

# Beyond the Pandemic: Reviving Europe's Banking Union

Ignazio Angeloni



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# **Beyond the Pandemic: Reviving Europe's Banking Union**

**by Ignazio Angeloni**



CEPR Press

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# List of abbreviations

AML	anti-money laundering
BLS	ECB Bank Lending Survey
BRRD	Bank Recovery and Resolution Directive
CDS	credit default swap
CET1	Common Equity Tier 1
CLO	collateralised loan obligation
CRR	Capital Requirements Regulation
EBA	European Banking Authority
ECB	European Central Bank
EDIS	European deposit insurance scheme
ESRB	European Systemic Risk Board
EU	European Union
FDIC	Federal Deposit Insurance Corporation
GDP	gross domestic product
G-SII	global systemically important institution
IDI	insured deposit institution
IMF	International Monetary Fund
LCR	liquidity coverage ratio
LSI	less significant institution
MREL	minimum requirement for own funds and eligible liabilities
NLP	non-performing loan
NRA	national resolution authority
OLF	Orderly Liquidation Fund
O-SII	other systemically important institutions
RoE	return on equity
SIFI	systemically important financial institution
SRB	Single Resolution Board
SREP	Supervisory Review and Evaluation Process
SSM	Single Supervisory Mechanism

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# 1 Introduction

In November 2014, the European Central Bank (ECB) took on a new role as banking supervisor of the euro area. This was part of a broader design aimed at transferring the banking regulatory framework from the national level to the European Union (EU) – the so-called ‘banking union’. Banks play a key role as savings intermediaries and providers of financial services in the continent; the banking union is therefore a reform comparable in importance to the customs union (1957), the competition framework (from the 1960s onwards), the single market (1990s) and the euro (1999). Besides its contribution to European integration, the banking union also offers an opportunity to strengthen the banking sector and improve its functioning, which is in the interests of all European citizens.

This report reviews how the banking union has functioned and discusses changes which may help improve its performance. I attempt to assess the banking union comprehensively, rather than looking at parts of it in isolation. Comprehensiveness helps because the building blocks of the reform – legislation, supervision, crisis management, competition and state-aid control – are interrelated; proposed amendments need to be examined from all relevant perspectives.

In early 2020, when this report was being completed, the coronavirus emergency struck. As these words are written, the health crisis and the ensuing global recession are in full swing and are producing unprecedented (in peacetime at least) policy responses in all fields, including banking regulation and supervision. While this will greatly affect the European banking industry and its regulatory environment, I have come to the conclusion that the reasons why the banking union needs reform will not be fundamentally altered by the current predicament. I have therefore kept my line of argument largely unchanged, adding a section at the end with some reasoned conjectures on how this crisis will impact European banks and what the policy response may look like.

Evaluating the banking union now is timely. Five years have given ample opportunity to the newly created authorities – the Single Supervisory Mechanism (SSM), centred on the ECB,<sup>1</sup> and the Single Resolution Board (SRB) – to get in shape and perform their functions. The ECB has conducted five annual reviews since 2014 of all banks under its direct remit. Each of these reviews included a detailed risk analysis and led to requests for each bank to undertake actions to reduce or better manage those risks. An assessment is also useful because the institutions responsible for banking policy in Europe – the European Commission, the ECB and the European Parliament – have all recently changed their leaderships or composition; this may facilitate renewed policy action.

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<sup>1</sup> In this report, when referring to supervisory powers or decisions the terms SSM and ECB are used interchangeably. This is justified by the fact that the supervisory powers within the SSM belong to the Supervisory Board, which is a body of the ECB.

Most observers agree that the banking union today is 'incomplete', but opinions differ on the specifics. Two views stand out. One contends that the main problem is the lack of a pan-European deposit insurance scheme. In all modern developed banking frameworks, deposit insurance provides safety to retail deposits, thus making the payment system more secure. This aspect is particularly important in the euro area, because due to its multi-country structure, loss of confidence in national banking sectors can easily lead to crises which undermine the single currency, as demonstrated in the sovereign debt crisis. A euro-wide deposit guarantee scheme has been proposed by the European Commission and supported by the ECB, but has not been implemented so far.

The second, opposing view argues that a common deposit insurance cannot be introduced while many banks are weakened by bad legacy assets, lest undue advantages may be conferred to those banks at the expense of others. Supporters of this view argue that deposit insurance should come at the end, once banks are safe, not at the beginning as a way to provide that safety. They point in particular to the concentration of sovereign exposures in bank portfolios, which generate a 'doom loop', or negative contagion, between banks and the respective sovereigns. I shall argue that this twin exclusive focus is misleading because repairs are needed in other areas as well.

From the start, the banking union was intended not only as a way to improve the institutional design of the euro area, but also to address an impending crisis. This helped initially to speed up implementation, but there is a risk that as the emergency subsides, the project is left unfinished. While graduality and delays in major institutional reform processes are not uncommon,<sup>2</sup> a banking union left at mid-way entails dangers. Two in particular can be mentioned here.

First, banking supervision has been moved to the ECB, but the burden of dealing with failing banks has remained national. In all cases of bank resolution and restructuring since 2014, national taxpayers and users of banking services (two groups of people which largely overlap) have covered the costs.<sup>3</sup> A disconnect has therefore been created between the responsibility of the controller and the burden that this responsibility entails. Over time, this is likely to raise questions about legitimacy of the banking union and undermine its acceptance. Even before this happens, it weakens the position of the European authorities (the SSM and SRB) relative to their national counterparts (national supervisors and resolution authorities) – "he who pays the piper calls the tune", as the popular saying goes.

Second, weaknesses in the existing crisis management framework make banking supervision more difficult and riskier. In dealing with weak banks, supervisors always face a trade-off between duly applying their rulebook, which implies bringing bank weaknesses to the fore, and putting financial stability – for which they are responsible – at risk. Without a foolproof bank resolution

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2 By comparison, the US banking regulation at the federal level has developed over more than a century. The regulation began to emerge at the beginning of the 20th century, with the creation of the Federal Reserve. It was greatly enhanced in the 1930s after the Great Depression has been repeatedly amended in the postwar period, with the latest major modifications taking place after the financial crisis of 2008.

3 The burden falls on all on all users of banking services because healthy banks which contribute to the deposit guarantee and resolution funds transfer at least part of the cost to their clients through fees and spreads. Ultimately, all bank clients bear the costs of the safety net. Taxpayers and users of banking services largely coincide, representing the vast majority of the total adult population.

framework, supervisors tend to delay their intervention, aggravating risks in the longer run and jeopardising their own credibility. As I discuss more extensively in Section 3.2 and Annex 2, supervision and crisis management are complements in a well-constructed banking regulation.

I start in Section 2 by looking at data illustrating the banking union's achievements vis à vis its goals, linking the progress made to some driving factors – economic and financial conditions, supervisory actions, and so on. The goals are grouped under three headings: restoring bank soundness; making banks efficient and competitive; and increasing cross-border integration. While stability was the overriding goal at the beginning, in order to exit the crisis, efficiency, profitability and integration have become more important as the need for a unified and competitive euro area banking sector, capable of supporting the area-wide economy and of withstanding global banking competition, has grown. Regardless of priorities, this overview suggests that the banking union at present falls short on all three counts. However, a judgement on this basis alone would be incomplete. Section 2 also discusses improvements made that have enhanced the 'quality' of supervision, meaning its transparency, accountability and even-handedness – all areas where the record is more comforting. While these are important achievements, they are not so much ends in themselves but rather means to other – so far largely unattained – goals.

Section 3 discusses policy actions. Areas of intervention are identified on both the supervisory side (clarifying and extending the supervisory toolbox; improving certain aspects of the legislation; strengthening macro-prudential supervision) and especially the crisis management side (broadening the powers, the tasks and the means available to the SRB; upgrading the state-aid regulation; building a framework for liquidating smaller and local banks). Emphasis is placed on the complementarity between supervision and resolution; supervision requires a sound resolution framework to perform its role. As I argue in more detail in an Annex, if supervision is strengthened, the recovery and resolution framework must be strengthened as well, to avoid increasing systemic risks or encouraging moral hazard. Among the possible policy interventions, changing the treatment of sovereign exposures and creating a European deposit insurance – the two reforms on which today's discussions predominantly focus – should not be regarded as a panacea, but rather as useful parts of a broader package.

Understandably, the attention of policymakers is now completely focused on stopping the coronavirus pandemic and mitigating its adverse human, economic and financial effects. As the emergency subsides, however, the underlying issues regarding the performance of European banking and its regulation will come to the fore again. The need to completing the banking union and improve its functioning will not go away, and may actually turn out to be strengthened. The reasons why this may be the case, and some views on how the euro area banking sector may be affected by the pandemic and what the policy responses to it may be, are sketched out in the last section.

I should state at the outset that, as author of this report, I am independent but not impartial. Having contributed to building the supervisory arm of the ECB in 2012-2013 and having been a member of the ECB Supervisory Board in 2014-2019, I share some responsibility for what has been done. I have also developed an attachment to this project; I believe that the banking union can work and that if it does, it will benefit European citizens. I hope that my contribution will help achieve the potential which has so far been elusive.

## 2 Progress made towards...

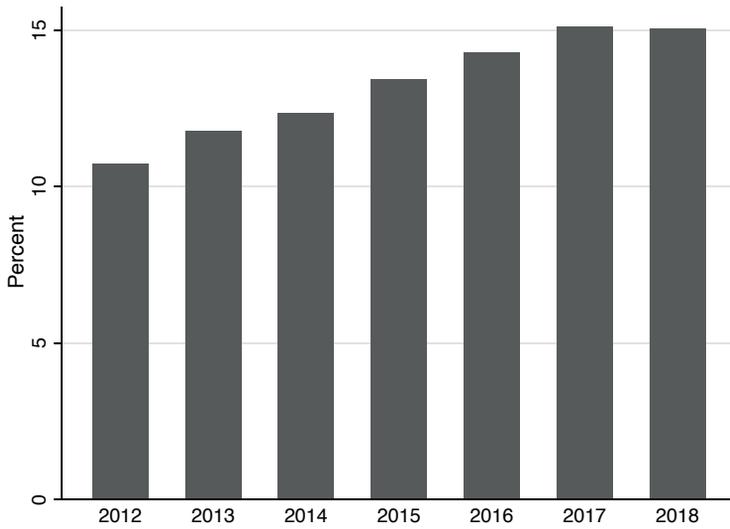
### 2.1 ...making banks safe and sound

Figure 1 shows the ratio of CET1 capital<sup>4</sup> to risk-weighted assets, on average over a sample of significant banks, from 2011 to today. The capital ratio increased significantly over this period. Before the launch of the banking union, in 2013-14, national supervisors encouraged banks to build up capital in the expectation that the ECB, due to take over supervision in 2014, would conduct a stress test and asset quality review to inaugurate more demanding capital standards. After the takeover, capital accumulation accelerated for about two years; during that period, the pressure of ECB supervision to improve bank solvency standards in the euro area reached a peak. After this push, momentum subsided in 2017 and 2018; a new orientation emerged in the EU at the time, de-emphasising the importance of further capital increases. ECB supervision communicated that a 'steady-state' level of capital had been reached and, in line with indications from the European Commission, introduced a distinction between 'required' and 'guidance' capital – the first being strictly mandatory, the second merely a medium-term reference. As a result, many banks scaled down their efforts towards further capital increases. Figure 2 shows the median of CET1 ratios and the dispersion, represented by the first and last quartiles of the cross-sectional distribution. One notices that the median tends to be lower than the average, and the gap between the median and the upper quartile tends to increase over time. The skewing of the distribution in the more recent period reflects the phasing-in of the macroprudential buffers, which apply only to large banks. In this phase, capital increases were taking place due more to the effect of the automatic phasing-in of the buffers rather than as a result of discretionary measures by the supervisor.

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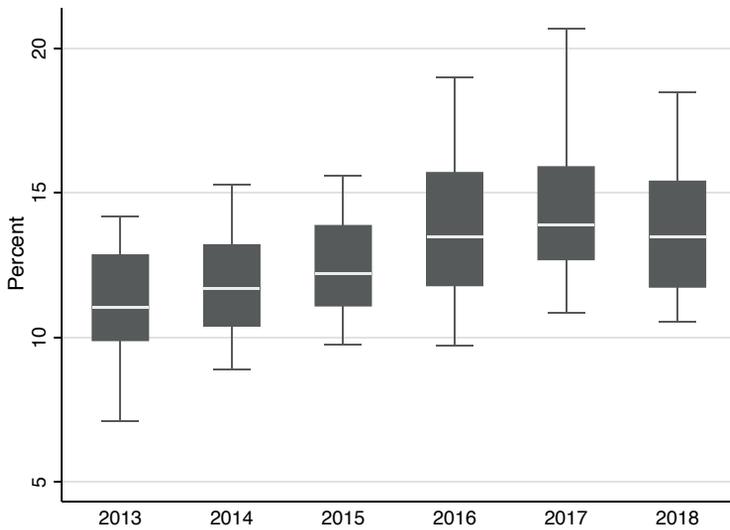
4 Common Equity Tier 1, the capital of highest quality in terms of its loss-absorbing capacity. It consists of ordinary shares and undistributed earnings, plus or minus relatively minor adjustments..

**Figure 1** Common Equity Tier 1 (CET1) ratio: Average across significant banks



*Note:* Ratio of CET1 to risk-weighted asset. Average across 108 banks supervised directly by the ECB.  
*Source:* BankFocus

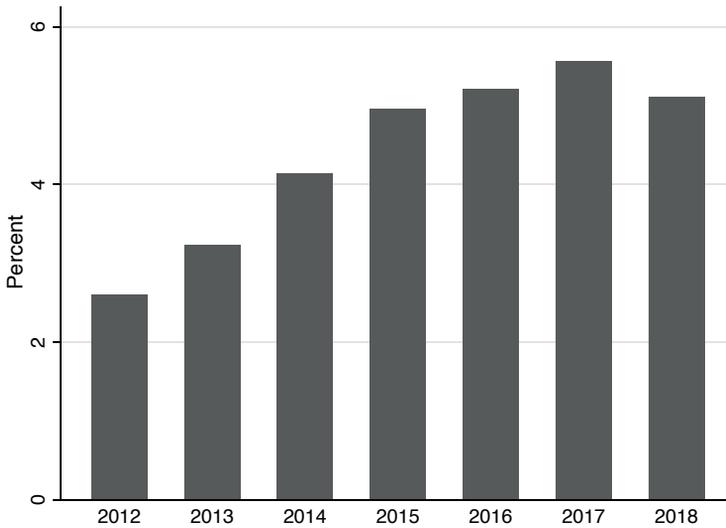
**Figure 2** Common Equity Tier 1 (CET1) ratio: Median and dispersion across significant banks



*Note:* Ratio of CET1 to risk-weighted asset. Dispersion across 108 banks supervised directly by the ECB. The upper, middle and lower lines correspond to the 75th, 50th (median) and 25th percentiles  
*Source:* BankFocus

Figure 3, showing leverage ratios (total capital divided by total unweighted assets), confirms the trends just mentioned. It also demonstrates that the increase in solvency standards was due predominantly to genuine capital increases, not to adjustments in the risk weights. This is important: risk-weight calculations depend on banks' internal models, hence lower weights though translating into higher capital ratios may not reflect actual reductions in risk. The ECB did, in fact, exercise an increasingly strict supervision over internal models during that period.<sup>5</sup> Also important is the fact that the recapitalisation did not produce negative effects on the supply of credit and its terms; according to the ECB's Bank Lending Surveys (BLS), credit supply conditions actually improved while banks were building up capital.<sup>6</sup>

**Figure 3** Leverage ratio: Average across significant banks



*Note:* Ratio of total capital over total exposures as defined by Basel III. Average across 108 banks supervised directly by the ECB.

*Source:* BankFocus

To what extent did the improved solvency standards result from the supervisory action of the ECB? Or put differently, to what degree would they have taken place anyway, regardless of the banking union and its core institution – the single supervisor? A counterfactual is not available. However, the significant pressure exercised by the ECB in that period and the opposition it faced, especially from some national banking sectors, leads to the reasonable conclusion that the new and demanding requirements introduced by the ECB, coupled with new systematic risk-assessment methodologies employed to back up these requests (more details on this below), at least accelerated the process significantly. Yet, progress has not been complete. In some cases, weak banks have gone out of business or restructuring or mergers have taken place. In several cases, however,

<sup>5</sup> See <https://www.bankingsupervision.europa.eu/about/ssmexplained/html/trim.en.html>.

<sup>6</sup> BLS reports are published here [https://www.ecb.europa.eu/stats/ecb\\_surveys/bank\\_lending\\_survey/html/index.en.html](https://www.ecb.europa.eu/stats/ecb_surveys/bank_lending_survey/html/index.en.html).

problems persist. For example, it is indicative that the majority of banks that were identified as having a capital shortfall in the ECB's 2014 comprehensive assessment are still relatively risky today, at least judging from the pillar II requirements applied to them.<sup>7</sup>

Capital – the maximum loss a bank can bear while maintaining a positive net value – is the most direct and commonly used metric of bank soundness, but other parameters play a key role as well. Liquidity – the ability to discharge obligations at short term – is critical to protect banks from funding shocks. Liquidity standards have improved significantly across the banking union over the time period we consider. On average across banks, the liquidity coverage ratio (LCR) rose in the five-year period from 150% to over 200%, in relation to future potential cash outflows.<sup>8</sup>

Bank soundness also depends critically on the quality of assets. Figure 4 shows ratios of non-performing loans (NPLs) to total loans on aggregate for a sample of significant banks. A sharp improvement is visible starting precisely in 2014. ECB supervisors have repeatedly presented this as a central focus of their supervisory approach and a major achievement under their remit; the numbers seem to back up these claims. While other factors have contributed as well (first and foremost, better economic conditions limiting the emergence of new NPLs and helping reduce the existing ones), the proactive supervisory action by the ECB did play a major role.<sup>9</sup> The progress, however, was not evenly distributed across countries (let alone banks), as can be seen in Figure 5. Many countries that had reached very high NPL ratios, including those which underwent internationally supported adjustment programmes, were able to reduce NPLs sharply (Greece and Portugal are notable exceptions). Italy, whose ratios were lower but whose absolute amounts are very high due to the size of the economy, also reduced its NPL ratios sharply, converging towards the euro area average. The diversity that still persists is evident in Figure 6, where recent data on NPL ratios are compared across countries.

