Expert Advice and Political Choice in Constructing European Banking Union[1]

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ABSTRACT

International actors promoted the transfer of regulatory authority and financial resources from national governments to the European Union in the context of establishing the prerequisites for financial stability in Europe through banking union. It was supplied, however, by a political process that kept significant resources in resolution and deposit insurance largely in national hands. This paper examines the politics behind those decisions, and how the hybrid of European and national competences affects bank regulation and financial stability in the EU. It concludes that the tension between strong EU supervisory powers and weak capacity to deal with insolvent institutions will persist.

Keywords:

INTRODUCTION

Banking union in Europe, like economic and monetary union, is incomplete. Its competing legal and political principles stress the transfer of authority to the European level in one area (bank supervision

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for systemically important institutions) and the retrenchment of responsible national sovereignty on the other (public backstops, deposit insurance, plus most resolution powers in a new European framework), despite advice from international experts to establish mutually-reinforcing institutions for financial stability at the European level. Banking union therefore does not eliminate the negative feedback loop between insolvent banks and sovereigns that it was meant to address. As a result, the European Stability Mechanism (ESM), which is outside the EU, will be the main backstop keeping the euro zone together during periods of stress. Distributional conflicts coupled with power politics explain much of why this happened. Germany, the Netherlands and Finland resisted proposals that would cost them money while France, Ireland and Southern Europe favoured proposals that would make them recipients. Banking union was constructed to serve the interests of the payers best, supporting strong supervision and resolution that minimizes public costs, while making national authorities largely responsible for public backstops, and protecting most national deposit insurance and resolution systems. Political logic trumped expert advice.

The rest of this article is structured as follows. Section two outlines expert advice on supplying deposit insurance, resolution systems and supervision in supplying financial stability. Section three briefly reviews theoretical considerations of supplying such institutions internationally. Section four unpacks the positions and motivations of key actors in supplying the institutions of banking union. Section five reviews the evidence and draws conclusions.

DEPOSIT INSURANCE, RESOLUTION, SUPERVISION AND FINANCIAL STABILITY

Banking union can be assessed in terms of how well it supplies financial stability. Financial stability refers to the capacity of banks (and other financial institutions) to meet the demands of their creditors and depositors on a daily basis. Deposit insurance aims to prevent bank collapses before they begin, while resolution systems prevent collapses from spreading to other institutions (contagion).The capacity of both, in turn, depends on strong pre-crisis supervision that minimizes demand to deploy these tools. The rest of this section unpacks deposit insurance, resolution and supervision, including state of the art changes in thinking about how they must be structured and deployed to have sufficient and maximum impact, adding how experts advocated the establishment of EU institutions. This sets the stage for the next section, which examines how European efforts to establish such measures fared, and why.

Deposit Guarantees and Financial Stability

The International Association of Deposit Insurers (IADI), plus the Academic Advisory Committee of the European Systemic Review Board (ESRB) other actors underline the importance of key attributes of deposit insurance if it is to contribute to financial stability. *Broad protection of depositors* forestalls depositor panic and bank runs when a bank collapse is feared or underway. International best practice covers 90-95% of depositors (not deposits) and all banks to minimise the likelihood of bank runs. The cost of covering so many depositors is contained by limiting the amount of insurance each depositor enjoys.[1] Coverage limits then give professional depositors an incentive to monitor the bank's behaviour closely.[2] *Information* ensuring public awareness of coverage and reimbursement methods and times and a system that is not too complex are also important to have the desired effect.[3] Finally, *timely intervention*, including the infrastructure and capacity to reimburse depositors within a week must be in place before a crisis to forestall depositor panic.[4]

Beyond coverage, information and timely intervention, deposit insurance requires independent, dedicated funds that are funded by banks prior to a crisis and replenished afterward. *Ex ante funding* ensures that banks are not called on to pay when they are least able to do so, leaving the public purse to pay the bill. The use of the reserve during an economic downturn also has a countercyclical macroeconomic impact that softens the blow of economic downturns and promotes a faster, more robust recovery. Replenishment, which is not only ex ante funding for the next crisis, but ensures that banks, rather than taxpayers, continue to be the primary contributors to deposit insurance (the *polluter pays principle*). The intent is not simply to save public money, but to *combat moral hazard* by giving banks and their stakeholders (shareholders, creditors and employees) an incentive to monitor their own risk of collapse and restrain reckless behaviour.[5] Deposit insurance can also be extended beyond cash deposits. Money market funds functioned as cash deposits before and during the collapse of Lehman, for example, requiring functional equivalent coverage to ensure financial stability.[6]

