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European Banking Union: Will Outsiders Be Affected?

European Banking Union

In the run-up to the financial crisis in 2007 European banks increased their cross-boarder linkages both through the creation of banking groups that spanned a number of countries and through increased reliance on financing in international financial markets. Stefan Ingves (2006) elaborated on the potential challenges associated with these developments and concluded that "the present situation with a growth of cross-border banks [...] combined with national responsibility for supervision and financial stability is not satisfactory. If we are hit by a critical crisis in one or more of the major financial institutions today, the regulatory and supervisory framework is not sufficient." Stefan Ingves went further and proposed as one of potential pan-European solutions that the mandate and responsibility for supervision of cross-boarder banks would be transferred from the national level to the EU level. "This would imply the creation of a European Financial Services Authority (FSA), as well as granting the European Central Bank (ECB) a role as a lender of last resort for cross-border banks." (Ingves, 2006).

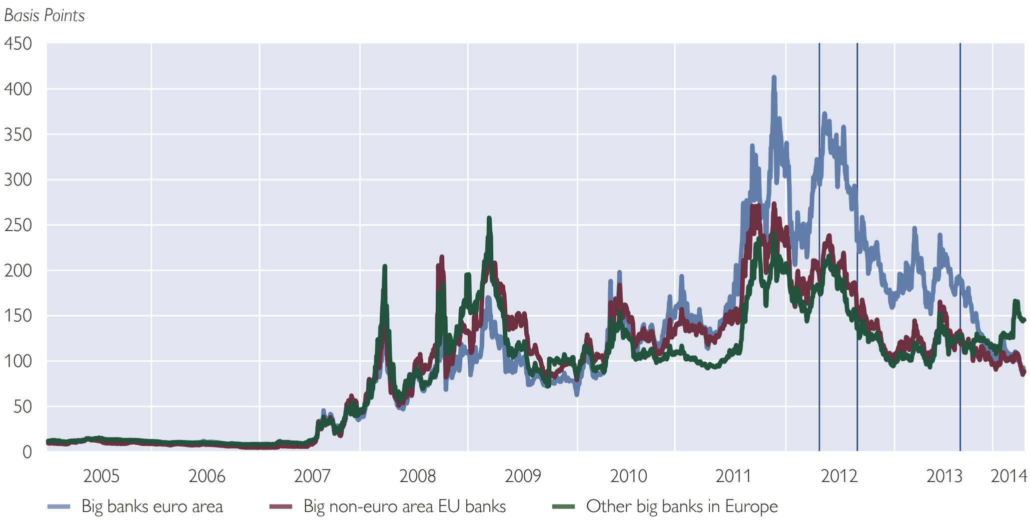
In the midst of the European sovereign debt crisis, the idea of a pan-European banking union gained momentum. In the spring of 2012, the European Commission called for the banking union, followed by a euro area summit statement. In the fall of 2012 the European Commission presented legislative proposals, with the stated objectives of breaking the linkages between Member States and their banks, increasing the credibility of the financial sector and to preserve taxpayers' money (European Commission, press release 10 September, 2012). At the time increasing the credibility of the financial sector of the peripheral euro area countries was pivotal as the capital flow out of those economies was heavy. As can be seen in chart 1 the Credit Default Swaps (CDS) spreads for all European banks declined in the summer and fall of 2012, while the spread between the CDS on euro area banks and non-euro area EU banks or other big banks in Europe did not start to decline notably until after the European Commission's press release in September. The spread between the CDS on euro area banks and non-euro area EU banks then disappears follow-

ing the announcement that the European Parliament had adopted the European Commission proposal in September 2013. This co-integration in the CDS spreads on euro area banks and other European banks indicates that the commitment to establishing a banking union has in fact increased the credibility of banks in the euro area.

