Opting into the banking union before euro adoption

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1 Background

The global financial crisis exposed weaknesses in the EU financial architecture, arising from misalignments between national mandates for financial sector oversight and the EU-wide operations of many market participants:

- *Negative externalities:* The pursuit of domestic financial stability and competitiveness objectives, as well as resident taxpayer interests can create negative externalities for other EU members, resulting in a sub-optimal Union-wide outcome. One example is the failure of home supervisors of banks with subsidiaries in Central and Eastern Europe to rein in credit expansion in the region, which fueled unsustainable domestic demand booms prior to 2008. Host supervisors' efforts to limit rapid credit growth were circumvented by redirecting borrowers from local subsidiaries to parent banks' headquarters (Hilbers et al., 2005). Another example is the bailout of companies from the financial conglomerate Fortis Group according to their country of incorporation, instead of restructuring on a consolidated basis (BIS, 2010).
- *Financial fragmentation:* The national nature of deposit insurance schemes and public backstops for financial institutions led to a post-crisis fragmentation of the European market for financial services, as the funding costs of financial intermediaries and ultimately the cost of borrowing for non-financial sector became linked to sovereign creditworthiness (ECB, 2012). As a result, a number of countries became caught in a negative feedback loop between bank solvency and sovereign default risks, posing a major challenge for euro area countries which do not have monetary autonomy (IMF, 2013a).

In the aftermath of the crisis, the EU and the euro area embarked on ambitious financial sector reforms aimed at harmonizing the regulatory and supervisory regimes of all participants in the EU single market for financial services. The European System of Financial Supervision[1] was set up in 2011, followed by the development of the Single Rulebook. The core of the Single Rulebook is now in place, with the entry into force of the Capital Requirements Directive (CRD IV) and the Capital Requirements Regulation (CRR) – which harmonize capital definitions and implement Basel III – although some elements are to be phased in gradually over time. Euro area countries took a step further by forming a banking union that centralizes bank resolution and creates common backstops and macroprudential mandate spanning the realm of the banking union. The banking union is open to non-euro area EU Member States.

2 Banking union modalities

The banking union architecture includes the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). They centralize bank supervision and resolution powers, respectively. The other key elements of the banking union – a truly common fiscal backstop and a common deposit guarantee scheme – are not yet in place.

The SSM is comprised of the ECB and national bank supervisors (box 1). The ECB is the overarching supervisory authority, directly supervising 120 significant banks[2] – jointly comprising almost 85% of total euro area bank assets – and overseeing national competent authorities' (NCAs') supervision of the other 3.500 less significant banks in the euro area. The ECB can take over direct supervision of any less significant bank at any time in order to maintain cross-country consistent and high supervisory standards, or if it deems the bank to have become significant.

The SRM is comprised of national resolution authorities and the central Single Resolution Board (SRB), which is a stand-alone institution (box 2). The SRB oversees the resolution of banks by national resolution authorities (which will follow the structures of the Bank Recovery and Resolution Directive (BRRD)), and directly handles the resolution of large and cross-border banks. From January 2016, it can

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1 Comprising the European Banking Authority (EBA), European Securities and Markets Authority (ESMA), European Insurance and Occupational Pensions Authority (EIOPA), the Joint Committee of the European Supervisory Authorities (ESAs), the European Systemic Risk Board (ESRB) and national supervisory agencies.

2 The significance of banks is based on the criteria set out in the SSM Regulation and the SSM Framework Regulation, namely: a) size (total assets exceeding EUR 30 billion); b) importance for the economy of the EU or any participating Member State (in particular, total assets exceeding EUR 5 billion and 20% of GDP of a Member State); c) significance of cross-border activities (in particular, if the ratio of its cross-border assets or liabilities to its total assets or liabilities, respectively, is above 20%); d) a request for, or the receipt of, direct public financial assistance from the European Stability Mechanism (ESM); e) one of the three most significant credit institutions in a participating Member State.

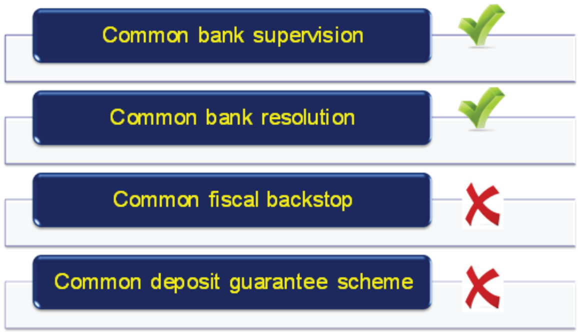
also draw upon a common, industry-funded backstop called the Single Resolution Fund (SRF), in order to resolve banks under the BRRD. The eventual size of the industry backstop is planned at EUR 55 billion (about 1% of covered deposits in the euro area).

The European Stability Mechanism (ESM) can directly recapitalize banks up to EUR 60 billion. This mitigates some of the potential fiscal problems associated with ESM indirect bank recapitalization, when a sovereign borrows from the ESM and then funnels those funds into its banking system. ESM bank recapitalization will not be available for any future non-euro area banking union participants, since the ESM Treaty is only open to currency union members. However, even if it were available, there are doubts about its effectiveness as a common fiscal backstop as currently formulated. The hurdles for its use are very high and in the event of systemic crisis, the ceiling on the funding available for recapitalization could be rapidly reached.

The granting of a banking union-wide macroprudential mandate to the SSM implies some constraints on national policies. The CRR/CRD IV legislative package defines a range of tools over which national macroprudential authorities may set stricter requirements (above the industry-wide, microprudential minima) based on systemic risk considerations, macroprudential concerns, or to address risks at individual firm level. In the case of banking union members, national competent authorities can still deploy macroprudential measures as they deem appropriate, subject to a notification requirement to the European Systemic Risk Board (ESRB). However, in the case of CRR/CRD IV measures (box 3), banking union-participating states must also notify the ECB of their intention 10 working days prior to issuance of their decision. If the ECB objects, then it supplies a written explanation within 5 working days, which the national authority must take into consideration. Furthermore, if the ECB wishes, it may apply stricter macroprudential requirements on banks, irrespective of whether they are under direct SSM supervision or not, than the national authorities (subject to similar notification and consideration timelines). At the same time, neither the ECB nor national competent authorities can compel loosening of macroprudential measures imposed by the other (i.e. national prudential norms can only be stricter than those prescribed by the ECB).