Beyond these factors, deposit insurance also requires an open-ended *public backstop* to deal with the collapse of multiple banks simultaneously that would otherwise bankrupt the deposit insurance fund and hurt the economy more broadly, a position supported by the ESRB.[7] This backstop, like deposit insurance itself, would need to operate at the European level to ensure financial stability for an integrated and interdependent European banking market. Otherwise, national deposit insurance systems would remain responsible without the capacity or powers to act on a European scale, and vulnerable to the unequal capacity of EU Member States to provide financial guarantees that reinforce them.[8] In the absence of a fiscal union that some analysts consider essential to providing this public backstop, an independent fund backed by the Member States like the European Stability Mechanism, with sufficient funds, and the capacity to leverage its assets through the issue of euro bonds is considered the next best option.[9] However, the ESM itself is designed to be used sparingly, to reinforce national responsibility for financial stability, and to reflect German veto power on the board.

Resolution and Financial Stability

Resolution has two key functions during a bank crisis: to ensure the continuity of financial services for normal bank clients, often at a new bank, and to minimize the impact of the bank's closure on other banks. Resolution involves the appointment of a manager for the bank who winds up the institution by prioritizing who gets whatever money is left in the bank, forthcoming from deposit or resolution insurance and otherwise claimable from counterparties. Counterparties are other institutions which may have outstanding claims on or debts to the bank under administration. Resolution not only sorts out the position of retail depositors, who are covered at least in part by deposit insurance, but also these commercial ones who are not. Optimally, a resolution authority can restructure the bank before a collapse actually occurs, leaving behind a smaller, but healthier and viable institution. Resolution therefore overlaps with supervision, which is responsible for ensuring that banks avoid behaviour leading to failure, or issuing an early warning for corrective action if a bank gets into trouble. A specific overlap may be a demand for banks to increase their capital or liquidity buffers to better withstand the collapse of other banks.

The most important resolution authority mechanism for fulfilling the functions mentioned above is restructuring bank assets. The formula for doing this affects the cost to creditors, to the resolution fund, and to the public sector backstop that provides additional capital in winding up the bank so that it does not threaten other institutions. Divergent national practices and authorities can therefore complicate resolution, even allowing states to favour national institutions, which makes a single approach and authority crucial for an integrated market. Resolution authorities employ three restructuring methods: separation of assets; transfer of business; and bail-ins. Separation of assets removes toxic assets (non-performing loans or exposures via other financial instruments that have a negligible market value) from the bank. These may be transferred to a bad bank established with state support. On the bank's financial records, this replaces a fictional display of healthy income and wealth with a realistic assessment, which may approach zero. Transfer of business sells what is left of the bank to another bank, normally after asset separation. A public entity known as a bridge bank may hold on to the remaining viable assets until a buyer can be found. Finally, resolution authorities may execute bail-ins by terminating or altering the contracts that the bank has with its creditors. These creditors are typically other institutional investors such as pension funds, hedge funds, mutual funds, money market funds and other banks. Resolution authorities may attempt to ensure that the bail-in compensates as much as possible for the writing down of toxic assets. What remains of the bank is a much smaller institution stripped of most of its assets and liabilities that can be transferred to another bank as it is closed as an independent business.

The need for a resolution fund occurs at the point where a bail-in large enough to compensate for the write-down of toxic assets exceeds the capacity of the further financial system to absorb and endangers financial stability. The resolution fund contains the severity of the bail-in, so that what remains of the bank (primarily insured deposits and remaining safe assets) can be transferred to a new owner without threatening the solvency of the bank's creditors.

The alternative to bail-ins of private creditors, or a supplement thereof through the resolution fund, is a bail-out with public funds. Although bail-ins were uncommon and bail-outs widespread at the beginning of the financial crisis, bail-ins have gained traction in global circles as necessary to counter the incentive for large banks to engage in moral hazard by increasing creditor vigilance alongside stronger supervision. Institutional investors would have greater incentives to sit on boards of directors, insist on more transparent reporting and regular controls in ways that retail depositors cannot.[10] Bail-ins also reduce to some extent the possibility that bailing out an insolvent bank could bankrupt the state providing the bailout. This is a new and important part of the European regime based on German, Finnish and Dutch demands.

As with deposit guarantee systems, there are also clear functional reasons for setting up an independent resolution authority and fund before a crisis erupts. Uninsured depositors and creditors need to know that the resolution authority can and will impose losses on them in the event of insolvency to increase the incentive to monitor the bank diligently, in cooperation with supervisory authorities.[11]

In this context, the European Central Bank underlined the need for a European Resolution Fund and Authority, coupled with deposit insurance, if it were to effectively break the negative feedback loop between bank debts and public sector debts in Europe. To do this, a Single Resolution Authority was required with the power to close a bank swiftly (in the interest of preventing contagion that could damage financial stability) and impartially (to ensure that investors from different member states are treated equally). It also would require access to a single resolution fund and to additional public funding at the European level in the course of a systemic crisis.[12] The ECB underlined that a coordination of national resolution authorities would not provide financial stability properly.[13] Similarly, Gros and Schoenmaker argue for the establishment of a European Deposit Insurer and Resolution Authority.[14]

