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How Does Differentiated Integration Work in the EU Financial Sector? Spotlight on Banking Union

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Abstract

Five years after the entry into force of the Banking Union, this Policy Paper assesses its effectiveness as a form of differentiated integration. This case study presents the legal and organisational dimensions of the Banking Union and describes its accountability mechanisms and procedures. At the heart is the question of whether the creation of the Banking Union has been effective in promoting integration among its members while avoiding distortions in the Single Market. To this end, also the impact of the Banking Union on the political unity in the European Union is analysed. This Policy Paper finds that the Banking Union has enhanced European integration in the financial sector without jeopardising the functioning of the internal market. Although the Banking Union is still incomplete, the benefits of participation create centripetal forces that are attractive also to non-euro countries.

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Executive summary

The Banking Union is one of the most recent examples of differentiated integration. Experience from the first five years since its inception allows us to draw up a first assessment on whether the Banking Union has been effective in promoting integration among its members while avoiding distortions in the Single Market.

This Policy Paper finds that the Banking Union has enhanced European integration in the financial sector without jeopardising the functioning of the internal market. Thanks to its institutional setup and legal safeguards, the Banking Union did not aggravate the initial differentiation between euro-area and non-euro area member states. The Banking Union was successful in containing the euro area sovereign debt crisis and contributed to a more viable banking sector. However, the doom loop was not removed and financial fragmentation continued.

Despite its limited track record, the Banking Union is attractive to non-euro countries as highlighted by the membership applications of Croatia and Bulgaria. Both countries perceive the reputational gain from participating in the Banking Union as beneficial for their economies and for their perspective to adopt the euro at a later stage. The withdrawal of the UK from the EU makes Denmark and Sweden rethink their official stance. This Policy Paper shows that the Banking Union's participation terms are sufficiently outsider-friendly and together with the economic benefits of joint supervision make a strong case for joining. Completing the Banking Union by resolving its internal shortcomings would make participation even more appealing for both outsiders and insiders.

The case of the Banking Union demonstrates that the more effective a given differentiated integration arrangement is, the more attractive it will be to non-participating member states, with the consequence of enhancing the political unity of the European Union. Therefore, this Policy Paper recommends to fully supra-nationalise not only bank supervision but also resolution and deposit insurance. Greater credibility of the bail-in tool will strengthen the banking sector in the Banking Union and thus encourage non-participating member states to join.

Introduction

When the Banking Union was set up in 2012 among only EU member states whose currency is the euro, this was a novelty for the Single Market – previously, financial market regulation had always been an area of uniform EU integration (Schimmelfennig 2016: 484). The Banking Union is a very prominent example of functional, sector-specific differentiated integration (Ferran 2017) and potentially temporal since in principle all EU member states have the possibility to join. By granting non-euro area EU member states the option to voluntarily participate at a later stage, the Banking Union was expected to play an integration-deepening role not only within the euro area but also for the EU as a whole. It was essential that the Banking Union did not jeopardise the Single Market; and in fact it was designed to reinforce it and eventually create positive spillover effects in the European integration dynamics. When the European Commission put forward its legislative proposals, the explanatory memorandum was very clear on these objectives:

"The creation of the banking union must not compromise the unity and integrity of the single market which remains one of the greatest achievements of European integration. [...] The single market and the banking union are thus mutually reinforcing processes." (European Commission 2012: 4).

Five years after the entry into force of the Banking Union, this Policy Paper assesses its effectiveness as a form of differentiated integration. At the time of writing, the Banking Union still consists of the 19 euro area countries. Two non-euro area countries which are on their way to adopting the euro, Bulgaria and Croatia, will join the Banking Union on 1 October 2020 while Sweden and Denmark are seriously considering a possible participation. Section 1 makes the case for creating the Banking Union by taking the euro area countries as a starting point. Section 2 looks at the legal and organisational dimensions of differentiated EU integration through the Banking Union. Section 3 describes the accountability mechanisms and procedures of the Banking Union's central actors. Section 4 examines the question which is at the heart of this case study: Has the creation of the Banking Union been effective in promoting integration among its members ("problem-solving capacity") while strengthening the Single Market and avoiding economic distortions or political fragmentation? Finally, Section 5 analyses the legal safeguards maintaining political unity and discusses the forces attracting or discouraging non-participating member states.

1. The case for creating the Banking Union

As the Great Financial Crisis of 2007/2008 evolved into the euro area sovereign debt crisis in late 2009, it aggravated the "vicious circle" between ailing banks and struggling sovereigns.[1] To break the sovereign–bank nexus of the particularly interdependent euro area countries, the time was ripe for deeper integration of their banking policies. Consequently, at the peak of the euro crisis, the European Council agreed in 2012 to establish the Banking Union, transferring large parts of supervisory and resolution competences from the euro area countries to the European Central Bank (ECB) and to the newly created Single Resolution Board (SRB). Non-euro area countries had preserved their competence in national monetary policies and thus did not feel similar pressure to overcome the "doom loop" by supra-nationalising banking supervision and resolution. This explains why the EU currently shows a differentially integrated system of EU banking policies where not all EU member states are participating in the Banking Union (Gren 2014: 71). However, as we will see in Section 5, the advantages of joint supervision and centralised resolution of banks are attractive also to non-euro area EU member states.

