credible. By contrast, more recent indications of investor perceptions suggest a much higher degree of expected toughness of the review, partly in reaction to the ECB's own communication about the AQR since October. This is mirrored in the behaviour of a number of banks that have raised additional capital in recent months, or appear to plan capital-raising in the near future.¹¹ In addition, there are recent indications that some banks which had high portfolios of home-country sovereign debt have started to reduce these. If confirmed, this trend would suggest a weakening of a critical component of the bank-sovereign vicious circle, namely the disproportionate accumulation of home-country sovereign risk in the balance sheet of many banks.¹²

¹¹ See e.g. Boris Groendahl and Sonia Sirletti, "Draghi Throwing Light on Bank Assets Spurs Fundraising Flurry," *Bloomberg News*, 29 January 2014

¹² Contrary to an often-heard argument, this "home bias" cannot be attributed to the much-criticized EU interpretation of successive Basel accords, under which sovereign debt is considered free of credit risk in regulatory capital calculations. While such "zero-risk weighting" does create an incentive for banks to hold EU sovereign-debt securities, it does not specifically encourage the purchase of home-country debt. The domestic home bias may result from various causes, including the banks' national supervisory context and corporate governance, but not from applicable regulations as framed by international standards and EU prudential legislation.

Current Outlook

A standard, if simplified, depiction of developed-economy banking policy frameworks identifies four core building blocks: regulation, supervision, resolution, and deposit insurance. For Europe's banking union to be complete, all four should be essentially shifted from the national to the European level.¹³ The current status is of a work in progress:¹⁴

- A significant part, but far from all, of the applicable regulation is now set at the EU level, building on a history of single market initiatives that long predates the start of banking union.¹⁵ The Capital Requirement Regulation of 2013¹⁶ for the first time sets out core prudential requirements in a fully harmonized manner, and thus marks a major advance towards the stated aim of a "single rulebook." However, member states continue to take solo initiatives as the UK, France and Germany recently did as regards the separation of functions within banking groups. The Bank Resolution and Recovery Directive (BRRD), which is almost finalized but not yet adopted, is a step towards harmonization of resolution frameworks (or creation thereof in countries which do not yet have one), but leaves significant scope for divergence between national legislative arrangements. Tax, insolvency and corporate governance frameworks remain almost entirely national, and thus differ widely from one country to another.
- The implementation of the SSM in November 2014 will represent an almost complete integration of supervision of the larger banks in the banking union area (euro area, plus member states which may join voluntarily). Member states outside this scope, including the UK, will retain separate supervisory frameworks, while the EBA provides some EU-wide coordination of supervisory standards and practices. National supervisory authorities will retain a role within the supervision of larger banks, under the authority of the ECB, and with much more autonomy as supervisors of smaller banks. How this role evolves over time, and the related question of how much the ECB may build up its own on-the-ground supervisory infrastructure in individual member states, remains almost entirely to be determined.
- Integration at the European level of the authority to resolve failing banks remains a distant prospect, for a number of reasons: There is no harmonised or EU-wide insolvency framework, and its creation would be a long-term effort; absent a treaty change, there is no obvious legal basis for a European resolution authority that could make quick, discretionary and independent decisions on bank crisis management while being embedded in the accountability framework of EU institutions; the absence of a genuine European fiscal union makes resolution funding problematic at the European level; and the pooling of resolution authority meets considerable resistance from national political environments. The current discussion on creating a so-called Single Resolution Mechanism is shaped by these constraints. Despite the name, all currently

¹³ See e.g. Jean Pisani-Ferry, André Sapir, Nicolas Véron & Guntram Wolff, "What Kind of European Banking Union?" Bruegel Policy Contribution 2012/12, June 2012; Thorsten Beck (ed.), *Banking Union for Europe: Risks and Challenges*, VoxEU.org e-book, October 2012; Rishi Goyal & co-authors, "A Banking Union for the Euro Area," International Monetary Fund Staff Discussion Note SDN/13/01, February 2013

¹⁴ See also Nicolas Véron, "A Realistic Bridge Towards European Banking Union," Peterson Institute for International Economics Policy Brief PB13-17, June 2013.