The ECB and ESRB also concurred with international experts on other details of institutional complementarity. They outlined that resolution funds must draw on deposit insurance funds to contribute to the costs of winding down a bank and ensuring the continuity of critical functions for the broader economy. To minimize the use of public funds in resolution proceedings, private actors should be expected to contribute first (unsecured creditors and uninsured deposits), followed by a resolution fund that banks pay for themselves, coupled with contributions from deposit insurance systems, and only then via a public sector backstop that would extend loans to the resolution fund. The fund would then repay those loans after the resolution and collect the balance from insured banks. The Scientific Advisory Committee of the ESRB concurred, stressing specific aspects for European financial stability. It emphasised the need for ex ante funds, as asking banks for capital during a crisis would be countercyclical for the general economy, and impractical when banks lack the capital to pay. [15] It also urged the establishment of a Single Resolution Authority and Fund over home country control so that a single body could deal with cross-border shifts in deposits during a crisis and avoid the weakest national resolution funds, deposit guarantee systems or public backstops from breaking under stress.[16] The Committee therefore viewed a combination of supervision, resolution and deposit insurance as necessary at the European level, coupled with access to the ESM as a public backstop and expressed concern that early Council plans for banking union had made no mention of such.[17] It went even further by arguing that resolution powers had to be sufficiently robust to ensure that public authorities could step in, take control, sort out the business and then restructure, recapitalise and reprivatize the good parts of the businesses without political interference.[18]

In the absence of common deposit insurance and resolution systems, the next best option is to coordinate national systems and pool funds. Early European Commission proposals for a European deposit guarantee system therefore included measures to ensure minimum coverage standards and cross-border transfer of data and home/host mutual assistance.[19] Coordination protocols focussed on cross-border payment, communication and public awareness, including issues of deposit coverage (scope and limits), payment methods and timing, in order to manage public expectations and avoid panic.[20] Suggestions to pool funds were made in 2010 and 2014.

Supervision, Moral Hazard and System Design

Bank supervision oversees the business activities of banks in accordance with regulatory law and standards, provides guidance, generates technical requirements and enforces compliance where necessary. Supervision promotes financial stability by ensuring that banks have sufficient liquidity to meet demand and sufficient solvency precautions (asset quality, capital ratios, net stable funding ratios, leverage ratios and stress tests that model the impact of negative shocks on bank viability). The costs to banks, as evidenced by stress tests in Europe and the United States, are considerable.

An initial concern for financial stability in Europe prior to banking union, with its fragmented political and regulatory structure, was that uneven application of supervision or outright forbearance by national supervisors confronted with distressed banks could distort competitiveness and competition and delay the exposure and cleaning up of toxic assets in the European banking market. The results would not only be felt in the continuing presence of zombie banks, which drag the economy down by soaking up capital without generating new credit (and therefore new economic activity), and in continuing uncertainty in Europe over how much cleaning up the banks would cost. This made discussions of burden sharing difficult, indeed impossible. European supervision was seen consequentially as imperative to provide a robust and even intervention into the European banking sector. It could then begin with a clean slate after the financial crisis, with confidence that forbearance and uneven application would not generate new crises. The Bank for International Settlements and the Academic Committee of the ESRB underlined strongly the need for a common supervisor that could prevent national forbearance.[21] Looking forward, the BIS noted that the need to look soberly at bank balance sheets and force corrective action on an ongoing basis would also become particularly important when quantitative easing is tapered to the extent that banks can no longer hide the extent of impaired assets.[22] This would be especially evident if national governments were incapable of recapitalizing banks in a crisis, as some southern European governments had been unable to do.[23] Robust supervision would therefore reduce the future likelihood of collapses in a range of scenarios, hopefully reducing pressure on resolution and deposit insurance systems.

The Centre for European Policy Studies (CEPS) added that a full banking union package could pave the way to global regulatory convergence on leverage ratios, further enhancing financial stability. They advocated focusing on overall leverage levels within the bank, which the FDIC employs as a measure that is objective, transparent and linked to the overall risk attached to individual banks, rather than the risk-weighted averages typically employed in Europe and in the Basel Accords. The FDIC shuns risk weights as prone to creative interpretation by banks and credit rating agencies, which undermines the usefulness of such information in assessing when a bank is at severe risk of failure or actually insolvent.[24] CEPS hoped that a strong ECB could start forcing down leverage levels in European banks that remain five to six times higher than in the United States on average.[25] American regulators forced down bank leverage levels after 2008, whereas their European counterparts did not, as they issued more debt to keep them afloat, particularly in the euro zone.