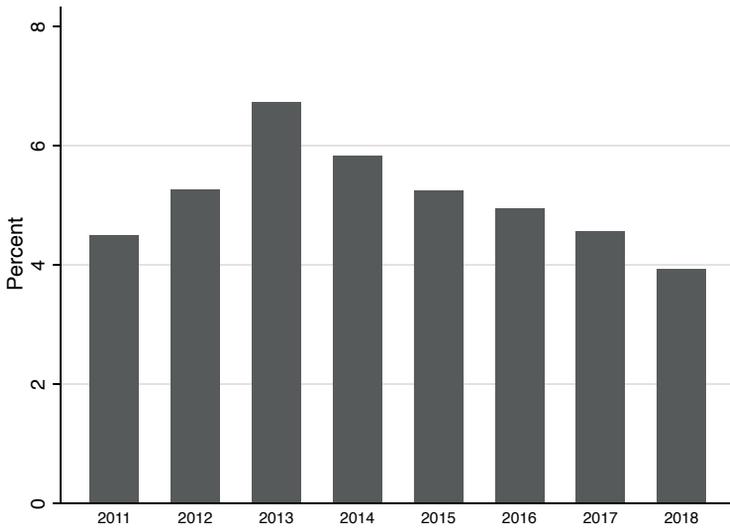
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7 Lack of data on stress test results and pillar II requirements at the individual level prevents a detailed analysis of how bank soundness has evolved over time. A first impression can be obtained by looking at how the 'shortfall banks' identified in ECB (2014a) have fared in the Supervisory Review and Evaluation Process (SREP) 2019 exercise, the results of which have been published for the first time. Most banks with a capital shortfall in 2014, if still existing, had an above-average P2R in 2019, implying that their underlying risk factors had not been fully resolved (although their extra riskiness may be offset by a higher capital cushion).

8 The LCR is a new liquidity metric introduced in Basel III. It is calculated as the ratio between liquid assets owned by the bank and the potential cash outflows projected ahead for 30 business days using conservative criteria.

9 The ECB launched an NPL action plan in 2017; see <https://www.bankingsupervision.europa.eu/banking/priorities/npl/html/index.en.html>. The ECB remained engaged in subsequent years, amidst hard opposition by part of the banking industry and occasionally of some national supervisors. At one stage, objections were raised by the European Parliament regarding the legal authority of the ECB in raising NPL provisions on the basis of general pre-announced criteria; more on this issue below.

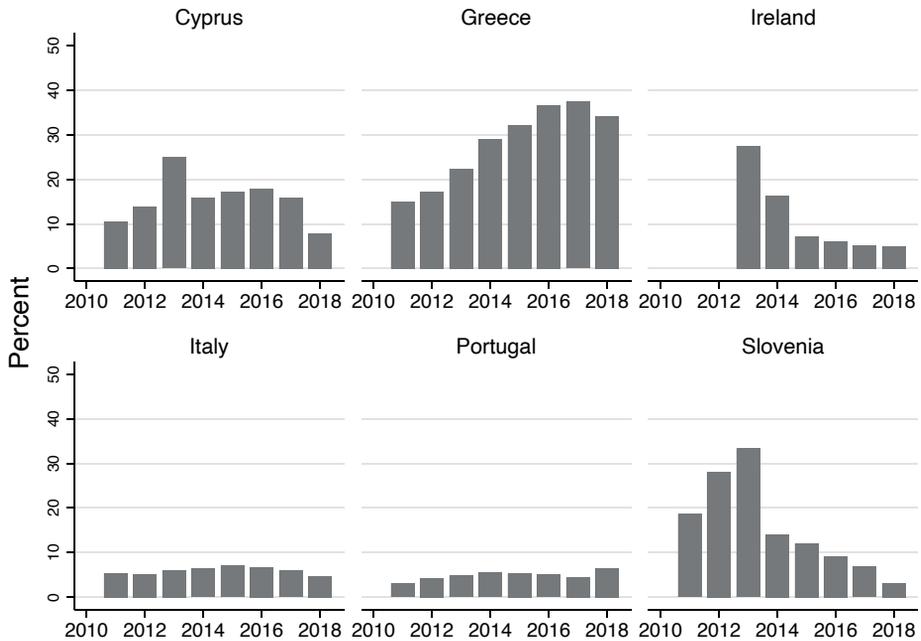
**Figure 4** Non-performing loan (NPL) ratio: Average across significant banks



Note: Ratio of non-performing loans over total assets. Average across 108 banks supervised directly by the ECB.

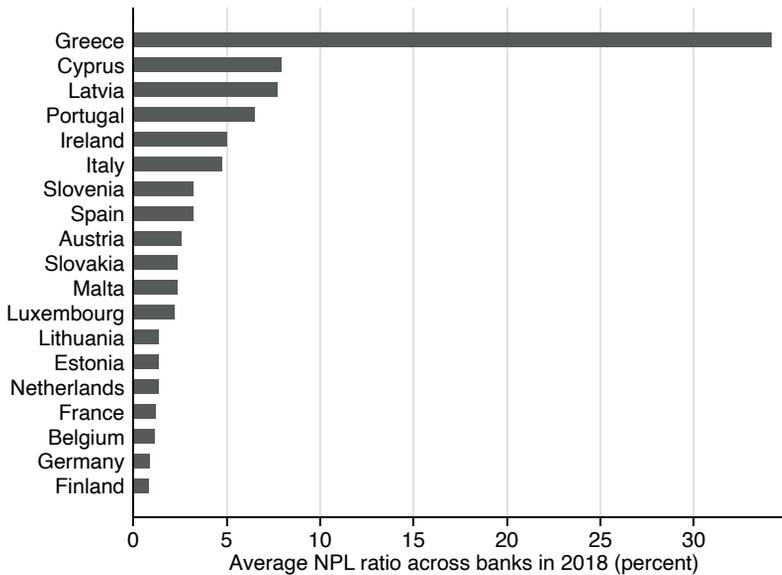
Source: BankFocus

**Figure 5** NPL ratio: Average across significant banks in selected countries



Note: Ratio of NPLs over total assets in selected countries, banks supervised directly by the ECB.

Source: BankFocus

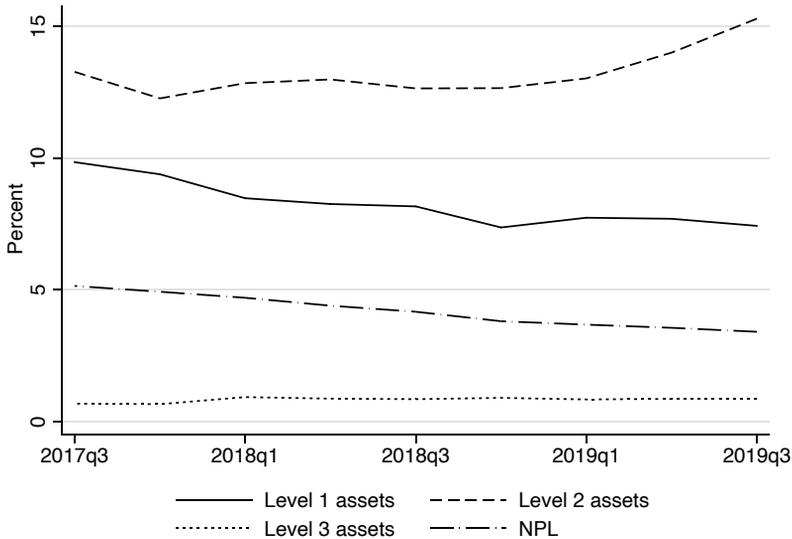
**Figure 6** NPL ratios in euro area countries, 2018

*Note:* Ratio of non-performing loans over total assets. Average across 108 banks in 2018 supervised directly by the ECB.

*Source:* BankFocus

Some European banks also hold large volumes of assets which, though performing, are to various extents illiquid and as such, potentially riskier. Accounting rules distinguish between Level 1 assets, which can be objectively priced because they are traded in active markets, Level 2 assets, which lack an active market and are priced based on similar assets traded in other markets, and Level 3 assets, for which a comparator market does not exist and which must be priced based on modelling assumptions. The latter two categories are present relatively more in balance sheets of large banks active in financial markets. Figure 7 presents evidence for the period 2017-2019, comparing these assets with NPLs. As one can see, Level 2 assets are very large and rising over time. Level 3 assets (the least liquid component) are comparatively minor. All in all, the combination of Level 2 and Level 3 assets covers a significant share of bank assets on aggregate. One must consider that the breakdown between these two components depends partly on judgement by the banks, and may therefore be subject to errors or bias. The recent increase of Level 2 assets may be linked also to the expansion of leveraged loans and the collateralised loan obligation (CLO) market, an asset class which is now giving rise to significant losses as a result of the Covid-19 crisis.<sup>10</sup>

<sup>10</sup> According to Bank of England (2019), CLO exposure of European (non-UK) banks should be in the order of 4% of the total CLO market, a much lower share relative to US and Japanese banks.

**Figure 7** Selected exposures by accounting category and NPL ratio: Average across significant banks

*Note:* The figure shows the ratios of selected exposures to total assets. Level 1, Level 2, Level 3 denote different accounting categories. Average across 108 banks supervised directly by the ECB.

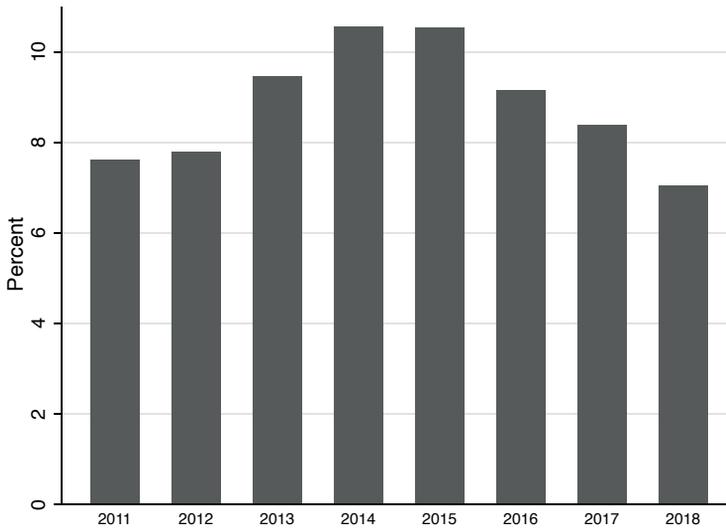
*Source:* ECB (Supervisory banking statistics)

The next few figures measure the interdependence between bank balance sheets and government finances, potentially giving rise to the ‘doom loop’ (on the relevance of the doom loop in giving rise to the euro crisis, see Annex 1). Figure 8 shows bank exposures to sovereigns.<sup>11</sup>

Following the financial crisis, those exposures rose rapidly in relation to total assets, from about 7% to over 10% in 2015, subsequently declining to below 8% in 2018. The situation differs sharply across countries (Figure 9). In Ireland, Italy and Spain, countries where the contagion between banks and sovereigns proved to be a critical factor in the crisis, sovereign exposures topped at 15%. Italy differs sharply not only in the much larger absolute size of these exposures, also but because in spite of the more recent decline, they have remained relatively high. By comparison, in Ireland and Spain they have fallen to just above 5%.

<sup>11</sup> This measure, used for simplicity, is not fully satisfactory; a better one would comprise exposures to own-country sovereigns only, including local governments and guarantees. I believe the underlying message would not be significantly affected.

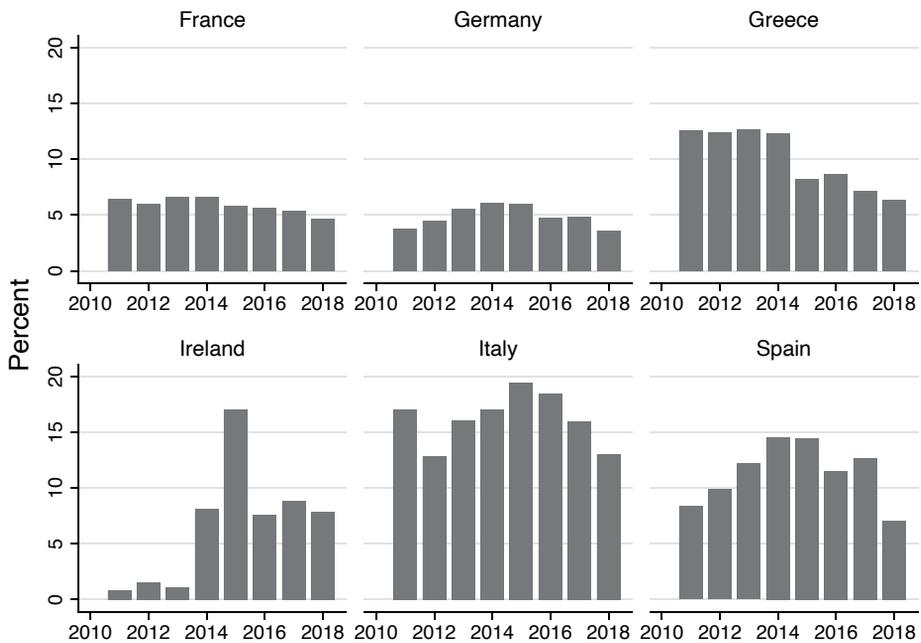
**Figure 8** Bank exposure to sovereigns: Average across significant banks



Note: Bank holdings of government securities as a share to total assets. Average across 108 banks supervised directly by the ECB.

Source: BankFocus

**Figure 9** Bank exposure to sovereigns: Average across banks in selected countries

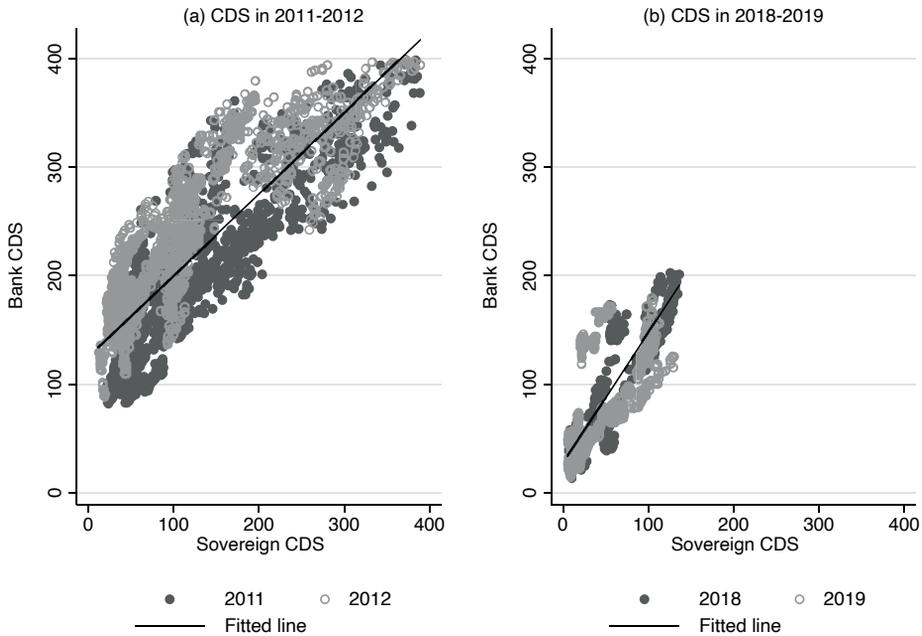


Note: Bank holdings of government securities as a share to total assets in selected countries. Average across banks supervised directly by the ECB.

Source: BankFocus

A more comprehensive indicator to gauge the contagion between banks and sovereigns is the risk correlation between banks and the respective sovereigns derived from credit default swap (CDS) contracts (e.g., ECB, 2014b, p. 78). This correlation is illustrated in the scatter plots of Figures 10a and 10b, where each point corresponds to a combination of a bank CDS spread and that of the respective sovereign in a given day. The years 2011-12 and 2018-19 are compared in two panels of the figures; individual years are shown in a different colour.

**Figure 10** Relationship between bank CDS and sovereign CDS



*Note:* Each dot represents a combination of a bank 5-year CDS premium and the respective sovereign's 5-year CDS premium in a given day. Bank CDS refer to banks with the highest asset size in the country in the given year. For 2019, due to lack of data, banks are selected based on their asset sizes in 2018.

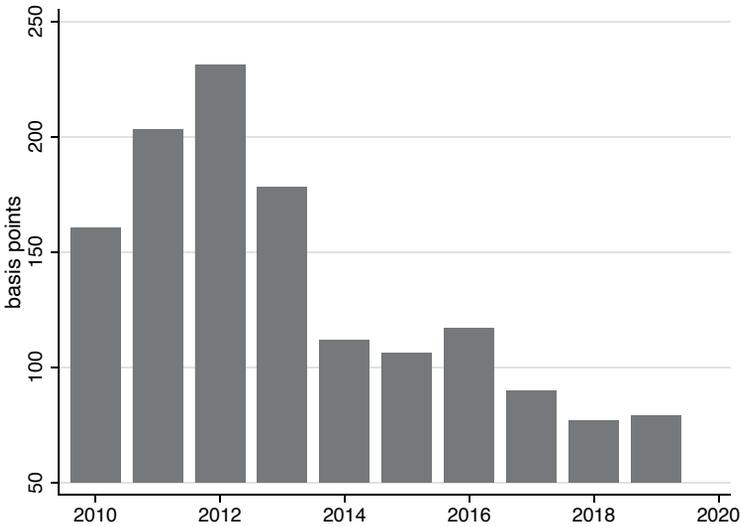
*Source:* DataStream and BankFocus

Two findings emerge. First, the cloud of points in 2018-19 is much more concentrated at low levels. Low default risks in 2018-19, for both banks and sovereigns, probably reflected the more stable financial market conditions resulting from the accommodative monetary policy stance adopted by the ECB. The second finding is that the cloud of points is still positively sloped in 2018-19; bank risks and sovereign risks are still correlated, though to a lesser extent. A linear interpolation has a slope of 0.8 in 2011-12 and 1.2 in 2018-19, indicating that bank CDSs are still dependent on their sovereigns,<sup>12</sup> but less than in the earlier period.

<sup>12</sup> The interpolating line for 2018-19 is calculated excluding a number of points located on a vertical string close to zero level of sovereign CDS; these points refer to German banks, for which the sovereign CDS is stable and near zero in the recent period. The hypothesis that the slope of the line is positive cannot be statistically rejected.

Figure 11 shows yearly averages of CDSs for a sample of ECB supervised banks, from 2011 onwards. A sharp decline occurred between 2012 and 2014. Again, this benefited from the monetary stance of the ECB, and particularly from orientations undertaken in 2012 to preserve the stability of the euro (the “whatever it takes” statement by Mario Draghi was in July 2012, and the launch of unconventional monetary expansion measures followed shortly thereafter). The establishment of the banking union is likely to have contributed as well, though its separate effect cannot be distinguished.

**Figure 11** Bank CDS: Average across a sample of banks



*Note:* Average of 5-year CDS premium of a sample of euro area banks, not all supervised directly by the ECB.  
*Source:* DataStream

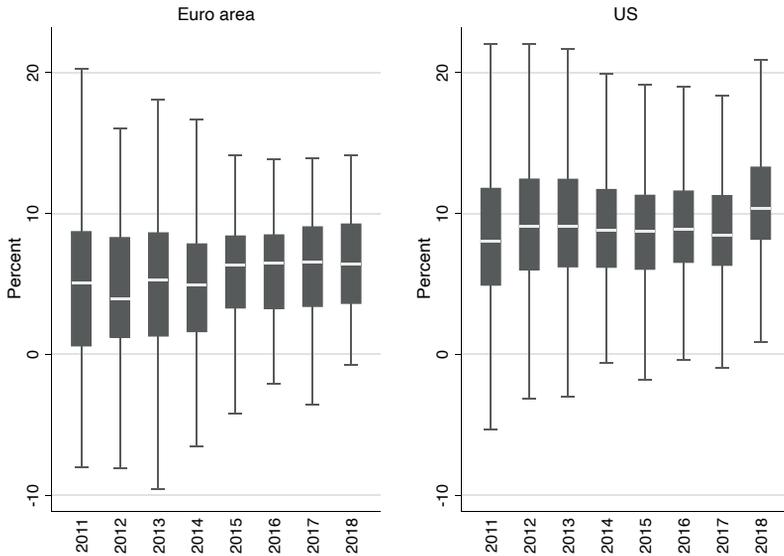
To sum up, major progress has evidently been made in strengthening the resilience of banks by reducing NPLs and increasing capital. ECB supervision is likely to have played a major role, but banks have also benefited from the economic recovery and the more general stabilisation of financial markets. Especially between 2014 and 2016, the contribution made by ECB supervision was pivotal in making banks raise capital and reduce their dubious exposures. However, it is clear that the doom loop between banks and sovereigns has not been conquered; bank risks are still closely linked to those of their sovereigns in some countries. Though now dormant as a result of low interest rates and ample liquidity, contagion potentially remains and may resurface in the future.