1 A vicious circle between banks and sovereigns arises when banks are exposed to domestic sovereigns because of excessive holdings of government bonds, and sovereigns in turn are exposed to domestic banks since governments ultimately bear the risk to support struggling banks if alternative measures are exhausted. The negative feedback loops between sovereigns and banks are discussed in greater detail by Altavilla et al. (2016) or Alogoskoufis and Langfield (2019).

2. Legal and organisational dimension of differentiated integration through the Banking Union

The Banking Union was supposed to foster financial stability by improving prudential supervision, avoiding public bailouts of credit institutions and protecting bank depositors (European Commission 2012). In the pursuit of these objectives, the President of the European Council, Herman van Rompuy, initially envisaged a safety net based on three pillars: centralised supervision, a common resolution framework for failing banks, and joint deposit insurance (Van Rompuy et al. 2012). This section will introduce the three pillars of the Banking Union and elaborate how they are intertwined with the rules and supervisory authorities of the Single Market.

Box 1 | The Banking Union as a form of differentiated integration in the EU

The Banking Union is a form of differentiated integration since participation is mandatory for euro area countries only. However, the scope of the Banking Union is not necessarily congruent with the eurozone since non-euro area countries can voluntarily participate in the Banking Union by establishing "close cooperation" between the national competent authority and the ECB (Article 7 SSM Regulation). The ECB then takes over direct supervision of significant institutions whereas the national competent authority maintains direct supervision of less significant institutions. Within this Single Supervisory Mechanism (SSM), all significant institutions are supervised by joint supervisory teams with staff from ECB and national competent authorities. By entering into close cooperation with the ECB, participating non-euro area member states automatically become part of the Single Resolution Mechanism (Article 4 SRM Regulation). Non-euro area countries not participating in the Banking Union collaborate with the ECB through "ordinary cooperation" for which Article 3 SSM Regulation requires the conclusion of bilateral memoranda of understanding.

2.1 The three pillars of the Banking Union

The first pillar of the Banking Union to be set up was the Single Supervisory Mechanism (SSM) which became operative on 4 November 2014. Regulation (EU) No 1024/2013 (SSM-Regulation)[2] made the ECB the "institutional hub" of the SSM (Ferran 2017: 254) by directly supervising all "significant" institutions[3] in the Banking

2 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, http://data.europa.eu/eli/reg/2013/1024/oj.

3 Significant institutions are those credit institutions and investment firms whose total value of assets exceeds 30 billion euro, or whose ratio of total assets over domestic GDP exceeds 20 per cent, and in any case the three largest credit institutions in each participating member state.

Union which to date comprises all 19 euro area countries. All other institutions qualified as "less significant" remain under direct supervision of national competent authorities. However, the ECB is empowered to decide to exercise direct supervision over them at any time.

As second pillar, the Single Resolution Mechanism (SRM) and the Single Resolution Fund (SRF) were established on the basis of Regulation (EU) No 806/2014 (SRM-Regulation)[4] and the Intergovernmental Agreement No 8457/14 (SRF Agreement)[5] adopted by all EU member states except Sweden and the United Kingdom. The SRM is centred around a newly created EU agency, the Single Resolution Board (SRB), which fully assumed its resolution authority on 1 January 2016. The Board's mandate does not only comprise the significant banks under ECB supervision but extends also to other cross-border groups established in the Banking Union. Its task is to draw up resolution plans for institutions under its remit – that is, plans to wind down failing banks in an orderly manner – and, if needed, to decide on the application of resolution tools and the use of the common fund (SRF). In case of a bank failure, the Board decides whether resolution is in the public interest – and therefore a contribution from the SRF could be warranted – or whether the bank can be wound down under normal insolvency proceedings.

In contrast to the ECB exercising direct power over individual banks within the SSM, the SRB relies for the implementation of its decisions on national resolution authorities (Article 29 SRM-R). However, if a national resolution authority does not apply or comply with a decision, the EU resolution authority may address executive orders directly to an individual institution. The common fund (SRF) is gradually built up until 2024 by contributions from the credit institutions in the member states participating in the Banking Union. To avoid a situation where, under extreme circumstances, the SRF is depleted, the Eurogroup on 4 December 2019 agreed in principle to allow the European Stability Mechanism (ESM) to act as a backstop and lend the necessary funds to the SRF to finance a resolution (Centeno 2019). While the backstop is to be introduced by 1 January 2024 at the latest, the corresponding amendments to the ESM Treaty still need to be signed and ratified by all euro area member states. If non-euro area member states join the Banking Union, the ESM and non-euro area member states will together provide the common backstop to the SRF, through parallel credit lines (Article 13 ESM 2019).

A European Deposit Insurance Scheme as third pillar of the Banking Union is a work under progress. As long as deposit insurance remains purely national, national deposit guarantee schemes remain vulnerable to large local shocks and member states' budgets continue to be exposed to risks in their respective banking sectors. A joint deposit insurance fund, managed under the auspices of the Single Resolution Board, would thus increase the resilience of the Banking Union against future crises. While the European Commission on 24 November 2015 submitted a legislative

4 Regulation (EU) No 806/2014 of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund..., http://data.europa.eu/eli/reg/2014/806/oj.