By design, the banking union is intended to raise the credibility and quality of banking supervision and to eliminate conflicts between home and host supervisors, as well as sever the links between banks and sovereigns by unifying the bank resolution and restructuring framework and providing a common, industry-funded backstop. This would in turn lead to lower bank compliance costs, the removal of any barriers to cross-border banking activity (which may be in place to protect national interests), lower resolution and restructuring costs, and ultimately lower bank funding costs.[3]

Chart 1: Banking union building blocks



However, the full benefits of the banking union will be realized once all its elements are in place, which is not yet the case (chart 1). While the SSM and SRM are now operational, an effective common fiscal backstop is still needed to break the sovereign-bank links (the ESM is currently acting as *de facto* common fiscal backstop for euro area banks). Other key elements include allowing the Single Resolution Fund (SRF) (which will be fully funded and mutualized only by 2024)[4] to borrow against future industry levies, and working towards a pan-European deposit guarantee scheme (DGS). Reaping the benefits of banking union membership also depends crucially on the effectiveness and efficiency of banking union day-to-day operation, including the coordination between the SSM and local supervisors, as well as to coordination between prudential policies at the national and banking union-levels and national monetary policies.

3 What does "opting into the banking union" entail?

Banking union membership refers to participation in both the SSM and in the SRM. For non-euro area economies, "opting into the banking union" would mean entering into a close cooperation with the ECB and amending national legislation to enable national authorities to work with the ECB and the Single Resolution Board (SRB) under their supranational frameworks for supervision and resolution, respectively. Whereas the outcome of the application is not conditional on the results from the

[3] See IMF's Staff Discussion Note on "A Banking Union for the Euro Area" (IMF, 2013) for a comprehensive discussion of the banking union design and benefits.

[4] The SRF will start out with national compartments which build up over time and are gradually mutualized building to 100% after 8 years, in 2024.

comprehensive assessment, the ECB can use its powers to request further information and carry out its own comprehensive assessment to steer the process. For countries that have already set a target date for euro adoption, joining the banking union prior to euro adoption effectively amounts to phasing in the necessary institutional and operational adjustments.

Chart 2: Modalities of banking union participation for opt-ins

Upon opting into the banking union, non-euro area members would not be treated in the same way as the euro-area members (chart 2): (i) *role in the SSM:* non-euro countries are not members of the ECB's Governing Council that is charged with adopting decisions drafted by the Supervisory Board (box 1);[5] (ii) *fiscal backstop:* non-euro area opt-ins are not eligible for direct bank recapitalization from the ESM; and (iii) *liquidity support:* non-euro area opt-ins would not automatically have access to the ECB liquidity facilities.[6] That said, there are some safeguards for non-euro area opt-ins, such as the reasoned disagreement procedure and the exit clause. The latter means that unlike euro-area members, non-euro area countries can terminate their participation in the banking union (though the ECB can take such decision as well).

[5] The ECB Governing Council cannot change draft supervisory decisions, but can object and refer them back to SSB for redrafting, or to a mediation panel to resolve differences among national competent authorities.

[6] At present, any liquidity provision by the ECB to non-euro area members via repo or swap lines is evaluated on a country-by-country basis and subjugated to monetary policy considerations.

Box 1: The SSM modalities

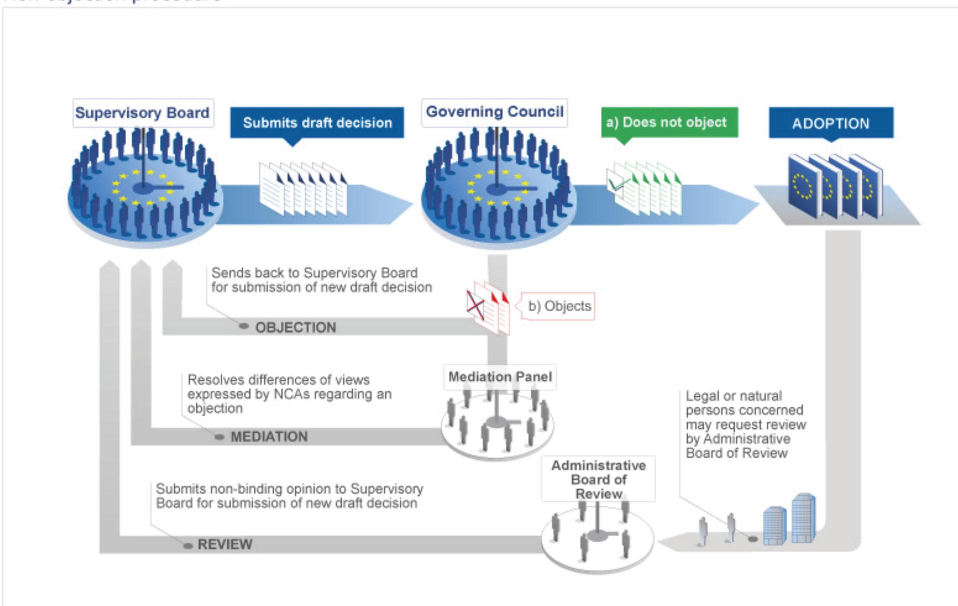
Oversight will be managed by a *Supervisory Board* (SB), based within the ECB, which consists of a chair and vice-chair (the latter also serving on the ECB Executive Board), a single representative from each participating Member State plus four ECB representatives and who are expected to act in their personal capacities for the good of the Union, rather than for national or group interests. In the event that a participating member state's national supervisor is not the national central bank, they may request that a representative of the national central bank also attends. For the purposes of voting however, the representatives of any one member state are considered as one member.

The SB will also make draft decisions, which are then referred to the ECB's *Governing Council* (consisting of ECB Board members and euro area national central bank heads). Regular draft decisions are passed by simple majority, while regulatory decisions with SSM-wide import are passed by qualified majority.[1] The ECB Governing Council then either adopts the decision on a lapse-of-time basis or objects to it. In case a decision is objected to, it is referred back to the SB for redrafting, or, as an intermediary step, goes to a mediation panel which works to resolve the differences in views across national competent authorities.

