Banking Union: Where does it stand? What next?

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Banking Union: Where does it stand? What next?

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Abstract

In response to the financial crisis, the Eurozone pursued a number of initiatives to create a safer financial sector for the single market. However, the divergent preferences between core and periphery countries and the negative legacy of the crisis have watered down ambitious reform plans for substantial risk-sharing arrangements. In this context, the Eurozone cannot strike a balance between solidarity and crisis prevention. Compared to mid-2012, the “window of opportunity” for strengthening the banking union seems closed for the moment. Paradoxically, doing reforms in fair weather is much more difficult, while the immediate reason for the sudden move to Banking Union was the intensifying euro sovereign crisis. As a consequence, the implemented reforms have limited scope and they leave room to financial markets for a disciplining role over states.

KEY-WORDS: Eurozone, banking union, reforms, risk-sharing, market discipline.
1. Introduction

The sovereign debt and banking crises of 2010-12 have led to significant changes in the institutions of the Eurozone. More specifically, the decision of heads of state or government of euro area countries on 28-29 June 2012 to establish the banking union was the hallmark of an important reform process. The three pillars of the banking union - the Single Supervisory Mechanism, the Single Resolution Mechanism and the European Deposit Insurance Scheme - ensure stronger prudential requirements for banks and common rules for managing troubled financial institutions. However, a common system for deposit protection has yet to be established and further measures are needed to tackle the remaining risks of the banking sector. During the past few years, many ambitious reforms have been watered down due to the political disagreement on the extent of solidarity required for a deeper banking and economic integration. A truly Eurozone budget does not currently exist; banking integration and the common deposit insurance scheme are proceeding at glacial speed; a decision on a common “safe asset” is in deep freeze (Pagoulatos 2020). What are the reasons which reduced the “window of opportunity” for implementing more ambitious initiatives after 2012? What is the content of the current debate on strengthening the banking union? How will the banking union be affected from the recent reforms of the Eurozone? Has the sovereign-bank doom loop been sufficiently severed? Is it possible to reconcile risk sharing with market discipline? We explore these questions looking at: (a) the role of a complete banking union and the surrounding political conflicts, (b) the possibility of opening a new “window of opportunity”, as it was the case in 2012, and (c) the content of the current reform proposals and the following political initiatives which have taken place.

2. The role of a complete banking union in the euro area

In the aftermath of the global financial crisis, a strong heterogeneity in macroeconomic variables remains in the EMU. For example, there is significant
heterogeneity in unemployment rates across the euro area countries. In this regard, the low degree of risk sharing through banking systems, capital markets, savings, and, to a lesser extent, fiscal policy within the EMU made things worse and delayed recovery (Gopinath 2019: 244). On the contrary, in the US, it is estimated that around 70% of local crises are absorbed through the integrated financial markets with the capital markets absorbing about 45% and the remaining 25% absorbed by the banking market. In the euro zone, however, the overall absorption rate is only 25% (Draghi 2018). Indeed, risk-concentration is significantly high in the economies of the Eurozone. European banks have been criticized for holding too much domestic government debt, before and during the crisis, intensifying the doom loop between sovereign and bank credit risks. Banks and sovereigns are linked by three interacting channels: (a) banks hold large amounts of sovereign debt; (b) banks are protected by government guarantees; (c) and the health of banks and governments both affects and is affected by economic activity (Dell’Ariccia et al. 2018: 6). There are “bad” and “good” reasons for that. The “bad” reason for increasing sovereign home bias is the excessive exposure to high-yielding risky sovereigns (Acharya and Steffen 2013), in combination with the long history of banking nationalism in Europe (Veron 2017). Basel bank regulations also treated sovereign debt essentially as risk-free, implicitly assuming that there would always be a bailout. On the other hand, the bank-sovereign nexus may be considered as a stabilizing force for home economies during market downturns when sovereign risk rises. Informational advantage might lead domestic banks to act as buyers of last resort, absorbing the local assets while foreign banks may rid themselves of their exposures (Saka 2016).