5 Agreement on the transfer and mutualisation of contributions to the Single Resolution fund, 14 May 2014, http://register.consilium.europa.eu/pdf/en/14/st08/st08457.en14.pdf.

proposal to establish the European Deposit Insurance Scheme, the legal process is halted, pending an agreement within the Council and the European Parliament. Consequently, the Banking Union is still lacking a mechanism to prevent bank runs and deposit flights out of countries hit by a sovereign debt crisis.

2.2 The Banking Union within the Single Market

The legal acts establishing the Banking Union were agreed by, and are open to the participation of, all EU member states (Schimmelfennig 2016: 490). While the Banking Union does not necessarily comprise all EU member states, it is closely intertwined with the Single Market through the rules and supervisory authorities building the EU framework for banking activities throughout the EU.

2.2.1 Single Rulebook for EU financial regulation

While the establishment of the Banking Union created a new club within the Single Market, its institutions and arrangements are bound by the "Single Rulebook" applicable across all EU member states. The Single Rulebook aims for a unified regulatory framework for the entire EU financial sector. It is mainly built on four legislative acts which primarily followed recent reforms of public international banking law driven by the Great Financial Crisis (Gortsos 2019: 22). The EU regulatory framework applies to the ECB and the SRB like it does to any other national competent supervisory or resolution authority in the EU.

In 2013, the European co-legislators adopted the Capital Requirements Directive IV[6] and the Capital Requirements Regulation[7] prescribing banks' prudential capital requirements. Regarding banking resolution, the Single Rulebook is governed by the Bank Recovery and Resolution Directive (BRRD)[8] prescribing measures for bank crisis prevention and crisis management. Mirroring the rules governing the SRB, the BRRD stipulates the conditions for bank resolution and the corresponding resolution tools to be applied by national resolution authorities. Both the SRM Regulation and the BRRD require that first shareholders, bondholders and uninsured depositors absorb losses of failing banks (bail-in) in order to reduce the need to bail out banks with public money (Article 32 BRRD, Article 18 SRM-R). The resolution framework tries to prevent taxpayers from carrying the financial burden of failing banks and aims to avoid negative repercussions on other banks and financial markets (Türk 2019: 53). Within the Banking Union, it is the SRB that applies the bail-in tool in accordance with the BRRD. The operation of national deposit guarantee schemes is outlined in the

6 Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms..., http://data.europa.eu/eli/dir/2013/36/2018-07-09.

7 Regulation (EU) No 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms..., http://data.europa.eu/eli/reg/2013/575/2020-06-27.

8 Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms..., http://data.europa.eu/eli/dir/2014/59/2020-01-07.

Deposit Guarantee Scheme Directive.[9] It requires member states to set up deposit guarantee schemes covering 100,000 euro per depositor per credit institution in the case of a bank failure.

All the legislative acts quoted above are complemented by the European Banking Authority – see below – which produces Binding Technical Standards and develops the non-binding "Single Rulebook Q&A" providing guidance on the practical implementation of the Single Rulebook.

2.2.2 European System of Financial Supervisors

Beyond the regulatory framework, the Banking Union is embedded in the European System of Financial Supervisors that was established after the global financial crisis had highlighted the lack of harmonised prudential regulation and coordinated supervision among EU member states. Following the recommendations of the "De Larosière Report" (Larosière 2009) a new body was created to oversee the EU's financial system – the European Systemic Risk Board (ESRB) – and a new EU authority to supervise the banking sector – the European Banking Authority (EBA). As regulatory authority, the EBA is contributing to the development of the Single Rulebook and fostering convergence of supervisory practices. The ESRB added macro-prudential oversight to the newly established European safety net with the aim to prevent or mitigate systemic risks for financial stability in the EU (Gortsos 2019: 32).

2.2.3 Third-country dimension

The provisions of EU banking law mainly apply to EU credit institutions and investment firms, but (partially) also to the establishment and operation of subsidiaries of non-EU credit institutions in EU member states (Gortsos 2019: 20). All institutions established in the European Economic Area (EEA) benefit from passporting rights allowing them to provide services throughout the EU, either directly from their home country or via branches established in another member state. Looked at another way, this means that non-EEA institutions are required to set up a fully fledged local subsidiary on EU territory to provide banking services within the EU. While the EEA countries Iceland, Liechtenstein and Norway are part of the Single Market, as non-EU Members they cannot join the Banking Union. Beyond passporting rights for institutions established in the EEA, there are no relevant equivalence provisions in EU banking legislation that would allow institutions from third countries (like the United Kingdom in the case of a hard Brexit) to access the Single Market (Duvillet-Margerit et al. 2017). Individual EU member states can allow institutions from third countries to open branches, but only within their own territory.

9 Directive 2014/49/EU of 16 April 2014 on deposit guarantee schemes (recast), http://data.europa.eu/eli/dir/2014/49/2014-07-02.