The banking union is defined as based on four pillars: a single regulatory framework for financial institutions, a Single Supervisory Mechanism (SSM), a harmonized system of deposit guarantee schemes, and a Single Resolution Mechanism (SRM). In March

Chart 1

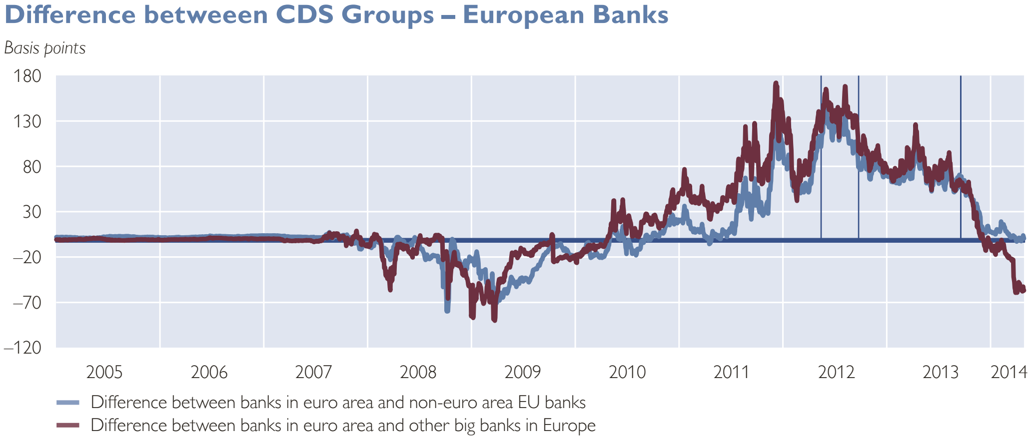
CDS Spreads – European Banks



Source: Bloomberg.

Chart 2

Differencе betweeen CDS Groups – European Banks



Source: Bloomberg.

2013[2] an agreement was reached on the SSM and in March 2014[3] an agreement was made on the SRM, while there remain differences of views on the modalities of the harmonized system of deposit guarantee schemes.

Theoretically the banking union has been proposed as a solution to the financial trilemma which had been highlighted during the financial turmoil (Hakkarainen, 2013). The trilemma refers to the mutual unattainability of financial stability, financial integration and national financial policy independence. Schoenmaker (2011) showed in a simple model of cross-border bank failures that financial stability and national financial policies were compati-

[2] *http://europa.eu/rapid/press-release_MEMO-13-251_en.htm?locale=en, retrieved on 21 July, 2014.*

[3] *http://ec.europa.eu/internal_market/finances/banking-union/single-resolution-mechanism/index_en.htm, retrieved on July 21, 2014.*

Table 1

Cross-Border Foreign Bank Claims

% of reporting country's GDP

Q4 10

Reporting country	Counterparty: DE	FR	IT	ES	UK	CH	PT	IE	GR	US	JP
DE		11.0	5.6	8.4	17.9	2.4	1.8	3.2	0.3	12.6	1.9
FR	14.2	×	6.2	5.7	21.4	2.6	0.9	1.2	0.3	16.4	5.1
IT	10.1	4.3	×	1.5	3.4	0.7	0.3	0.4	0.0	1.4	0.1
ES	0.9	2.1	0.7	×	13.8	0.8	1.6	0.3	0.0	4.6	0.3
UK	11.1	21.2	1.4	3.3	×	2.5	0.3	2.9	0.4	24.3	8.5

Q4 13

Reporting country	Counterparty: DE	FR	IT	ES	UK	CH	PT	IE	GR	US	JP
DE		8.3	2.7	4.6	13.6	1.4	0.3	1.0	0.6	6.8	0.5
FR	5.7	×	5.3	4.5	17.6	1.2	0.6	1.8	0.0	5.4	4.8
IT	7.1	3.2	×	1.3	3.4	0.3	0.0	0.2	0.2	1.6	0.1
ES	0.9	4.5	0.9	×	6.8	0.3	1.2	0.3	0.0	4.2	0.3
UK	5.5	12.1	0.5	4.1	×	1.8	0.3	1.1	1.4	11.6	5.8

- >15
- 10–15
- 5–10
- 2.5–5
- <2.5

Source: BIS, Macrobond and staff calculations.

ble only if financial integration was limited. Given the high level of financial integration in Europe he concluded that the EU had two options to solve the trilemma. The first option is to reverse the current level of financial integration, i.e. reinforcing local control by ring-fencing the cross-border operations of financial institutions, and requiring systemically important banks headquartered in other countries to operate through locally incorporated subsidiaries rather than branches. This has occurred to a certain extent during the European sovereign debt crisis as can be seen in table 1. Cross-border foreign bank claims declined substantially between 2010 and 2013 in part due to attempts by local authorities and banks to preserve financial stability at the national level instead of the pan-European level. The second option is moving financial regulation, supervision and responsibility for financial stability to the European level. Hakkarainen (2013) suggests along similar lines that there are three options: renationalizing the financial markets (losing the single markets, single currency and single monetary policy), accepting the risk of financial instability, or creating a banking union with single supervision and resolution.