All of these points are clear expressions of intent by ECB, ESRB and global actors (IMF, IADI) in favour of centralized institutions in all three areas. The European Commission supported these positions in principle but found itself accommodating political demands to pass legislation. Those protected the prerogatives of the Member States from 2013 onward. The politics of responding to such pressures are analysed below.

THEORETICAL CONSIDERATIONS OF SUPPLYING BANKING UNION

Rather than follow expert advice outlined above, the EU elected to coordinate national deposit insurance and resolution systems and minimize the relevance of an (automatic) European public backstop to the respective funds. Conflicts between Member States, whether real or potential, and between them and the European institutions they reject, help shed light on why.

Theoretically and practically, the supply of European institutions is best explained by the intergovernmental nature of the EU decision-making process in establishing new institutions.[26] That view maintains that international negotiations on institutional development, cooperation and pooled resources are dominated by national governments who focus on the distribution of resources across countries, and exercise power to the extent that they can to secure the best outcome possible for themselves. Consequences for others are of a lesser priority. If true, then significant transfers of resources across borders and regulatory authority to the supranational level to secure mutual gain should be limited. Instead, voluntary measures[27] and coordination through networks of national competent authorities that preserve national autonomy[28] with minimal impact on those with the greatest power resources are more likely. Agreements will reflect the preferences of the most powerful, and with the strongest unilateral alternatives.[29]

The alternate hypothesis, based on either a liberal institutionalist theory of international relations or neofunctional theory of European integration is that functional incentives supported by supranational actors and private transnational coalitions will create pressures for national governments to create European level institutions. Positive welfare gains sufficient to induce cooperation include insurance against potential loss.[30] Insurance and regulation are shifted to the same level of activity as those of economic actors to avoid a suboptimal capacity to handle risks. Pooled or common financial resources to combat threats to financial stability where they are greatest to preserve and integrated, interdependent banking market are consistent with this view, whereas intergovernmentalism expects the deliberate reinforcement of national responsibility so that financial stability in the broader banking market declines.

SUPPLYING BANKING UNION

European DGS

The DGS Directive (2014/49/EU) opted to set minimum standards for national deposit insurance systems and to coordinate their use in cross-border insolvencies. It provides exemptions for certain categories of banks, such as credit unions, public sector savings banks and banking cooperatives, which the German government had defended heavily.[31] Deposit insurance can be used in resolution proceedings, but borrowing across DGS systems is voluntary. This results in an undersupply of financial stability when measured against the requirements of banking sector officials discussed above. National banking systems subject to greater volatility and stress are more likely to lack sufficient funds, both from deposit insurance and public backstops during a credit event.

Despite the functional necessities of establishing common deposit insurance and resolution systems at the European level, two thorny distributional issues complicated international negotiations--whether national governments or Europe collectively should provide funds, including a public backstop, and whether banks should all pay equally into the system, regardless of their risk profile. Net contributor countries sought to minimize costs by ensuring that private actors pay as much as possible, and that the collective funds are kept smaller rather than larger. They were also concerned that asymmetric benefits to countries with the weakest banking sectors encourage moral hazard, and damage the competitiveness of their own banks.[32] These concerns indeed led Germany, the Netherlands and Finland to reject European deposit insurance funds, reject the right of national funds to borrow from one another in an emergency, and restricted use of European Stability Mechanism funds for insolvent banks when deposit insurance had run out.[33]

An additional issue for national deposit insurance systems in Europe with distributional consequences is the coordination of national practices. This extends beyond the technicalities of sorting out who pays when bankruptcy affects depositors in more than one country, to preventing beggar-thy-neighbour policies that force other states to spend more on deposit insurance. The Irish introduction of unlimited deposit insurance in 2008 without consulting other EU Member States was viewed in other European capitals and in Brussels as disruptive, as it threatened capital flight out of other countries into Ireland until other countries followed suit and provided greater deposit guarantees. It was therefore easy to find agreement in the Council to improve coordination and information across countries, which might slow down or prevent similar situations from occurring in the future.