## 2.2 ...improving bank efficiency and competitiveness

A complementary goal of the banking union was to help euro area banks overcome the debilitating effects of the crisis by becoming more profitable and competitive. Profitable banks can more easily obtain capital internally through undistributed profits and externally by attracting investors. Interpreting bank

profitability requires caution, however. Before the crisis, banks appeared to be highly profitable because they had moved up along the risk-return frontier, also using regulatory loopholes to economise on equity. At its outset, ECB supervision faced a trade-off between helping banks reconstitute their capital base and increasing the return on capital at the same time. Such trade-off can only be overcome by increasing efficiency.<sup>13</sup>

**Figure 12** Return on equity: Median and dispersion across banks

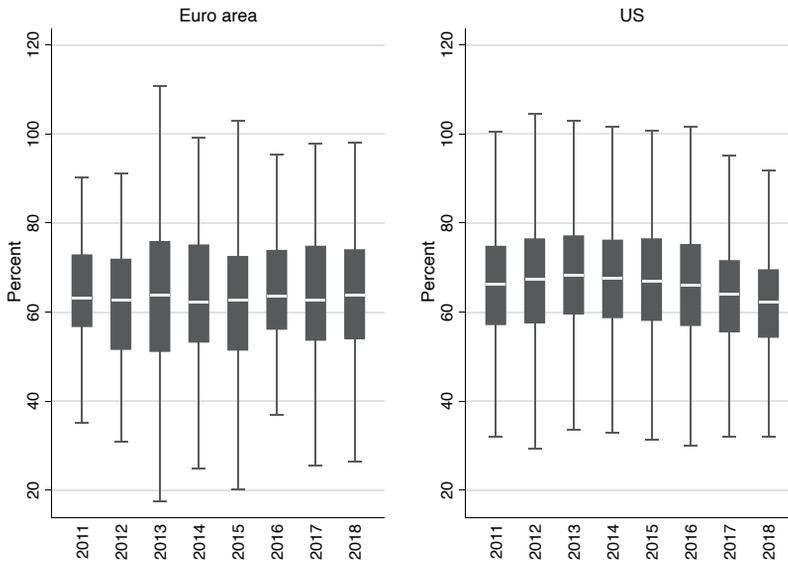


*Note:* 108 banks supervised directly by the ECB and a sample of US banks. The upper, middle and lower lines correspond to the 75th, 50th (median) and 25th percentiles, respectively. For the US, the data covers 1,112 banks having consolidated assets in 2019 exceeding \$300 million.

*Source:* BankFocus

Developments in bank profitability are depicted in Figure 12, which shows the median and cross-sectoral dispersion of return on equity (RoE) for a sample of euro area banks, as well as the corresponding measures for a sample of US banks. US banks are more profitable and the margin has increased recently. Dispersion around the median has declined in both the US and the euro area. Interestingly, as Figure 13 shows, the higher profitability of US banks does not depend on cost performance. The median cost/income ratio in the US is only marginally lower, although in recent years it has been on a downward trend, unlike in the euro area. In the euro area, the cost performance is very diversified, as is visible from the larger discrepancy between the best and the worst performers.

<sup>13</sup> Another factor entering into the relationship between stability and profitability is competition. By enhancing the level playing field across borders, the banking union tends to induce more competition. Vives (2016) argues that there is a trade-off between competition and stability, but that sound regulation may improve the tradeoff. I have discussed how this applies to the banking union in a speech in 2016 (Angeloni, 2016a).

**Figure 13** Cost-to-income ratio: Median and dispersion across banks

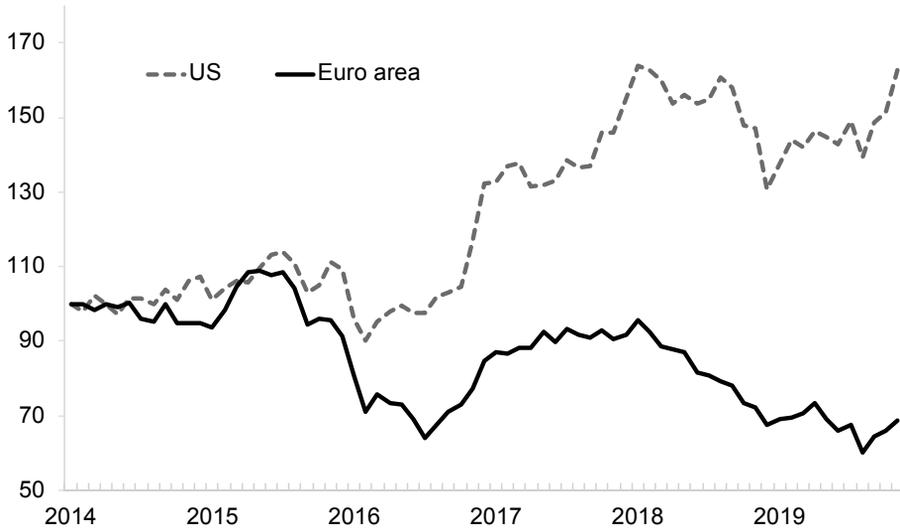
Note: 108 banks supervised directly by the ECB and a sample of US banks. The upper, middle and lower lines correspond to the 75th, 50th (median) and 25th percentiles, respectively. For the US, the data covers 1,112 banks having consolidated assets in 2019 exceeding \$300 million.

Source: BankFocus

Bank returns over time are one key factor driving their stock market performance. Figure 14 shows aggregate stock market indices of listed banks in the euro area and the US, using 2014 as a starting point. The performance diverges in 2015-2016, in correspondence with a sharp decline in euro area bank profitability (ECB, 2019, Chapter 3) and following the Greek crisis, which transmitted negative contagion effects in the euro area. Thereafter, the stock market value of euro area banks recovered gradually, whereas that of US banks increased sharply. After overcoming a temporary sell-off in US bank stocks during 2018, at the end of 2019 bank stock market values in the US were over 50% higher than in 2014, while those of euro area banks were significantly below. Price-to-book ratios (Figure 15) and price/earnings ratios (Figure 16) are markedly lower in the euro area in 2019, again neglecting a temporary US underperformance in 2018.<sup>14</sup>

<sup>14</sup> In 2018 US bank stocks were negatively affected by concerns about economic prospects and risky leveraged lending, but those concerns proved short-lived.

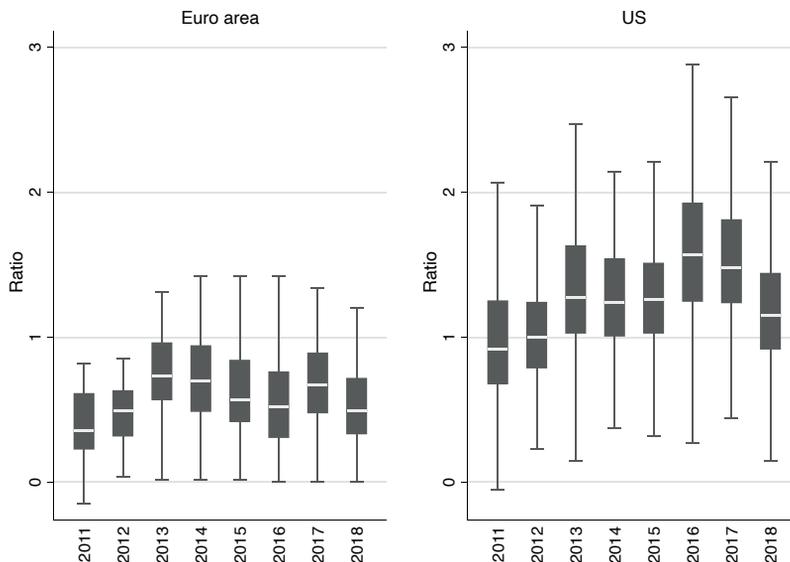
**Figure 14** Stock market valuation of euro area and US banks (index, Jan2014 = 100)



Note: Dow Jones US Banks index (close price) for US banks and Stoxx Price Index (close price) for euroarea banks.

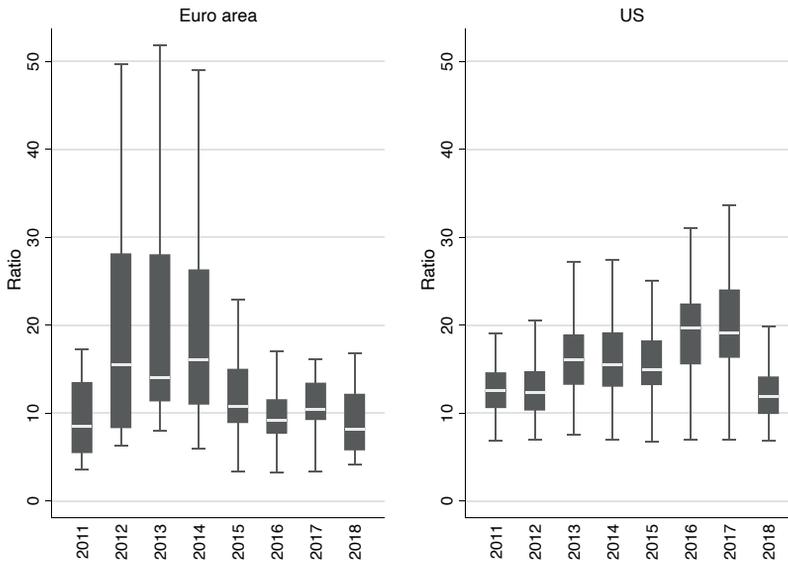
Source: Global Financial Data

**Figure 15** Price/book ratio: Median and dispersion across banks



Note: 108 banks supervised directly by the ECB and a sample of US banks. The upper, middle and lower lines correspond to the 75th, 50th (median) and 25th percentiles, respectively. For the US, the data covers 1,112 banks having consolidated assets in 2019 exceeding \$300 million.

Source: BankFocus

**Figure 16** Price/earnings ratio: Median and dispersion across banks

Note: 108 banks supervised directly by the ECB and a sample of US banks. The upper, middle and lower lines correspond to the 75th, 50th (median) and 25th percentiles, respectively. For the US, the data covers 1,112 banks having consolidated assets in 2019 exceeding \$300 million.

Source: BankFocus

Important to note is the fact that the gap in stock market performance between the euro area and the US has not declined since the banking union – if anything, it has increased (ECB, 2019, Box 5). While stock market valuations are rather volatile in the short run, over the medium term a clear tendency can be discerned: the new regime has not had the desired effect on investor confidence for euro area banks.

Several factors can explain this. One is the less favourable macroeconomic conditions: over the 2012-2018 period, GDP growth in the US was a full percentage point per year higher than in the euro area. Another may have to do with the lower level of bank risks: other things equal, in banking as elsewhere lower risk gives rise to lower returns (in risk-unadjusted terms). US banks have, in recent years, engaged heavily in risky leveraged lending.<sup>15</sup> In this respect, the efforts by European regulators in achieving the first goal – making banks safer and sounder – may have played against the second.

The trade-off between safety and profitability can be improved by making banks more efficient, but this involves structural change, which takes time. The euro area banking sector entered the crisis with considerable excess capacity (Draghi, 2016); reducing this capacity, in particular among the less-efficient segments of the banking population, could therefore be a promising avenue to increase efficiency. To some extent this has happened. The number of credit institutions has fallen in the post-crisis years in most euro area countries, and so has the

<sup>15</sup> See for example the recent FDIC Quarterly Report, (<https://www.fdic.gov/bank/analytical/quarterly/>). This is confirmed by the high default rates of leverage loans after the Coronavirus crisis.

number of bank branches and bank employees.<sup>16</sup> This consolidation process is still ongoing, especially in the countries where banks are more numerous (Germany and Italy). In Germany, consolidation is part of a long-term process; in Italy, the decline in the number of banks after the crisis marked a reversal after the increase of the pre-crisis years. Consolidation has taken place overwhelmingly among small institutions; in the medium-to-large segment, mergers or restructuring involving considerable downsizing have been rare.<sup>17</sup>

### 2.3 ...promoting banking integration

The third metric of success of the banking union is its impact on banking integration. Building a well-integrated banking sector was not an explicit objective of the banking union at the outset, but its importance cannot be overstated. Given the role banks play in financial intermediation in all countries, without a single banking market there can be no effective cross-border diversification of risks in the euro area.<sup>18</sup> The very fact of establishing a single regulatory framework has no meaning if not in an integrated banking market.

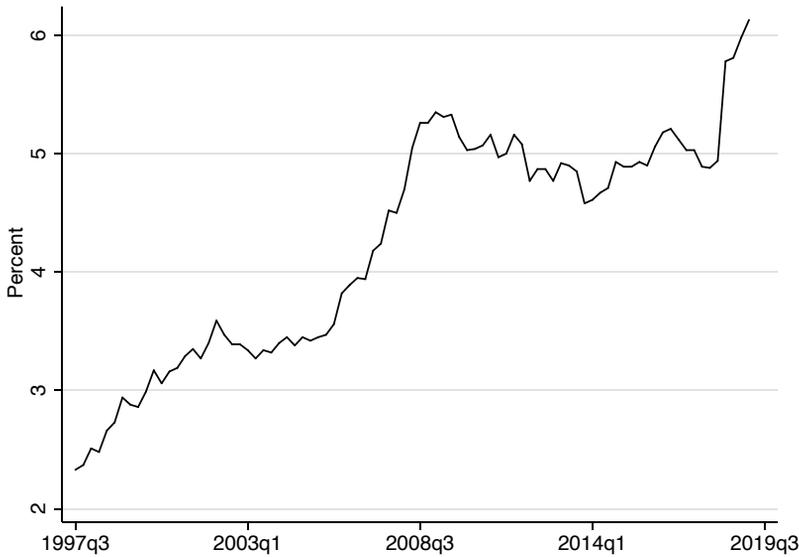
Since the early 2000s, the ECB has monitored the area-wide integration of banking and other financial market segments using two approaches. One measures the amount of transactions effectively taking place across borders. A large volume of transactions suggests that borders do not stand in the way of a single market. However, for the 'law of one price' market integration leads to lower risk-adjusted price and return differentials; when differentials vanish, no cross-border transactions need to take place. Evidence of integration is therefore also provided by the convergence of prices. The two approaches, one quantity-based and the other price-based, are complementary and the corresponding indicators need to be monitored jointly. In what follows, evidence is presented based on both quantities (cross-border flows of deposits, loans, liquidity, securities, as well as cross-border establishments and mergers) and prices (convergence of returns on several bank instruments).

Starting with quantity-based measures, Figure 17 shows the volume of cross-border intra-euro area loans granted to non-banks by euro area banks in recent years. One can see a gradual increase over time, with a retrenchment during the euro crisis (2008-2013) followed by a resumption of the increase thereafter. No break is visible in correspondence with the banking union (either the announcement in 2012, or the start of the single supervision in 2014).

16 Data on structural trends for the banking sector, by country and for the area as a whole, are available on the ECB website (<http://sdw.ecb.europa.eu/browse.do?node=9691570>); see ECB (2017).

17 In the small-to-medium bank segments, mergers and rescues have typically been supported or even engineered by national banking authorities, often burdening other banks. This was the case, for example, for high-profile rescues enacted in Italy such as Banca Carige (a relatively small bank supervised by the ECB) and Banca Popolare di Bari (a bank below the 'significance' threshold, directly supervised by the Bank of Italy). A similar model was used also in Germany for the Landesbank NordLB, whose recapitalisation was supported jointly by the group of German savings banks and the regional state of Lower Saxony.

18 On the nexus between banking union and banking integration, see Draghi (2014). Euro area risk-sharing and the channels contributing to it, including the banking sector, are discussed in ECB (2018a).

**Figure 17** Intra-euro area cross-border loans (% of total loans)

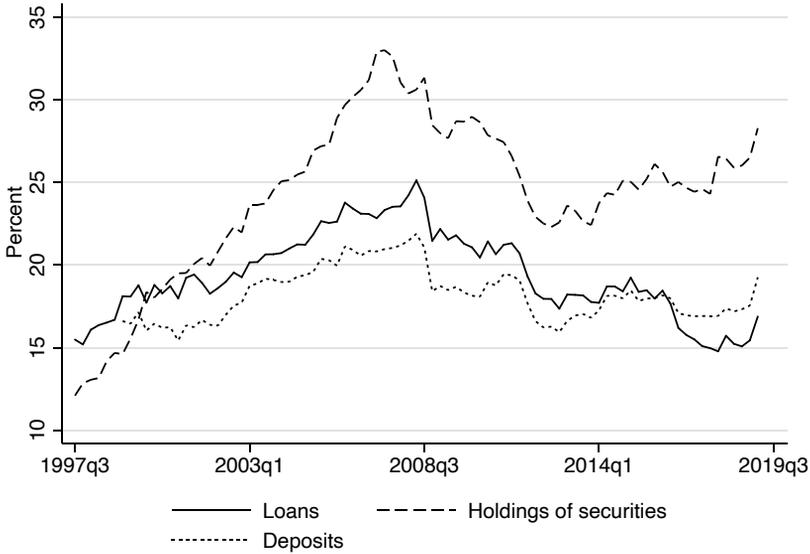
Note: Percent of loans to non-bank clients granted in other euro-area countries, as a ratio to total loans.

Source: ECB (indicators of financial integration in the euro area)

Figure 18 looks at interbank transactions. We consider three channels of interbank flows: deposits, securities holdings, and loans. In all three channels, interbank flows are much larger than transactions between banks and non-banks; this shows that the banking channel is a predominant contributor to financial integration in the euro area. The crisis led to a sharp reduction of cross-border flows in all three segments, as a result of a retrenchment of financial activity within national borders. There was not much sign of improvements after the crisis in the loan and deposit channels. Conversely, the securities channel has grown significantly, representing now around 28% of total interbank exposures (33 percent was the pre-crisis peak).