The idea of the financial trilemma is akin to the much discussed monetary policy trilemma which states that with free capital mobility it is impossible to conduct independent monetary policy, unless the currency floats. Aizenman, Chinn and Ito (2010) revalued the importance of the monetary trilemma in light of the recent financial crisis. They concluded that the choice of which two of the three goals were adopted was directly related to the macroeconomic goals that had been selected. More recently Rey (2013) showed that the global financial cycle, which depends on the monetary policy in the center country, did constrain national monetary policies regardless of whether exchange rates floated or were fixed. She concluded that the global financial cycle had in fact converted the trilemma into a dilemma, where independent monetary policies have to rely on managing the capital account. In light of developments following the financial crisis it appears to be likely that the impacts of the global financial cycle are no less important for financial stability regulations than for the conduct of monetary policy.

The question to ask then is whether it is clear that a banking union is the right solution to the financial trilemma for Europe. Could the benefits of securing financial stability under national financial policies outweigh the benefits of striving for an ever more integrated cross-border financial market? Theory has not been developed sufficiently to

answer the question concerning the trade-off between these choices. More importantly for the topic addressed here, the question about who should participate in a banking union has not been answered. Should a banking union be limited to countries in a currency union with unified monetary policy, or should countries rather participate based on financial integration, irrespective of a currency union? Further, how much financial integration would make a banking union beneficial or potentially necessary?

The economic literature indicates that efficient currency unions are limited to countries that have high factor mobility and adhere to similar economic fluctuations (Mundell, 1961 and 1973). For free trade agreements the literature indicates that such agreements are most beneficial to "natural trading partners" (Krugman, 1991). Hence a trading union may be highly beneficial between countries which are far apart geographically with dissimilar economies with the exception of their connections through trade. Economic research concerning these two kinds of economic integration agreements is vast and spans decades, while research on optimal banking unions is in its early stages and somewhat lacking.

The European Commission has decided that the European banking union should include euro area countries plus non-euro area EU Member States that opt into the cooperation. Other countries will then remain outside. Elliott (2012) agrees with this decision, arguing that other options may be politically impossible. That argument is however not backed by economic research.

Outside or Inside

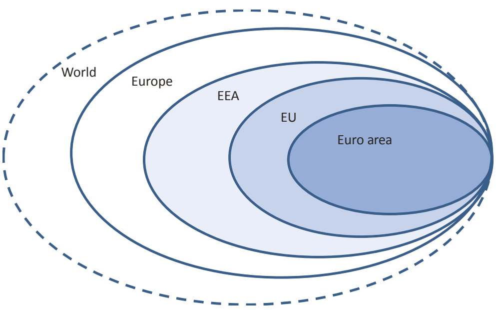
For the banking union there are levels of "outsidedness", both in respect of the euro area vs. the EU vs. EEA. vs. rest of Europe vs. others. Non-euro area EU Member States have the option of joining the banking union while EEA countries are obligated to adopt the common rulebook while they do not have the option of joining the banking union. Other countries stand completely outside.

Non-Euro Area EU Member States

There are ten non-euro area EU Member States and they make up about 26.6% of the gross domestic product of the EU. The so-called "outs" have the

Chart 3

Multinational Banks Operate Subsidiaries and Branches Not Only Cross-Borders within the EU



Source: Central Bank of Iceland.

option to participate in the banking union through a close cooperation agreement. They are however required to implement the common rulebook, and in an effort, called for especially by the UK, to protect their interest the voting rules for decision making in EBA will be strengthened to require a double majority. That is a simple majority amongst banking union member states and a simple majority among those EU Member States that opt to stand outside the banking union.[4]