3. Accountability mechanisms and procedures in the Banking Union

When creating the Banking Union, the very idea of elevating supervisory and resolution tasks to the European level was to remove them from political influence which in the past had entailed supervisory forbearance and public bailouts of banks.[10] Since the transfer of banking supervision and resolution competences to the ECB and the SRB entrusted them with significant responsibilities (Teixeira 2019: 144), it seems warranted to analyse whether the shift of power to the European level was accompanied by the establishment of appropriate accountability arrangements.[11]

The multi-level accountability mechanism in the Banking Union can be considered as a novelty in European law: for the first time, both the European Parliament and national parliaments exercise democratic control over the same European institutions and bodies (Teixeira 2019: 146). Article 20 SSM-R (Article 45 SRM-R) stipulates the reporting requirements that the ECB (SRB) must follow with regard to other EU institutions such as the European Parliament and the Council, while Article 21 SSM-R (Article 46 SRM-R) governs the interaction of the ECB (SRB) with national parliaments. While the multi-level accountability mechanism is innovative and extensive, the mere existence of a multitude of accountability procedures does not necessarily equate with substantively holding the ECB and the SRB to account (Dawson et al. 2019: 86). Practical experience with the European Parliament's right to hold the ECB to account shows that Members of the European Parliament ask numerous questions but hardly challenge the ECB's conduct or scrutinise the ECB's achievement of the objectives of the SSM (Maricut-Akbik 2018).

The underlying issue at the heart of the balancing act is the trade-off between independence and accountability. Independence was enshrined in the founding regulations of both the SSM (Article 19 SSM-R) and the SRM (Article 47 SRM-R) whereas the independence of the ECB as an EU institution is additionally enshrined in the Treaties and thus more far reaching than that of the SRB as an EU agency. However, the rationale for independence that is widely accepted for central banks' monetary policy is contested when it comes to banking supervision. Still, the fact that we have a Banking Union with democratic feet of clay becomes most obvious in the exclusion of the European Parliament from the set-up of the SRF. Due to German

10 Acknowledged in Recital 6 SSM-R: "The stability of credit institutions is in many instances still closely linked to the member state in which they are established. Doubts about the sustainability of public debt, economic growth prospects, and the viability of credit institutions have been creating negative, mutually reinforcing market trends. This may lead to risks to the viability of some credit institutions and to the stability of the financial system in the euro area and the Union as a whole, and may impose a heavy burden for already strained public finances of the member states concerned."

11 For the purpose of this section, accountability is defined as "a relationship between an actor and a forum, in which the actor has an obligation to explain and to justify his or her conduct, the forum can pose questions and pass judgement, and the actor may face consequences" (Bovens 2007: 450). Legitimacy goes beyond the concept of accountability by comprising the "beliefs within a given constituency or other relevant audience that a political institution's exercise of authority is appropriate" (Tallberg and Zürn 2019: 585).

reservations against the mutualisation of financial losses from bank failures, the requirement to make contributions to the SRF remained with the member states and the SRF was concluded outside the Treaties as an intergovernmental agreement (Ferran 2017: 266), thus beyond the European Parliament's control. It can be argued that this severe clash of democratic representation cannot be resolved by accountability (Möllers 2019). However, when looking at the political and economic conditions that shaped the Banking Union, one has to confess that "it is […] unclear which solution could be accepted as enjoying a satisfying degree of democratic legitimacy" (Möllers 2019: 207). Given the controversy about the Banking Union's legal fundaments anchored partly outside of the EU framework of common market legislation, achieving fully fledged legitimacy would be tantamount to squaring the circle.

4. Effectiveness: Problem-solving capacity of the Banking Union

By harmonised supervision, common resolution and joint deposit insurance, the Banking Union wanted to break the vicious circle between financial and sovereign debt posing an existential threat to the euro area and its single currency. Thus, in order to evaluate the problem-solving capacity of the Banking Union, this section analyses whether it has delivered on its promise to remove the sovereign–bank nexus for the euro area countries and whether it has succeeded in avoiding any inconsistencies between the EU member states participating in the Banking Union and those not participating.

4.1 Banking supervision

With regard to banking supervision, one can observe that institutions have become safer and sounder since the inception of the SSM: banks built up additional capital to absorb potential losses and improved their asset quality (Angeloni 2020: 4-9). The high quality of supervision carried out by the SSM is also acknowledged by member states not participating in the Banking Union (Task Force Concerning Denmark's Possible Participation in the Banking Union 2019: 5). However, the doom loop could not be eliminated: "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" (Angeloni 2020: 13). Likewise, banking integration has only made limited progress since the launch of the Banking Union (Angeloni 2020: 21) and the market consolidation, necessary to help euro area banks to become more profitable and competitive, has not taken place (Schweitzer 2019: 131). A central reason for the insufficient progress in this regard is that supervision is not as strict as it should be because it cannot rely on a strong mechanism dealing with failing banks (Angeloni 2020: 58). The misfunctioning of the crisis management framework will be discussed in the following section.

While the objectives of joint supervision via the SSM have not all been translated into practice yet, the experience with the interaction between ECB and EBA dispels concerns about possible disintegration in the Single Market. The risk of a two-tier EU bank regulatory and supervisory system leading to inconsistencies for banks established inside and outside the Banking Union (Gren 2014: 77) did not materialise. In the absence of formal coordination mechanisms, one reason for the generally smooth cooperation between ECB and EBA might be that their experts have interacted in different international bodies and policy networks and may thus "share a regulatory and supervisory 'esperanto', which should help them to formulate a consistent policy approach between the Single Market and the Banking Union" (Gren 2014: 80-81).