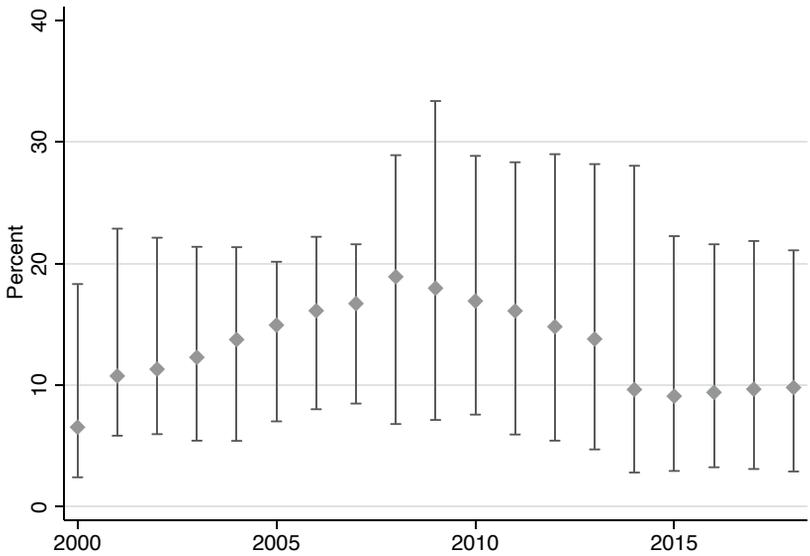
Figure 19 looks at banking integration through the lens of cross-border establishments. The figure shows the dispersion of the total assets of foreign branches and subsidiaries of euro area banks across euro area countries. The incidence of cross-border establishment fell sharply after the crisis, from close to 20% to about 10%. It has not recovered thereafter. This, as well as other evidence regarding cross-border mergers and acquisitions (ECB, 2017, Section 2.1), confirms that cross-border banking has not become more attractive after the launch of the banking union.

**Figure 18** Intra-euro area cross-border interbank exposures (% of exposures in each category)



*Note:* Percent of interbank exposures in other euro-area countries, as a ratio to exposures in each category.  
*Source:* ECB (indicators of financial integration in the euro area)

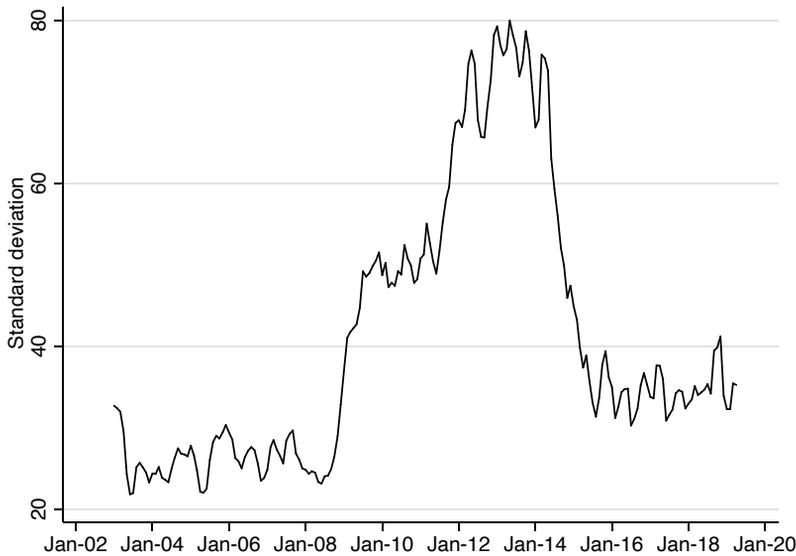
**Figure 19** Percent of assets in cross-border euro area branches and subsidiaries: Median and dispersion



*Note:* Percent of total assets of foreign branches and subsidiaries (intra area) to total assets, banks supervised directly by the ECB. The upper (lower) spike is the value of third (first) quartile. The diamond is the median  
*Source:* ECB (indicators of financial integration in the euro area)

The evidence from price indicators is more encouraging. Figure 20 shows cross-border standard deviation of interest rates on loans above €1 million with floating rates granted to non-financial corporations. After a sharp increase during the crisis, the deviation drops sharply in the 2013-14 period and stays low thereafter. The timing suggests, once more, that this more likely owed to the result of the stabilisation of market conditions which followed the monetary expansion by the ECB than to the banking union itself.<sup>19</sup> The reduction in cross-country dispersion of interest rates on loans mimics closely the convergence that was taking place, in those years, in other interest rates.

**Figure 20** Cross-country standard deviation of corporate loans interest rates



*Note:* Cross-country standard deviation of interest rates on new loans to non-financial corporations. Loans over €1 million to non-financial corporations, floating rates and up to 1-year maturity.

*Source:* ECB (indicators of financial integration in the euro area)

Several reasons explain the limited progress so far on banking integration. The retrenchment of banks behind national borders often followed internal reorganisations within large groups, within which cross-border business was often considered 'non-core' and hence disposable. The refocusing of banks on domestic activities occasionally occurred in the context of adjustment programmes supported by the European Commission. This, however, is only part of the explanation. Banks benefit from cross-border establishment only if they can allocate capital and liquidity resources in an efficient way; under European legislation, this is possible only to a minimal extent. I will return to this issue below.

<sup>19</sup> As argued also by Hoffmann et al. (2019).

## 2.4 ...enhancing supervisory transparency, accountability and even-handedness

Prior to 2014, banking supervision was conducted in different ways across euro area member countries, dictated by local practices and traditions. Those traditions incorporated knowledge and time-tested practices, but were not mutually consistent or, in many cases, ideal. Many of them would have something to bequeath, but none could become the accepted model for the newly established single authority.

The SSM is built upon a combination of national supervisory experiences and the ECB's area-wide focus and independent, transparent and accountable policymaking style. This approach made possible significant advances towards a more modern, transparent, accountable and even-handed supervisory model.<sup>20</sup> For that purpose, novelties were introduced in both the methodological and organisational side and the content and modality of external communication.

The main analytical tool used by the ECB to assess bank risks and to set supervisory requirements is the Supervisory Review and Examination Process (SREP). ECB supervision has introduced a SREP methodology which uses the best parts of earlier national approaches and adapts them to the euro area. SREP involves bringing in, on an annual basis, all available information on all main sources of risk for each significant banking group, divided in four chapters: business model; governance and risk management; risks to capital; and risks to liquidity and funding. Sectoral risks are quantified in scores, which are then aggregated in an overall score. Quantitative information is combined with qualitative assessments by line supervisors and assembled using a standard methodology. SREP helps combine information in a consistent way, thus contributing towards ensuring balanced treatment across banks. In a multi-country context, it also helps a comparable treatment across countries. The SREP methodology is made public to a large extent (ECB, 2018b); the results were initially kept confidential, but this has recently changed.<sup>21</sup> Smaller ('less significant') banks not falling directly under ECB supervision are not subject to the same procedure, but guidelines for carrying out a corresponding exercise in each country have been issued.<sup>22</sup>

In addition to SREP, the ECB conducts regular stress tests, both as part of the biannual exercises coordinated by the European Banking Authority (EBA), and on its own for supervisory purposes. Information derived from biannual stress test exercises is published by the EBA and the ECB; so far supervisory stress test results have remained confidential.

Within the supervisory process, national and ECB contributions are combined at all levels. Regular supervision is conducted by groups – Joint Supervisory Teams (JSTs), one for each banking group under ECB remit – which include both ECB and national supervisors. Groups are led by ECB staff. Their composition combines specialist knowledge from national experts with the overall consistent supervisory approach and area-wide perspective which can be contributed by

20 Such advances have been described extensively elsewhere; see for example selected speeches of ECB supervisory board members, available on the ECB supervision website (<https://www.bankingsupervision.europa.eu/home/html/index.en.html>).

21 Starting in 2020, SREP results are published following a more transparent approach adopted by the new SSM Chair, Andrea Enria (see <https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200128-20e2703d8e.en.html>).

22 See [https://www.bankingsupervision.europa.eu/banking/lis/srep\\_for\\_lis/html/index.en.html](https://www.bankingsupervision.europa.eu/banking/lis/srep_for_lis/html/index.en.html).

ECB staff. At the decision-making level, the high body preparing each decision is the Supervisory Board,<sup>23</sup> which includes the heads of national supervision authorities plus six members appointed by Europe (the Chair, the Vice Chair and four members appointed by the ECB Governing Council). Both national and European members are bound by a European mandate, enshrined in the SSM Regulation.<sup>24</sup>

These arrangements have helped the ECB supervision to attain a high level of transparency, by both historical and international standards. The ECB provides comprehensive information about its supervisory activities on its website, as well as through speeches, reports and other analytical documents and monographies (the so-called 'thematic reviews').<sup>25</sup> Further progress is nonetheless possible. Few elements resulting from individual supervisory processes are disclosed (for example, risk factors regarding individual banks and the rationale underlying specific prudential requirements), and little information is provided regarding the agendas and proceedings of the Supervisory Board. Public consultations are organised for the most important policy decisions, but press conferences by the Chair or the Vice Chair are rare (in contrast with the ECB's monetary policy arm). Further advances over time towards a more open approach are desirable and conceivable.

Major progress was also made on democratic accountability. The ECB has sealed an agreement with the European Parliament regarding exchanges of information, both regular and publicly disclosed and occasional and confidential.<sup>26</sup> The ECB maintains an active exchange particularly with its Economic and Monetary Affairs Committee, and participates in occasional hearings in national parliaments. While increasing the accountability of the ECB, the political dialogue has at times opened the door to political interference, with potential side effects on the conduct of supervisory policy (more on this below).<sup>27</sup>

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23 The ECB Governing Council is formally the only decision maker of the ECB; supervisory decisions are routinely brought to it for a short no-objection procedure.

24 Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions; see <https://eur-lex.europa.eu/legal-content/en/TXT/?uri=celex%3A32013R1024>.

25 A recent example is the thematic review on profitability and business models (ECB, 2018c).

26 See the information at <https://www.bankingsupervision.europa.eu/organisation/accountability/html/index.en.html>

27 A discussion of supervisory independence, its benefits and risks, can be found at <https://www.bankingsupervision.europa.eu/press/speeches/date/2019/html/ssm.sp190322-c231d57793.en.html>.

## 3 Reviving Europe's banking union

The discussion on policy measures is organised under seven headings:

1. Supervisory tools
2. Crisis management
3. State-aid control
4. Less-significant banks
5. Macroprudential supervision
6. Sovereign concentration risk
7. Deposit insurance

The proposals are deliberately comprehensive and ambitious, focusing principally on the objectives to be achieved and only tangentially on the constraints inherent in reaching consensus or making compromises. The first two items in the list are presented together up front because they are closely related; as will be argued, there are strategic complementarities between supervision and crisis management. Less evident synergies also exist with the other headings. For example, a well-developed and actively employed macroprudential framework allows the microprudential supervisor to apply its instruments to individual banks in a more intrusive and rigorous fashion, because it mitigates financial stability concerns.

No consideration is given here to the issue of Eurobonds, in spite of the fact that their adoption has been advocated by some as a complement of the banking union. By pooling sovereign risks, liabilities issued by the EU or by EU entities, carrying a joint or several guarantee of the member states, would evidently help neutralise the contagion between weak national banking sectors and the respective sovereign. This would only happen, however, if such liabilities represented the totality or at least a very large portion of the sovereign debts held in bank portfolios. This is, at best, a rather distant prospect. Less obvious is the fact that more nuanced schemes, such as the Blue Bonds proposal from Bruegel (von Weizsäcker and J. Delpla, 2010), while perhaps valuable for other reasons,

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would give much support to the banking union, because in such schemes each member state would remain, at the margin, responsible for supporting its own banks in case of crisis. Other proposals which do not incorporate mutualisation of sovereign risks would, a fortiori, contribute even less.<sup>28</sup>

Likewise, there is no discussion here on money laundering, an issue which has gained prominence in recent years. Anti-money laundering (AML) supervision remains a national responsibility. At the European level, the European Banking Authority (EBA) contributes to “preventing the use of the financial system for the purposes of money laundering and terrorist financing”<sup>29</sup> and does so by undertaking actions such as collecting information, coordinating the national authorities, and adopting standards and measures within its mandate.

Following a number of prominent money-laundering cases involving euro area banks,<sup>30</sup> a consensus has developed that Europe’s AML framework should be overhauled by creating an area-wide dedicated supervisor. ECB President Mario Draghi endorsed this view in June 2019,<sup>31</sup> and a group of finance ministers, including from countries affected by the scandals, issued a non-paper in November 2019 with specific proposals.<sup>32</sup> Important details remain to be defined, however, including where to locate the authority – in the EBA or, as seems more likely, in a separate institution.

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28 For example, Brunnermaier et al. (2016) propose the creation of European ‘safe bonds’ composed of senior tranches of securitized portfolios (ESBies) of sovereign issues. Banks would swap their holdings of (mostly domestic) sovereigns for ESBies, while junior tranches and residual (not securitised) bonds would be held by other investors. This arrangement would supposedly eliminate the loop. However, the proposal has two problems. First, peripheral countries’ banks would hold significant amounts of junior tranches and residual bonds as well, either because the available supply of ESBies would not satisfy their demand or because they would seek high yields on their investment, or – most likely – for both reasons. Second, in case of a negative shock to the banking sector of a peripheral country, the respective sovereign would need to issue residual bonds, hence putting its solvency in jeopardy. The scheme therefore does not eliminate either the contagion from governments to banks or the reverse one, in peripheral countries – which is the relevant issue to be solved. A significant degree of debt mutualization is necessary for the loop to be mitigated – a point illustrated in more detail by Minenna (2017).

29 See the EBA Regulation, <https://eur-lex.europa.eu/eli/reg/2010/1093/>.

30 Two episodes, in particular, drew considerable attention. In February 2018, ABLV, Latvia’s third bank, was cut-off from dollar funding by the US authorities after they had obtained evidence of systematic money laundering. Short of liquidity, the bank was put in a moratorium and subsequently declared failing by the ECB. The ECB, which had had the bank under supervision for over three years, had noted weaknesses in the internal governance and control framework, but lacking specific investigatory authority had not connected them to fraudulent activities. More recently, the EBA has been criticized for not acting, in April 2019, on specific evidence regarding an Estonian branch of the Danske (Denmark’s largest bank), involved in large illicit international transactions. These episodes, together with others, highlighted the shortcomings of the European anti-money laundering framework and triggered a debate on how it should be reformed.

31 See one answer during the Q&A session of the press conference held after a Governing Council meeting taking place in Vilnius (Latvia); <https://www.ecb.europa.eu/press/pressconf/2019/html/ecb.is190606-32b6221806.en.html>

32 See this document here <https://www.parlementairemonitor.nl/9353000/1/j9vvij5epmj1ey0/v13lk3xwdet3>.

### 3.1 Supervisory tools

The Regulation establishing the SSM provides a strong charter to the ECB supervision: it clearly defines its objectives and explicitly spells out the powers and instruments the ECB is assigned to achieve them. The Regulation, approved by the European political decision-making bodies during the course of 2013, reveals a clear intention to grant the ECB all tools and authority needed to conduct banking supervision according to modern international standards.

Of particular importance is Article 16, which stipulates that, in case a bank does not fulfil its legal requirements or if the ECB judges that those requirements may be breached in the near future, or more generally if the ECB considers that the bank's governance does not fulfil safety and soundness criteria, the ECB can take a number of discretionary initiatives, including: requesting a capital increase (pillar II, over and above the legal pillar I requirement) or extra provisions; demanding capital plans; imposing restrictions to specific forms of business or to the distribution of profits; setting additional liquidity requirements; obtaining additional information or imposing disclosures; removing and replacing managers; and so on. The detail and the comprehensiveness of this Article leave no doubt about the fact that the legislators intended to give to the ECB supervisor ample discretion in exercising its function, subject to pillar I legal requirements and strict accountability criteria (the latter are spelled out elsewhere in the Regulation). Such discretion and flexibility played an essential role in allowing the ECB to achieve the results on bank capitalisation and non-performing loans which I described earlier in this report.

In spite of the regulation's clarity in principle, however, the combination of it with other parts of the legislative framework works in practice to significantly limit the ECB's leeway in using its tools. Three obstacles in particular contribute to create legal uncertainty regarding the ECB's effective powers. The restraining influence of legal uncertainty cannot be overemphasised; supervisors rarely act if their decision entails a risk of being legally challenged.

The first problem is that the European banking legislation is not complete, in the sense that it does not cover all relevant areas or that it requires national acts to become applicable. The ECB is bound to apply national laws in all cases where either European legislation does not exist or it consists of European directives which enter in force only after national transposition laws are approved.<sup>33</sup> This limitation applies to crucial areas such as the check of fitness and propriety of bank administrators and managers. National laws transposing European directives create disparities in the legal framework across different countries, as well as legal uncertainty in some cases. Before the banking union, national transpositions were justified in a number of instances to fit national specificities and objectives of national legislators and supervisors. In the single supervisory area, they are no longer justified from a prudential regulation or supervisory perspective and risk upsetting the supervisory effectiveness and level playing field.

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33 Art 4.3 SSMR says: "For the purpose of carrying out the tasks conferred on it by this Regulation, and with the objective of ensuring high standards of supervision, the ECB shall apply all relevant Union law, and where this Union law is composed of Directives, the national legislation transposing those Directives. Where the relevant Union law is composed of Regulations and where currently those Regulations explicitly grant options for Member States, the ECB shall apply also the national legislation exercising those options." Early drafts of the SSM regulation did not contain this limitation (see, for example, [https://www.ecb.europa.eu/ecb/legal/pdf/com\\_2012\\_511\\_en\\_acte\\_f.pdf](https://www.ecb.europa.eu/ecb/legal/pdf/com_2012_511_en_acte_f.pdf)).

The second limitation is that European law, even when consisting of regulations directly applicable by the ECB without national transposition, like the Capital Requirements Regulation (CRR),<sup>34</sup> contains areas left to national determination ('national options or discretions') – clauses that, much like transposition laws but more specific in scope, open the door to country-specific legislation deviating from the common rule. This avenue has been used to prevent the ECB from authorising cross-border liquidity movements between subsidiaries of large banking groups, thus preventing banking integration. For example, the Belgian banking industry and regulators have defended ring-fencing the liquidity of domestic banks, which largely consist of foreign-owned subsidiaries, on the grounds that in the absence of an effective pan-European crisis management framework including deposit insurance, depriving them of liquidity buffers would endanger financial stability in Belgium.<sup>35</sup> Unlike in the case of capital requirements – where, unfortunately, EU law sets rigid requirements at the subsidiary level, not waivable by the supervisor, and therefore does not allow capital reallocation within cross-border groups – the law authorises supervisors to waive liquidity requirements at the local and cross-border level. The ECB has opened up, under certain conditions, liquidity movement across countries.<sup>36</sup> It has also, within its mandate, made an effort to ensure a better alignment of the banking union's prudential framework with the Basel III standards. These efforts, however, were not very successful.<sup>37</sup> Deviations from the Basel framework are, by and large, enshrined in EU law, as are the limits to intra-group capital mobility. The remaining hurdles to cross-border liquidity management, however, depend on national legislation. ECB supervision could also contribute, within the existing rules, by according more systematic benefits to cross-border groups which undertake intra-area diversification.<sup>38</sup>

A third and more subtle issue arises from the principle, inherent in legislation, according to which pillar II requirements must always refer to specific circumstances of individual banks. In itself, this principle is unquestionable; pillar II supervisory decisions always refer to individual banks, because they cater for idiosyncratic risks not already accounted for by pillar I requirements (legal requirements applying equally to all banks). In order to enhance transparency and facilitate understanding, the ECB has adopted the practice of accompanying pillar II requirements with 'supervisory expectations' – general overarching criteria, publicly announced, that individual decisions must be consistent with. In 2017, the European parliament objected to this practice with regard to prudential provisions set by the ECB on NPLs, based on the argument that supervisory expectations are akin to additional layers of legislation. This specific

34 Adopted in 2013 (see <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32013R0575>) and subsequently revised.

35 See André Sapir's comments on Belgium in Schoenmaker and Véron (2016).

36 This was done by harmonising the options and discretions available to national supervisors; for more detail, see Angeloni and Beretti (2015) and [https://www.bankingsupervision.europa.eu/press/publications/newsletter/2017/html/ssm.nl170517\\_2.en.html](https://www.bankingsupervision.europa.eu/press/publications/newsletter/2017/html/ssm.nl170517_2.en.html).