The non-euro area member states of the banking union – who do not have representation on the ECB Governing Council – would be invited to send representatives to the ECB Governing Council, if the ECB contemplates an objection to an SB draft decision or if the non-euro area members disagree with a draft decision of the SB. If no satisfactory compromise can be found in the subsequent reconciliation process, the non-euro area member state can notify the ECB that it will not be bound by such decision. If the "reasoned disagreement" with the decision is not accepted, this can result in the eventual suspension or termination of the member state's cooperation with the ECB in the SSM (per Article 7, SSM Regulation).

[1] *A qualified majority is defined in Article 16(4) of the Treaty on European Union (TEU) and Article 3 of Protocol Number 36 on transitional provisions associated with TEU (reweighted according to the membership of the SSM).*

Decision-making process of the Single Supervisory Mechanism:
Non-objection procedure



Source: www.bankingsupervision.europa.eu/organisation/governance/html/index.en.html.

Box 2: The SRM modalities

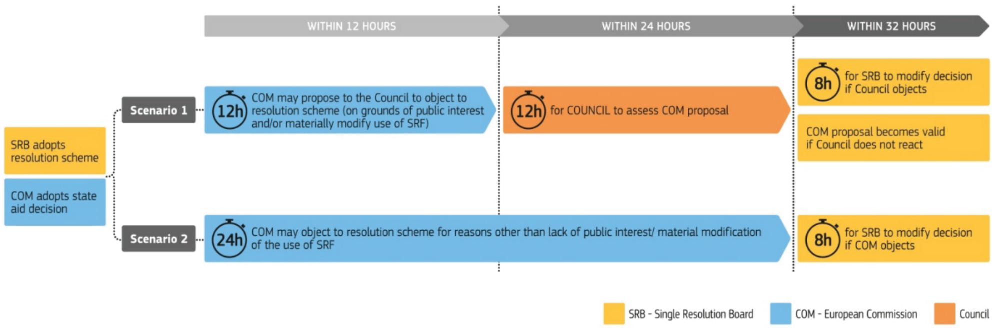
Decision-making in the SRM

The governing body of the SRM is the *Single Resolution Board* (SRB), which consists of a chair, vice-chair, three other full-time members, and one representative from the national resolution authorities of each participating member state. The chair, vice-chair and other full-time members, constituting the *executive of the SRB,* are all appointed by the European Parliament from a short-list of candidates drawn up by the Commission.

Resolution decisions are drafted by the executive of the SRB and are assumed adopted by the SRB unless there is an objection by one of the representatives of the participating member states (similar to the non-objection procedure used by the SSM). In the case of an objection, the SRB meets in plenary (all members) and takes the resolution decision, based on a *simple majority* rule. In general, the plenary SRB meets at least twice a year, to review the budget and assess resolution activity, but it may also meet at the behest of the chair or if more than EUR 5 billion in funds from the SRF have been used in any 12 month period.

The resolution procedure also involves close coordination with the European Commission and the EU Council (see below)

Resolution procedure in the banking union



Source: europa.eu/rapid/press-release_MEMO-14-294_en.htm.

Contributing to the SRF
Under the SRM Regulation and SRF intergovernmental agreement, all participating member states contribute (whether euro area or not) and are able to access the SRF under the SRM. A bank's *ex ante* contributions to the SRF are calculated *pro rata* with its share of total liabilities minus covered deposits of all banks in participating member states (plus a risk-adjusted contribution drawing upon BRRD criteria; see the SRM Regulation, Article 70).

Box 3: Macroprudential policy space for the banking union members

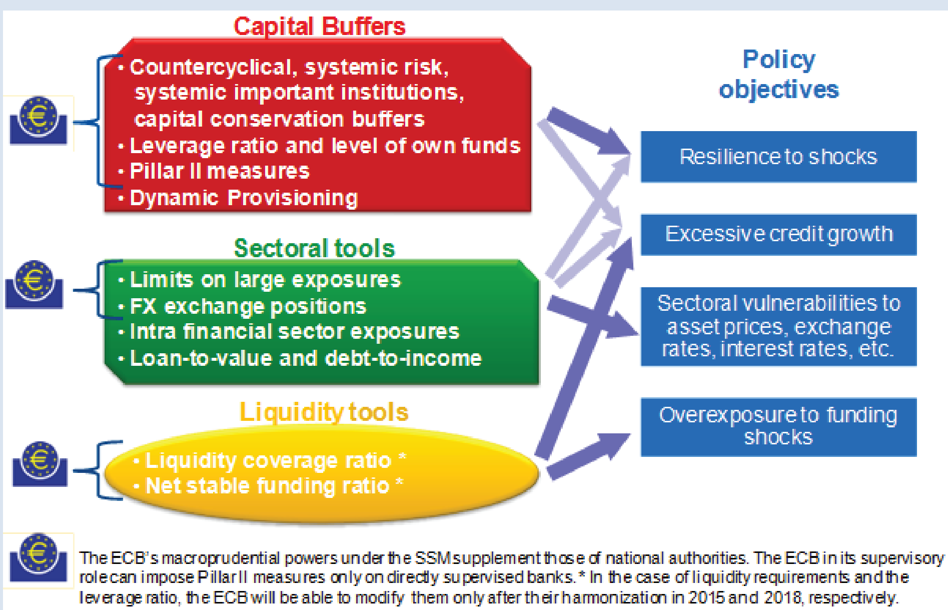
For banking union members, the SSM entails some additional constraints on macroprudential policies. Under the SSM Regulation (Article 5), national competent authorities (NCAs) can still deploy macroprudential measures as they deem appropriate, following the usual practice of submitting them to the ESRB for a non-binding opinion. However, in the case of CRR/CRD IV measures (see below), banking union-participating states must also notify the ECB of their intention 10 working days prior to issuance of their decision. If the ECB objects, then it supplies a written explanation within 5 working days, which the national authority must take into consideration. Furthermore, if the ECB wishes, it may apply stricter macroprudential requirements on banks, irrespective of whether they are under direct SSM supervision or not, than the national authorities (subject to similar notification and consideration timelines)

The CRR/CRD IV legislative package defines a range of tools over which national macroprudential authorities may set stricter requirements (above the industry-wide, microprudential minima) based on systemic risk considerations, macroprudential concerns, or to address risks at individual firm level. These are subject to a notification requirement to the European Systemic Risk Board (ESRB) and include:

- Pillar I measures – countercyclical capital buffer and additional capital buffers for systemic risk, systemic important institutions, and capital conservation, as well as the leverage ratio and the level of own funds. In addition, national authorities can set higher risk weights on real estate exposures and large exposures;
- Pillar II measures – a wide range of measures at the level of individual institutions or group of institutions with similar risk profile, imposed following a supervisory review and evaluation process aimed at identifying risks they face or pose to the financial system;
- Liquidity provisions – liquidity coverage ratio and net stable funding ratio;
- Limits on large exposures and intra financial sector exposures.