4.2 Bank crisis management

As far as the bank crisis management of the Banking Union is concerned, the SRB is engaged in resolution planning of the banks under its remit and requires them – in line with SRM-R and BRRD – to build up adequate loss absorbing capacity (Minimum Requirement for own funds and eligible liabilities, MREL) to avoid negative feedback loops in case of bank failure. However, data recently published (EBA 2020: 15) shows that close to half of the banks are not meeting their end-state minimum requirement for loss absorbing capacity (MREL). Thus, if they fail before reaching the end of their respective transition period, an orderly wind-down cannot be guaranteed which in turn poses severe contagion risks for the financial system. The SRF, still being built up and not yet relying on a fiscal backstop, is insufficient to plug the gap. Consequently, "the risk of Member States being required to use public funds for financing the resolution of banks is real, particularly, where there is a cross-border element" (Türk 2019: 57). Or put differently, "the link between banks and the state that the SRM meant to sever is still alive" (Schweitzer 2019: 132).

Past experience highlights that despite the entry into force of the BRRD and the entry into office of the SRB, the handling of bank failures hardly followed the "standard script" (Angeloni 2020: 33) of resolution or wind-down under normal insolvency proceedings. In the vast majority of bank failures since 2015, member states ingeniously exploited the loopholes in the legal framework and circumvented the application of bail-in or even the involvement of the SRB. For fear of triggering contagion in the financial system or putting losses on uninsured depositors, member states opted for bailing out banks with public money.[12] Only in the case of the Spanish Banco Popular did the SRB decide resolution to be in the public interest, and required shareholders and bondholders to take a hit before the failing bank was sold to the Spanish competitor

12 The Italian Banca Monte dei Paschi di Siena benefitted from precautionary recapitalisation which does not involve the SRB but only the European Commission verifying that the strict conditions of extraordinary public support (Article 32 paragraph 4 letter d BRRD) are fulfilled. For Banca Popolare di Vicenza and Veneto Banca, the SRB declared no public interest in resolution of these two regional banks which subsequently received public liquidation aid under the Italian insolvency regime. Italy's Banca Carige received support from the voluntary arm of the Italian deposit guarantee scheme, not triggering SRB involvement or bail-in. Germany's NordLB and Portugal's Caixa Geral de Depositos both were recapitalised with taxpayers' money, but the European Commission qualified the respective interventions as "market-conform", so officially no state aid triggering bail-in and resolution was granted.

Banco Santander.

To sum up, the harmonisation of national bank resolution practices that the SRM was supposed to deliver in the Banking Union has occurred only to a limited extent (Quaglia 2017: 16-17). Still, it is not only EU member states participating in the Banking Union that have found ways to circumvent the bail-in rules enshrined in the EU-wide applicable BRRD. Member states not participating in the Banking Union have also invented creative solutions to bail out institutions located on their territory (Andersen et al. 2017). In this regard, one has to observe that the creation of the SRB did not create an uneven level playing field between EU member states participating and not participating in the Banking Union. However, within the Banking Union, the misfunctioning of the bank crisis framework perpetuated the existing divisions between countries: on the one hand, we have states in the periphery of the euro area with vulnerable banks which weren't bailed out during the financial crisis and which haven't been resolved after the entry into force of the BRRD for fear of incalculable risks to the financial markets and national budgets; on the other hand, countries in the centre of the euro area that bailed out ailing banks in the financial crisis with the result of making them more robust and competitive (Quaglia 2017: 21-22).

The crisis management framework was meant to be completed by a joint European Deposit Insurance Scheme. While the Banking Union's third pillar is lacking, the Deposit Guarantee Scheme Directive harmonised the operation of national deposit insurance schemes. The EBA is monitoring that all EU member states gradually fill up their national schemes to the agreed target level and thus ensures a level playing field within the EU. The recent case of the institutional protection system of the German savings banks (Storbeck and Arnold 2020) shows the supplementing pressure that the ECB exerts on the banking groups under its remit – even indirectly supervised ones – to come in line with the Deposit Guarantee Scheme Directive rules that apply across all EU member states.

4.3 Comparison with "ideal solution" benchmark

The previous sections presented in detail how the Banking Union has produced some negative effects in the euro area periphery by elevating supervision but not resolution and deposit insurance on the European level (Quaglia 2017: 18). In order to assess better the problem-solving capacity of the Banking Union, this section makes a comparison with the hypothetical best solution (Lavenex and Križić 2019: 11) that leading experts regard as attaining the desired goals. As outlined above, the Banking Union that was eventually set up between 2012 and 2014 is different from the one that was originally envisaged in 2012, and remains somehow incomplete (Quaglia 2017: 2).[13] Thus, despite the establishment of the Single Resolution Mechanism,

13 The resolution pillar rests on an SRF with insufficient volume and lacking a fiscal backstop to handle the failure of bigger banks at the European level. Distrusting the ability of the SRM to deal with distressed banks, member states prefer to bypass resolution at the European level and deal with bank failures at the national level instead. Institutions whose resolution is deemed by the Single Resolution

there is no solid safety net at the European level to cushion the failure of significant banks. In turn, the weakness in the SRM crisis management framework is preventing strict banking supervision by the SSM: "Without a workable resolution framework, supervision cannot act timely and decisively, because it may itself become a source of risk" (Angeloni 2020: 29).