In this context, the role of a fully operational banking union in the euro area is two-fold: (a) to manage the flow of credit risk emanating from weak banks to the balance sheet of their sovereigns and (b) to manage the flow of credit risk emanating from sovereigns to the banking system holding sovereign debt (Acharya 2012, Goodhart and Schoenmaker 2009). In the same vein, an integrated architecture for financial stability would reduce financial fragmentation and weaken the vicious loop in many countries of rising sovereign and bank borrowing costs. Moreover, a single regulatory and supervisory framework would contain systemic risks and limit the moral hazard related to common safety nets; a single resolution mechanism with adequate financial backstop would isolate and minimize areas of weakness; and a common safety net would help prevent massive deposit runs (Goyal et al. 2013: 6,7). In addition, another group of safe asset proposals consider that a European-level safe asset could emerge as part of a borrowing capacity for a European budget or for European institutions (Best 2018: 11).
In the light of the above, the current debate on banking union is over whether to put risk sharing or risk reduction first. Solidarity means, by definition, a kind of risk sharing and debt mutualization but, on the other hand, moral hazard always exists in such a process. Nordic countries are in favour of the banking union ultimately being completed although they believe that the first priority should be risk reduction (Smid et al. 2018). For example, the idea of a full common safe asset to manage the flow of credit risk emanating from sovereigns to the banking system holding sovereign debt was rejected by the fiscal conservatives (Issing 2009). A common European safe asset tends to improve Euro area financial stability by limiting destabilizing capital flows as well as break the bank-sovereign nexus by limiting domestic bias in bank portfolios. For this reason, several proposals have been put forward, ranging from full to partial or common issuance, some based on mutualisation and others entailing no joint liabilities (Monti 2010, European Commission 2011, van Riet 2017, Leandro and Zettelmeyer 2018). Nevertheless, breaking the doom loop requires the adoption of a common safe asset, since “all regulatory designs are constrained by the incompleteness of euro area sovereign debt markets, which make it impossible to assemble a portfolio that has sufficiently low concentration and credit risk” (Alogoskoufis and Langfield 2019).

Consequently, beyond the technical aspect of risk-sharing, there are two different strategies that are unfolding on the future of the banking and economic union in general: on the one hand, there are those proposals that seek to create a large and robust bond market in the Eurozone in order to deepen the single financial market and, on the other hand, proposals with far more political content that tend towards fiscal union by promoting the creation of a mechanism to help troubled economies to maintain a stable source of funding, even in times of crisis (Claeys 2018). The divergent interests of core and periphery economies are explained by the different variables that affect fluctuations of growth rates. More specifically, institutional integration plays a positive role for growth, overall and for the periphery in particular. Looking into the variables which are linked to differences in growth rates the findings affirm a positive association of the EU institutional and political integration with long-run growth, for periphery countries particularly (Comunale and Mongelli 2019a). In the opposite direction, deeper financial integration seems to have beneficial effects on the core economies, but it is not significant in the periphery (Comunale and Mongelli 2019b).
3. The lost opportunity for deepening the banking union

A) The “window of opportunity” in 2012

In the recent literature on explaining the response to the sovereign debt crisis in the euro area there is a trend detected towards a new type of intergovernmentalism that includes to some degree a neofunctionalist perspective (Bickerton et al. 2015, Schimmelfennig 2015, Schmitter and Lefkofridi 2016, Epstein and Rhodes 2016, Schimmelfennig 2017). On the one hand, liberal intergovernmentalism explains the politics to cope with the euro area crisis by the influence of national preferences and bargaining power. On the other, the core assumption of the neofunctionalist approach connects the degree of integration progress with the realization of mutual gains from cooperation in policy arenas characterized by high levels of functional interdependence. In this context, divergent national preferences on distributional consequences of fiscal consolidation were accompanied by a common willingness of member states to preserve the euro. This led, in turn, to incomplete solutions based on minimal supranationalism, which deepened integration in an asymmetric way. Asymmetric effects took place to prevent complete collapse, but the core development is that financially powerful member states imposed limited risk-sharing on weaker economies (Jones et al. 2016, Donnelly 2014). If that is the case, competing coalitions of member states that shared any similar economic interests by saving the common currency resulted in an incomplete banking union (Howarth and Quaglia 2016, Quaglia 2017): banking supervision was supranationalised; resolution was supranationalised although there is still room for intergovernmental bargaining and a relatively high degree of discretion exercised by national resolution authorities; and a single deposit guarantee scheme was not established.