National macroprudential authorities retain control over macroprudential measures, not specified in Union law, such as the loan-to-value and debt-to-income ratios, among others (chart below). This is subject to a notification requirement to the ESRB and possible intervention by the EU Council. In addition, until the harmonization of the liquidity requirements in 2015 and the leverage ratio in 2018, member states can set unilaterally these measures.

Mapping Macroprudential Tools to Objectives



Source: Authors' compilation, mapping to objectives is based on IMF 2013b.

4 Opting into the banking union: analytical framework

4.1 Theoretical considerations

Domestic financial stability is an overarching objective of national supervisors, but supporting growth – by ensuring access to credit for nonfinancial firms and adequate profitability for financial intermediaries – is often an implicit goal as well. This dual objective entails tradeoffs. While tighter prudential and macroprudential supervision reduce the risk and cost of financial instability, they also dampen credit growth and lower bank profitability. At the end, the weights that national supervisors put on stability and growth objectives would determine the stringency of national prudential supervision. These weights may vary across countries, depending on the institutional setup of financial sector oversight (its independence and accountability), the type of financial system (bank versus market-based credit provision), ownership of the banking sector (domestic versus foreign), and the degree of market concentration.

Other policy instruments may also be used to promote financial stability objectives, such as monetary policy (including lender of last resort (LoLR) facilities) and safety nets (including deposit guarantee schemes (DGS), resolution funds, and other backstops). For example, different combinations of DGS and bank prudential and macroprudential regulation could be used to reduce the risk and cost of financial instability. Here, there are tradeoffs as well. More generous deposit insurance lowers the cost of a banking crisis, once it occurs, but would induce moral hazard at the bank level leading to higher probability of a crisis. On the other hand, more stringent bank prudential and macroprudential regulation would impose more discipline on banks and reduce the risk of financial instability, but hurt bank profitability and credit access, as discussed above.

Furthermore, the design of national supervision and safety nets in a multi-country integrated market has to take into account potential cross-border spillovers. Tighter supervision which makes the domestic banking system safer may also be good for other countries with which this country has close links, by reducing financial stability risks. On the other hand, tighter supervision may make domestic banks less competitive vis-à-vis foreign banks. This suggests that while there may be incentives for national supervisors in a financially integrated region to cooperate, independent regulators may also have an incentive to promote the competitiveness of domestic banks by lowering their own supervisory standards, which could trigger a “race to the bottom.”

When will a centralized solution (“banking union”) be preferred by national supervisors as a way to achieve their national stability-growth objectives? For each individual country, the balance between banking union advantages and disadvantages is determined by policy preferences and country characteristics:

- *Policy preferences* – the theoretical literature suggests that countries that are similar in their regulatory preferences along the economic growth – financial stability axis will tend to see higher net benefits to coordination. But in order for such national supervisors to prefer a banking union, the common standards must be stricter than the ones existing in individual countries (Dell'Ariccia and Marquez, 2006). If however, the initial cross-country differences in supervisor preferences are significant, the centralized solution may not be an optimal choice for all. In more extreme cases, regulatory preferences may be distorted by vested interests of bank shareholders, debtors, and creditors (Scherf, 2014), in which case joining a regulatory union may be a way to reduce "regulatory capture."
- *Country characteristics* – parallels between the decisions to join a banking union and a currency union bring out additional factors pertinent to the decision. Greater "similarity" between economic characteristics of current and prospective banking union members reduces the probability of an idiosyncratic shock driving a wedge between national interests and that of the banking union. When idiosyncratic shocks do occur, the more flexible the product and labor markets, the smaller the need for policy reaction that might be in conflict with union-wide policies. Lower supervisory quality and lower backstops at the national level likely increase the benefits of having common (tighter) regulatory/supervisory standards and common (larger) backstops.[7] Limited domestic policy space could also reduce the potential costs of joining the banking union.

4.2 Application of analytical framework to "opt-in" choice

Based on the theoretical considerations outlined above, the "opt-in" choice can be seen as a solution to a "pay-off" matrix (table 1). Table 1 juxtaposes country characteristics (top row) and policy objectives (first column) to determine whether joining the banking union could help or hinder (second column) the achievement of these objectives. In table 1, blank cells indicate that a particular benefit or cost of joining will accrue independent of the balance of policy preferences or whether a country ranks low or high on a particular country characteristic. Green cells indicate an added benefit and red cells reflect extra loss in one of the states (low or high) of country characteristics. The country characteristics in table 1 are the ones that appear most relevant for the decision to join the common currency area or the common regulatory area based on the literature:

[7] Recent research on the optimum currency area highlights the benefits of financial markets integration and of importing prudent economic management by pegging the domestic currency to that of a dominant economic power (see, for example, McKinnon, 2004). In addition, a common fiscal backstop in a banking union serves the role of an insurance policy, upon which individual members can draw in the event of an asymmetric shock.