¹⁵ These include a series of banking directives since 1977; the Financial Services Action Plan, published in 1999 and implemented in the following years; and the Larosière Report of February 2009, which led to the creation of the EBA and the emphasis on a "single rulebook."

¹⁶ 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.

considered options, including the proposal published in July 2013 by the European Commission, make the SRM a much less centralized, let alone “single” framework than is the case of the SSM. At this point, it is unclear when SRM legislation may be adopted, if at all, even though most negotiating parties state the aim of finalizing it before the end of the current European Parliamentary term.

- A European deposit insurance system, which would go beyond the currently considered harmonization of national systems, is not being discussed at all, given its direct link with the issue of European fiscal union. This is because a deposit insurance system, even if pre-funded, needs a clear and unlimited fiscal backstop to be credible, and is essentially useless if it lacks credibility. It is self-evident that the bank-sovereign vicious circle will remain an instability factor as long as deposit insurance systems remain national, as was graphically illustrated by the developments in Cyprus in March 2013. Some European policymakers have acknowledged that European deposit insurance would be needed in the long term. But there is no prospect of progress on this front in the near future, unless forced by disruptive market developments.

The “Supervision First” approach and its consequences

As this summary review suggests, the choice made by European policymakers has been one of phased deployment of banking union, rather than a “big bang” approach in which all building blocks would be assembled simultaneously. It can be summarized as “supervision first,” accompanied by an acceleration of regulatory harmonization and the convergence towards a single rulebook. The SRM is in all scenarios a hybrid structure, and will have no practical impact until well after the completion of the phase of bank restructuring that may immediately follow the AQR. Supranational deposit insurance is not even on the horizon.

This phased approach is frustrating to observers of the important policy interdependencies between the four building blocks listed above. It should be noted, however, that it is in line with the letter of the euro area summit statement of 29 June 2012, which explicitly put supervision first and did not even mention the SRM, which the European Council first introduced (without clearly specifying its aims) in December 2012. While several individual policymakers have expressed concerns about the policy mismatches that may be created by the phased approach, a big bang approach has never been official EU policy.

The underlying logic of the phased approach is twofold. First, it acknowledges the multiplicity of links between banks and sovereigns, both implicit and explicit, and infers that severing all these links cannot realistically be achieved in one single go. Second, it identifies supervisory integration as a necessary first step. The reason is that without a single supervisor, there can be no common trust about the true condition of individual banks in all participating countries, and therefore no effective management of financial risks inherent in any European-level banking policy initiative. In this approach, the policy mismatches that result from the phased rollout of banking union are accepted as a necessary price to pay for the sake of operational, legal and political practicality. Specifically, any financial risk mutualisation must be preceded by a credible removal of “legacy” risks resulting from past national banking policy choices, a vision now materialized by the fact that the restructuring triggered by the AQR may rely only on national backstops.

This approach was exposed most clearly so far by Germany’s Federal Finance Minister in an important newspaper comment in May 2013, concluding: “A banking union of sorts can thus be had

without revising the treaties, including a single supervisor; harmonised rules on capital requirements, resolution and deposit guarantees; a resolution mechanism based on effective co-ordination between national authorities; and effective fiscal backstops, also including the European Stability Mechanism as last resort. This would be a timber-framed, not a steel-framed, banking union. But it would serve its purpose and buy time for the creation of a legal base for our long-term goal: a truly European and supranational banking union, with strong, central authorities, and potentially covering the entire single market.”¹⁷

This vision has been essentially adhered to in subsequent policy developments. It remains crucially predicated on orderly market conditions. It does not involve permanent hostility to financial risk mutualisation, which may become possible once the centralized supervisory practice has established sufficient common trust. But the protracted pace of trust-building also means that the benefits of banking union can only be reaped gradually, with significant economic pain associated with adjustment in the meantime.