Nevertheless, recent literature has not yet scrutinized the timing of the setting up of the European Banking Union. The banking union as a term was first introduced in the European public debate at the end of 2011 and was widely used by European officials in the spring of 2012 (Veron 2015). Until then, the EU followed the recommendations of the Jacques de Larosière report, which rejected the introduction of a single surveillance mechanism as unrealistic and recommended the creation of the European Banking Authority (EBA) to organize a more formal coordination of national supervisory authorities. So, what explains this policy change? Our analysis for examining the “window of opportunity” in mid-2012 is based on the “multiple streams” theory of policy formation. This theory is concerned with three categories of independent variables that interact to create “windows of opportunity”: (a) the “problem stream” is filled with perceptions of problems that are seen as “public”; (b) the “policy stream” is filled with
the output of experts and analysts who examine problems and propose solutions; and (c) the “political stream” comprises factors such as changes in national mood, executive or legislative turnover (Béland and Howlett 2016). The “window of opportunity” in mid-2012 turned up as a result of the coupling of two main streams: the political stream and the problem stream. These developments, in turn, brought about a significant policy change. First, Spain’s request for financial assistance altered the “framing contest” of the Eurozone crisis, accelerating the creation of the banking union. Framing contests refer broadly to “the way in which political elites, such as the news media, politicians, interest groups, and other political players, define the political space and erect the boundaries within which a public policy issue will be considered” (Callaghan and Schnell 2005: xi). In this regard, it is important to underline that “if Spain had agreed to an adjustment program before the spring of 2012, the window of opportunity for the banking union would not open because the bank recapitalizations would have been negotiated bilaterally with the Troika” (De Rynck 2014). Consequently, European leaders, and Angela Merkel in particular, recognized the increased systemic risk and the contagion risk against the backdrop of the problematic Eurozone architecture. Since then, the need for accelerating the creation of a permanent crisis resolution mechanism and the establishment of the banking union were considered top priorities (ESM 2019b:132). The European Stability Mechanism (ESM), a permanent solution for the lack of a backstop for euro area countries which no longer maintain access to external finance, was established in October 2012. The ESM is the successor to the European Financial Stability Facility (EFSF), which was set up as a temporary solution in June 2010 and provided financial assistance to Ireland, Portugal and Greece.

Furthermore, the change in the conceptual framework of the crisis encountered the political developments (“political stream”) that took place in some politically important countries, i.e. Italy, Spain and France, during November 2011-May 2012. The first political change took place in Italy, in November 2011. The technocratic government of Mario Monti replaced the government of Silvio Berlusconi, who resigned on 12 November 2011, under the pressure of financial markets. Mario Monti, on the other hand, was welcomed with great satisfaction by the financial markets. At the same time, the Spanish government’s bond yields approached the levels of Portugal and Greece in their time of need, and socialist Prime Minister Zapatero called early elections in December 2011. The conservative leader Mariano Rajoy emerged as a winner with a very rigorous financial agenda supporting an adjustment programme of €65 billion in the next two years, the largest ever in the Spanish history. Subsequently, in May 2012, François Hollande won the presidency of France, promising a “new start”
and an end to the austerity measures imposed by Germany. Despite their ideological differences, all the new leaders signaled a new era of political stability in Southern Europe. Moreover, the political changes marked the creation of a robust coalition against Germany’s restrictive fiscal policies. For example, the change of government in Spain in November 2011 brought “a significant change in crisis management: the style became more adversarial, less predictable”. In February 2012, the prime minister Rajoy announced that “Spain would not meet its fiscal targets and hinted he was not prepared to agree on binding new restrictions” (Brunnermeier et al. 2016: 353). The effects of the above political changes were shown at the European Council of 28-29 June 2012, which confirmed the decision to support the European Banking Union. At this Council, the President of the European Council was invited to develop, in close collaboration with the President of the Commission, the President of the Eurogroup and the President of the ECB, a specific and time-bound road map for the achievement of a genuine Economic and Monetary Union. The report “Towards a Genuine Economic and Monetary Union” including “four essential building blocks” for the future EMU: an integrated financial framework, an integrated budgetary framework, an integrated economic policy framework and strengthened democratic legitimacy and accountability (European Council 2012). It was upon these “building blocks” that European leaders decided to take on significant political initiatives for the strengthening of banking and economic integration.