Since bank supervision and crisis management complement each other (Recital 11 SRM-R), the "ideal solution" for the Banking Union would have been to establish a fully fledged bank resolution pillar. This would mean to empower the SRB to put all failing significant banking groups into resolution irrespective of any public interest test and by this exclude them from national interventions. To prevent any inconsistencies among member states when winding down less significant banks, national insolvency laws would need to be harmonised. Alternatively, the SRB should be entrusted to oversee national insolvency proceedings for less significant banks that do not fall under its remit to ensure a minimum level of harmonisation. Moreover, the SRF would need to be topped up to a level comparable to the funds available to the US Federal Deposit Insurance Corporation. The SRF should, as soon as possible, be backed up by a credit line from the ESM to dispel any doubts about insufficient funding. Finally, a European scheme protecting bank deposits should be created to effectively prevent contagion risks at the national level. Equipped with these instruments and firepower, the BRRD/SRM-R bail-in tool would be more credible and the SSM could be more rigorous in forcing weak banks to exit the market. While these changes amount "to a 'Copernican revolution' with respect to the present approach" (Angeloni 2020: 34), they would radically increase the attractiveness of the Banking Union for both the member states already participating and those considering joining. Last but not least, the Banking Union would benefit from an improved accountability mechanism enhancing democratic control: the intergovernmental agreement establishing the SRF should be integrated into the legal framework of the EU to no longer exclude the European Parliament; and the ECB and SRB should become more transparent towards the European Parliament and the general public without compromising banks' business secrecy.

5. Impact on European Union's political unity

The creation of the Banking Union marked a major step towards deeper integration in the field of financial policy but at the same time increased differentiated integration among EU member states. While the falling apart of the model of a united Europe is an inherent risk in every step of differentiated integration, the concern that the Banking Union launched with euro area countries only would perpetuate or even deepen the

Board not to be in the public interest are wound down under national insolvency law which is not harmonised across member states. The joint European deposit guarantee scheme is still under discussion, although the failure of a large bank risks to overstrain national deposit insurance schemes potentially causing troubles for other banks which are required to fill the financial gap in the national systems.

initial differentiation and put “the EU onto a slippery slope” (Schimmelfennig 2016: 499) was not confirmed. This section will demonstrate that the positions advocated by national governments are shaped not only by quantifiable net welfare gains but depend also on indirect costs and benefits.

5.1 Legal safeguards addressing disintegration risks for non-participating member states

The Banking Union’s legal framework features several safeguards preventing differentiation from causing distortions in the Single Market (Ferran 2017: 253).

First, both SSM-R and SRM-R contain unity-protection provisions requiring the ECB and the SRB to refrain from any “action, proposal or policy” that would discriminate against any member state or group of member states (Article 1 SSM-R), nationality or place of business (Article 6 SRM-R). Both bodies are obliged to respect the interest of member states participating and not participating in the Banking Union (Article 17 SSM-R, Article 6 SRM-R) and shall carry out their work “with full regard and duty of care for the unity and integrity of the internal market” (Article 1 SSM-R, Article 6 SRM-R).

Second, non-participating member states’ national resolution authorities always participate in the SRB’s plenary sessions, as well as in any SRB executive session where the crisis management concerns an institution that has subsidiaries or significant branches in the non-participating member state (Article 53 SRM-R). This treatment equals the terms for member states participating in the Banking Union.

Third, the voting procedure for important decisions taken by qualified majority in the EBA’s Board of Supervisors representing competent authorities from all EU-27 member states requires a single majority from both participating and non-participating member states (Article 44 EBA-Regulation). This “double majority” ensures the balancing of interests from member states inside and outside the Banking Union (Gren 2014: 72).

5.2 Legal provisions putting all participating member states on equal footing

From the very beginning, the Banking Union was centred on the euro area but designed to be “open to the extent possible to all Member States wishing to participate” (European Council 2012: 7). The legal framework thus facilitates admission for non-participating member states by putting them on equal footing with the founding members of the Banking Union.

As far as the SSM is concerned, national central bank governors of EU countries having established close cooperation with the ECB[14] will not be represented in the

14 For instance, Bulgaria and Croatia will be in close cooperation with the ECB from 1 October 2020

ECB Governing Council where decisions are taken. However, they will be represented in the ECB Supervisory Board where decisions are drafted. Since the SSM-R stipulates that decisions drafted by the ECB Supervisory Board are adopted unless the ECB Governing Council objects to them, the ECB Supervisory Board is deemed to be the "de facto central decision-making authority" (Gren 2014: 74). Concerns that the exclusion of non-euro area member states from the ECB Governing Council would create a "second-class SSM participation" and would discourage them from joining the Banking Union (Tröger 2014: 490-491) proved wrong. On the contrary, practical experience shows that from the more than 7,500 supervisory decisions drafted by the ECB Supervisory Board not a single one was objected to by the ECB Governing Council (Task Force 2019: 9). As additional safeguard, non-euro countries have the possibility to object to a supervisory decision taken by the ECB Governing Council or have – as ultima ratio and in contrast to euro area member states – the option to exit the Banking Union. The governance arrangements of the SSM-R appear to go as far as is legally possible to place euro and non-euro member states on an equal footing (Ferran 2017: 267).