37 Since 2014, the European Union has been singled-out as "materially non-compliant" with the Basel III standards; see Financial Stability Board (2019). Deviations relate mainly to three aspects: the deductions of insurance participations from the banks' regulatory capital, the application of capital charges on credit risk on OTC derivatives (so-called CVA adjustment) and the regulatory treatment on exposures to small and medium enterprises. In 2015-16 ECB supervision waged a largely unsuccessful attempt to bring into line the first aspect, among the banks under its supervision.

38 In principle this element is taken into account in the assessment of the bank's business model. In practice, the extent to which this actually happens depends on judgement by the bank's JST.

case was subsequently clarified,<sup>39</sup> but the experience should serve as a reminder that the law should not prevent pillar II requirements from being communicated by announcing general criteria. In fact, the law should encourage such practice because transparency about the general criteria used by the supervisor improve the understanding of specific decisions and avoid the risk that such decisions may appear (or even become) ad-hoc and arbitrary.

These and any other ambiguities need to be removed from legislation if the ECB is to fulfil its prudential function effectively. The existing supervisory toolbox should not be enlarged, but only made usable without legal inconsistency or uncertainty.<sup>40</sup> While the revision of the EU banking law enacted in 2019, the first after the launch of the banking union, made progress in a number of areas, it did not provide sufficient clarity in this respect. A further review is therefore necessary. In this context the relevant substance of the SSM Regulation, spelling out the ECB's goals, powers and instruments, should be included with sufficient detail into a legal text directly applicable by the ECB, such as the Capital Requirements Regulation. Care should be taken to ensure that such provisions do not conflict with, or in case prevail over, other parts of EU and national legislation. The ECB's supervisory powers would remain subject to pillar I requirements and to the ECB accountability framework. Prudential options and discretions currently assigned to member states should be entrusted to banking supervisors and applied by the SSM in a consistent way as part of their mandate.

As mentioned already, one reason why member states adopt a defensive attitude against cross-border integration is that financial stability may be at risk in some countries unless national prudential requirements are preserved. Strengthening supervisory powers therefore requires strengthening the crisis management framework as well.

### 3.2 Crisis management

The bank crisis management framework includes all provisions, instruments and means used by public authorities to deal with non-viable banks. The European crisis management framework is worth examining in some detail because a central reason for the insufficient progress of the banking union more generally is precisely the fact that the crisis management framework is not sufficiently developed.

The law governing crisis management in the EU, the Bank Recovery and Resolution Directive (BRRD),<sup>41</sup> which was passed into law in 2013 and entered in force fully in 2016, regulates the various processes through which a bank in critical conditions is restructured to overcome the crisis and resume business if possible, or is wound down if necessary. The word 'recovery' refers to a milder process whereby the bank adopts measures to improve its soundness, short of a deep restructuring and while remaining in operation. The recovery function

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39 See the summary at [https://www.bankingsupervision.europa.eu/press/letterstobanks/shared/pdf/2019/ssm\\_supervisory\\_coverage\\_expectations\\_for\\_NPEs\\_201908.en.pdf](https://www.bankingsupervision.europa.eu/press/letterstobanks/shared/pdf/2019/ssm_supervisory_coverage_expectations_for_NPEs_201908.en.pdf)

40 One exception regards capital waivers for subsidiaries, still not allowed in the EU law. Banking groups operating in more than one country through subsidiaries should be allowed to waive capital requirements on specific entities, subject to prudential assessment of the supervisor.

41 See [https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/bank-recovery-and-resolution\\_en](https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/bank-recovery-and-resolution_en)

is entrusted to the supervisor; by contrast, resolution, in the EU and almost everywhere else, is governed by a different institution, albeit in strict cooperation with the supervisor. The European authority competent for resolution is the Brussels-based Single Resolution Board (SRB).

Supervision and crisis management are complementary. The supervision authority requires banks to properly control and contain their risks, but in doing so may at times bring those risks to the fore. The supervisor also has the power to declare the failure of the bank and withdraw its license. The crisis management authority manages the bank after failure has occurred, ensuring that losses are distributed fairly and that the risks are not spread to the rest of the system. Without a workable resolution framework, supervision cannot act timely and decisively, because it may itself become a source of risk. These concepts are further developed in Annex 2.

More specifically, a well-constructed bank crisis management framework is supposed to fulfil three related functions (Financial Stability Board, 2014). The first is to contain systemic risk, ensuring that financial stability is not endangered by the failure of individual banks. A proper crisis management framework not only neutralises contagion from the failing bank to the rest of the system when it occurs, but also prevents it. To this aim, part of the safeguards is established *ex ante*, ensuring that at any time bank balance sheets are well structured to absorb losses and plans are prepared for possible resolution. Other safeguards are provided *ex post*, when the resolution process actually takes place.

The second purpose is to make for a fair distribution of the losses arising from the bank's crisis. When a bank fails there are always losses; usually they are already incurred in economic terms and largely irreversible, although they do not yet appear in the accounts. Losses that cannot be recuperated need to be shared among the stakeholders involved, which include the owners of the bank (shareholders), the creditors, other banks (whether they are creditors or not), and possibly public finances (the taxpayer). What 'fair' means depends on circumstances and may result from prudential considerations and political preferences. Shareholders, and to an extent also creditors, accept a financial risk when investing in a bank. Depositors, usually the largest and less sophisticated category of investors, are also exposed to a risk but are protected by the safety net, because of the collective interest in maintaining a safe payment system. Other banks may have stake as well, because they are exposed to the failing bank or more generally benefit from financial stability.<sup>42</sup> The taxpayer may also be involved, because financial stability and the smooth provision of banking services are public goods. There are no reasons of principle why taxpayers (the population at large) should *a priori* be excluded from any burden sharing – in practice, they rarely are. By contrast, the post-crisis European legislation embodies a preference for 'fiscally neutral' interventions, which limit as much as possible the burden on the taxpayer.

The third purpose of the crisis management framework is to contribute to strong and healthy banks by making sure that the market mechanism works and failures can actually occur. To enhance efficiency, an element of Schumpeterian 'creative destruction' must exist in the banking sector as well. The market provides

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<sup>42</sup> This is a specific feature of the banking system, where individual banks may suffer from others' failures if they affect financial stability, in addition to benefiting from it because of the demise of a competitor.

incentives for good management but for that to happen, failure – including managerial and shareholder punishment – must be possible. If a bank is too big to be allowed to fail, for example, the beneficial effect of the market mechanism ceases to function.

The resolution steps of the European framework are codified in detail by the BRRD and the SRM Regulation.<sup>43</sup> They all involve the SRB together with the national resolution authorities (NRAs), the latter as contributors to certain decisions and operational arms. Two phases should be distinguished: the first, *ex ante*, is the preparation when the bank is still deemed safe and sound; the second, *ex post*, consists of the actual execution. Box 1 provides a primer on both.

**Box 1** Resolution planning and execution at the SRB

The preparatory phase conducted by the SRB includes drafting resolution plans – sometimes referred to as ‘living wills’ – for each bank. The resolution plan provides a roadmap for a bank in case it needs to be resolved, identifying the functions that are critical to preserve in the public interest, removing obstacles to resolution that may exist in the bank’s internal organisation or balance sheet, making sure that sufficient information is available for valuing the bank, and eventually identifying the ‘strategy’ to be followed in the resolution process.<sup>44</sup>

If the bank comprises several entities in a group, the strategy establishes whether each entity is to be treated separately or if the group should pool losses at its head company and cover them as one (‘multiple point of entry’ or ‘single point of entry’ resolution). The strategy specifies what form the bank will assume after resolution (if and how the balance sheet should be split so as to isolate the losses, whether/how bail-in should be applied, and so on).<sup>45</sup> Preparation also requires identifying, on the liability side of the bank, parts which can be ‘bailed-in’ (written down or converted into equity) at the point of resolution in order to absorb losses.

Bail-in follows a legally prescribed sequence: shareholders first, followed by creditors of ascending order of seniority, and lastly depositors. Insured depositors are immediately reimbursed by the bank’s domestic deposit guarantee scheme. If loss absorption involves the use of public funds or the Single Resolution Fund, bail-in requirements (minimum amount of involvement of creditors in covering losses) apply.<sup>46</sup> The SRB specifies, for each bank, the requirements in terms of liability instruments that can be bailed-in (Minimum Requirements for Eligible Liability, or MREL), as well as their split among such instruments between subordinated and senior debt (subordination requirement). MREL requirements have been set by the SRB for all banks, but since balance sheet adjustment takes time, they have not yet been fulfilled by most banks; for many banks, they may take years to complete.

43 The text of the SRM regulation is found here <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0806&from=EN>.

44 Details can be found on the SRB website (<https://srb.europa.eu/en>).

45 For a description of the ‘resolution tools’, see SRB (2016).

46 At least 8% of total unweighted liabilities must be bailed in, after which the SRF can intervene for at most 5% of the same amount of liabilities (see SRM regulation referred to above, Art. 27).

The execution phase includes the valuation of the bank as a whole or separately of its assets, depending on the strategy followed, and the actual implementation. The actual strategy to be followed is chosen at the point of resolution; the plan is not prescriptive at that point (the main purpose of preparing a plan in advance is to induce awareness and readiness by the bank). Two valuations are normally performed: one 'ex ante' for planning purposes to measure the asset values using standard accounting criteria; and another closer to resolution, taking into account the more realistic economic values, to help determine the resolution tools used and the extent of bail-in.<sup>47</sup>

One or more 'resolution tools' can be used in combination: sale of the entire business, separation of 'good' from 'bad' assets (the latter preferably sold to specialised investors for liquidation), a 'bridge bank' to preserve the bank temporarily for sale at a later date, and bail-in.<sup>48</sup> Through the latter, certain liabilities are written off or converted in order to cover losses or recapitalise the entity which remains in business.

Figure 21 shows in a simple scheme for how a bank crisis is supposed to be handled in principle. A bank falling below its minimum capital requirement and unable to restore solvency in a short time, or that lacks liquidity to fulfil its payment obligation, is declared 'failing or likely to fail' by the supervisor. By law, recourse to state aid triggers failure automatically, except in particular circumstances.<sup>49</sup> After that, the ball passes to the SRB, which at first needs to determine if the bank performs functions which involve the public interest. If so, resolution is justified, with due assistance from the public authorities to ensure that risks do not spread and the essential functions are maintained; if not, the bank can undergo an ordinary insolvency procedure, which does not include such precautions. Since there is no insolvency regime at the European level, in this case a national regime applies. If there is public interest, two alternatives exist: either a private solution is available, for example in the form of a suitable acquirer (selected by the SRB through a sale process); or public intervention is necessary. Public intervention may involve state aid and potentially the use of the Single Resolution Fund. Public support requires shareholders and creditors (potentially with the only exception of insured depositors) to share losses (i.e., bail-in). Other banks may also participate to loss-sharing, via a national deposit insurance or in other forms.

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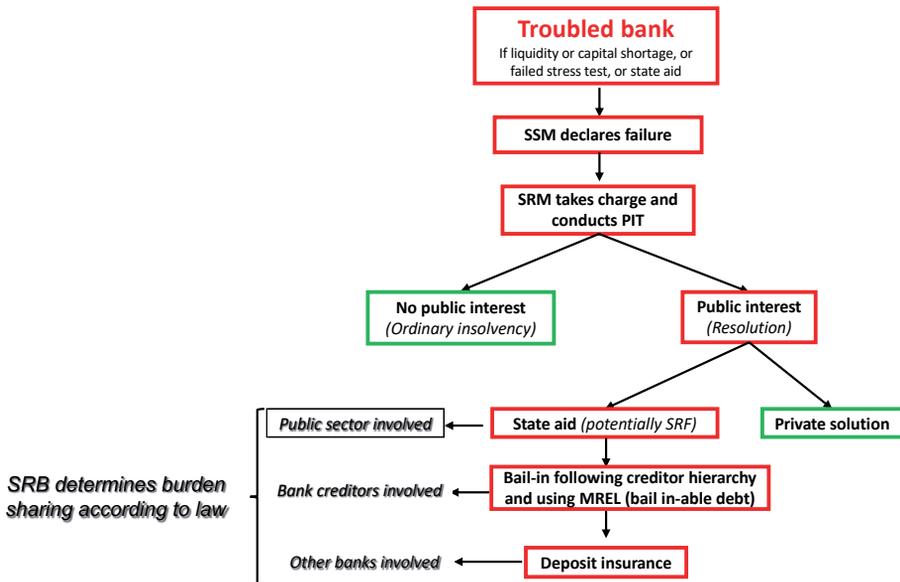
47 A third valuation is made normally after resolution, to verify that no creditor has been damaged by the resolution process more than would have been under normal insolvency (the 'no creditor worse-off principle'). Details can be found at [https://srb.europa.eu/sites/srbsite/files/framework\\_for\\_valuation\\_feb\\_2019\\_web\\_0.pdf](https://srb.europa.eu/sites/srbsite/files/framework_for_valuation_feb_2019_web_0.pdf).

48 The "resolution tools" are codified in detail in the BRRD.

49 See Article 34 of the BRRD.

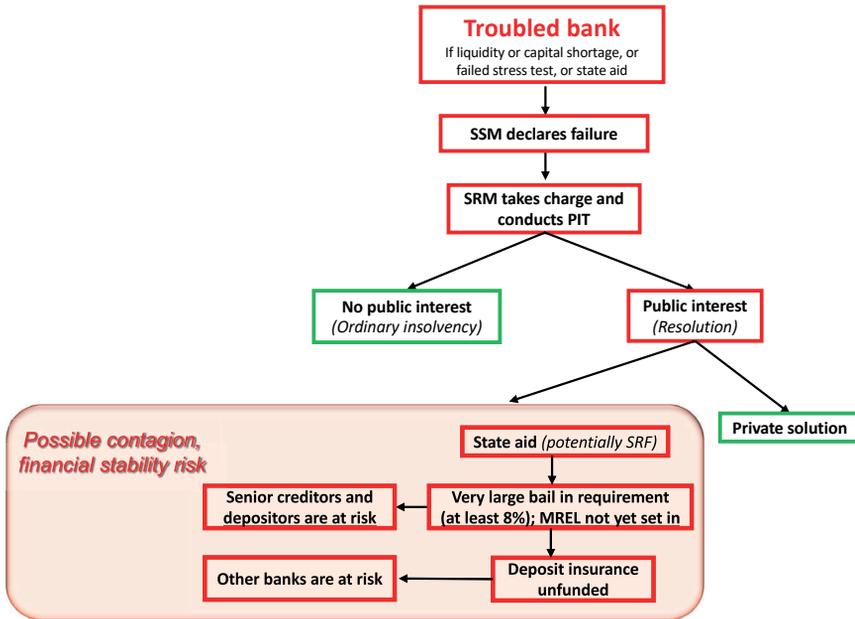
In practice, two hurdles make this ‘standard script’ not easily applicable (Figure 22). First, the bail-in requirements under public support are demanding. In spite of the efforts by the SRB to set MREL requirements, so far few banks have a balance sheet structure organised in a way that allows orderly bail-in.<sup>50</sup> Liabilities are made-up to a large extent of senior instruments or even deposits held by retail investors, which may have trouble understanding their risk profile. In these circumstances, bail-in becomes politically sensitive and may even trigger disorderly conditions. This risk is compounded when subordinated instruments or non-listed shares are in the hands of unaware investors, perhaps following encouragement by the bank itself (banks typically also act as a financial advisor for their clients, in a potential conflict of interest). The second problem is that reimbursing depositors may entail a heavy burden for national deposit insurance schemes, if the latter are not sufficiently funded. In that case, when the bank fails, other banks have to step in immediately by providing significant funds up front. While funds are in principle recouped later, the initial shock may erode confidence in otherwise healthy banks and trigger contagion in the system.

**Figure 21** Banking union crisis management: How it works in principle



<sup>50</sup> The EBA's first MREL quantitative report published in February 2020, based on end-2018 data, shows that out of 222 EU banking groups examined, 117 have a MREL shortfall for a total of €178 billion, while 105 are either on target or in surplus (EBA, 2020). Due to various data issues, however, the survey covers only 13 out of 19 banking union countries. Moreover, an additional €50 billion shortfall may result (depending on discretionary decisions to be made by the resolution authorities) from the new subordination requirements established by BRRD2.