The European Commission proposed a regulation for the establishment of the Single Supervisory Mechanism (SSM) in September 2012. The initiative to create the first pillar of the banking union was formalized on 15 October 2013, when the Council of the European Union approved Regulation (EU) 1024/2013. The SSM came into force on 4 November 2014, thereby the ECB assumed the supervisory tasks assigned in accordance with the SSM Regulation. Thereafter, the SSM supervises directly the systemically important banks of the participating countries. In addition, the ECB may at any time demand and take over the direct supervision of smaller banks. Furthermore, all euro area member states participate automatically in the SSM and other EU countries that do not yet have the euro as their currency can choose to participate in “close cooperation” with the ECB. It is worth noting that the establishment of the SRM took place despite the strong resistance from key local interests, mainly the dissatisfaction of small/medium public saving banks (Sparkassen and Ländesbanken) and cooperative banks, which are the central pillar of liquidity for the regional development in Germany. Given the vital role of saving banks in the economy, the German government favored a limited scope of single supervision, focusing exclusively on systemically important banks, in order to maintain saving banks
under domestic control (EUobserver 2013). In this direction, the German saving banks association supported that “banks that are too big to fail - not savings banks - should remain the regulatory priority”. Additionally, the German saving banks underlined that the new supervisory mechanism should “take into account the different circumstances” (Financial Times 2012) and the specific characteristics of each individual economy.

Regarding the second pillar of the banking union, resolution is the orderly restructuring of a bank when the bank is failing or likely to fail. This procedure ensures that a bank failure does not harm the broader economy or cause financial instability. In July 2013, the Commission issued a proposal for the establishment of the Single Resolution Mechanism (SRM). The final agreement was accomplished at a meeting of the Economic and Financial Affairs Council in December 2013. The SRM applies to all the banks being subject to the SSM. The organization of the SRM mirrors that of the SSM, as far as the division of responsibilities between the supranational authority and the national authorities is concerned (Baglioni 2016: 95). The tasks of resolution are assigned to the Single Resolution Board (SRB), in collaboration with national authorities, which retain responsibility for executing the resolution actions. The SRB consists of representatives from the ECB, the Commission and the national resolution authorities; also, it covers all the banks headquartered in Banking Union member states. Additionally, the SRB holds broad powers in cases of bank resolution upon notification by the European Central Bank, which decides when a bank is failing or likely to fail. Otherwise, the Board on its own initiative would adopt a resolution scheme placing the bank into resolution. The Board would also determine the application of resolution tools and the use of the Single Resolution Fund (SRF). Decisions by the Board would come into force within 24 hours of their adoption, unless the Council, acting by simple majority on a proposal by the Commission, objected or called for changes (Council of the European Union 2013). It is worth noting that the German government with their allies (Holland, Finland) opposed the Commission’s decision-making power on the approval of a resolution plan and they pushed to assign this responsibility to the Council (El Mundo 2013a).