Since the SRB is an EU agency established under Article 114 TFEU, its governance does not differentiate between euro and non-euro member states but only between participating and non-participating member states. As far as the SRF is concerned, the corresponding Intergovernmental Agreement, from which the United Kingdom and Sweden opted out, foresees equality between all Banking Union participants: the joining member state must transfer into the SRF an amount equal to the amount it would have transferred if it had been an original participant (Ferran 2017: 266).

5.3 Centripetal forces attracting non-participating member states to join

Fairness of the terms of participation is a necessary, but not sufficient precondition for non-euro member states to join the Banking Union. Whether they exercise the option to enter into close cooperation with the ECB depends on the net welfare gains they see in entering the Banking Union (Ferran 2017: 279). While the calculations of policy preferences of private and public stakeholders are different in each non-euro member state, there are centripetal forces which apply to all.

First, subjecting domestic banks to central supervision by the ECB provides "additional eyes" with international expertise, a broader basis for comparison and freedom from supervisory capture of national authorities (Grundmann 2019: 103). If markets and investors have more confidence in European supervision than in national oversight, Banking Union participation is a competitive advantage reducing banks' funding costs.

Second, the inclusion of national supervisors in SSM's joint supervisory teams ensures that local context, business structure and knowledge of particular banks are still taken into account (Grundmann 2019: 104). The fear that supra-national

until their adoption of the euro at a later date.

supervision would be to the detriment of member states' regulatory autonomy (Schimmelfennig 2016: 489) is thus substantially reduced.

Third, while the SRM is still in the set-up phase, the SRB, in the longer term, will gain more experience than national authorities in dealing with large failing banks (Task Force 2019: 7). The SRF, still being gradually built up by the industry and awaiting a fiscal backstop, will be financially stronger than the funds available under national resolution schemes and could thus limit the risk for individual member states to bail out domestic banks.

Fourth, joining the Banking Union will increase member states' ability to protect national interests and influence the EU legislative process. While EU financial regulation is negotiated in trilogues including all EU member states, only member states participating in the Banking Union can influence the input of ECB and SRB to EU Commission proposals. After the withdrawal of the United Kingdom from the EU, the balance of power within the Single Market is expected to shift towards the member states forming the Banking Union, which accounts for 90 per cent of the banking activities in the EU-27 compared to 75 per cent in the EU-28 (Task Force 2019: 15). The possible risk of non-participating member states being marginalised is an additional reason to join the Banking Union (Task Force 2019: 18).

Fifth, for EU member states that intend to introduce the euro, membership in the Banking Union – together with participation in the Exchange Rate Mechanism (ERM) II – is a preliminary step towards the adoption of the single currency. The Eurogroup established this practice with Bulgaria and intends to apply a similar approach for other member states that wish to join ERM II (Eurogroup 2018).

5.4 Centrifugal forces said to discourage non-participating member states from joining

While the Banking Union comes with a number of economic and political advantages as presented in the previous section, it also entails some centrifugal forces that have the potential to discourage non-participating member states from joining. On closer inspection, though, the strength of these forces dissipates.

The most tangible cost of the Banking Union is the higher human resources required in national competent and resolution authorities for supporting the work of the ECB and the SRB as well as additional expenditures to finance the SSM and the SRF (Task Force 2019: 6, 8, 14). However, one has to bear in mind that first, all expenditures for SSM and SRM as well as potential losses from the SRF are financed by the banking industry, and second, the additional supra-national layer decreases the funding costs for banks while reducing the risk for member states budgets to be overstrained by the need to bail out institutions.

Finally, the prediction that countries whose banking sector shows low internationalisation and high foreign ownership would "prefer national regulation in order to be able to protect domestic banks and exert control over foreign-owned banks" (Schimmelfennig 2016: 488) has to be rejected as Bulgaria and Croatia will participate in the Banking Union before enjoying the benefits of the single currency. Likewise, recent reflections in Sweden and Denmark on joining the Banking Union seem to refute the assumption that "countries with high regulatory quality and capacity are not in need of improved reputation and are better off going it alone" (Schimmelfennig 2016: 489).

5.5 Practical considerations of selected countries not (yet) participating

At the time of writing, eight of 27 EU member states are not participating in the Banking Union. While all of them have in common that they are non-euro countries, the Banking Union outsiders can be grouped into three broad categories. First, Czech Republic, Poland and Hungary are currently not considering participation in the Banking Union. Their lack of interest cannot be explained by weighing the centrifugal and centripetal forces presented in the previous section but has to be attributed to the refusal by the respective governments to adopt the euro and the general euro-sceptic public opinion (Leuffen et al. 2013: 176-178). Second, in Denmark and Sweden, a policy discussion is ongoing on joining the Banking Union but both countries have not concluded yet on participation. Third, Bulgaria, Croatia and Romania have signalled their intention to join the Banking Union. Whereas Bulgaria and Croatia have successfully applied to participate in the Banking Union and the ERM II with a view to adopting the euro at a later stage, Romania has not yet done so. This section takes a closer look at the reflections of the two groups that are considering participation or that have already chosen to join the Banking Union.