- The degree of real or financial integration with the euro area (columns 1 and 3) determines the relative likelihood of common versus asymmetric shocks and hence, risk-sharing preferences;
- The degree of economic flexibility (column 2) reflects the ability of the economy to absorb shocks; less flexibility makes it more likely that negative shocks could trigger financial instability.
- The share of local bank assets owned by euro area banks (column 4) indicates the importance of intra-group cross-border flows of euro area banks for domestic financial stability.
- The supervisory standards (column 5) refer to the stringency of rules and quality of supervisory processes at the local level.
- Local backstops for the financial system include local deposit guarantee schemes (DGS) (column 6) and fiscal policy space (column 8) refers to national capacity to absorb shocks. Their adequacy is inversely related to countries' potential exposure to contingent liabilities, as measured by the ratio of insured deposits to GDP, and the size of public debt relative to GDP.
- Policy space indicates the availability and effectiveness of monetary and fiscal policies (columns 7 and 8), as tools for demand management. Fiscal policy space can be proxied by the ratio of public debt to GDP, whereas the availability of monetary policies depends on the nominal anchor (exchange rate versus inflation) chosen by the central bank.

4.2.1 Would joining the banking union reduce financial stability (FS) risks for the new members?

YES, if joining the banking union:

- Improves the overall quality/stringency of supervision. To the extent that supervision under the SSM will be stricter than current national supervision, banks would be safer and financial stability risks would be lower. This would be the case, if the SSM: (i) sets microprudential standards for local banks that are at least as strict as the current standards in force in the new members; and (ii) succeeds in distancing supervision from the influence of local vested interests, especially the "too big to fail" domestically-owned banks. In order for these benefits to accrue, it is critical for the SSM to establish early a strong track record. That said, differences in legal and accounting standards across members would complicate harmonized supervision in the banking union. *New members with less stringent supervisory standards and those with weaker local backstops would benefit more* (table 1, columns 5, 6, and 8, ranks: low).
- Limits negative externalities stemming from the actions of current banking union member banks. The participation of the non-euro area countries in the banking union could further reduce the scope for regulatory arbitrage and leakages of

macroprudential measures aimed at safeguarding financial stability in member countries.[8] The possibilities for regulatory arbitrage have already been reduced through the Single Rulebook, but the SSM would ensure compliance through centralized supervision and greater harmonization of supervisory practices. *New members with strong financial links with the euro area, and a significant presence of banking union member banks* (table 1, columns 3 and 4, ranks: high), as well as those with *less stringent supervisory standards and weaker local backstops* (table 1, columns 5, 6 and 8, ranks: low) *would benefit more.*

- Better access to information and better home-host coordination through direct participation in the SSM.[9] Joining the banking union would provide non-euro area members: (i) greater access to supervisory information on cross-border banks operating in their jurisdictions (and also in other jurisdictions);[10] and (ii) ability to directly participate in the SSM/SB decision making process, though acting in their personal capacities for the good of the Union, rather than for national or group interests. There is a range of views on whether this would ultimately give "opt-ins" greater leverage over decisions regarding parent banks. On the one hand, as a member of the SB, the "opt-ins" representatives would be able to vote on *all issues,* including the ones that are currently beyond the purview of local supervisors.[11] On the other hand, because of different treatment of the euro area and non-euro area members of the SSM (discussed above), the ability of "opt-ins" to influence decisions may be weaker than that of the euro area members. Another important issue is that after opting into the banking union, the new

[8] The macroprudential measures adopted by the local authorities to slow rapid credit growth in CESEE countries during the pre-crisis boom were often not very effective because they were not matched by similar measures by the home country supervisors of euro area banks operating in CESEE countries.

[9] Prior to the banking union, cross-border coordination of banking supervision of a banking group would occur via a college of supervisors, involving supervisors from those jurisdictions spanned by the group. The college would provide a venue for interactions between supervisors across countries to facilitate information sharing and coordination (particularly in emergencies or cases of restructuring or resolution). A key innovation of the banking union is the removal of this institutional layer for coordination between its members.

[10] Being part of the supervisory college, non-euro area member can request any information about parent banks that it deems relevant. Because there is a need to request information, access to information may not always be as timely as desired. In comparison, being part of the SSM would automatically grant access to all info about the parent bank as well as other euro area banks.

[11] Currently, the extent to which local supervisor is able to influence any given decision depends on the specific issue under consideration and who has competency over this issue. E.g., in the case of capital/liquidity requirements at the group level, if a home supervisor decides to increase the requirements for the whole group, the host supervisor cannot block this decision; in the case of capital/liquidity requirements at the subsidiary level, the host supervisor has the final say.

member would no longer have the final say on certain matters that are of particular importance to them (e.g. local liquidity requirements, box 3). Hence, the net gain/loss of influence on the decisions regarding parent banks would depend not only on the "opt-ins" role in the SSM, but also on how much control they will *de facto cede* by joining the banking union. The would imply that *new members with strong financial links with the euro area and a significant presence of the banking union member banks would benefit* (table 1, columns: 3 and 4, rank: high), subject to the caveats discussed above.

NOT necessarily, if joining the banking union:

- *Limits the ability to use prudential tools to address country specific shocks,* to the extent that the loss of powers is not compensated by a commensurate decline in the frequency or size of such shocks. Under the Single Rulebook, local supervisors have significant flexibility to impose additional macro- and microprudential requirements, early intervention powers and ability to set conditions under which the local CB could provide liquidity assistance to troubled banks. After joining the SSM, some of this flexibility (including "good" discretion) could be lost. For example, in the event "opt-ins" are hit by asymmetric shocks, SSM's prudential requirements may end up being stricter than might be warranted given country-specific circumstances, which could lead to higher (than optimal) incidence of bank closures or to lower recovery values on distressed assets (less of "good forbearance"). *This consideration is most relevant for countries that are relatively less integrated with the euro area and hence more exposed to asymmetric shocks* (table 1, columns 1 to 4, ranks: Low), *as well as for supervisors with greater capacity to intervene* (table 1, column 5, rank: high).
- *Leads to loss of full control over cross-border capital and liquidity flows,* to the extent that the loss of powers is not compensated by a commensurate reduction in the likelihood of negative spillovers or in the absence of alternative mechanisms for dealing with such spillovers. Ring-fencing of capital and liquidity of the euro area banks' subsidiaries was used by national supervisors during the crisis to prevent problems in foreign parent banks from spilling over to the domestic banking systems. After joining the banking union, local supervisors will lose control over the liquidity requirements at the subsidiary level, though they will retain the ability to set large exposure limits.[12] To the extent that banking union would completely eliminate any negative externalities, the "opt-in" supervisor should not be

[12] While in a banking union it will be much harder for host supervisors to block intra-group cross-border transfers, there are still some powers that are given to member states that could be viewed as safeguards. E.g., there is large exposure regime in the CRR and there are two discretions: one given to supervisor and the one that allows member states to impose large exposure limits (Article 493). The supervisory decision can never overrule the decision of a member state.

concerned about losing the ability to ring-fence after joining the banking union. However, to the extent that some spillovers remain a possibility, national supervisors may perceive a loss of control over cross-border intra-group flows as potentially increasing the risk of financial instability. *These considerations are most relevant for counties where the euro area banks' subsidiaries dominate in the local banking market* (table 1, columns 3 and 4, ranks: high), *as well as for supervisors with greater capacity to intervene* (table 1, column 5, rank: high).