The initial response of the European Commission regarding deposit guarantee systems came in 2008, and was limited to modest technical measures to enhance efficiency in national systems. The draft directive proposed to shorten the payout times for depositors (to three days from three to nine months) to increase the amount covered (from 20 000 euros to 100 000) and to mandate cooperation between national systems, albeit in an unspecified manner.[34]

Subsequent bank failures during the 2010 onset of the euro zone crisis led to a reformulation of the draft directive, this time targeting financial and other cooperation across national systems, to address the chronic instabilities of southern Europe in particular. The proposals failed to address shortcomings in public backstops however. The Council agreed to minimum standards for national systems and providing for coordination between them, but not to introducing common European deposit guarantees. Coordination measures were designed both to prevent the Irish scenario from repeating itself--coverage for deposits shifted across borders after the point of failure would not be possible,[35]--and to prevent northern European systems from having to pay for the collapse of southern European banks with branches in the north, by ensuring that national deposit insurance systems of a bank's home jurisdiction would ultimately cover liabilities in other EU Member States.[36] National governments would then be responsible individually for shortfalls in the system as the public backstop. These details strengthen, not weaken the link between national governments, DGS and banks headquartered in their jurisdictions.[37] Commission plans to require risk-weighted premiums were rejected in favour of Member States deciding how to charge banks.[38] Similarly, most European Parliament demands fell by the wayside. However, they did secure 100 000 euros standard coverage.[39]

The Commission tabled a new European DGS proposal in September 2012 to reflect an emerging global consensus that deposit insurance funds should be deployed as part of bank resolution. The logic that the deposit insurance would pay out less by helping prevent outright failure than waiting for an actual collapse reflected the state of the art in maximizing the contribution of deposit guarantee funds to financial stability. Given the willingness of European states to pass related legislation on resolution, it appeared an opportune moment to secure agreement on deposit insurance. However, the continued prospect of cross-border transfers led northern European states to block an agreement. The proposed right to borrow across national DGSs was expressed again as an option,[40] and then withdrawn entirely in a later Commission proposal, following German objections to features which could result in cross-border transfers, a "fiscal union through the back door."[41] The revised proposal was considered insufficient by a number of outside specialists. Rather than national coordination, the IMF made it clear that a truly European DGS was essential for financial stability.[42]

An alternative from Gros and Schoenmaker attempted to secure agreement despite distributional concerns by lowering the prospect of immediate transfers between states and lowering transaction costs for states without ex ante funded systems. They argued for a combined European Deposit Insurer and Resolution Authority whose powers and funds would be phased in alongside national institutions to take over from national authorities and ex ante funds over a 20-year period. Countries with ex ante systems would transfer assets gradually to the European system, while countries with ex post systems, like the Netherlands, would build up their contributions over time.[43]

Gros and Schoenmaker also tried to minimize the concern of Germany and others likely to have to be net payers into a transfer system that feared paying for the existing toxic assets of foreign banks. They proposed that only well-capitalized banks should enter the system, so that the fund's establishment would not make large transfers to cover past losses (legacy problems). Those debts would remain national problems.

The Gros/Schoenmaker plan hoped that zombie banks could be cleared up in an orderly fashion and distributional concerns regarding unknown liabilities across countries be resolved simultaneously. It therefore dovetailed with Germany's demand that European deposit insurance or resolution funds could only be considered after the establishment of the ECB as the single supervisor for the European banking system (below).[44] As Gros and Schoenmaker underline, however, supervision equally requires strong resolution and deposit insurance systems.

Nevertheless, the Council chose a plan for coordinated national approach coupled with minimal cross-border transfers at the discretion of Member States. The discretion of member state governments in granting loans to the DGSs of other countries reflects not only an undersupply of the public backstop to deposit guarantees, but an asymmetric one at the European level. Countries with higher credit ratings enjoy a stronger capacity to borrow to shore up their systems in an emergency, whereas the banking systems of financially weaker countries need to reduce their balance sheets more vigorously than elsewhere to lower demand for capital. Alternatively it ensures that the EU's more financially powerful countries are more fully capable of coercing national governments faced with failing banks to close them against their will. Germany, the Netherlands and Finland recognized and showed that they would not share costs in a deposit guarantee system in the 2013 Cyprus bank crisis. Instead they used Cyprus' incapacity to pay to exert pressure on it to restructure and resolve banks in return for ESM assistance. The head of the euro group, Dijsselbloem, was even willing to undermine confidence in deposit insurance across Europe, and thereby the effectiveness of financial stability measures overall, in the process of coercing restructuring of the Cypriot banking sector.[45] This was to be done without cost to northern taxpayers by imposing haircuts also on insured deposits. The proposal was retracted on Germany's insistence to prevent bank runs throughout the euro zone's southern periphery.

As Gros and Schoenmaker suggested, Germany, the Netherlands and Finland adopted the position, and later the eurogroup, that national governments would have to take responsibility for legacy debts of national banks made before any European resolution mechanism would enter into force, thereby blocking recapitalization of Southern European and Irish banks by their northern European neighbours, as the potential recipients had requested.[46] Financial assistance through the ESM would only be possible in resolution and restructuring cases that shut banks down, discussed below. Given the dominance of the German coalition within the ESM, funding would therefore only be negotiable for future crises, and only when the recipients accepted eurogroup demands on when and how a bank is to be closed, as in the Cyprus case.[47]

Overall, expert advice was adopted for national deposit insurance systems, while politics ensured that it was accepted for calls to develop a European authority and fund as outlined above.