Figure 22 Banking union crisis management: Issues arising in practice



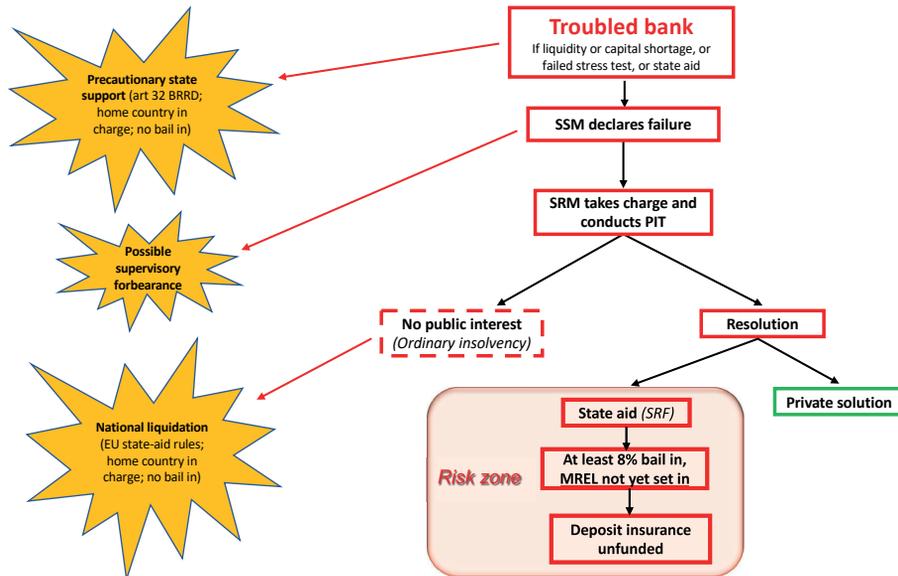
Recent experiences of bank crises under the banking union have shown the difficulty of applying the ‘standard script’ and resulted in a flurry of ingenuities to bypass the rules (Figure 23).<sup>51</sup> One alternative has consisted in providing state support at an early stage, using exceptions to the rule that state aid triggers failure automatically (Art 32 BRRD).<sup>52</sup> Another avenue is to resort to national

51 An overview of individual cases is provided in Angeloni and Ugena (2019).

52 This was the case, in 2017, of the precautionary recapitalization granted to Monte dei Paschi di Siena (MPS) and the liquidity support granted to Banca Popolare di Vicenza and Veneto Banca (VV). These cases are different. In the first, the Commission approved a request for precautionary recapitalization by the state ex-art 32 of BRRD, using as metric to estimate the capital need the results of the 2016 stress test. In the second, the Commission approved a request for liquidity support through state guarantees, also ex-art 32 of BRRD; subsequently, however, lacking a prospect of recapitalization along the same lines, the two banks were declared failing by the ECB and, following a decision by the SRB that those banks entailed no public interest, the banks were liquidated nationally and their best parts acquired by Banca Intesa; liquidation aid was authorized pursuant to the 2013 Commission state-aid communication. In spite of the differences, there is an element in common. In both cases, exceptions provided by art. 32 BRRD were made without a thorough check of the balance sheets through an Asset Quality Review (AQR). In the MPS case, an AQR may have led to a more expensive restructuring and greater need for private capital. But in 2019, before Coronavirus struck, MPS still had a high NPL ratio and an operating income overburdened by provisions, in spite of considerable losses incurred by its public shareholder. In the case of VV, had an AQR been performed the bankruptcy might have occurred earlier, but possibly at a lower eventual cost. In both cases, a problem resided in an ill-conceived art 32 of BRRD. This article does not require an AQR before authorizing a “financial stability exception” (in the form of precautionary state capital or liquidity guarantee), but only a stress test; however, it does require that all incurred losses be covered by private capital. In cases like the aforementioned ones, a stress test without AQR is not enough. Rather than banning state aid for past losses, the law should preferably authorize state aid only after an AQR has been made, following which the balance sheet would be cleaned up entirely. The shareholders and the state would then need to assess how much private capital can be obtained and whether the operation is worth the cost. This approach would give a better assurance that what remains in operation is a healthy bank.

insolvency, which, in absence of a European regime, is subject to milder bail-in requirements.<sup>53</sup> For this avenue to be pursued, the SRB must declare that liquidating the bank involves no public interest – a conclusion whose logic clashes with its classification as ‘significant’ (thereby requiring supervision at European level) and with the fact that it may subsequently receive state support at the national level. More subtly but importantly, the problems inherent in following the ‘standard script’ may induce supervisory forbearance – i.e., the supervisor postponing intervention in the hope that easier solutions may somehow be found later. Postponing the problem may at times increase risks and the costs of the eventual solution.

**Figure 23** Banking union crisis management: Escape routes



Unlike what is needed for supervision tools, upgrading the resolution framework requires rather radical changes of existing rules and practices. The principle should be to assign to the SRB adequate powers, instruments and resources to directly execute the resolution processes under its remit. This amounts to a ‘Copernican revolution’ with respect to the present approach, according to which national resolution authorities are in charge of executing the key steps, with the SRB in a largely coordinating role.

A basic question to be solved up front is to which banks should resolution apply. At present, the SRB only resolves banks that entail a ‘public interest’, determined by a ‘public interest test’ that the SRB itself conducts. Public interest is deemed to exist if the bank is interconnected with other banks to the point of

<sup>53</sup> See [https://ec.europa.eu/competition/state\\_aid/legislation/temporary.html](https://ec.europa.eu/competition/state_aid/legislation/temporary.html), in particular paragraphs 43-45.

causing potential contagion, or if it performs functions that need to be protected from the bank's failure in the collective interest. Otherwise, the bank undergoes national liquidation, potentially with state aid without requiring bail-in. Not only is the public interest test highly complex and judgemental, it may also give rise to distorted incentives and contradict the logic of the banking union. The latter is based on the distinction between significant banks supervised by Europe and less significant ones supervised by member states with European oversight. Significant banks fulfil criteria of importance for the area and also for the national economy where they are located. Many banks with only a national footprint are classified as significant despite only having domestic business because in the monetary union, contagion risks stem from macroeconomic and fiscal linkages as well. There is thus no reason why banks supervised centrally should not undergo resolution at the European level as well, by the SRB. This would ensure symmetry of roles and incentives between the responsibility of supervision and resolution. Conversely, less significant banks may remain, as long as they continue to be supervised nationally, subject to national resolution procedures, with SRB oversight and coordination in order to limit inconsistency of treatment across banks.<sup>54</sup>

The amendments to the resolution framework can therefore be summarised as follows:

1. As a rule, all ECB-supervised banks when failing should undergo resolution by the SRB. Exceptions could be made only in extreme cases, for example for banks which have shrunk for two years well below the significance threshold and are regarded as no longer having material relevance for the national economy or the euro area.<sup>55</sup> The SRB would also remain responsible, as it is now, for resolution planning and for removing obstacles to resolvability regarding significant banks.
2. The SRB would execute the resolution process directly,<sup>56</sup> the national resolution authorities (NRAs) would cooperate by providing information and expertise as needed. The SRB in particular would choose the strategy, conduct valuations, select potential acquirers for whole or parts of the banks, choose temporary administrators, determine bail-in and burden-sharing arrangements, and directly enact all resolution steps and monitor their execution, making use, if needed, of the resources of the Single Resolution Fund. The SRB should also be granted certain additional powers which have proved useful to the United States in the financial crisis, such as the power to offer loss-sharing arrangements to attract acquirers and create 'shell' companies where parts of the resolved bank can be located on a temporary basis. The SRB would therefore perform a role akin to 'receivership' in the

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<sup>54</sup> To prevent any inconsistency, bankruptcy laws need to be harmonized within the banking union. This remains a long-term goal, on which work is ongoing. By contrast, in the United States, where a single legal framework exists, the FDIC is responsible for all banks. The size and resources available to the Division of Resolutions and Receiverships of the FDIC have increased by a factor of 4 during the recent financial crisis, due to the large number of bank failures; see Chapter 6 in FDIC (2017).

<sup>55</sup> To recall, banks must remain below the significance thresholds for 3 consecutive years below losing the significance status.

<sup>56</sup> At present the implementation of the resolution process is entrusted to the national resolution authorities and its execution is subject to "close monitoring" by the SRB; see SRB regulation, Art. 28 and 29.

United States (for a summary of how the FDIC operates in the United States and its role in the crisis, see Box 2).

**Box 2** The Federal Deposit Insurance Corporation (FDIC) model<sup>57</sup>

The FDIC was created in 1933 as part of the policies adopted during the Great Depression, with the goal of maintaining stability and public confidence in the nation's banking system. Currently, the FDIC has three main responsibilities: providing deposit insurance to all depositors, with a limit of \$250,000 per depositor; supervising state-chartered banks and savings institutions that are not members of the Federal Reserve System; and acting as receiver, or liquidating agent, when an insured deposit institution fails.

First, the FDIC protects insured depositors at banks and savings associations (insured deposit institutions, or IDIs) of all sizes. When an IDI fails, the FDIC reimburses insured depositors fully, usually within 1-2 business days. Deposit insurance draws on the deposit insurance fund (DIF), constituted by collecting risk-based insurance premiums from IDIs. IDIs deemed to pose a greater risk to the DIF are required to pay higher insurance premiums. The DIF is backed-up by a credit line from the US Treasury; any uses of this credit line must subsequently be refunded through additional bank contributions.

Second, the FDIC acts as the primary federal supervisor for state-chartered banks and savings institutions that are not members of the Federal Reserve System. For these institutions, the FDIC performs risks management, trust, Bank Secrecy Act/Anti-Money Laundering and information technology examinations in cooperation with state banking regulators. Also, in the supervisory field, the FDIC collaborates with other federal regulators in monitoring risks at financial institutions, including large and complex financial companies for which the Federal Reserve Board (FRB) is the primary federal supervisor. Large financial companies annually submit resolution plans for the FRB and FDIC's joint consideration.

Third, the FDIC acts as the receiver or the liquidating agent for failed IDIs (receiverships). The FDIC has the responsibility for efficiently recovering the maximum amount possible from the disposition of the receivership's assets and the pursuit of the receivership's claims. The receivership management process begins when the failing institution's chartering authority revokes its charter and appoints the FDIC as a receiver. As receiver, the FDIC values a failed institution, markets the failed institution to healthy institutions, solicits and accepts bids for the sale of some or all of the institution's assets and assumption of deposits, determines which bid is least costly to the DIF, and works with the assuming institution through the closing process. Importantly, the FDIC can enter into loss-sharing agreement with the acquirer, using its resources, thereby providing an incentive to the process, respecting the least cost approach with discretion and judgement. This flexibility has

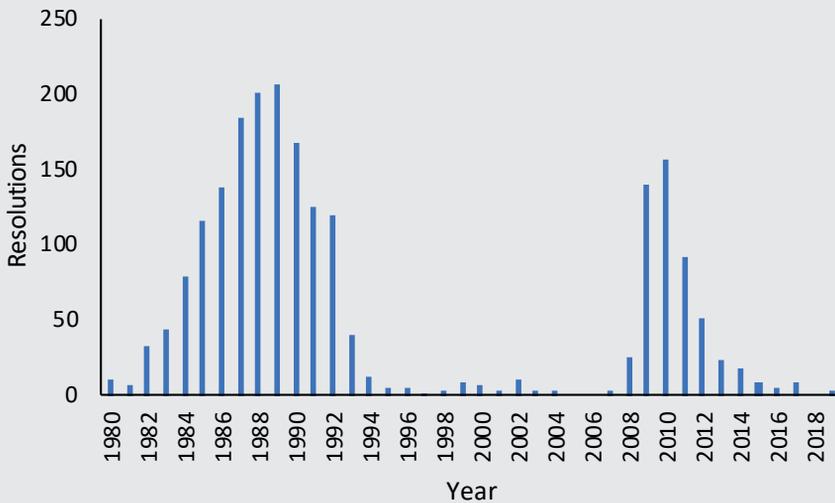
<sup>57</sup> This box condenses information contained in three FDIC publications: the FDIC Strategic Plan (<https://www.fdic.gov/about/strategic/strategic/index.html>), its Resolution Handbook (<https://www.fdic.gov/bank/historical/reshandbook>) and FDIC (2017). The FDIC website is extremely informative on resolution rules and practices in the US, as well as on the way the FDIC powers were used in the financial crisis.

been used extensively in the recent crisis. In case there is no acquirer, the FDIC liquidates the failed institution's remaining assets and distributes any proceeds of the liquidation to the FDIC and other remaining creditors. The FDIC can deviate from the minimum cost principle in a financial crisis, by applying a 'systemic risk exception'. The receivership management process ends when the failed institution is closed or the proceeds from liquidation are distributed to creditors.

Figure 24, published by the FDIC, shows the number of institutions resolved by the FDIC in 1980-2019, highlighting the two peaks during the savings and loans crisis (mid-late 1980s) and the great financial crisis (2008 to 2013).

The Dodd-Frank Act of 2010 created a back-up resolution mechanism, the Orderly Liquidation Authority (OLA), with an associated Orderly Liquidation Fund (OLF), specifically for systemically important financial institutions (SIFIs) whose resolution under bankruptcy would pose serious risks to financial stability. The OLA is intended to enable the FDIC to liquidate SIFIs, while ensuring that shareholders, creditors, and culpable management are held accountable without imposing burdens on taxpayers. In the case that the OLA is invoked (by two-thirds of the Federal Reserve Board of Governors and the Treasury Secretary), the Treasury lends the FDIC money to resolve the failing SIFI, up to as much as 90% of the bank's total assets. If the resolution incurs a net cost, the FDIC recoups the money spent by imposing a fee on the other SIFIs.

**Figure 24** FDIC resolution activity, 1980–2018



3. Until convergence to the MREL targets established by the SRB (including those relating to subordination) is reached, the SRB should have the authority to derogate from the burden-sharing and bail-in conditions established by the BRRD in case of state-aid and access to the Single Resolution Fund.
4. Insolvency proceedings for less significant institutions (LSIs) would still be executed by NRAs under SRB coordination,<sup>58</sup> following harmonised procedures. NRAs would need to fulfil independence requirements, being functionally and organisationally separated from other authorities.
5. Finally, deposit insurance schemes as well as NRAs should be adequately pre-funded and endowed by properly trained and independent staff.

### 3.3 State-aid control

In the EU, state-aid control in banking, as well as in other sectors, is exercised by the European Commission as part of the competition framework. Considering the multi-country structure of the Union, this aims at preventing member states from distorting cross-border competition by providing support, via regulation or in other ways, to domestic companies.

While this argument may apply in principle to all sectors, in banking the establishment of the banking union has changed the underlying logic in two ways. First, banking regulation, supervision and crisis management are moved to the European level, thereby removing the main tool available to member countries to prop up national champions. Second, the progress towards an integrated pan-European banking sector requires more attention to systemic risks. State intervention, or rather the potential activation of a state-supported safety net, helps ensure financial stability by providing a public backstop in times of crisis. Public authorities should be trusted to have the means to maintain financial stability in all cases, even though the actual script governing such a role may not be made explicit in order to prevent moral hazard. Ensuring financial stability is a public function in all jurisdictions – one that, for example, has played a key role in the recent crisis. Consistent with this logic, in the United States, banks are exempted from state-aid control and banking competition is in the remit of the Federal Reserve. A modification of the existing EU arrangements along similar lines would therefore be useful<sup>59</sup> – though this issue is beyond the scope of this report.

A specific problem also arises because of the inconsistency between the communication issued by the Commission in 2013 and the BRRD, which was introduced more recently. Both are in force and both deal with public support to banks. The former, introduced before the banking union was established, embodies milder bail-in provisions (sometimes called ‘burden sharing’), limited to subordinated debts. It also covers cases where state aid is admitted to contain

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<sup>58</sup> In addition, one could envisage the possibility for the SRB to exercise the resolution powers over LSIs directly, to ensure consistent application of high standards, using a formula similar to that in Article 6.5.b of the SSM regulation.

<sup>59</sup> On this see Angeloni and Lenihan (2015).

risks for financial stability. The coexistence of partly conflicting provisions creates an incentive to bypass European rules. Incorporating the 2013 text in a revised version of the EU crisis management law, with the necessary amendments, would eliminate the inconsistency.

In doing so, the element of flexibility provided by the 2013 provision should not be lost, but preserved and applied especially during the transitional period until bank balance sheets have been adjusted to the new MREL targets. State-aid limitations need to be suspended when financial stability conditions require so. For this purpose, as already noted, the SRB should have the authority to derogate from state-aid rules in case of need, in particular until complete fulfilment of MREL requirements. Even after that situation is reached, it would seem prudent to retain some discretionary override power, if justified by proven financial stability concerns.

### **3.4 Less-significant banks**

The distinction between significant banks, which fall under direct ECB supervision, and less-significant ones, which are supervised nationally under ECB guidelines, is sometimes misunderstood. At the outset, it was rationalised for two main reasons. One was practical: ECB supervision – at the time a new authority numbering only a few dozen people – could not possibly start supervising several thousand banks, many of which were very small with only a local footprint. While this may be deemed as being overcome now, the second reason is more fundamental. Significant banks, identified by quantitative and qualitative criteria, are banks which can potentially trigger area-wide contagion. As already mentioned, they include not only institutions with cross-border interconnections, but also banks with purely domestic relevance which can trigger contagion via the national economy and the fiscal sector. This explains why many mid-sized lenders, and indeed also tiny ones chartered in small countries, are regarded as significant and supervised centrally.<sup>60</sup>

Banks can move across the two categories; usually they do because of a change in size change.<sup>61</sup> Often there is little difference between banks belonging to different categories in terms of their size or type of business. Many euro area banks are mid-sized and close to the significance asset threshold of €30 billion; in fact, at present the majority of significant banks are within a range of €20 billion above that threshold. There is usually little difference in terms of business models between smaller significant banks and larger less-significant ones. Whether above or below the threshold, most banks engage in traditional retail business and compete in the same business segments, and often also in the same geographical areas. To avoid distortions, the regulatory regime should be as similar as possible. The European banking structure is constantly changing, with smaller banks

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<sup>60</sup> The supervisory approach, however, should be the same for both categories – ‘direct’ and ‘indirect’ supervision are supposed to be equivalent except for the organizational modality. In fact, the ECB is required to take upon supervision of LSIs in order to “ensure consistent application of high supervisory standard” (SSM regulation, Art. 6.5.b).

<sup>61</sup> To avoid excessively frequent changes across the two categories, the ECB stipulated that a bank must no longer satisfy the criteria to be classified significant (or less significant) for three years in order to become less-significant (significant) (see the ECB Framework Regulation at [https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2014.141.01.0001.01.ENG](https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.141.01.0001.01.ENG)).

disappearing if they do not achieve a profitable scale or merging with others in order to reach that scale. It is important that supervision and resolution complement each other in a way that facilitates the consolidation process while maintaining financial stability and keeping taxpayer risk at a minimum.

Along these lines, a few steps can be recommended. One already alluded to would be to establish a harmonised liquidation/resolution regime for less-significant banks.<sup>62</sup> As a minimum, if harmonising bankruptcy laws across 19 different proves too complex, consistent guidelines for member states should be enforced. As already mentioned, the regulatory overlap between the 2013 state aid communication by the Commission and the BRRD, which gives rise to differences in state aid treatment between the two types of banks, should be eliminated.

Moving back to the SSM, work should continue towards aligning 'direct' and 'indirect' supervision. Much has been done already: Joint Supervisory Standards have been introduced applying to both categories of banks, and guidelines to conduct SREP on less significant banks have been issued. Information flows and cooperation between ECB and national authorities should be strengthened; there is no reason why full information on all banks should not be promoted throughout the SSM. The possibility for the ECB to assume direct supervision of LSIs, so far almost never used, should be employed more actively when conditions require so, including cases in which banks receive support from the state or from other banks as a result of major restructurings.

### 3.5 Macroprudential supervision

Following global post-crisis orientations and guidelines from the standard setters, Europe introduced from 2010 onwards an institutional framework for macroprudential policy. The main steps were the creation of a European Systemic Risk Board (ESRB);<sup>63</sup> the launch of a new banking law (CRDIV and CRR), providing legal basis to macroprudential instruments; and, more recently, the establishment of the SSM, whose regulation assigns to the ECB, together with micro-supervisory tasks, the power to activate the macroprudential instruments included in European law under certain conditions and in shared competence with the member states.<sup>64</sup>

The combination of micro- and macroprudential provisions in the same body of law suggests that the legislator regarded macroprudential policy as part of a broader prudential policy framework, of which micro-banking supervision is also a part. Macroprudential instruments applied to banks are typically the same used by the banking supervisor. The difference is in the scope and the criteria with which they are applied: macroprudential powers are not targeted to individual banks based on their individual risk characteristics, but either to groups of banks, exposures or sectors, or to individual banks because of the systemic risks they transmit to others. Systemic risks include, notably, the transmission of effects

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62 Its creation has recently been advocated also by the SRB chair, Elke Koenig (Koenig, 2018).

63 The ESRB is a forum established in 2011 and hosted by the ECB which has the responsibility of issuing risk warnings and policy recommendations regarding macroprudential policy in the EU.