The banking union also allows the SRF to support financially the restructuring process. The SRF is composed of contributions from credit institutions through the pooling of financial resources of national funds of participating countries. Furthermore, it is important to underline the ability of the SRF to borrow from the markets. In 2012, the then Internal Market Commissioner Michel Barnier proposed alternatively that the ESM should assume the permanent rescue backstop facility task. On the other hand, the German government opposed strongly these proposals. Wolfgang Schäuble, the then German Finance
Minister, challenged the legal basis of Barnier’s proposal (El Mundo 2013b) and insisted that a resolution process “could only be the responsibility of the national resolution authorities” (DW 2013). Five years later, a wider package of measures to complete the Banking Union, which was approved in December 2018, included the introduction of the common backstop for the Single Resolution Fund (SRF). The common backstop will be in place by 1 January 2024 at the latest. The size of the credit lines will be aligned with the target level of the SRF, which is 1% of covered deposits in the Banking Union (currently estimated at around €55 billion) (SRF 2019: 1). If the credit line is used, the SRF will pay back the ESM loan with money from bank contributions within three years, although this period can be extended by up to another two years. As a result, it will be fiscally neutral over the medium term (ESM 2019a). Additionally, a contribution from the SRF to recapitalisation may be made only under two key requirements included in the Bank Recovery and Resolution Directive (BRRD): the bail-in of at least 8% of total liabilities including own funds (TLOF), and a contribution of a maximum of 5% of TLOF. Furthermore, the use of the SRF would be assessed by the Commission to ensure it complies with State aid rules. Nevertheless, some national authorities have resisted in several cases a complete implementation of the BRRD. For example, the Italian authorities lobbied the Commission for leeway and looked into the intricacies of the BRRD to find the extent of discretion allowed for policy makers, just as was the case with the treatment of three failing Italian banks-Monte de Paschi, Veneto and Vicenza-that were resolved in 2016/2017 (Donnelly and Asimakopoulos 2019).

As regards the third pillar of the European Banking Union, the insurance deposit scheme remains merely a system of national deposit guarantee schemes. More specifically, the Directive 2014/49/EU provides that all deposits up to €100,000 are protected all over the EU. Despite the pressure from the European Commission for a single insurance deposit scheme, the German government “has long opposed it, fearing a political backlash to the idea that its funds could be used to guarantee the deposits of savers in other European countries” (Reuters 2015). In addition, the fear of moral hazard has resulted in the rejection, by the German authorities, of any form of debt mutualization, like a single European liability – proposed by the Commission in October 2017 (European Commission 2017). From the point of view of the Germans, “entrepreneurial and political responsibility and liability must not be separated”, while a single European liability “leads to the opposite outcome” (Handelsblatt 2018).
B) This time is -actually- different...

In the mid of 2015, the so called “Five Presidents’ report”, authored by Jean-Claude Juncker, Donald Tusk, Jeroen Dijselbloem, Mario Draghi, and Martin Schulz, was published outlining plans for strengthening the economic and monetary union by 2025 at the latest. Since then, a lot has been done towards completing the EMU. However, the banking union’s architecture is not yet complete. Compared to mid-2012, there are strong differences resulting in minimizing the “window of opportunity” for significant reforms. First, as regards the problem stream, the economic situation over the last three years is clearly more stable, less pressing and the spreads of the periphery countries remain under control. The European Commission in an update ahead of the Euro Summit of December 2018 underlined that the global financial crisis that hit Europe “laid bare some of its institutional weaknesses. Thanks to determined efforts, Europe is now experiencing a robust economic recovery with growth in all Member States. This provides a window of opportunity to take the next steps towards deepening Europe’s Economic and Monetary Union. It is essential for its members as well as for the EU as a whole” (European Commission 2018: 2). But doing reforms in fair weather paradoxically is much more difficult, while the immediate reason for the sudden move to Banking Union was the intensifying euro sovereign crisis (Schöenmaker 2016). At the political level, apart from President Macron, the leaders of two other politically important countries, namely of Italy and Spain, have just taken office and their prospects are not yet clear. In Italy, the new coalition government is based on two parties (the Democratic Party and the Five Stars Movement), and it is doubtful whether they have the power to handle the tedious and demanding negotiations at a European level. In Spain, the coalition government includes the anti-systemic Podemos, under the socialist Prime Minister Pedro Sánchez, and it is doubtful whether it can overcome internal divisions among the heterogeneous members that make up the parliamentary majority. In addition, Chancellor Merkel’s self-declared last term in office reduces the possibility for important steps towards reforming the Eurozone at a bare minimum.