Implications for the SRM

As previously mentioned and given the logic of the supervision-first approach, there is a gap between what the SRM’s name promises and what the single resolution mechanism can realistically deliver.¹⁸ The absence of a European insolvency framework implies that, for the near future at least, the SRM has to work in practice through national resolution regimes as established or harmonized in accordance with the BRRD. Moreover, the *Meroni* doctrine of the European Court of Justice, not to mention political resistance, limits the potential for the Single Resolution Board (SRB) to make autonomous, discretionary decisions that could be enforced directly in a resolution process, leading to excessive complexity and unpredictability of the SRM decision-making procedures. Meanwhile, in the absence of progress towards fiscal union, the single resolution fund (SRF) can only be of limited size, which restricts its potential effectiveness as a crisis management tool – irrespective of how rapidly its initially separate “compartments” are “mutualized.” It should be noted that these limitations apply similarly to the European Commission’s proposal for the SRM published in July 2013, the Council version negotiated by ECOFIN in December 2013, and the European Parliament’s negotiating positions which are currently being discussed.

It remains to be seen whether a compromise will be found in the current negotiation, in which case the final SRM Regulation could be published around mid-2014; or whether it will be left pending and rolled over to the next European Parliamentary term, in which case one might expect a final text in the first half of 2015. If no compromise is found this spring, it will surely lead to many comments characterizing the impasse as a major setback for banking union. Ironically, however, a delay may actually improve the conditions for forming the SRM, without having a significant adverse practical impact (the most important provisions of the SRM are not expected to kick in before 2016 in any event). The key point is that if the AQR is broadly robust and successful in addressing the “legacy” issue, as appears currently more likely than not, then a discussion on the SRM in early 2015 might include policy options that are currently considered a no-go area at this point, including in

¹⁷ Wolfgang Schäuble, “Banking Union must be built on firm foundations,” *Financial Times*, 13 May 2013.

¹⁸ An early exposition of this analysis is in Nicolas Véron & Guntram Wolff, “From Supervision to Resolution: Next Steps on the Road to European Banking Union,” Bruegel Policy Contribution 2013/04, February 2013.

Germany.¹⁹ As a consequence, the conclusion of the SRM negotiation in the next two months should by no means be seen as a make-or-break test of the future of European banking union. The make-or-break test is and remains the AQR, including subsequent bank restructuring.

Policy steps beyond the AQR

Again under the assumption of a broadly successful AQR and subsequent wave of bank restructuring, 2015 would open a new phase that would correspond to what the above-cited article called the “timber-framed banking union” – an improvement on the pre-2012 situation that makes the monetary union more robust and the banking market more integrated, but with lingering risks associated with an incomplete banking union.

The finalization of the SRM, expected to be reached in 2015 if not before, will probably not mark the beginning of a steady-state in banking policy. To the contrary, a number of tensions are likely to appear rapidly or gradually between the newly established European framework (in supervision and to a lesser extent in resolution) and remaining arrangements at the national level. This is likely to open a new sequence of banking policy initiatives.

- In terms of EU legislation, the next Commissioner for financial services will need to take a position on the proposal for structural separation of activities within banking groups published by the European Commission in January 2014, in echo to the so-called Volcker Rule in the US, the Vickers Report in the UK, and legislation adopted in individual euro area countries such as France and Germany. Beyond this, a number of additional legislative adjustments to the respective roles and responsibilities of the ECB and national supervisors in supervising banks may need to be considered, depending on the type of operational and governance relationships that are established over time within the SSM.²⁰ A broader agenda might involve the gradual formation of a more integrated framework for corporate governance, insolvency procedures and tax treatments of banks in Europe, at least as an option that banks that would opt for a “European banking charter.”²¹
- The ECB’s supervisory decisions will be consequential for the future reshaping of the European financial system. Significant developments of privatization, consolidation and restructuring can be expected among European banks well beyond the immediate aftermath of the AQR, as this is often the case following the resolution of major systemic banking crises. The ECB has been fairly explicit in calling for more cross-border consolidation among European banks, and also in calling for a larger role for non-bank financial intermediation in Europe, especially as banks are likely to

¹⁹ That being said, it is to be hoped that the BRRD will be adopted in final form before the end of the current European Parliamentary term. Its policy parameters have been agreed by all EU institutions since December 2013. Taking it hostage to a delayed conclusion of the SRM discussion, as some members of the European Parliament seem tempted to do, would add more significantly to the uncertainty about future bank restructurings than a delay of the SRM legislation itself, and thus be detrimental to the prospects for resolving the current banking fragility during the AQR phase.