4.2.2 Would joining the banking union reduce the cost of financial distress, once it occurs?

YES, if joining the banking union:

- *Increases efficiency and reduces the cost of bank resolution.* The BRRD already goes some way towards achieving this objective, but the SRM further ensures that the process of winding down of large cross-border banks is orderly and "least cost" on a consolidated basis. *This is a positive factor for all, but especially for those countries that host subsidiaries of euro area banks* (table 1, column 4, rank: high).
- *Provides access to common backstop* (SRF). Joining the SRM allows local banks to have access to a larger backstop without adding to the fiscal burden of the sovereign. Having access to a common backstop (SRF) would be relatively more attractive for countries that are more likely to be hit by asymmetric shocks and those with *weaker local backstops.* However, these benefits are limited until the SRF is fully mutualized. The national contributions to the SRF will be only gradually mutualized over the course of the next eight years, reducing the appeal of this aspect of banking union membership in the interim. *Hence, less integrated countries* (table 1, columns 1 to 3, ranks: low) *and those with weaker local backstops* (table 1, columns 6 and 8, ranks: low) *would derive the biggest benefit once the fully mutualized backstop is in place.*

NOT necessarily, if joining the banking union:

- Leads to some loss of local control over the resolution process, without commensurate risk-sharing on supra-national level. Once a non-euro area member joins the SRF, the decision on whether or not to resolve a bank under SSM supervision will be taken at the banking union level. Until the SRF is fully mutualized, this raises the risk that the resolution decision may not fully take into account available financing (for resolution purposes), as the latter would still largely consist of local DGS and local fiscal backstop. In addition, there is a risk that the SSM will apply stricter criteria (than might be warranted by local conditions) in determining whether a bank is solvent or not, which would lead to higher incidence of resolution under the banking union. *This consideration is most relevant for* *countries with strong supervision (table 1, column 5, rank: high), those in which subsidiaries of cross-border banks that would be resolved directly by the SRM have significant market share* (table 1, column 4, rank: high), *as well as countries with less adequate local backstops* (table 1, columns 6 and 8, ranks: low).[13]

4.2.3 Would joining the banking union facilitate or hinder achieving macroeconomic objectives?

- Joining the banking union could reduce the national policy makers' ability to support access to credit through prudential measures, particularly when country specific circumstances require more supportive financial regulation than in other banking union members.[14] This is partly an artifact of the asymmetry between the powers of the ECB and national supervisors to tighten and loosen prudential norms: (i) national prudential norms can only be stricter than the floor set by the ECB; and (ii) the ECB may always strengthen macroprudential policies, but it cannot compel loosening. While in principle, the ECB does not have to set the same macroprudential standards across all banking union members, it is not clear how much heterogeneity it may be prepared to accept given its objective of ensuring level playing field and preventing regulatory arbitrage. *This consideration is most relevant for less integrated economies that are more likely to find themselves facing different cyclical conditions than the rest of the banking union* (table 1, columns 1 to 4, ranks: low), *as well as for supervisors with greater capacity to intervene* (table 1, column 5, rank: high).

4.2.4 Does monetary policy autonomy make a difference?

All banking union members, including those in the euro area, retain some policy instruments (for example, taxes and subsidies, housing policies, and so on) that could potentially be used to offset the impact of measures adopted at the banking union level. However, non-euro area members will have an additional tool – they

[13] In addition, initial conditions may matter as well. If asset quality, liquidity and profitability of local subsidiaries of euro area banks are stronger than in the rest of the banking group, local stakeholders would be worse off if a banking group is resolved at banking union-level (on a consolidated basis) rather through the local resolution process. While this consideration is not relevant in a steady state, it may provide a disincentive to joining the banking union from a position of relative strength.

[14] For example, during the crisis, some European countries used prudential measures to enhance credit supply, including a reduction in risk weights for SME loans when calculating banks' capital adequacy ratios, forbearance of nonperforming loans, and countercyclical macroprudential regulations (see e.g., GFSR (2013) for details).

will retain sovereignty over monetary and exchange rate policies.[15] In the banking union, these national policies would need to be coordinated not only with prudential measures taken at the national but also at the banking union level. Independent monetary policy provides an additional policy tool to manage the impact of shocks on the economy that could, in principle, allow a non-euro area banking union member to take advantage of the upsides offered by the banking union, while mitigating potential downsides. In that regard, *perspective banking union members without independent monetary policy will, hence, be at a disadvantage relative to their inflation-targeting peers* (table 1, column 7, rank: low).

4.3 Considerations for "new" Member States

Certain characteristics of Central and Eastern European EU Member States make them particularly sensitive to the lack of equal (or fully equivalent)[16] treatment of non-euro area countries in the banking union:

- *Central and Eastern European (CEE) EU Member States are more prone to idiosyncratic shocks, making them more likely to test the inadequacies of the existing setup.* Despite significant progress in EU integration and income convergence since the mid-1990s, the real income gap (relative to the euro area) is still substantial for most CEE EU Member States (chart 3). This is a symptom that their economic structures are yet to converge sufficiently towards the prevailing structures in the euro area.[17] And, whereas labor markets in the CEE EU Member States are, on average, more flexible than in the euro area – with lower statutory minimum wages, union density rates and more decentralized wage bargaining structure than in the euro area – the region falls short in the area of liberalization of business regulation (chart 4).

[15] Monetary policy remains a national responsibility prior to euro adoption, but is subordinated to EU Treaty obligations. In particular, its main objective should be price stability, with exchange rate policy being treated as a matter of common interest.