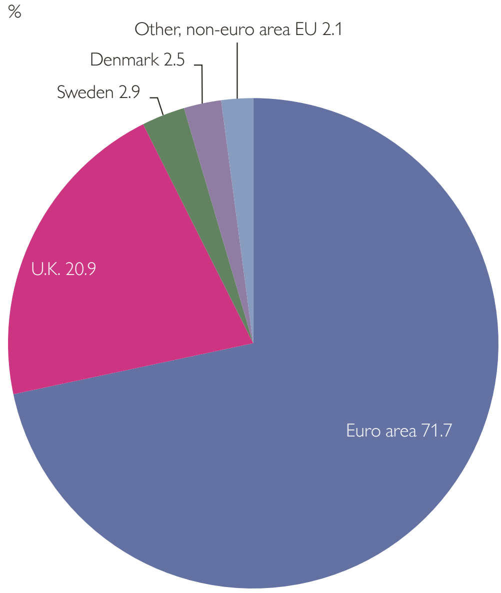
The banking union offers risk sharing, especially once the common safety nets with backstops are in place, and the aim is to ensure least-cost bank resolution. It will most likely reduce compliance costs for cross-border banks and eliminating home-host coordination issues. The quality of supervision may also improve. But there may also be costs and complications associated with opting to join the banking union. Those potentially include loss of sovereignty and less flexibility in dealing with domestic problems with micro- or macroprudential policies (Goyal et al., 2013). Additionally it is not even certain that a banking union which includes explicit and implicit safety nets and deposit insurance is even advisable in the absence of a currency union. The literature is unfortunately scarce concerning that as Giovanni Dell'Ariccia pointed out in his presentation at the 42nd Economics Conference in Vienna in 2014.

Among the non-euro area EU Member States the UK is the largest and it is home to the largest banking sector in the EU. The UK has decided not to participate in the banking union, leaving out over one fifth of all monetary and financial institutions in the EU. Given the size of the UK's financial sector, the establishment of the banking union is likely to have more extensive ramifications for the UK than for many other non-euro area EU Member States. At the same time the five largest banks in the UK have more assets outside the EU than within the EU excluding the UK. That

Chart 4

Balance Sheet of MFIs in the EU in 2013

%



Source: Bankscope.

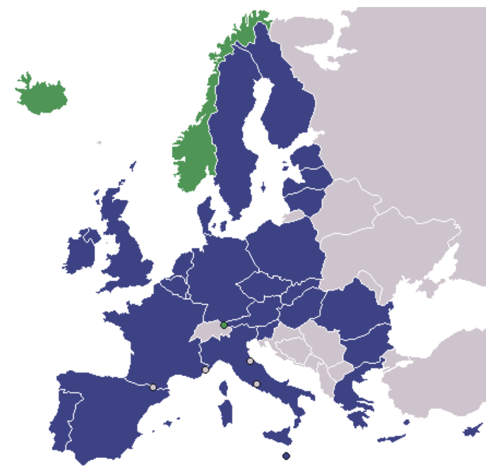
[4] *European Commission 19 March 2013, press release http://europa.eu/rapid/press-release_MEMO-13-251_en.htm, retrieved on 21 July, 2014.*

would indicate that financial integration with the rest of the world is higher than with the other EU Member States, potentially supporting the argument for the UK not joining the banking union (Schoenmaker and Siegmann, 2013).

It remains to be seen what other non-euro area EU Member States decide concerning banking union membership. It is likely that the non-euro area EU Member States en route to becoming euro countries will opt to participate in the banking union while other countries may decide by weighing the above-mentioned potential costs and benefits. Some may opt to stay outside, especially to begin with, as the UK has done.[5]

Chart 5

Member Countries of the EEA Agreement



Source: EFTA.

EEA Countries

The European Economic Area (EEA) consists of the EU Member States and three EFTA states (Iceland, Liechtenstein and Norway) and joins its members into an Internal Market governed by the same basic rules. These rules enable goods, services, capital and persons to move freely within the EEA. The EEA agreement hence covers rules pertaining to the financial market or more precisely the single rulebook. The EEA EFTA states are hence obliged to implement all EU Acquis pertaining to financial markets. This has proven to be challenging as increasingly the four European Supervisory Authorities (ESAs[6]) have been given wide-reaching powers to issue decisions that are binding for national authorities and individual market actors. This arrangement raises a number of questions relating to the EEA Agreement and poses constitutional challenges for the EEA EFTA states.[7] With regard to Iceland for example these constitutional issues are first that the implementation of the ESAs' regulations would clearly involve the transfer of sovereign powers to the EU institutions, which is incompatible with Iceland's constitution, and second that from a constitutional point of view, it would be unacceptable to leave final rulings on rights and obligations of subjects within Icelandic jurisdiction entirely, and without any judicial review by Icelandic or EFTA courts, to the ESAs. It has been tentatively suggested that an agreement on a horizontal approach within the existing EEA two-pillar structure could be reached and the EEA EFTA states are currently in talks with the EU on this.[8]