²⁰ On 7 February 2014, the ECB launched a public consultation on a draft Regulation establishing its framework for cooperation with national authorities within the SSM. This however is likely to frame a permanent arrangement, and is probably best seen as a first step in what may be a long sequence of adjustments.

²¹ See e.g. Martin Cihak and Jörg Decressin, “The Case for a European Banking Charter,” International Monetary Fund Working Paper WP/07/173, July 2007; Vitor Constâncio, “Banking union and the future of banking,” speech at the IIEA in Dublin, 2 December 2013.

keep deleveraging for at least some time.²² The ECB may also be expected to encourage European banks to diversify their portfolios of sovereign debt away from their current home-country bias, which creates an unnecessary concentration of risk in a banking union context, and there are early indications that it might gradually impose limits on banks' credit exposure to their respective home-country sovereigns.²³ The ECB can also be expected to strengthen and harmonize accounting, risk-weighting and provisioning practices of banks across the banking union area; to streamline cross-border regulatory processes in order to deliver on its promise to reduce cross border banks' regulatory compliance costs; and to impose more consistent public disclosures by banks and market discipline, not least by itself publishing more granular data about European banks than is currently done by national regulators.²⁴

- The ECB may also gradually expand its scope of direct supervision to smaller banks within the SSM, as it gradually builds up its supervisory resources. This is likely to be especially sensitive in Germany, where savings banks and cooperative banks are subject to highly specific oversight regimes. But leaving these banks permanently outside of the ECB's direct authority may also give rise to perverse incentives and regulatory arbitrage, which in turn could generate potential instability over the longer term.
- A new balance will need to be found between the ECB and fellow bank supervisors outside of the banking union area. This is of course crucially dependent on the future evolution of the relationship between the UK and the EU. In the immediate future, the review of the EBA, scheduled in 2014 together with that of other European Supervisory Authorities (for securities markets and insurance companies), provides an opportunity to strengthen the EBA's capacity to act as a neutral actor that can credibly mediate differences between the ECB and other bank supervisors in the EU. This would require significant reform of the EBA's governance, well beyond the changes brought by the regulation adopted together with the SSM in 2013.
- The practice of bank resolution, both by national resolution authorities and by the SRM, will need to address major questions raised by the adoption of the BRRD and the stated aim to avoid recourse to government budgets in resolution funding. This track record will necessarily be shaped by successive crises, and it may take time to be able to form a clear judgment on the practicality and sustainability of the legislative choices made in the BRRD and SRM. This in turn may lead to future legislative adjustments. One major question, itself dependent on other institutional developments within the EU, is whether the SRB will be able to establish itself as a credible resolution authority, or whether another institutional overhaul will be needed in this area, including the option to transfer its resolution mandate directly to the European Commission. Similarly, only time will tell if the current hosting of the SSM by the ECB is sustainable over the longer term, or if a tighter separation of supervision from monetary policy might be necessary.
- Last but not least, the stability of the EU institutional framework itself cannot be taken for granted. There could be major changes in the next decade in terms of EU Membership (the

²² See e.g. the speech by ECB Vice President Vitor Constâncio referenced in the previous note; and Mario Draghi, "Financial Integration and Banking Union," speech for the 20th anniversary of the establishment of the European Monetary Institute in Brussels, 12 February 2014. See also André Sapir and Guntram Wolff, "The Neglected Side of Banking Union: Reshaping Europe's Financial System," note presented at the informal ECOFIN meeting in Vilnius, 14 September 2013, published by Bruegel.