In Denmark and Sweden, cross-border banking business shows characteristics similar to those of euro area countries, suggesting that from an economic perspective there is a strong case for joining the Banking Union (Jensen and Schoenmaker 2020: 3). While bank supervision in both countries is deemed to be of high quality, the failure of the largest domestic banks might overstrain the national safety nets (Jensen and Schoenmaker 2020: 6). Consequently, Denmark and Sweden conclude that in a systemic crisis, access to the SRF at the European level could reduce the risk of domestic bailouts with domestic taxpayers' money (Task Force 2019: 14; Swedish Ministry of Finance 2019: 26). Politically, Denmark and Sweden both consider the incompleteness of the Banking Union and the uncertainty of its future development as a reason for postponing the decision on participation. For Sweden whose democracy is known for its openness and transparency, the Banking Union's imperfect accountability mechanism is another bone of contention (Swedish Ministry of Finance 2019: 33). On the other hand, the risk of being marginalised in the post-Brexit Single Market speaks in favour of joining the Banking Union sooner rather than later (Task Force 2019: 18; Swedish Ministry of Finance 2019: 31).

For Bulgaria, Croatia and Romania, the reasons for joining the Banking Union are different. Unlike Denmark and Sweden, the banking systems of the three Central and Eastern European countries show an extremely high share of foreign ownership but no domestic banks of systemic importance (Belke et al. 2016: 28-29). All three EU member states are predominantly seeking to receive the ECB "badge of quality" in the expectation that European supervision will improve stability and refinancing conditions for their domestic banks (Ferran 2017: 269). The reputational gain from participation in the Banking Union is so strong that Bulgaria and Croatia are willing to join the Banking Union prior to adopting the euro. While many operational issues remain to be resolved before Romania will be in a position to officially ask for admission to the Banking Union (Ilie 2020), Bulgaria and Croatia submitted formal requests to enter into close cooperation with the ECB in July 2018 and June 2019, respectively. On 10 July 2020, the ECB Governing Council decided that on 1 October 2020, Bulgaria and Croatia will become the first non-euro members of the Banking Union.

Conclusion

The Banking Union has enhanced European integration in the financial sector without jeopardising the functioning of the internal market. Thanks to its institutional setup and safeguards in its legal framework, the Banking Union did not aggravate the initial differentiation between euro-area and non-euro area member states. While the ECB as the central body has driven the development of the Single Rulebook in banking regulation, the EBA has ensured that the rules are applied consistently across all EU member states.

The Banking Union was successful in containing the euro area sovereign debt crisis (2009–2012) and contributed to a more viable banking sector. However, lacking a fully fledged crisis management framework at the European level, the strictness of bank supervision has been compromised thus far. As a result, the doom loop has not been removed and financial fragmentation within the Banking Union continues. Built on fundaments partly outside of the EU legal framework, the Banking Union suffers from imperfect democratic legitimacy. Despite its limited track record, the Banking Union is attractive to non-euro area member states. Croatia and Bulgaria praise the badge of quality of ECB supervision and its positive effects on their economies and successfully requested to enter into close cooperation with the ECB. On the other side of Europe, Denmark and Sweden acknowledge the importance of Banking Union participation in a post-Brexit Single Market and are rethinking their official stance.

This paper shows that the modalities for joining the Banking Union are sufficiently friendly towards non-euro area member states. Given also the economic advantages from joint supervision and risk-sharing in case of bank failures, this paper sees a strong case for Banking Union outsiders to participate. But uncertainty about the future development of the Banking Union and limitations in its accountability mechanism make undecided member states continue to hesitate. More generally, the case of the Banking Union demonstrates that the more effective a given differentiated integration arrangement, the more attractive it will be to non-participating member states and consequently the more promising for enhancing the political unity of the European Union. It is thus in the interest of insiders and outsiders to complete the Banking Union by fully supra-nationalising not only supervision but also resolution and deposit insurance. Greater credibility of the bail-in tool will strengthen the banking sector in the Banking Union and make it more appealing for member states not participating yet.

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EU Integration and Differentiation
for Effectiveness and Accountability

Differentiation has become the new normal in the European Union (EU) and one of the most crucial matters in defining its future. A certain degree of differentiation has always been part of the European integration project since its early days. The Eurozone and the Schengen area have further consolidated this trend into long-term projects of differentiated integration among EU Member States.

A number of unprecedented internal and external challenges to the EU, however, including the financial and economic crisis, the migration phenomenon, renewed geopolitical tensions and Brexit, have reinforced today the belief that **more flexibility is needed within the complex EU machinery**. A Permanent Structured Cooperation, for example, has been launched in the field of defence, enabling groups of willing and able Member States to join forces through new, flexible arrangements. Differentiation could offer a way forward also in many other key policy fields within the Union, where uniformity is undesirable or unattainable, as well as in the design of EU external action within an increasingly unstable global environment, offering manifold models of cooperation between the EU and candidate countries, potential accession countries and associated third countries.

EU IDEA's key goal is to address **whether, how much and what form of differentiation is not only compatible with, but is also conducive to a more effective, cohesive and democratic EU**. The basic claim of the project is that differentiation is not only necessary to address current challenges more effectively, by making the Union more resilient and responsive to citizens. Differentiation is also desirable as long as such flexibility is compatible with the core principles of the EU's constitutionalism and identity, sustainable in terms of governance, and acceptable to EU citizens, Member States and affected third partners.

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