The political reluctance to complete the banking union manifested, for example, at the end of March 2018, even though the Eurozone’s heads decided that “in the next six months, the work of finance ministers should focus on areas where the convergence of views is greatest. Gradual progress on issues such as the completion of the Banking Union [...] should significantly strengthen the resilience of EMU” (Euro Summit 2018). More specifically, the French President supported the creation of a pan-European bank deposit guarantee fund, as well as the completion of the Single Resolution Fund, funded by the ESM. A few weeks before the Summit, Emmanuel Macron believed that together with the
German Chancellor Angela Merkel they would present a common line for the planned Eurozone reform ahead of the Summit of March but that was not confirmed. As a result, President Macron appeared at the Summit along with Mariano Rajoy and Antonio Costa. This alliance emphasized the formation of a pole against the reluctance of Berlin and its allies, which did not support any form of mutualization (Euractiv 2018). In this direction, the Danish, Estonian, Finnish, Irish and Latvian Ministers for Finance in a joint communiqué in March 2018 referred to their objections to the reform plans, and they put the issue of budgetary discipline on top of the agenda (Reuters 2018). One and a half years later, a common deposit insurance scheme is still proceeding at glacial speed. However, German Finance Minister Olaf Scholz offered a ray of hope in November 2019. The SPD politician said that the European Union needs to increase its pace regarding the banking union and signaled a willingness to compromise on the EU-wide bank deposit reinsurance, in an op-ed for the Financial Times. In this context, he proposed a “European Reinsurance System” for bank deposits to complete the banking union (DW 2019).

Lastly, the most crucial development, which postpones more ambitious reforms, is related to the new European Commission’ priorities, under President Ursula von der Leyen. Instead of the previous Commission’ strategy under Jean-Claude Juncker, whose strategy implied a more “political” management of the European Union’s economic crisis, der Leyen identifies the adaption of Europe to geopolitical developments as top priority. Europe has to deal with the consequences of US President Donald Trump’s unilateral initiatives; Turkey’s invasion in Syria; Libyan crisis; and the new state of the agreement on the Iranian nuclear program after the assassination of Qasem Soleimani by an American drone (Pagoulatos 2020).

4. The hesitant reform steps and the still incomplete banking union

In 2018, the joint proposals of fourteen economists in France and Germany on the reform of the Eurozone opened de novo a pan-European debate on its future architecture (Benassy-Quéré et al. 2018). These proposals seek to strike a balance between risk-sharing and crisis prevention by finding a middle-ground between solidarity and responsibility in order to break the “bank-sovereign nexus”: the fact that European banks hold a large bulk of government bonds of their home country (“home bias”). The open debate already includes the French President’ package of reforms (DW 2018) as well as the Spanish proposals (Almunia et al. 2018), which entail more banking and fiscal integration. In this
direction, we have to include the Commission Communication of October 2017 “on completing the banking union” (European Commission 2017). On the other hand, there is strong opposition on such a prospect from creditor countries, due to moral hazard and the legacy of “bad” debt of the periphery banks (Euractiv 2018). After the launch of these proposals, a series of political initiatives has taken place. As it will be shown these initiatives are closer to the joint proposals of the Franco-German economists than those that imply deeper banking and institutional integration.

First, the Heads of State or Government in December 2018 approved a package of measures to complete the Banking Union and to strengthen further the Economic and Monetary Union (EMU) and the European Stability Mechanism (ESM). Nevertheless, a common system for deposit insurance and a common safe asset as well have not yet been decided and further measures are needed to tackle the non-performing exposures of the banking sector via a European “bad” bank.

In 2019, there were the Euro Summit of June, a Eurogroup meeting on December 4, and the Euro Summit of December. Eurozone leaders agreed on further technical work on previous decisions (i.e, the Euro Summit of December 2018) for strengthening the banking union in particular. This is important because the timing of the intervention really matters, with speedier resolutions often entailing lower ex-post fiscal burden (Claessens et al. 2012). Little has been done, however, to weaken bank-sovereign nexus; for example, through a pool of assets diversified across countries. For the euro area, where fiscal stabilization policies are national in nature, the creation of sovereign-bond-backed securities would have the potential of increasing private risk sharing across borders. This would automatically spread default risk across borders, curtailing banks’ exposure to sovereign risk, and limit the sovereign-bank nexus (Dell’Ariccia et al. 2018: 38). Nevertheless, creating safe European assets, such as euro bonds, would involve a number of joint liabilities of all member states within a common fiscal policy (Brunnermeier et al. 2011). Such political initiatives (that is, a common fiscal policy) have not been taken. The ESM reform, for example, provides a limited and strictly conditional financial assistance toolkit.