64 Details on how such responsibility is discharged, on the existing macroprudential instruments and on how they have been used are available in the ESRB and ECB websites. The content of this section is largely based on Angeloni (2016b) and Angeloni (2018).

and feedbacks between the banks and the broader economy (Hanson et al., 2011). Assessing these linkages requires macroeconomic and market expertise available to central banks; for this reason, the ECB and other central banks are normally involved, together with finance ministries and other sectoral supervisors.

Macroprudential instruments included in EU law consist essentially of capital surcharges on banks which have systemic characteristics because of their size or interconnection with the rest of the system, or which provide finance to the real estate sector. Of particular relevance is the capital buffers on globally active banks (G-SIIs), calculated with methodologies set by the Basel Committee on Banking Supervision. Buffers on banks which have domestic systemic relevance ('other systemically important institutions', or O-SIIs) follow EBA guidelines. These buffers, by construction, do not vary over the cycle. By contrast, the countercyclical capital buffer is calibrated to change over the cycle to ensure that banks set aside extra capital during booms. This buffer serves the dual purpose of avoiding a build-up of risk in the cyclical upswing and of the risk of a credit crunch in the downswing. All macroprudential requirements must be fulfilled in high-quality capital (CET1). The SSM Regulation provides that they are set by national authorities, in consultation with the ECB; the ECB can increase the requirements, but cannot adjust them downwards (the 'top-up' power).

The information provided by the ESRB, the richest source on EU macroprudential policies,<sup>65</sup> offers a number of insights. The first relates to O-SIIs. Banks subject to this buffer are selected by member states based on a methodology referring to domestic conditions, with little or no regard to international consistency. In some case, as acknowledged by the ESRB itself (Mazzaferro and Dierick, 2018, Section 3.4), buffer sizes do not adequately reflect the business or risk characteristics of the banks. Moreover, a good deal of discretion is applied by national authorities in setting O-SII buffers.<sup>66</sup> Another feature relates to the countercyclical capital buffer. This buffer, which the recent crisis experience suggests should play a key role, has barely been used. Despite the euro area having gone through a full cycle between 2014 and 2019, of the 19 countries of the euro area, as many as 14 (representing over 80% of area-wide GDP) have left the countercyclical buffer inactive (formally, it is set with parameter at zero) throughout the cycle. In a recession – such as the one triggered by the coronavirus pandemic, for example – banks in those countries are unable to benefit from a relaxation of the buffer. Notable is the fact that the ECB has never chosen to exercise its 'top up' privilege with regard to any of the available macroprudential buffers, hence effectively surrendering its shared role in conducting macroprudential policy in the euro area.

Interestingly, the scarce use of macroprudential instruments in practice contrasts sharply with the frequency and force with which such use is advocated by academics and often by policymakers as well.<sup>67</sup> In fact, macroprudential tools have been used predominantly by developing countries (Cerutti et al., 2015).

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<sup>65</sup> See [https://www.esrb.europa.eu/national\\_policy/html/index.en.html](https://www.esrb.europa.eu/national_policy/html/index.en.html).

<sup>66</sup> In some case the buffers are already phased in (set at their steady-state level), whereas in others they are phased in gradually over several years into the future, granting a temporary advantage to the banks concerned.

<sup>67</sup> For recent comments regarding the United States, see Kohn (2019).

Making macroprudential policy more active would not require amendments of existing legislation, only a more proactive and coordinated initiative by the ECB and national authorities.<sup>68</sup> To that aim, common methodologies should be agreed within the macroprudential structures established in the ECB<sup>69</sup> to assess the dynamic and cross-sectional consistency of capital buffers. Systematic cross-checking would help structure and discipline the policy process. It would also give a basis and rationale for the ECB to use its 'top-up' prerogative.

It would also seem useful to establish practices whereby macroprudential deliberations are communicated to the public more transparently, either at the regular ECB press conferences or dedicated press conferences. At present, the ECB's vice president, responsible for the financial stability function in the central bank, regularly presents the *ECB Financial Stability Review* to the press but makes no specific statements on macroprudential policies or decisions by the ECB; this should change. In addition, macroprudential analyses should benefit from better integration of the supervisory and the monetary arms of the central bank. The Supervisory Board should debate not only microprudential but also macroprudential supervisory issues more systematically and the synergy with the monetary areas of the bank should be fully exploited.<sup>70</sup>

### 3.6 Sovereign concentration risk

In recent discussions on the euro area financial architecture, there has been much focus on the possibility of setting limits to the concentration of sovereign exposures by banks. Supporters of the idea argue that the zero-risk assumption accorded to these exposures in current legislation defies reality (few sovereigns enjoy top ratings today), is prudentially unsound and exacerbates the doom loop between banks and sovereigns. Opponents respond that penalising sovereigns would damage the financial system, increase systemic risk and put European banks at a disadvantage relative to their American and Asian competitors, which do not have such restrictions. The prudential treatment of sovereign exposures (together with that of deposit insurance) has taken centre stage to such an extent in the debate that it seems difficult to make progress in reforming the banking union unless this issue is not somehow addressed.

Sovereign exposures are 'special' in many ways. Everywhere, they provide the nearest available thing to safe assets; as such they offer a reference for other private sector contracts banks are involved in (e.g. in repos or as collateral). Sovereign exposures tend to be very large in virtually all financial sectors, and domestically are not easily diversifiable. The potential contagion between banks and sovereigns is reciprocal, because not only are banks exposed to sovereigns, but sovereigns are exposed to banks due to their role as ultimate backstop of the bank safety net. Part of the complexity of the problem stems from the fact that measures discouraging sovereign exposures by banks may, on the one hand, help reduce the risk of contagion, but on the other hand they may, at least in the short term, hurt banks if those measures negatively affect the sovereign bond

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68 Areas of improvement are discussed Draghi (2019).

69 Such structures are described in Angeloni (2016b).

70 These arguments are developed in Angeloni (2017).

market. There is a vicious circle to be broken, and interventions in this area needs to be gradual and cautious. Banks should be protected from excessive sovereign concentration, but without jeopardising that special role or otherwise increasing risks.

Some have actually made the opposite argument, suggesting that banks' sovereign exposures benefit financial stability because they help stabilise bond markets in a crisis (e.g., Visco, 2016). When sovereign risk premia increase, so the argument goes, banks tend to buy government bonds to take advantage of profitable carry trades or because of explicit or implicit pressure from governments.<sup>71</sup> The beneficial stabilising effect would be lost if bank holdings were discouraged, and in extreme cases pro-cyclical effects and even systemic risk may arise.

A number of proposals for how to deal with the issue have been put forth.<sup>72</sup> Without entering into specifics about alternative solutions, three considerations should be made.

- First, to prevent procyclicality, time-varying risk measures should not be used to calibrate the stringency of the framework. In answering those who argue that bank sovereign holdings are beneficial to stability, one must distinguish *structural* from *cyclical* changes. A lower concentration of domestic sovereign exposures does not preclude cyclical movements in bank holdings that may help stabilise the market. To neutralise the 'doom loop', what matters is the *level* of concentration, not its *variation* over the cycle.
- Second, any new rules should be designed in such a way to discourage excessive concentration of individual sovereigns, not the overall holdings of euro area sovereigns. The goal is to help diversify sovereign holdings across euro area countries without discouraging the overall demand for public sector instruments.<sup>73</sup>
- Third, any intervention in the delicate mechanisms affecting banks and sovereign markets should be phased in gradually, allowing both the system and the authorities to learn from experience and adapt. Mild and progressive capital charges are preferable to strict limits to avoid 'cliff effects'. A stable environment, consisting of pillar I measures with low and adjustable parameters, should be preferred because they would be more stable, predictable and less prone to ad hoc judgement and potentially market pressure.
- Finally, any modification of the existing arrangements should avoid creating a competitive disadvantage for European banks relative to competitors established in non-EU jurisdictions; it should therefore be coordinated at international level with the relevant standard setters.

<sup>71</sup> Such behaviour has actually been observed in the recent financial crisis; see Altavilla et al. (2016).

<sup>72</sup> For a recent example, see Alogoskoufis and Langfield (2019).

<sup>73</sup> Véron (2016) proposed to apply concentration charges to exposures towards individual sovereigns above certain ratios to CET1 capital. Excess exposures calculated in this way would be added to risk-weighted assets as a pillar 1 measure. The scheme has the advantage of being insensitive to risk, but penalises large holdings to sovereigns, even if well diversified. To avoid discouraging the demand for government bonds, only excessive concentration within sovereign portfolios should be penalised.

On these premises, it is safe to assume that even if a new framework were to be implemented soon, it would take years, if not decades, for the bank portfolio holdings to be altered in a significant way. Regardless of whether or what reform is undertaken, one should not expect the banking union to benefit significantly in the foreseeable future. Reform in this area may rather have a structural value, bringing benefits in the longer run.<sup>74</sup>

### 3.7 Deposit insurance

In 2015, the European Commission proposed a European deposit insurance scheme (EDIS) in which European financial support to national insurance schemes would be provided incrementally in three phases. Only in the last phase ('full insurance') would EDIS fully backstop the national schemes. In 2017, the Commission scaled down the proposal, suggesting that EDIS should initially provide only liquidity support; loss cover would kick in only partially, at a later stage and under certain conditions.<sup>75</sup>

The launch of a pan-European deposit insurance scheme would contribute to solidifying the banking union, providing more safety to retail depositors. It would also contribute to mitigating opposition to euro area banking integration. The lack of a pan-European deposit guarantee scheme has been cited, especially by member states hosting large cross-border subsidiaries, as the reason why capital and liquidity cushions need to be maintained at local entities rather than be allowed to move freely across subsidiaries and their head companies within cross-border groups (so-called 'ringfencing'). As already mentioned, one of the main reasons that ringfencing is adopted is because host countries' deposit guarantee schemes are exposed to the risks of domestic subsidiaries, if protection is not forthcoming from the head company in times of crisis. Under current legislation, such protection cannot be taken for granted; EDIS would therefore mitigate the need to ringfence. However, what matters more here is that cross-border groups have sound resolution plans and credible commitments to provide intra-group support that are enforceable across borders.<sup>76</sup> Again, we return to the critical necessity of having a sound resolution framework. This, more than EDIS, would be the decisive step to remove obstacles to liberalising cross-border intra-groups flows.

A recent analysis by the ECB supports this argument (Carmassi et al., 2018). The authors analyse the impact of bank failures in the euro area for the solvency of EDIS, structured as proposed by the Commission, and for the extent of subsidies that would arise across countries. The study assumes an EDIS in steady state, with a size equal to 0.8% of covered deposits. EDIS provides full cover of losses; contributions by banks to the insurance fund are risk-based and bank failures occur according to the respective probabilities of default. Two main results are

74 Views on the implications of sovereign portfolio diversification by banks differ. Vítor Constâncio, for example, regards diversification as neither necessary nor beneficial (Constâncio, 2019). I am grateful to him for thorough discussions on this issue, at the end of which we fully understood each other but did not fully agree.

75 See [https://ec.europa.eu/info/publications/171011-communication-banking-union\\_en](https://ec.europa.eu/info/publications/171011-communication-banking-union_en). The German finance minister has recently supported a form of EDIS under certain conditions, most notably limits to sovereign concentration risks (see [https://www.bundesfinanzministerium.de/Content/EN/Standardartikel/Topics/Financial\\_markets/Articles/2019-11-06-Bankenunion.html](https://www.bundesfinanzministerium.de/Content/EN/Standardartikel/Topics/Financial_markets/Articles/2019-11-06-Bankenunion.html)).

76 This point has been analyzed in depth by Erwin (2018).

borne out. First, the planned dimension of the fund would be sufficient to protect depositors even in the most severe cases – more severe than the recent financial crisis. The second conclusion is that the scheme would not imply any significant cross-subsidisation – banks would be covered roughly to the extent of their contributions, which would be risk-based (i.e., the higher the riskiness of a bank relative to its European peers, the higher the fee it would pay). This result, which intuitively follows from the fact that both contributions and failure probabilities are linked to the banks' risk parameters, also implies that EDIS in steady state would not involve cross-country transfers. As Carmassi et al. (2018) conclude, *“EDIS would offer major benefits in terms of depositor protection while posing limited risks in terms of EDIS exposure, since the probability and magnitude of interventions are likely to be low. EDIS will play a key role in terms of confidence building, also avoiding risks of self-fulfilling prophecies on bank runs. Additionally, based on the results shown in this paper, there is no risk of unwarranted systematic cross-subsidisation.”*

The analysis also implies, however, that in the assumed conditions (steady-state equilibrium, risk-based contributions, a workable resolution framework), the national deposit insurance schemes should on average be able to cover risks stemming from national banking systems. A loss guarantee from EDIS, in that situation, would therefore not be necessary; liquidity support would be sufficient to ensure depositor confidence.

EDIS, therefore, though possibly helpful in providing the same cover and safety to all depositors in the banking union, would not provide a fix for the other problems inherent in the crisis management framework. Conversely, a network of national deposit insurance schemes, well-funded and linked by liquidity arrangements along the lines foreseen in the milder and more recent Commission proposals, may well be sufficient if a solid crisis management framework – including a large, funded and backstopped resolution fund – exists.

The funding requirement is particularly important. As concrete cases have shown, the impact on other banks, via unfunded deposit insurance schemes, of guaranteeing up front the reimbursement of covered deposits for failing banks is likely to be too strong. The risks of overburdening other banks, possibly triggering contagion to them, is likely to encourage rescue operations that minimise short-term costs at the expense of longer-term sustainability. Besides being a necessity demonstrated by concrete cases, ex-ante funding is also mentioned in the Bank for International Settlements (BIS) ‘core principles’ of effective deposit insurance, endorsed by the International Association of Deposit Insurers (BIS, 2010; IADI, 2014). National authorities should assess the necessary funding conservatively, considering the prospective bank risks. The required minimum established by the European Directive on deposit guarantee schemes (0.8% of covered deposits) may not be sufficient in all cases.

The BIS core principles also specify requirements of good governance for deposit insurance schemes, consisting of clear and transparent mandates, adequate resources, appropriate instruments and independence from external influence. Strong governance arrangements are essential for institutions that provide, in all effects, the ultimate protection of financial stability. Though no recent overview is available,<sup>77</sup> it appears that not all the above requirements are met at present in all banking union member countries.

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77 The Financial Stability Board conducted a review in 2012 (FSB, 2012).

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## 4 Conclusions and summary of proposals

The banking union has already brought about major improvements in the European bank regulatory framework and helped strengthen the banking sector significantly, but its overall performance after five years of operation falls short of what was initially foreseen and desired.

This report takes stock of the situation and proposes some actions which may help unlock further progress. The main recommendations are summarised in Box 3.

### **Box 3** Summary of proposals

- Overhaul the crisis management framework, granting the Single Resolution Board (SRB) responsibilities and instruments comparable to those of the US FDIC.
- Assign to the SRB the responsibility to resolve, as a rule, all failing banks under direct ECB supervision ('significant banks').
- Enhance the flexibility of the Single Supervisory Mechanism, removing legislative limits to Pillar II supervision and explicitly recognising the benefits from cross-border bank diversification.
- Adopt a proactive and coordinated macroprudential stance, especially with regards to counter-cyclical tools.
- Harmonise the liquidation regime for smaller banks under national direct supervision ('less-significant banks'); the SRB would oversee national insolvency proceedings to ensure adherence to the harmonised regime.
- Allow state support and the use of the Single Resolution Fund with less stringent bail-in requirements under certain conditions (e.g., definitive exit from the market, or thorough clean-up of the balance sheet based on an Asset Quality Review and Stress Test).
- Ensure that national resolution authorities/deposit guarantee schemes are funded, properly staffed and functionally independent, and promote mutual support schemes along the lines proposed by the Commission.
- Encourage a gradual cross-border diversification of bank sovereign exposures, in coordination with other jurisdictions and the international standard setters.

I have suggested that the limitation of the present arrangements lies largely in the insufficient development of the bank crisis management function and, to a lesser extent, in certain weaknesses of the supervisory arrangement. In a well-functioning banking framework, effective supervision requires a smooth resolution process. Such complementarity does not exist yet in the banking union.

The SRB should be propped up to ensure it can directly restructure banks and, when necessary, make them exit the market smoothly and securely. For this purpose, its powers, competencies and financial means need to be enhanced. The ECB's supervisory powers need to be clarified and proactively exercised to break national barriers and facilitate a freer and safer functioning of the single banking market, under the umbrella of a single regulatory framework. Macroprudential policy, so far confined largely to announcements and research, should play a more concrete role as a key part of the prudential framework.

More effective and integrated treatment is also needed with regard to the myriad of small and medium-sized banks, which Europe dubs 'less significant' and leaves in the hands of national authorities. The time is also ripe for a review of the way in which Europe exercises state-aid control in banking; here, the focus should shift from the realm of competition policy to that of prudential policy. On both counts, the arrangements existing in the United States offer a good model to follow.

Changing the treatment of sovereign exposures and creating a pan-European deposit insurance are no panacea, but can be useful parts of a broader reform package.

In 2013, inaugurating its new supervisory arm, the ECB foreshadowed a new era for euro area banks, made up of greater investor confidence, timely and smooth bank failures if necessary, and public backstops to maintain financial stability. Those goals remained largely unfulfilled when the pandemic struck – more tragic and unexpected than the preceding financial crisis. Europe should not wait for another calamity before addressing the shortcomings of the banking union head on.

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## 5 Beyond the pandemic

In early 2020, when the coronavirus pandemic struck, the European banking sector was still healing from the earlier financial crisis and the resulting double-dip recession. Solvency and asset quality indicators were much improved from the time the banking union was launched in 2012, but there were still wide differences across banks and countries. A number of banks were still potentially unviable, and many struggled to find a sustainable business model in an environment made difficult by low economic growth and zero or negative interest rates.

As the time of writing this section (April 2020), national and European authorities are adopting unprecedented measures to help the economy and the banking sector. More measures will follow in the coming months, as the recession will hit the banking sector more extensively. The impact of the crisis varies across banks and countries, and so too will the intensity and the cost of the support measures. The initial conditions – how strong and resilient banks were initially, or in other words, how advanced the recovery process from previous crises was – will matter. Moreover, early evidence suggests that bank difficulties may coincide, in some countries, with fiscal sustainability problems, potentially leading to further contagion between banks and sovereigns and to divergence within the euro area. The economic impact of this crisis is more severe than that of the financial crisis, but its more protracted effects will depend on the timing and the shape of the recovery, itself likely to differ across countries depending on the severity of the contagion and the nature of the health policies undertaken. Strains in the single currency of the type experienced in 2011-12 may re-emerge.

The pandemic and the ensuing lockdown impart both a supply and a demand shock. When businesses close and workers stay home, aggregate supply falls. Meanwhile, as retail activities and value chains come to a halt, the demand for final and intermediate products also collapses. Banks are affected on both the asset and the liability side. Hard data are not available yet, but the nature of the transmission channels can be conjectured. Retail credit is likely to experience a sharp deterioration in quality – with a consequent surge of non-performing loans – as well as an increase in credit demand, as firms and individuals need to replace forgone revenues with borrowing. One can expect a sharp decline of bank profits, mainly via loan-loss provisions, and large temporary losses for many banks. This will put strains on capital, at a time when capital markets are not functioning properly and risk aversion is high. On the positive side, funding should remain resilient in the foreseeable future, thanks to proactive support by the central bank. With equity under pressure, the public sector in some countries will need to step in, offering guarantees (largely already announced) and, going forward, possibly capital injections. Appropriately, the competition arm of the European Commission has already announced a temporary suspension of state-aid rules.<sup>78</sup>

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<sup>78</sup> See the EC website at [https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT\\_20\\_479](https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT_20_479).