European Resolution

European resolution is divided into coordination and supranational decision making about the onset of resolution. The Bank Restructuring and Resolution Directive (BRRD, 2014/59/EU)[48] sets minimum national standards on resolution rules and procedures and mandates contacts and cooperation across national authorities on implementation. The Single Resolution Mechanism (SRM) Regulation establishes the Single Resolution Board (SRB) and grants it the responsibility to review those plans, ensure cooperation and recommend resolution of an insolvent institutions to the Commission and Council. The Commission decides however, subject to Member State approval in the Council, after which a national authority executes the plan under SRB supervision. It is therefore a system that primarily coordinates national authorities. The SRM also establishes a Resolution Fund with national compartments that will be mutualized over a period of 10 years.

The introduction of the SRM in the EU fell significantly short of BIS, IMF, ECB and ESRB expectations, and short of the achievements secured in the Single Supervisory Mechanism. The political and legislative process necessitated working through issues of national harmonization and coordination first as the parties determined how far they could go with regard to the establishment of a European Resolution Authority (ERA) and Fund. The first tasks were handled in the BRRD. The authority and use of the fund were handled in the Single Resolution Mechanism Regulation, while an intergovernmental agreement outside the EU establishes and manages the fund itself.

The draft BRRD was tabled in June 2012, three months before the proposal for the Single Supervisory Mechanism, but concluded only in May 2014, due hesitancy in Council over whether European powers were needed, and what common standards of resolution should apply. Like the DGS Directive, it first attempted to coordinate national systems and harmonize certain elements rather than establish a European authority and fund.

The implications of resolution were clear to national governments, as evidenced in Council documents. They acknowledged that the powers of a resolution authority can be wide-ranging, affecting the power of not only creditors, but of its shareholders and owners through the transfer business (to another company or bridge institution), selling assets within the group without the approval of shareholders if necessary.[49] However, their response to the draft insisted that the BRRD respect the principles of European company law.[50] This impedes resolution involving the parts of a bank or an entire bank from one EU member state to another, given that EU company law allows Member States to place effective impediments to the migration of a company out of its jurisdiction.[51]

Some of the Council's deliberations focused on technicalities of coordination between national authorities (information sharing and setting up resolution colleges for cross-border cases). Others focused on setting minimum standards for national resolution laws, authorities and funds. They agreed that Member States should appoint independent resolution authorities, ensure their involvement in resolution along guidelines set out by the European Banking Authority,[52] but also to resolve banks as much as possible without extraordinary public support, including finance from the general budget.[53] This expectation reverberates with arrangements made by euro zone Member States for the ESM in 2013 that any loans made to a country for resolution purposes must first minimize the size of the public backstop required. Resolving banks with a minimum of public support (bail-out) and maximizing the cost paid by private actors (bail-in) was demanded by the Netherlands and Germany, and opposed by governments in Southern Europe, France and Ireland. Nevertheless, elected finance ministers were to be involved in resolution proceedings. This underlines that the

Council's concerns were about public expenditure far more than ensuring independent control by resolution authorities, as technical experts had advocated.

Bail-ins nevertheless raised national differences in algorithms--how to choose which private investors should suffer first and most--which took time to resolve. Although the ECB urged Member States to decide on one list, the Council initially could not come to an agreement on a single standard.[54] It also deferred the requirement for countries to put bail-ins before bailouts until 2019, thereby preserving national differences temporarily. Although the euro group could coerce such a choice for Cyprus at the moment of insolvency, it was not able to do so for countries dealing with banks that were not on the brink.

The BRRD's final format ensured that shareholders would suffer the first losses, followed by unsecured creditors, with covered deposits enjoying the highest level of protection.[55] National authorities would be able to make further exceptions in conformity with national resolution law where imposing a haircut would prevent the provision of 'critical functions', or would unleash further contagion, or impose losses on other creditors. While the later passage of the SRM Regulation placed an additional layer of European supervision on top of this national process (discussed below), national authorities remain largely in control of the details that matter most in a resolution, such as the detailed pecking order of claims and exemptions.