5. Struggling to balance solidarity and responsibility

The Franco-German economists have become disappointed by the lack of progress on reform path (Bénassy-Quéré et al. 2019). The authors argued that risk-sharing and market discipline are not antagonistic but rather complementary, compromising thus between those who advocated a specific stabilization budget for the euro area (France and Spain) and those who rejected the priority of a common euro area budget (Pisani-Ferry and Zettelmeyer 2019). However,
the economists’ proposals imply more market discipline than risk-sharing. That said, more ambiguous progress in the banking union’s completion is out of play. Furthermore, these proposals include a “conditional solidarity”. More analytically, three basic mechanisms are proposed for a “conditional” and limited debt mutualization:

The first mechanism concerns the bank debt and involves the creation of a deposit insurance scheme, which however remains fragmented. In particular, it is proposed that “losses should first be borne by the relevant ‘national compartment’ of the scheme, while common funds (either a separate mutualized compartment, or all other compartments jointly) can be tapped only in large, systemic crises which overburden one or several national compartment(s)”. In this way, “separate collective deposit insurance schemes (e.g. associated with national or cross border institutional protection schemes) could be treated as separate compartments, on a case-by case basis under general criteria to be set in order to deter abuses” (Benassy-Quéré et al. 2018: 8).

The second one concerns the allocation of financial risks to minimize the insolvency risk, which is more pronounced for the Eurozone member states in comparison with similar countries which have a national currency. According to the economists’ view that finally was adopted by policymakers, the fundamental principle for a member state to be granted with ESM’s assistance is to comply with the fiscal rules on budgetary limits and public debt sustainability. Moreover, the requesting country should have access to international capital markets on reasonable terms and a sustainable external position. As a result, market discipline, introduced through these requirements, imposes stricter constraints to risk-sharing and does not mitigate the sovereign-bank risk nexus. And here comes the following paradox: Such a mechanism is created for ensuring fiscal and financial stability, but it ultimately makes financial markets key in decision-making for states’ access or not to financial assistance. In theory, these proposals focus on minimizing the risk of idiosyncratic demand shocks and the risk of a national banking crisis. Nevertheless, they neglect the insolvency risk of euro area membership, which is, as mentioned earlier, absent for similar countries with monetary autonomy (Bofinger 2018).

The third mechanism, in line with the above proposals, is the creation of a “euro safe asset”. Safety is achieved by some combination of diversification and seniority, which means that financial intermediaries buy a standardized diversified government bond portfolio and use it as collateral for the newly issued securities in several tranches. Introducing such assets in parallel with a regulation on limiting sovereign concentration risk is expected by the authors to further contribute to financial stability. However, given that the government
bonds of the debtor countries have lower credit ratings, it is difficult to find buyers for subordinated debt in times of crisis, as the Franco-German economists themselves admit. This proposal therefore limits risk-sharing, since “bonds of countries that lose market access should no longer be eligible for purchase by safe asset issuers” (Benassy-Quéré et al. 2018: 18). A weak point of this proposal is that the unequal position of the member states is not considered. Due to the existing high debt ratios of some countries, the disciplining role of financial markets over states will perpetuate pockets of weakness between debtor and creditor countries. For this reason, the real problem that remains untouched from the Franco-German economists is how to compromise market discipline with financial stability, without causing a crisis at the time of introducing the proposed regime (“transition problem”).