The dimensions these phenomena will assume are unknown; the orders of magnitude can only be guessed. The IMF Spring World Economic Outlook predicts a decline of euro area GDP of 7.5% in 2020. On this basis, one may assume a decline in all private revenues for the year as a whole of some 10% percent, or €1.6 trillion (public expenditures, representing about 13% of GDP in the euro area, will not decline and will actually probably increase). This amount, corresponding to about 12% of the total of outstanding bank credit to the private sector, can be thought of as an upper bound on the additional credit the economy may demand from the banking sector. Assuming a leverage stable at 5%, the absorption of total capital would be €80 billion – somewhat below 10% of total existing euro area bank capital. On top of this, one can expect a significant accumulation of new NPLs. Taking as benchmark the increase seen after the preceding financial crises (about 10% in terms of the NPL ratio), the increase in total NPLs may be as high as €1.3 trillion. If, however, one assumes – as the IMF does at the moment – a relative rapid recovery starting in the second part of 2020, such ratio and the eventual losses may be significantly lower, perhaps just 10% of that amount. If so, the total eventual erosion of capital (from new credit as well as NPLs) for the euro area could be in the order of €200 billion euros.

An equity shortfall of this magnitude or greater can only be filled through a combination of sources, combining public injections and guarantees, as well as temporary supervisory forbearance, with private means to the extent possible. This is, in fact, the avenue already undertaken by national and euro area authorities. The German government has announced a comprehensive plan including, on top of over €100 billion in immediate help to families and business, an Economic Stabilization Fund within the Kreditanstalt für Wiederaufbau (the German state development bank) which should be able to mobilize up to €600 billion in corporate support in the form of guarantees and equity.<sup>79</sup> France<sup>80</sup> and Italy<sup>81</sup> have also announced plans along similar lines, albeit less sizeable. At the time of writing, a European support package is also being negotiated. The ECB has stepped in in two stages, first announcing a securities purchase programme for up to €750 billion (the Pandemic Emergency Support Program, or PEPP), and subsequently removing, at least temporarily, the country limits on the amounts of securities that can be purchased and further extending the range of instruments accepted as collateral for open market operations.

The duration of the support programmes will of course depend on the duration of the crisis. The IMF assumes – rather technically – that the output loss will be concentrated in the second quarter of 2020 and that it will be followed by a recovery in the second half of the year, extending into 2021. The full restoration of ‘normal’ economic conditions will have to wait until the health risk has subsided, meaning until a vaccine or a successful treatment for the ill are found and are made available to the population. Experts suggest that this may not happen before mid-2021.

What next? What will the exit strategy from this unprecedented programme of anti-crisis public support look like? One can only express the hope that the lessons of this crisis will be learned and followed-up consistently. With hindsight, it is now broadly accepted that financial regulators in advanced

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79 Details are on the finance ministry website (see <https://www.bundesfinanzministerium.de/Content/EN/Standardartikel/Topics/Priority-Issues/Corona/2020-03-25-combating-the-corona-virus.html>).

80 See <https://www.economie.gouv.fr/coronavirus-soutien-entreprises>.

81 See <http://www.mef.gov.it/>.

economies arrived at the financial crisis of 2008 unprepared, underestimating the build-up of risk in the financial sector and not having ensured that banks had sufficient margins in their balance sheets to face large, unexpected shocks. The reform programme that followed that crisis was meant to remedy that failure, on the premise – so often reiterated – that the next crisis would be different from the previous one. This forecast proved correct, but the reform programme was left unfinished. Covid-19 caught the European banking sector again partly unprepared. This report has argued that regulators and supervisors could have done better in several respects: clearer legislation, more active use of the micro and macroprudential instruments, stronger capital cushions, more prompt and complete removal of bad assets, and not least, an effective framework to deal with unviable banks.

Ultimately, the lessons of this crisis for banks and regulators will not be much different. Hopefully they will be better heeded.

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# Annex 1: The euro crisis and the rationale of the banking union

The banking union was Europe's response to the financial crisis (2007-2008) and its aftershock, the euro sovereign debt crisis (2009-2012). Had these twin crises not occurred, banking supervision and resolution would in all likelihood have remained national prerogatives, subject to at most mild European coordination arrangements. This conjecture is supported by the fact that the possibility of creating a single European supervision was actually discussed by the architects of the euro when negotiating the Maastricht Treaty, but was discarded in the belief that other arrangements (European coordination directives, non-binding fora, and, on the fiscal side, the Stability and Growth Pact) would by themselves ensure the viability of the euro area financial sector, in calm as well as in crisis times.

The crisis exposed the fallacy of this belief and left European banks much weakened and in need of repair. Massive balance sheet losses had accumulated mainly from real estate exposures. Part of these stemmed from complex financial products linked to home mortgages in the United States, particularly on the balance sheets of German banks (Hellwig, 2018). Other losses accrued from domestic real estate exposures, whose size and valuation had grown disproportionately pre-crisis (this was the case in Ireland and Spain). Yet other losses derived from asset price declines, especially in the early phases of the crisis. Last but not least, in certain peripheral countries, banks had accumulated large non-performing loans as a result of inappropriate lending practices in earlier years as well as the economic recession.

Bank losses were not unique to Europe; to no lesser extent, they affected banks in the United States as well. US banks were initially hit harder, with the crisis having originated there. The US authorities underestimated the crisis at first,<sup>82</sup> but quickly realised that decisive policy action was needed to restore bank viability in order to help the economic recovery. Actions included decisive monetary policy accommodation, exceptional interventions by the Federal Deposit Insurance Corporation (FDIC)<sup>83</sup> and, subsequently, various forms of federal government support to banks in order to help control systemic risks and kick-start the recovery. With the adoption by Congress of the Dodd-Frank Act in 2010, supervisory powers were strengthened and centralized in the Federal

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82 As suggested by the rather confident tone adopted in speeches by some Fed governors in 2007; see <https://www.federalreserve.gov/newsevents/speech/2007speech.htm>.

83 The FDIC, in agreement with the Fed and the Treasury, decided in September 2008 to activate for the first time a 'systemic risk exception' to the rule according to which its interventions should minimize the cost for the deposit insurance fund (FDIC, 2017).

Reserve, and the FDIC was given new instruments and resources to ensure the orderly liquidation of systemic banks in case of failure.<sup>84</sup> Box 2 summarises how the FDIC – which embodies in many ways the best practice for resolution authorities worldwide – operates after these changes.

In Europe, the possibility of centralising banking policies at euro area level was first envisaged in concrete terms between late 2011 and early 2012.<sup>85</sup> Up to that point, the prevailing view was that the conservative business model of European banks and the presence of the euro itself, with the ECB acting as lender of last resort, would protect the monetary union from the destabilising effects of the crisis.<sup>86</sup> The political leaders launched the banking union in the euro summit meeting at the end of June 2012.<sup>87</sup>

While the political decision was in the making, Europe had to intervene twice, in Ireland and Spain, to prevent banking crises in those countries from spreading abroad and breaking the single currency. The Spanish example exemplifies well the nature of the problem and the rationale for establishing the banking union.<sup>88</sup>

By 2011, the Spanish savings banks ('cajas') had developed an unsustainable exposure to the booming domestic real estate market, favoured by low interest rates and amidst lax prudential standards. As the house price bubble started to burst, bank credits began to default on a massive scale. Spain's public finances were initially sound by EU standards (indeed, it was a role model until 2007, with public debt below 40% of GDP and government accounts in surplus). From that moment on, public debt rose quickly, up to a peak of over 100% in 2015; what was originally a banking problem became a fiscal problem. In the banks, the solvency issue – bad loans eroding the capital base – became a liquidity issue, as they quickly lost deposits and other sources of funding. The run on Spain's financial sector peaked in the spring of 2012; by that time, around €400 billion of funds had fled the country, close to half of the country's bank deposit base. Between mid-2011 and mid-2012, when the country's assistance programme was agreed on, the risk of Spain leaving the euro increased sharply (De Santis, 2015).

The Spanish problem epitomised the euro area fragility inherent in the transmission of risks between banks and public finances. A 'doom loop' arises when banks are exposed to domestic sovereigns (both via their holdings of government bonds and because weak finance prevent governments from supporting banks when the need arises) and sovereigns in turn are exposed to domestic banks (because governments are first in line in supporting ailing banks). This vicious circle played a role in aggravating the crisis in Ireland and Spain (where risks started from the banking sector and then extended to

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84 See Box 2 for a description of how the FDIC operates.

85 Nicolas Veron first used the term 'banking union' in a December 2011 column on VoxEU (Veron, 2011). In April 2012, then-IMF Managing Director Christine Lagarde called for a banking union, giving detail of what it should consist of: "...monetary union needs to be supported by stronger financial integration which our analysis suggests be in the form of unified supervision, a single bank resolution authority with a common backstop, and a single deposit insurance fund" (Lagarde, 2012). At about the same time, ECB President Draghi made the same call in the European Parliament (Draghi, 2012).

86 After the introduction of the euro in 1999, the European Council launched the 'Lamfalussy framework', made up of consultation committees without decision-making power. Even after the crisis, until 2012, most EU member states did not see the need of strengthening the EU banking framework. An unsuccessful proposal to do it was made in 2007 by Tommaso Padoa-Schioppa, Italy's finance minister at the time.

87 See the concluding statement of that meeting at [https://www.bankingsupervision.europa.eu/about/milestones/shared/pdf/2012-06-29\\_euro\\_area\\_summit\\_statement\\_en.pdf](https://www.bankingsupervision.europa.eu/about/milestones/shared/pdf/2012-06-29_euro_area_summit_statement_en.pdf)

88 The Spanish crisis is described in detail in Santos (2017).

public finances), in Greece (where the sequence of contagion was opposite), as well as in Italy (where causation went both ways). The single currency and full capital mobility, implying that bank deposits can move seamlessly and without risk across banks and countries, exacerbates this fragility. Mitigating it requires diffusing the concentration of banking risk at the national level. The banking union diffuses the risks by diversifying the safety net, which in turn requires, to match the incentives, that supervisory controls be centralised as well.

While it was the doom loop and the risks of euro exit which made its case compelling and triggered the landmark June 2012 decision, the banking union also facilitated the cleaning up of bank balance sheets in a number of countries. It did so by conferring the task to a newly created institution with proper authority, reputation and purpose – the SSM, located in a well-established institution and supported by a strong charter and by a new legal framework - the Capital Requirements Directive and Regulation (CRD and CRR, respectively) – covering micro- and macroprudential supervision. The new European framework was designed to be consistent with guidelines issued by the global standard setters (the Basel Committee on Banking Supervision, under the aegis of the Financial Stability Board and G20), thereby also fostering the alignment of the European banking regulatory and supervisory framework with global standards.

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## Annex 2: On the complementarity between supervision and resolution

Post-crisis policy and academic discussions were heavily influenced by the priority of reforming financial regulation to ensure that financial risks, especially in the banking sector, would be under control in the future so that the crisis experience would not be repeated. One focus was on ‘optimal financial regulation’ (e.g., Goodhart et al., 2012; Kashyap et al., 2017) – how to design rules so as to maximise collective welfare, which implies avoiding disruptive crises. However, with very few exceptions, this literature has concentrated only on the ‘ex-ante’ dimension of financial regulation – how to set the best combination of rules and enforcement (laws, secondary regulation, banking supervision, market practices, disclosures) in such a way to prevent or mitigate risks before they occur. Very little attention has been devoted to the ‘ex-post’ dimension – how to deal with bank crisis situations after they have become manifest.<sup>89</sup> Yet the two dimensions are linked, and neither can work well without the other.

Banking supervision, in particular, consists both in enforcing existing rules and exercising discretion in applying those rules when the legislation prescribes so. In exercising discretion, the supervisor can apply various degrees of strictness. For example, more or less demanding parameters can be utilised in designing stress tests; more or less rigorous criteria can be used in performing regular supervisory reviews; and more or less challenging approaches can be adopted to set pillar II requirements on capital and provisions. The stricter supervision is, the more likely it is that a larger number of banks will be unable to satisfy its requirements, and therefore will need to undergo recovery or resolution processes.

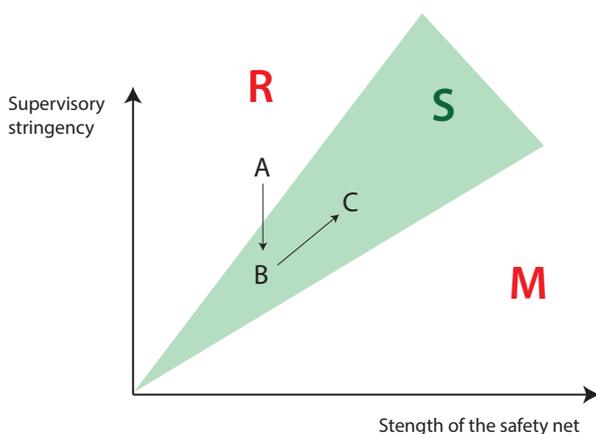
In determining the proper degree of supervisory strictness, a trade-off arises. On the one hand, stricter criteria result in a more solid banking sector, because banks that satisfy the stricter requirements have more solid and resilient balance sheets. On the other hand, a stricter supervision increases the number of banks that do not satisfy the requirements. As these banks approach the point of failure, they can transmit risk to other banks. Such risks are neutralized by combining the more rigorous supervision with a sound crisis management mechanism, ensuring that bank restructuring happens smoothly. Rigorous supervision, in other words, must be accompanied by a well-functioning crisis management framework. The existence of the latter improves the trade-off, making supervision more effective. Conversely, if crisis management is weak, supervision must adopt a softer approach – less demanding and more prone to forbearance – to avoid becoming itself a cause or a trigger of instability.

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<sup>89</sup> For example, in Brunnermeier et al. (2009), only a few cursory lines, out of a total of 80 pages, are devoted to this aspect.

Assessing the ‘strength’ of the crisis management framework is not easy. Several metrics are relevant. One of them is organisational: crisis management is more effective if it can intervene rapidly and decisively under stress. For this, a good cooperation between the supervisor – which is responsible for the bank until the point of failure – and the resolution authority – which assumes responsibility thereafter – is essential. The resolution process, whether it consists in winding down or restructuring it in various forms, critically requires information and expertise provided by the supervisor. In addition, the framework is stronger if it can mobilise the necessary resources more rapidly and effectively. The losses of a failed bank can be provided for either by the bank itself by bailing in creditors, by the taxpayer (in case of state aid), or by other banks. As argued elsewhere in this report, all three sources can in principle contribute, and the distribution of the burden depends on a number of considerations that vary according to the specific situation.

The complementarity between supervision and resolution is visualised in Figure 25. The vertical axis measures the degree of supervisory stringency, an increase in which can take the form of a more intense and proactive use of supervisory tools as discussed above. The horizontal axis measures the potency of the safety net – the strength and coverage of the arrangements that diffuse and neutralise banking risks when they arise. Those arrangements can take various forms; they can consist of cross-border risk sharing, which helps diversify country-specific risks, but may also consist of forms of domestic public support to banks, or in a more effective recovery and resolution framework. The latter could also be in the form of a safe cushion of bail-in-able debts on the banks’ balance sheets. Any additional arrangement making balance sheets more capable of covering losses without disruptive systemic or idiosyncratic implications would be represented by a rightward movement in the figure.



Each point in the quadrant therefore represents a combination of a given degree of supervisory stringency and a given condition of the safety net. An upward movement (more stringency without a safer crisis framework) may, in the short run especially, induce additional risks in the system. A rightward movement expresses a more extensive or effective safety net, but the implications depend on the way the crisis framework is strengthened. The strengthening may occur by introducing crisis-contingent provisions within the bank (e.g., adding bail-in-

able instruments in the balance sheet), outside of the bank but within the country (e.g., resolution funding or deposit insurance financed by domestic banks or by the sovereign), or outside of the country (area-wide resolution funding or deposit insurance). In all cases, financial stability is likely to be strengthened. Rightward shifts may induce moral hazard, to the extent that the safety net may encourage risk taking behaviour by the bank. This possibility is more evident in the case of area-wide deposit insurance (bank risks are to some extent shifted abroad) but moral hazard may arise also as a result of domestic safety nets, in which risks are shifted to other banks or to the taxpayer.

There is an area in the quadrant that we may call 'safe' (denoted by S and shaded in green), where the combination of supervisory stringency and crisis management framework does not generate risks for the system. The area labelled R above it is a 'risky' area where the added stringency of supervision is not complemented by a corresponding improvement of the safety net. The area labelled M, to the right, denotes combinations where the extra security provided by the safety net, not supported by enough supervisory strength, gives rise to moral hazard. North-East movements (from B to C in the figure) denote situations where both the strength of supervision and the crisis framework are upgraded together. Such moves are likely to make the banking sector both stronger (higher intrinsic value of the balance sheet) and safer (less individual and systemic risk).

Situations where supervisory stringency is not matched by sufficient crisis management arrangements (e.g., point A) are not likely to be stable. Banking supervisors tend to procrastinate or refrain from action in absence of effective crisis management arrangements. More typically, they may adjust the stringency of their action to the prevailing crisis management and financial stability framework (a move from A to B).

Regulatory changes can modify the shape of the green zone. For example, its rightward frontier shifts to the right if, for example, moral hazard is reduced by introducing more effective penalties to managers in case the bank makes recourse to public support. This leads to a larger area, all other things equal.

In 2012, at the peak of the euro crisis, the European Union launched the banking union, a project involving the transfer of large parts of the bank regulatory and supervisory framework from the national domain to the euro area. Its aim was to reinforce the euro architecture and to strengthen the area's banking industry, both put to a severe test by the crisis. The project led to the creation of a supervisory function in the European Central Bank (ECB) and of a new area-wide resolution authority, the Single Resolution Board (SRB).

Today, although the euro area banks are better capitalised and more robust, the central objectives of the banking union remain elusive. The banking sector remains fragmented, overbanked and largely unprofitable. Stock market values are depressed. Cross-border banking has not picked up, hence the benefits of risk diversification are not attained. The large euro area banks struggle to hold their position in the global competitive playfield.

The coronavirus crisis adds to the problems. At present, the market mechanisms are suspended under a layer of state guarantees and regulatory forbearance. As the economy recovers and the public support is lifted, however, the preexisting weaknesses will come back to the fore, magnified.

This report reviews the situation and suggests possible regulatory changes to revive the banking union, focused on three strategic goals: reducing overbanking, especially among the weaker players; favouring consolidation and efficiency among the stronger ones; and strengthening balance sheets further, while encouraging cross-border diversification. The proposed measures cover, among other areas, the crisis management mechanism, with a revamp of the instruments and functions of the SRB; banking supervision, to enhance the ECB's action in the micro- and macroprudential fields; and the state-aid controls in the banking sector.

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