[5] *The UK's parliamentary publications (2012): http://www.publications.parliament.uk/pa/ld201213/ldselect/ldeucom/88/8804.htm#note23, retrieved on 21 July, 2014.*

[6] *ESRB, EBA, ESMA, EIOPA.*

[7] *European Economic Area Joint Parliamentary Committee (2013).*

[8] *European Economic Area Joint Parliamentary Committee „The future of the EEA and the EU's relations with the small-sized countries and Switzerland" CO-rapporteurs: Paul Rübig (EPP, Austria) Svein Roald Hansen (Labour Party, Norway). 30 May, 2013.*

A more relevant issue in this context is the exclusion of the EEA EFTA countries from the banking union at the same time as the EEA agreement supports legally a high degree of financial integration that gives the EEA countries few choices when it comes to solving the financial trilemma problem. The authorities seem to face the dilemma of having nationally financial policy independence and the EEA agreement may make it difficult to limit financial integration, which according to theory may come at the cost of financial stability.

It is accepted in Iceland that the international expansion of the domestic banking system and unrestricted capital movements in the years prior to the financial collapse in conjunction with a lack of cross-border supervision and more importantly a lack of credible backstops was one of the main causes of the failure of the big banks. The so-called passport that the EEA agreement gave the domestic banks turned out to be costly for the economy. The risks have been largely unchanged since prior to the crisis and an establishment of a European banking union does little to mitigate them. It is hence left up to the EEA EFTA countries to deal with the risks within the framework of current international agreements. Currently risks are managed in Iceland with capital controls but it has been stated by the Central Bank of Iceland that one of the prerequisite to lifting the capital controls is the implementation of a number of prudential rules aimed at mitigating risks arising from unrestricted capital movements (Central Bank of Iceland, 2012). This is an attempt to solve the financial trilemma within the given framework and to maintain financial stability, which is one of the objectives of the Central Bank of Iceland.

Others

There seems to be little concern about the potential effect of the banking union in non-EU and non-EEA countries. Little discussion is taking place about the banking union and there is little if any literature on the potential effect of the banking union on non-EU or EEA member states.

Issues to Consider for Outsiders

It may be worth looking at some potential issues that countries outside the banking union may have to think about. There is little research on this so the

points mentioned below may be seen as motivation for further research and the discussion remains at this time incomplete.

- *Competitiveness and financing costs of euro area banks vs. outsiders*

Will banks within the banking union have a competitive advantage? The potential competitive advantage may come about due to the market perceiving supervision as being enhanced within the banking union and also due to the increased credibility of the explicit and implicit safety net and backstop for the banks.[9] The credibility of the supervision, safety nets and backstop will be based upon the credibility of the ECB and the fiscal situation in the euro area countries combined. Financing costs may hence decline for some banks as the creditworthiness of individual banks may be lifted above the *sovereign cap*, thus exceeding the creditworthiness of their home member state. It may hence become possi-

ble, given that the safety nets become credibly independent of the status of the sovereign of individual countries, that a bank will be able to finance itself at a lower cost than the bank's home country.

Initially market reaction does indicate that financing costs will indeed decline for members of the banking union as charts 1 and 2 show. Further research is needed to substantiate whether banks in the participating countries will in fact enjoy a discount on their financing. However, increased competitiveness of banks within the banking union is not guaranteed with lower financing costs only. It may still be the case that due to – for example – an increase in supervisory burdens competitiveness would not increase. One potential way to estimate the industries' view on the benefits of the banking union is to monitor the behavior of outside banks within the banking union. If outside banks will strive to become a major subsidiary, which means they will become a part of the banking union supervision and safety nets, it can be deduced that they believe that the benefit of becoming an insider outweighs the costs.