[16] Discussions on the common fiscal backstop are ongoing with the view to achieving a better symmetry between euro area and non-euro area banking union members. See data.consilium.europa.eu/doc/document/ST-16250-2014-INIT/en/pdf.

[17] Synchronization with the euro area is notably higher for Hungary and the Czech Republic relative to other CEE EU Member States.

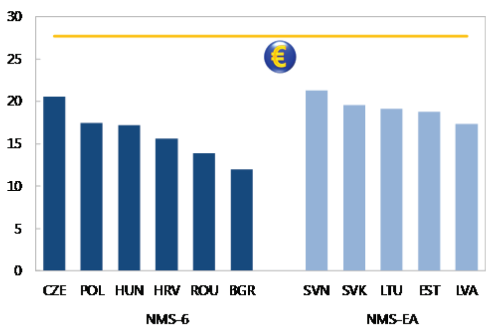
Table 1: Simplified taxonomy of benefits and costs of joining banking union for non-euro area countries

Policy objective		Benefit or Cost of Joining the Banking Union	Real Sector				Financial Sector				Supervision/Backstops				Policy Space			
			(1) Degree of real convergence/ integration with the euro area		(2) Degree of labor & product markets flexibility		(3) Degree of financial integration with the euro area		(4) Banking system structure (share of banks owned by euro area banks)		(5) Supervisory standards		(6) Industry-funded backstops (DGS)		(7) Monetary		(8) Fiscal	
			High	Low	High	Low	High	Low	High	Low	High	Low	High	Low	High	Low	High	Low
Financial stability	Likelihood of distress	1. Improve the overall quality of supervision										+		+				+
		2. Limit negative externalities from euro area banks					+		+			+		+				+
		3. Increased access to info and improved home-host coordination through SSM					+		+									
		4. Reduce ability to mitigate country specific shocks		-		-		-		-	-							
		5. Constrain ability to control cross-border intra-group flows					-		-		-							
	Cost of distress	6. Increase efficiency and lower cost of cross-border bank resolution							+									
		7. Provide access to common, industry-funded backstop (SRF)		+		+		+						+				+
		8. Loss of some local control over resolution process in the absence of fiscal backstops							-		-			-				-
Growth		9. Reduce ability to smooth credit cycles through prudential measures		-		-		-		-	-					-		

Note: *The table presents a simplified taxonomy of country characteristics (top row) and policy objectives (first column) and whether joining the banking union could help or hinder the achievement of these objectives (rows showing potential benefits and costs). The cells in the matrix indicate whether country's ranking on a given country characteristic has a material impact on the benefits or costs of joining (e.g. the degree of real or financial integration with the euro area (columns 1 and 3) affects the relative likelihood of common versus asymmetric shocks, with lower integration = higher likelihood of asymmetric shocks and hence costs of giving up local policy space to respond to them). Types: for each characteristic listed in the top row, a country can be of two types: "High" – at or above the average across banking union members; and "Low" – below the average across banking union members. Payoffs: "–" (extra loss); "+" (added benefit with diagonal stripes indicating only partial benefit during transition to full SRF mutualization); and "blank" (particular benefit or cost of joining does not depend directly on country ranks on a particular economic characteristic).*

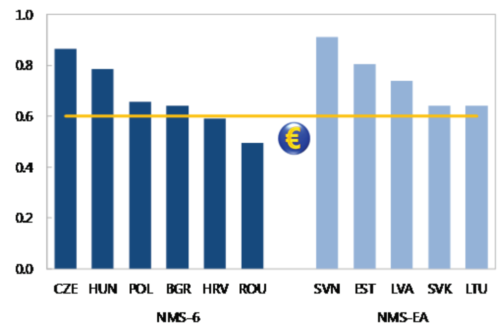
Chart 3: CEE EU – real convergence with the euro area

Gross domestic product per capita, 2013
EUR thousand, purchasing power standard



Source: Eurostat; and Haver Analytics.
Note: NMS – EU new Member State in Central and Eastern Europe
EA – euro area
€ – Symbol signifies euro area average of plotted data

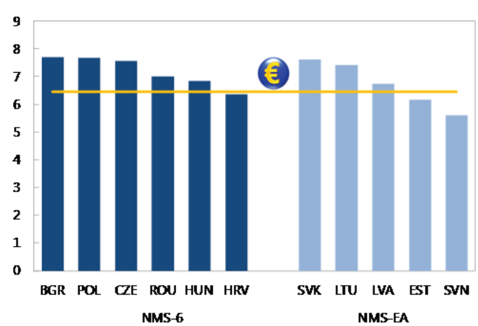
Business cycle synchronization with euro area, 1998–2013
Contemporaneous correlation of output gaps



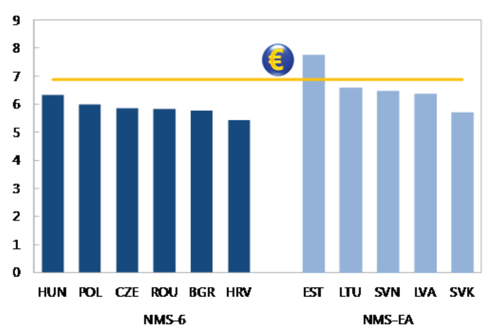
Source: IMF staff calculations.
Note: Output gaps are extracted with the Baxter-King bandpass filter. Euro area average is an unweighted average correlation for the 12 initial members.

Chart 4: CEE EU Member States– labor and product market flexibility

Labor market regulations, 2011
Index, 10 = least restrictive



Business regulations, 2011
Index, 10 = least restrictive



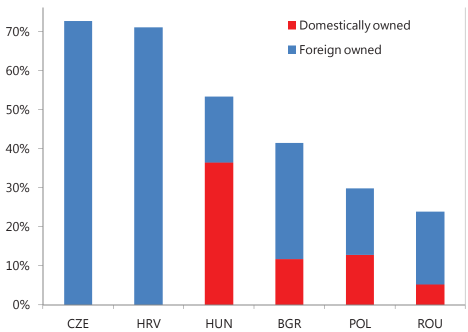
Source: Economic Freedom of the World.