The ECB critiqued the Council's decision to wait until 2019 for the bail-in provisions of the draft directive to take effect. Resolution authorities would lack one of the most important tools in doing their jobs, which would undermine the intent of the BRRD.[56] It also argued that the discretion of national law and authorities could generate legal uncertainty for investors, supervisors and others in addition to making forbearance possible. It levelled the same critique against the lack of rules regarding the pecking order of creditors who would be called on to contribute to a bail-in. This would create an incentive for political manoeuvering at the national level as governments sought to maintain control, management and/or ownership over domestic banking institutions,[57] making bail-ins work differently from country to country, and more slowly. [58]

The issue of which national resolution authority or authorities would have the power to direct such matters was also an issue for dealing with multinational banks. As with deposit insurance, the issue was decided by assigning authority for all parts of the bank and its subsidiaries to the country in which the bank is headquartered.[59] Although there were provisions to form resolution colleges of multiple national authorities would be formed to cover multinational banks, the Council's position was that lead authority would have the power to act even over the objections of other authorities.[60] This strengthens the power of national authorities supervising the EU's largest multinational banks at the expense of countries served by those banks.[61] This outcome has long-term market advantages for banks headquartered in countries where the sovereigns are best able to provide lender of last resort services in the form of cash injections or debt guarantees—in Germany and a few selected countries allied with it.

Between 2013 and 2014, the Council's position on shared resources shifted meaningfully, particularly with regard to shared resolution funds, but in ways that continued to keep the available funds small and therefore ensure continued reliance on national funds. As late as 2013, the Council had not yet agreed to share resolution fund money across national borders, [62] ex ante funding was still an option rather than a requirement, and the level of funding was half the international standard with assets of 0.8% of covered deposits 10 years after the directive enters into effect (rather than the international norm of 1.5% immediately). [63]

The only agreements in 2013 were demands made by Germany, the Netherlands and Finland that protected existing national systems and reduced the likelihood of public money being used to resolve a bank, nationally or collectively. Banks would be required to pay for the fund, based on liabilities and risk, and countries would be able to make the resolution fund part of deposit insurance or bank insurance, allowing for a minimum of adjustment in national systems. National resolution funds could be used for direct recapitalization, but only after creditors had been forced to take a haircut 8% or more of the bank's liabilities.[64] This restricts the use of resolution funds by EU Member States in protecting their banking sectors. Effectively, the BRRD limited itself to setting the standard for newly established national resolution systems and their coordination. European elements were dealt with later in conjunction with the establishment of a European entity for resolution.

The power of what was to be the European resolution authority in 2014 was more than states had agreed to previously, but less than experts had called for. Instead of an institution modelled on the FDIC with sweeping powers, the EU established a Single Resolution Board as a layer coordinating and working together with national resolution authorities (NRAs) in recommending resolution of banks to the European Commission and the Member States in the Council. The Board itself is comprised of five standing board members, plus all of the national resolution authorities of the euro zone (plus any other states that wish to join the system). The Board recommends to the Commission whether a bank should be wound down and presents that decision together with a resolution plan, which is drawn up by the national resolution authority in question, or in special cases, by the resolution college of two or more national authorities that are significantly affected. Pending approval by Commission and Council, the Board then hands over implementation to the national authority, which executes in accordance with national law, which may differ on material matters of importance to creditors. Adding to this already cumbersome and time consuming process, the Board may not intervene at an earlier stage to put a bank under administration and recapitalize, as suggested by experts above, but only when collapse had become clearly unavoidable. National powers and laws therefore still remain important.

Meanwhile, the Resolution Fund was set up in such a way that national funds and public backstops will continue to have vital roles to play. The SRM Regulation finally provided the legal means by which deposit insurance funds would be used to supplement resolution funds. It also stipulates the broad terms of the establishment of the Fund, including ex ante funding and replenishment, the gradual mutualization of the Fund on an accelerated time schedule of eight years rather than 15 years as originally envisaged, so that contributions can flow across national borders, and earlier if required. But the Regulation stipulates that the Fund is to be used as a last resort only, and that the Fund remains outside the EU on the basis of intergovernmental agreement rather than EU law. It also kept the size of the Fund at its original low level of 55 billion euros. This ensures that anything beyond the size of a single large institution would have to be handled by another fund, such as national public backstops or an intervention by the ESM, which provided 100 billion in assistance to Spain in 2012, for comparison, and has a combination of subscriptions and leverage totalling 1 trillion euros.[65]

Overall, politics proved more important that expert advice in shaping European resolution. National competent authorities and laws remain strong within a coordinating framework. Concessions were found on the resolution fund, but the volume of shared resources is modest in comparison to ESM capacity, and to liquidity needs demonstrated in the resolution of banks in Spain in 2012.

European Supervision

The EU agreed fairly quickly on establishing the ECB as the lead banking supervisor for the internal market. The ECB directly supervises 128 of the EU’s largest banks, holding more than 80 per cent of all bank assets and develops the Single Rulebook on supervision that national supervisors apply to the rest. It relies, however, on national authorities for data and implementation aspects of its duties.