- *International cooperation*

There are potential pros and cons here for outsiders. For home-host supervisory and resolution cooperation for cross-border banks outsiders will now only have to deal with one consolidated supervisor and resolution authority. This will increase effectiveness in dealing with cross-border matters. However, there may be a risk of competence creep, as the ECB may be in the position to exert more authority than authorities from individual Member States are able to exert.[10]

- *Small fish in a big pond*

As the three large Icelandic banks grew bigger much of the growth occurred via expansion into foreign markets, most notably other European markets. The banks were small in all of these countries, staying well below the radar of the national supervisory authorities until it was too late. At the same time the banks became too large for Iceland. There is a risk that this problem has been elevated by enlarging the supervisory area to the whole euro area. Branches and subsidiaries set up by banks from small countries outside the euro area may become very large relative to their home country while they will not reach the status of a major subsidiary and hence will not fall under the common supervision, resolution and

[9] *Pentti Hakkarainen (2013).*

[10] *UK Parliamentary Publications (2012).*

deposit insurance. This is something outsiders will have to be mindful of, especially those who have banks that have the European passport such as non-euro area EU Member States and the EEA EFTA countries.

• *Financial flows and financial stability*

Government supervision and implicit and explicit safety nets provide crucial support for private banking firms. During periods of financial calmness a small price is placed on credible supervision, resolution and deposit insurance. During periods of financial turmoil this changes. These fluctuations in market sentiment toward the importance of financial supervision and credibility of explicit and implicit backstops may have a great effect on capital flows. If the banking union will result in a credible supervisor, resolution and deposit insurance for the euro area banking sector, then there is the risk that outsiders who cannot match that credibility will experience increased fluctuations in financial flows. During times of calmness or complacency toward financial risks financial flows will be based on prices, with little concern for supervision and safety nets. A few basis point differences in the pricing of financial assets will entice investors. However, once market scrutiny turns to potential risks, funds will flow to countries with more credible supervision and backstops. This may increase financial fluctuations in countries that stand outside the banking union.

It is important for outsiders to strive to maintain supervision as credible as it is within the banking union. Additionally, what is potentially more important, is to maintain the same credibility in the safety nets and backstop behind the financial system. It is hence pivotal that the financial system will not outgrow the explicit or implicit safety nets and backstops in place. This may prove to be a challenging task for national micro- and macroprudential supervisors as they will have to restrain the economy from making the most of potential capital inflows in times of complacency. Immoderate capital inflows, which are often accompanied with a rapid growth of the domestic financial system, raises domestic asset prices, exchange rates, imports and over all domestic demand. It magnifies economic growth. The supervisors will have to remove the punchbowl once the party gets going, or else risk an abrupt capital reversal where capital will flow to countries where supervision and explicit and implicit safety nets are credible.

• *Will big euro area banks get bigger?*

The banking union widens the borders of the home market for banks within the union. A bank which has a large balance sheet compared to the GDP of e.g. the Netherlands, Spain or Ireland, does not appear nearly as big when compared to the GDP of the euro area, or the EU. Helmut Ettl pointed this out in his presentation at the 42nd Economics Conference in Vienna in 2014. For example, the balance sheet of the largest bank in Ireland is now over 200% of Ireland's GDP, while it will be well below 5% of the GDP of the euro area. The largest banks in the euro area have total assets only amounting to little over 20% of the total GDP of the euro area. This may cause complacency while the banks which may have already been large when compared to their home countries, grow until their balance sheets become large when compared to the euro area GDP. One of the lessons of the recent financial crisis is that in fact banks which are labelled as "too big to fail" or even "too big to rescue" are simply "too big," period. A change in point of reference to the GDP of the euro area potentially escalates the problems that eventually may appear if banks can grow significantly under the single supervisory mechanisms. One hindrance to the growth of banks has in fact been the differences in supervisory regulations between countries and the capability of individual countries' implicit and explicit safety nets. The full banking union will remove these hindrances to growth. The likelihood is then that large banks will grow larger. The potential risks associated with banks within the banking union becoming "too big" before they run into serious trouble are grave both for countries within the banking union and outside it.

Conclusions

The creation of the banking union is a step in the direction of increased financial and economic integration in the euro area. Potential effects of the banking union on those standing outside have not been adequately researched. Theoretical and empirical research may not be available for a number of years. The issues mentioned here concern competitiveness, international cooperation, big banks and financial stability for outsiders. Most of them rely on the premise that the banking union will improve supervisory quality and increase the credibility of safety nets and backstops within the euro area. Outsiders will then have to strive to match that quality and credibility of financial supervision, which will hopefully bring us a financial system that supports growth with financial intermediation and is at the same time more resilient during times of financial turmoil.

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