- *Ability to influence decisions related to parent banks is critical for the CEE EU* Member States because most of their banking systems are dominated by the euro area bank subsidiaries, which tend to be more important for local economies than for the parent banking groups (chart 5). If under the banking union most *barriers to cross-border transfers* of capital and liquidity are removed, this could reduce the required capital and liquidity buffers at the subsidiary level, but it would also take away some of the local authorities' ability to ring-fence (Cerutti et al., 2014). Having less control over intra-group cross-border flows could be partly offset, however, by the benefits that come with direct participation in the SSM, which would allow opt-ins to vote in the SB on issues that are currently beyond the purview of local supervisors. It also remains to be seen how the SSM will balance prudential considerations of host and home countries, and address potential concerns that considerations related to larger financial systems/institutions, which have a greater bearing on the financial stability of the banking union as a whole, would be viewed as more important.
- *Access to common liquidity and fiscal backstops is important for the CEE EU Member States,* because (i) they still have large external liabilities, though many subsidiaries are now less reliant on foreign parent bank funding than before the crisis; (ii) banks in CEE EU Member States typically hold less bail-inable funds (other than uninsured deposits) than euro area banking groups operating in the region. The CEE EU Member States are, therefore, more likely to benefit from the risk-sharing aspect of the SRF or other common backstop (chart 6).

Chart 5: CEE EU Member States – Banking sectors dependence on foreign banks

Three largest banks by assets, 2013

% of GDP

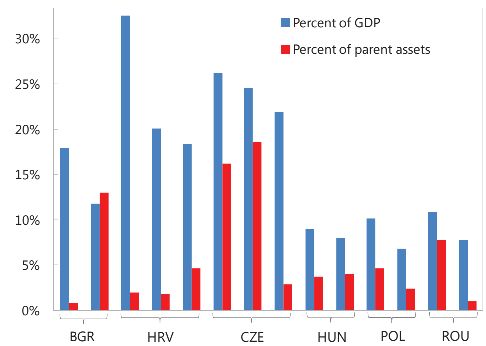


Source: Bankscope; and IMF staff estimates.

Note: Top 3 banks would be expected to come under SSM.

Assets of largest foreign-owned banks in CEE EU

Individual bank assets

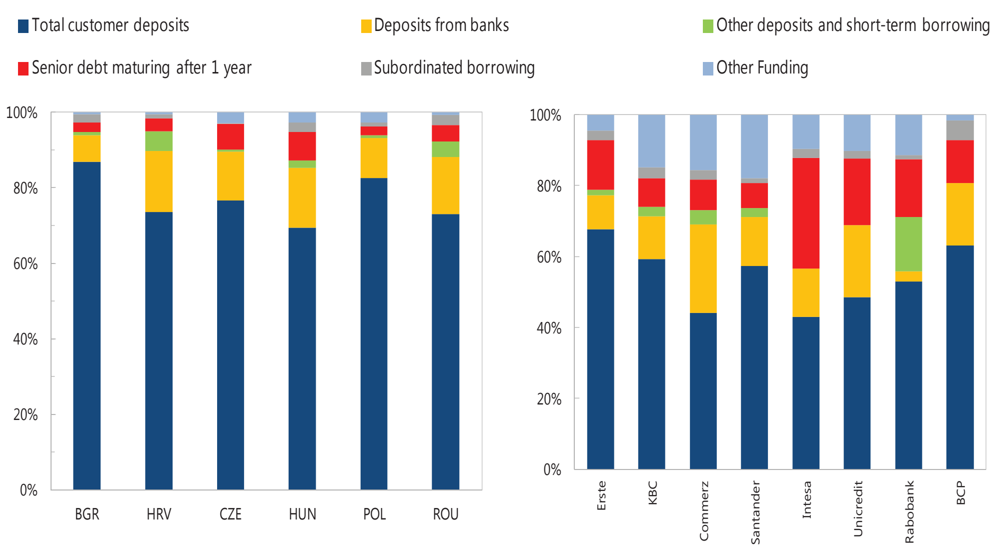


Source: Bankscope; and IMF staff estimates.

Note: In some cases, the source data are consolidated for the financial group, in which the bank is part of.

Chart 6: CEE EU Member States – bank funding structures, 2013

USD billion; % of total



Source: Bankscope; and IMF staff estimates.

Note: Based on largest 10 banks in each country and selected parent banks.

5 Summary

The lack of equal (or fully equivalent) treatment of the banking union members and non-euro area opt-ins – regarding their role in the Single Supervisory Mechanism (SSM), as well as access to common liquidity and fiscal backstops – makes opting into the banking union before euro adoption less attractive.

The choice of an early "opt-in" entails a number of country specific trade-offs:

- Economies that are less integrated with the euro area and hence more likely to find themselves facing different cyclical conditions than the rest of the banking union (e.g., Bulgaria, Croatia) face a trade-off between gaining access to a larger industry-funded common backstop (SRF) and giving up some flexibility to deal with country specific shocks. While the upside will fully materialize only once the SRF is fully mutualized, the downside can be properly assessed only when there is more clarity on and experience with the relevant banking union operational modalities.
- Economies where the euro area banks dominate local banking systems (e.g., Czech Republic, Croatia) face a trade-off between direct participation in the SSM deliberations (which entails better access to information and ability to participate in the decision-making on parent banks) and ceding full control over intra-group cross-border capital and liquidity flows (ability to ring-fence). The big unknown here is the extent to which negative externalities stemming from the activities of the euro area cross-border banks would indeed be effectively eliminated under the banking union, as this would determine the value of having control over the intra-group cross-border flows for local authorities.
- Countries with monetary and exchange rate flexibility would need to better understand how the centralization of micro- or macroprudential powers under the banking union would affect their ability to conduct monetary policy/lender-of-last-resort functions effectively. While the non-euro area banking union opt-ins could, in principle, use their monetary policy/exchange rate flexibility to offset tighter macroprudential requirements set at the banking union level, in practice, this could lead to tensions that would need to be resolved.

Despite the current shortcomings of the banking union, some countries can still find it advantageous to opt-in, as a way to enhance the quality and credibility of bank supervision or to gain access to larger industry-funded common backstops.

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