The distribution of costs and benefits between states in the euro zone (a political motivation), proved even more important than evenness of supervision (a technical motivation) in determining the strength and early establishment of the Single Supervisory Mechanism. Although there were disagreements about how many banks the ECB would supervise directly, Germany and its closest allies on the Council demanded a strong European bank supervisor in exchange for any financial assistance they would provide to other countries. In 2012, this concerned the extension of 100 billion euros in loans to Spain to contain and resolve a mid-level collapse of the savings bank sector. As negotiations over banking union continued, it extended to concerns about the cost of a resolution system as well. Germany, the Netherlands and Finland cited concerns about moral hazard and unknown financial exposures in the European banking system that might burden them, and expected that a strong supervisor could detect and force the liquidation of toxic assets that might otherwise become liabilities for national governments, resolution and deposit insurance systems, and in turn, for the EU Member States, either as members of a future common resolution fund (which was under discussion) or as contributors to the ESM. Supervision was a much less pressing priority for most other euro zone Member States in comparison to financial support, particularly those seeking the swift establishment of the ESM in June 2012. However, those euro zone member states accepted the necessity of supervision as the price of accessing a collective public backstop in the ESM that they could not supply themselves individually.[66] The more precarious the banking sector, the more concerned the governments had to be about the potential negative impact of aggressive supervision, but the inability of some governments to rely on bond markets for financing public debt during periods of stress make it plain that they had to accept these terms.[67]

What is remarkable is how strong the ECB turned out to be despite the initial reluctance of Germany, its main supporter, to allow supervision over any but the 25 largest EU banks. The development of an algorithm extending direct coverage to 128 banks, based on a wider definition of systemic importance, was the first successful move taken to expand authority beyond its original mandate. The decision to complement EBA stress tests with its own Asset Quality Review in 2014 was a second successful move.[68] The AQR signalled to banks and supervisors early that the investigation would be more strenuous than previous stress tests run by the EBA, leading most of them to significantly increase capital over the course of 2013, and for those that failed to make the grade, to do so afterward as well. This message apparently only failed to reach Italian banks and supervisors in time, given that Italian banks constituted half of all failures. This certainly hardened the ECB's reputation. Nevertheless, German support remained firm throughout. The third move is the development of the single rulebook that national regulators are expected to apply to other banks as well.

This raises the question of whether the Single Resolution Board might develop the same degree of power, and whether that institution and the ECB have power independent of the political backing they enjoy. Even though the Board's powers are less extensive than those of the ECB as the Single Supervisor, given the reluctance of most governments to relinquish involvement in bank affairs, SRB strength is essential in signalling to banks and national supervisors that there are real consequences if banks fail to take precautions to prevent collapse. This has not been tested yet, but the German strategy of keeping cross-border transfers to a minimum and reinforcing incentives to national authorities to keep their houses in order is consistent with continued political backing, and as in the case of supervision, using the ESM to keep political discontents in line. The SRB is therefore likely to be used rarely, but decisively, without serious political challenges.

In the case of supervision, expertise does well, but politics, particularly the demands of Germany and its allies, moved in the same direction and supported it in ways that was not the case for strong European resolution powers or deposit insurance funds.

CONCLUSIONS

This article began with the premise that politics is more important than expertise in determining the transfer of authority and funds from the national to the European level in the banking union project. Expertise matters, but goes to addressing national institutions and practices unless politics agree to establish institutions supranationally. This need for European institutions and funds is driven by functional necessity in part (see the trigger of Spain in 2012) that could not be managed in an, ad hoc, limited fashion, but suppled by power politics over the distribution of resources and the need to protect national banking systems to some degree. This is evidenced by the limited development of supranational funds, so that the ultimate backstop remains with individual member states, and where necessary, the ESM, coupled with strong supervision to minimize the likelihood they will have to be used in the future.

All of this means that banking union is built on a tension between strong transfer of supervision to the European level, but significant conservation of national authority in deposit insurance, resolution and provision of public backstops. This reinforces the link between national sovereigns and banks that banking union was meant to reduce or eliminate for the time being. This was deliberate, and ongoing vulnerability of euro zone banks to future shocks is the result, particularly in the euro zone's periphery.

Given the weakness of European crisis management as a result, banking union's hope is therefore on prevention more than crisis management. There is little doubt that the European Central Bank has done its utmost to expand its authority when given the opportunity in important areas and will continue to do so with positive effects on bank balance sheets. There are also reasons to believe that the SRB will also be an institution to contend with, though not with as much freedom to innovate as the ECB. The ECB's capacity to extend its mandate puts greater pressure on banks and national regulators and is enhanced by a politically permissive environment, in which the countries that pay most to bolster national public backstops with the ESM and eventually, modest shared resolution funds, support it.

The other components of banking union, however, support national responsibility for keeping banks in order and dealing with the consequences when banks fail or are close to failing. In the medium to long term, the existence of the ESM is sufficient to ultimately keep financial stability together when national deposit insurance, resolution funds and public backstops fail, but primarily in ways that continue to put pressure on the weakest links of the European banking system.

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