²³ Interview with Danièle Nouy, Chair of the SSM Supervisory Board, *Financial Times*, 10 February 2014

²⁴ See Christopher Gandrud and Mark Hallerberg, "Supervisory Transparency in the European Banking Union," Bruegel Policy Contribution 2014/01, January 2014.

possible UK referendum, not to mention separatism in Catalonia and Scotland); the internal boundary between the euro area, the banking union area (assuming some non-euro area countries opt to join it), and the rest of the EU; the role of the European Parliament in legislative initiative, budgetary oversight, and executive scrutiny, as well as its internal political dynamics; and the evolving functions of the Commission, of the Presidency of the Council, and of present and future institutions that may be specifically tailored for subsets of countries such as the euro area. Depending on future political, economic, financial and legal developments, what is now often referred to as fiscal union and political union will continue to be discussed, with possible changes in policy framework, including perhaps the European treaties.²⁵ These may in turn open up new possibilities to address the unfinished agenda of banking union, especially as regards bank crisis resolution and deposit insurance.

It is impossible to predict when such developments may unfold, if at all. On the one hand, it is far from clear that a “timber-framed” banking union is capable to deliver long-term stability in the European financial system. On the other hand, it may be argued that the previous state of affairs created by the Maastricht Treaty, with monetary union but no banking union at all, was inherently even more instable than an incomplete banking union – and it lasted more than a decade. Developments exogenous to the EU may also possibly affect the timetable.

Short-Term Choices

While many difficult choices lie ahead over the medium term, the above analysis suggests that by far the most crucial issue in the short term is the AQR – a much more critical hurdle than the legislative tussle over the SRM. An unsuccessful AQR may compromise any further future steps towards banking union, with material negative consequences for the future prospects of the ECB, the euro area, and the EU. Conversely, a robust AQR and aftermath that would convincingly address the “legacy” issue would help restore normal credit conditions throughout the EU, and would open up new policy space and enable progress in significant areas that appear presently deadlocked.

Now that the SSM Regulation has been adopted, the key players in the remaining AQR sequence are the ECB, individual national governments (which would have to steer the restructuring of banks that may be found unviable, or “problem banks”), and the European Commission competition-policy arm (DG COMP) as the EU authority that controls state aid. Of these, in principle at least, DG COMP has the simplest task, as it relies on significant experience and precedents through its review of past bank restructuring cases, especially in the last seven years of crisis. It has issued a revision of its rules early in the AQR sequence, in force since August 2013. These enhance DG COMP’s ability to block state aid that it deems in breach of EU law. As previously mentioned, they also specifically mandate that junior creditors should take losses before any state aid is envisaged (unless market conditions were to deteriorate sharply, in which case a systemic risk exemption could apply). However, their application stops at the boundary between junior and senior debt, and it seems that DG COMP will leave any choice of “bail-in” or imposition of losses to senior creditors to the individual member states.

²⁵ For further elaboration, see Nicolas Véron, “Challenges of Europe’s Fourfold Union,” testimony before the Subcommittee on European Affairs of the US Senate Committee on Foreign Relations, 1 August 2012.

The interplay between the ECB and member states is less predictable. On the one hand, no member state wants the ECB's reputation to be impaired, and in this respect, the incentives for cooperation are stronger than with the EBA in 2011. On the other hand, bank restructuring is always politically painful, and has often led to the fall of governments or of individual senior policymakers. Thus, member states may be tempted to resist calls from the ECB to restructure problem banks in their remit. Conversely, the ECB is firmly committed to defending its reputation and independence, but it cannot be entirely insensitive to the potential systemic risk implications of its prudential decisions.

Location of problem banks

Where problem banks may be located, and how serious their problems are, is a matter of guesswork at this point. Current levels of transparency vary enormously across countries and bank models. Among the 124 banks in the AQR sample,²⁶ less than half (representing about 60 percent of total assets) are publicly listed or part of listed groups, and thus subject to the disciplines of listed-company disclosure. There is arguably more predictability on banks of countries that are or have recently been subjected to an assistance programme (i.e. Greece, Ireland, Portugal, Spain and Cyprus), as these have had to undergo stringent examination and stress testing under the auspices of the so-called Troika. However, these represent only one-quarter of the sample's banks and less than one-fifth of the total assets.