Another deficiency of their proposals is the lack of measures to limit the risk of non-performing exposures of banks. Low interest rates, combined with high stocks of non-performing loans (NPLs), negatively affect bank profitability. Only if we find a solution to reduce the outstanding stock of NPLs, we pave the way for a real single deposit insurance system, which “will contribute decisively to breaking the vicious circle of bank and state debt”, as the governor of the central bank of Spain commented in the same vein (Reuters 2018). But the main obstacle to this process is again the fear of moral hazard. Some member states are worried about the potential losses stemming from the “bad” debt of other member states. Germany, the largest economy in the EU, has rejected plans of risk-sharing on the banking market, fearing that German taxpayers will end up paying the bill for banks of the debtor countries. These objections may be dispersed if the nominated entity to absorb “bad” loans raises money issuing bonds or equity. That is the case of a European “bad” bank. In more detail, the proposal of the head of the European Banking Authority, Andrea Enria, includes the establishment of a European Asset Management Company, financed mainly by private resources. This entity will buy non-performing loans at the market value or at significant discount, selling them within the next three years (Enria 2017). Should sales not be realized, the states and the shareholders will cover the losses. If a specific trade operation fails, the state is required to recapitalize the bank; also the shareholders of that bank will bear the cost of the failed trading operation. In this way, the fear of moral hazard seems to be reduced (Enria 2017). On his part, Klaus Regling, the director of the ESM, supported the proposals of the European Banking Authority (EBA) to create a pan-European “bad” bank. Regling pointed out that such a plan “may need a role for the public sector”, and that “the new (public) entity will aim to acquire up to €250 billion, of about €1 trillion of bad loans in EU lenders’ balance sheets” (Reuters 2017).
A final concern that emerges from the Franco-German economists’ proposals is whether the market discipline ensures financial stability. The global financial crisis of 2007/8 has shown that credit flows are particularly procyclical and volatile. Accordingly, for some countries, the global financial cycle can lead to excessive credit growth in boom times and excessive retrenchment in bad times. In short, the global financial cycle seems to be associated with “surges and retrenchments in capital flows, booms and busts in asset prices and crises” (Rey 2018: 2).

6. Conclusion

During the euro area sovereign debt crisis, sovereigns were exposed to bank risk, and banks were exposed to sovereign risk. This two-way risk exposure generated a “vicious circle”. In this regard, the role of a fully complete banking union in the euro area is two-fold: (a) to mitigate the credit risk arising from troubled banks to the balance sheet of their sovereigns and (b) to mitigate the credit risk generating from sovereigns to the banking system holding public debt. Yet the establishment of the European banking union is not complete. On the one hand, all systemically important banks have been subject to a joint supervision at supranational level under the Single Supervisory Mechanism (SSM). Moreover, introducing the common backstop for the Single Resolution Fund (SRF), to be provided by the ESM, further enhanced the credibility of the Single Resolution Board (SRB) as the resolution authority in the banking union. On the other hand, breaking the doom loop between banks and sovereigns requires more risk-sharing and initiatives to help banks diversify their investment in sovereign bonds. To this end, the adoption of a common safe asset to manage the flow of credit risk emanating from sovereigns to the banking system is needed. Accordingly, a European Insurance Deposit Scheme (EIDS) is still lacking, along with further measures to tackle the remaining risks of the banking sector; in particular, those related to non-performing loans (e.g. a European-level “bad” bank).

On these crucial issues, a battle of interests between core and periphery economies is unfolding. The European “South” advocates more solidarity and deeper banking integration. In the opposite direction, limited risk-sharing and fiscal responsibility seems to be the priorities of the core economies. Accordingly, in an attempt to reconcile solidarity and responsibility, certain political initiatives and proposals on the future of the Eurozone consider risk-sharing and market discipline as complementary elements, which should be conditio sine qua non for the new Eurozone architecture. Building bridges between the two poles is extremely important, from a political, economic and financial perspective. However, the “window of opportunity” for significant political initiatives, as
it was the case in 2012, no longer exists. In fact, the lack of substantial risk-sharing arrangements creates higher risk of financial instability. The negative legacy of crisis in the banking sector reduces the attractiveness of common safety networks. Market discipline seems to be the concept for the organization of the Eurozone, as Eurozone’s policy makers assign a disciplining role to financial markets over states. This development marks a significant shift in the relation between governments and financial markets, in the after 2007/8 era; and as Habermas says “the imbalance between the imperatives of the market and the regulatory power of politics has been identified as the real challenge under these conditions” (Habermas 2012: 337).

Notes

1. “The policy window is an opportunity for advocates of proposals to push their pet solutions, or to push attention to their special problems” (Kingdon 2015: 165).
2. The number of significant institutions that was directly supervised by the European Central Bank (ECB) from 1 January 2019 stands at 119 following the annual review of significance and ad hoc assessments (ECB 2018).

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