The banks on which there is generally least visibility at this point, i.e. unlisted banks in non-programme countries, represent 43% of the banks in the sample, and almost a third of the total assets. In aggregate asset terms, these banks are concentrated in France (EUR 3.5trn), Germany (EUR 3.2trn), the Netherlands (EUR 1.9trn), Belgium (EUR 0.7trn), and Italy (EUR 0.6trn). These banks are not necessarily those where most problems lie, but, if all things were equal, they should arguably be considered those with the highest potential for surprises springing out of the AQR. In fairness, however, all things are by no means equal, including as regards the reliability of public disclosures by listed banks in different member states. Ultimately, only the AQR itself can answer the question of which banks are problem banks – which is precisely why the AQR is so critical.

ECB challenges

The ECB has incentives to be rigorous, and its communication so far, while understandably sparing, gives no reason to suspect a lack of resolve. Even though some preparations have suffered delays, it is advancing rapidly in the early phase of the AQR, which represents a massive operational, logistical and technical challenge. Key choices, on which no final decisions have been publicly announced yet, include the scoring methodology and tools for the supervisory risk assessment; the details of the process and methodology to review and evaluate assets; and the respective consideration of the AQR and of the stress test in determining each bank's capital needs at the end of the exercise.

Communication itself is a uniquely delicate challenge, given the potentially long time span between the finalization of the asset quality review itself, perhaps in the late spring or early summer, and that of the stress test, currently planned in October 2014. It appears implausible that the ECB would not

²⁶ Not counting four banks in Malta and Slovakia which are subsidiaries of banks otherwise included. For the list, see Decision of the European Central Bank of 4 February 2014 identifying the credit institutions that are subject to the comprehensive assessment (ECB/2014/3). The numbers that follow are from the author's calculations based on The Banker database, with reference to 2012 assets.

communicate the AQR results to the respective banks. But among those that are listed or otherwise subject to public disclosure requirements, some may have to disclose at least part of the relevant information publicly, especially if it is not aligned with prior financial communication – which may in turn give rise to challenging potential liability issues. This could lead to an acceleration of the timetable, at least for some banks, unless the finalization of the AQR itself is delayed compared to initial plans.

Member states' challenges

The choices to be made by member states that may have to restructure banks as a consequence of the AQR, both individually and collectively, are at least as challenging as those faced by the ECB. Some have endeavoured to minimize the potential capital gaps by relieving banks of part of their future tax liabilities, which can then be included in capital calculations as so-called deferred tax assets, through non-sector-specific tax decisions that may therefore not be considered state aid by DG COMP (and give rise to limited political opposition compared to other forms of public financial assistance). But this channel of assistance may not apply to all member states, or be sufficient to fix all problems.

The discussion of specific challenges in individual member states goes beyond the scope of this statement, and is made particularly problematic by the difficulty to locate the problem banks as described above. From a European perspective, however, at least two specific questions stand out, in both cases because of significant potential benefits from collective action.

- The first question is whether to impose losses on problem banks' senior creditors, assuming the "bailing in" of junior ones is not sufficient to absorb the identified financial gap. As previously mentioned, the European Commission's state aid framework does not prescribe a stance in this respect. Nor does EU legislation: the bail-in provisions of the BRRD and SRM will not in any scenario enter into force before 2016. As a consequence, member states have discretion to decide on whether to bail in the senior creditors of their problem banks. This creates a potential for damaging policy inconsistency, for two main reasons. First, and as in previous phases of the crisis, banking nationalism concerns may result in a race to the bottom, as no member state may want to impose bail-in decisions that could put its domestic banking sector at a disadvantage compared to the neighbors' in terms of future funding conditions. Second, there is a risk of exacerbation of the bank-sovereign vicious circle, in a scenario in which fiscally weaker member states would have less policy autonomy than fiscally stronger ones, and may thus be forced by their peers to go further in the direction of senior creditor bail-in. Such a scenario would defeat the whole purpose of banking union, by entrenching the perception that banks headquartered in fiscally fragile countries are intrinsically less likely to reimburse their creditors.

As a consequence, there is a strong case for an ex ante commitment mechanism that would prevent divergent attitudes to senior creditor bail-in in different member states, at least within the banking union area. It is not clear that this should or could include a pre-commitment on what the approach to bail-in will be, as this may be dependent on future market conditions and on the magnitude of problems uncovered by the AQR. But it should at least include a statement of intent from the highest political level, i.e. a joint declaration of euro area heads of state and government, that they will adopt an identical stance as regards senior creditor bail-in in all cases of bank restructuring associated with the AQR; and probably also, an indication of process on

how this intent would be fulfilled in practice, under the short-term pressure that bank restructuring decisions typically entail. Whether existing national legislation in some member states may need to be amended in order to allow such cross-border consistency would also need to be checked.

- The second question concerns the management of restructured banks and assets by member states as a consequence of the AQR. On the one hand, this will understandably be seen as a matter of national sovereignty, not least because of potential fiscal implications. On the other hand, and from a more technical standpoint, there is a powerful case for joint management (not implying joint liability), because of the enormous cross-border synergies that could be involved. Practitioners of past and present “bad banks”²⁷ know that there are considerable financial benefits of experience in this matter, or conversely, that starting such a practice from scratch and in isolation entails a potentially very costly learning curve.

There would thus be a considerable public interest in envisaging a European Asset Management Company (AMC) which could manage assets on behalf of the individual member states, with separate accounts implying no mutualisation of financial risk, but which would reap the operational synergies from the critical mass of portfolios under management. This would allow for the build-up and retention of adequate investment management skills, especially in assets held outside of the home country. To give an example, both Dexia and WestLB had assets in the United States. The resolution of these two banks would have gained from a joint management of these portfolios. Multiplied across the euro area, the potential savings from such a joint operational approach could involve very large sums for the respective countries’ taxpayers. Importantly, it would also prevent a not unthinkable scenario in which different national bad banks would compete against each other to sell similar distressed assets in the same period, thus reducing the proceeds for national budgets.²⁸ Even though such an initiative would surely elicit political resistance, its financial advantages justify its joint consideration by euro area member states well in anticipation of the delivery of the AQR results. The creation of an effective European AMC would require at least a few weeks of preparation. Enabling national legislation may also be needed, at least in some countries.

The mere enunciation of these choices underlines how difficult it could be to make the AQR and subsequent bank restructuring a policy success, even as the initial phases of the exercise have been encouraging (based on what can be observed from an outside position). The European elections in May give extra weight to short-term political considerations, and their results may also add to the constraints on policymakers later in the year, at least in some member states. But decision-makers must keep in mind that the AQR is, in practical terms, the key to economic recovery in the euro area. Conversely, allowing “zombie banks” to continue their operations while hoping for the best would be

²⁷ The term “bad bank” is highly imprecise and has been used in different financial contexts that are not at all comparable with each other. It is used here in a generic sense of a vehicle to manage distressed assets, with no indication of the specific financial engineering that might be involved.

²⁸ An early proposal along these lines is in Adam Posen & Nicolas Véron, “A Solution for Europe’s Banking Problem,” Peterson Institute for International Economics Policy Brief PB09-13, June 2009. The author is also grateful to Hans-Jürgen Walter at Deloitte for sharing his thought-provoking presentation “Do We Need a European Bad Bank?” at the Euro Finance Week in Frankfurt, 19 November 2013.

even more costly to Europe's taxpayers and citizens than have been all the excessive publicly-funded bailouts of the past few years.²⁹

²⁹ As the text of this statement is expected to be published shortly by Bruegel and the Peterson Institute, this version, delivered in Lisbon on 26 February 2014, is to be considered a draft for reference purposes.