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Completing Europe's banking union: economic requirements and legal conditions

Thorsten Beck, Jan-Pieter Krahnén, Philippe Martin, Franz Mayer, Jean Pisani-Ferry, Tobias Tröger, Beatrice Weder di Mauro, Nicolas Véron and Jeromin Zettelmeyer

Executive summary

THE EUROPEAN UNION'S banking union project started in mid-2012 in response to the euro-area crisis, with the goal of breaking the bank-sovereign vicious circle. The objective was also to restore private liability in banking and to move towards an integrated supranational market for banking services. For all the progress achieved in the past decade, particularly in banking supervision, these aims have not yet been accomplished.

THIS POLICY CONTRIBUTION analysis the deficiencies of the current framework and identifies possible responses, in line with three levels of reform ambition. We label these 'incremental' (broadening the scope for private-sector burden-sharing in future cases of bank failures), 'real' (effectively breaking the bank-sovereign vicious circle), and 'cosmic' (a single, seamlessly integrated banking market). European policymakers should set their sights on the second level, which we view as achievable within the current decade, requiring new EU legislation but no change to the European treaties.

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1 The banking union project

The great financial crisis and the euro-area crisis led to substantial reform of financial safety nets across Europe and – critically – to the introduction of supranational elements. Specifically, a supranational supervisor was established for the euro area, with competences and tasks depending on the systemic relevance of supervised credit institutions. A resolution mechanism was created to allow the frictionless resolution of large financial institutions. This resolution mechanism has been now complemented with a funding instrument.

For all the progress that has been achieved, the banking union remains unfinished, and has major deficiencies. The Eurogroup in June 2022 concluded a round of negotiations between EU countries by calling for further reform in the area of crisis management and resolution¹.

This Policy Contribution assesses the current and the desired state of the banking union project. The key underlying question is the level of ambition and how it matches with effective legal and regulatory tools. Two questions structure our evaluation:

- What would be a reasonable definition and rationale for a ‘complete’ banking union, and what legal reforms would be required to achieve it?
- Banking union is a case of a new remit for European Union-level policy that so far has been conducted on the basis of long-existing treaty stipulations, namely Article 127(6) of the Treaty on the Functioning of the European Union (for banking supervision) and Article 114 TFEU (for crisis management and deposit insurance). Could banking union be completed through secondary law, or is a more comprehensive overhaul of the legal architecture required to ensure legal certainty and legitimacy?

2 State of play

Europe’s banking union was a major component of the EU’s policy response to the great financial crisis (GFC) of 2007-2009 and the euro-area crisis of 2010-2015. Its stated aim, pithily formulated at its inception in mid-2012² and expressed repeatedly afterwards, was to sever the vicious link between bank and sovereign fragility, which had dominated the euro-area sovereign debt crisis. Two related complementary aims, which pre-dated the banking union but became important drivers of its agenda, were, first, the restoration of private liability in banking, to overcome the implicit government guarantee that had allowed large banks in pre-GFC years to ensure wholesale funding at favourable conditions despite ultra-thin capital layers³; and second, to reinforce the basis for a European single market in banking services, which had begun to emerge in the 2000s but was based on shaky foundations and had been shattered by the two crises.

For reasons that have been explained elsewhere (eg Bénassy-Quéré *et al*, 2018), meeting all three objectives required common banking supervision, a harmonised and centrally administered European⁴ crisis management and deposit insurance (CMDI) regime allowing orderly bank resolutions, and appropriate regulatory treatment of sovereign exposures so that

1 See Eurogroup statement of 16 June 2022, available at <https://www.consilium.europa.eu/en/press/press-releases/2022/06/16/eurogroup-statement-on-the-future-of-the-banking-union-of-16-june-2022/>.

2 Euro Area Summit Statement, 29 June 2012, at https://www.bankingsupervision.europa.eu/about/milestones/shared/pdf/2012-06-29_euro_area_summit_statement_en.pdf.

3 See, for example, High-level Expert Group on reforming the structure of the EU banking sector (2012).

4 We use ‘European’ here as shorthand for supranational arrangements or institutions applicable to the banking union, which as of late 2022 includes the euro-area member states plus Bulgaria and Croatia.

member states could no longer lean on domestic banks for concessionary financing conditions that ultimately exacerbate the bank-sovereign nexus.

Despite the original political vows (Van Rompuy, 2012) and notwithstanding specific proposals by the European Commission and academics, the banking union is far from complete. First, significant crisis-management competences remain at national level. Second, even where crisis-management competences have been centralised – in the resolution area – there is a strong incentive to avoid applying this EU-level resolution option. Third, EU-level regulation that mitigates home bias in bank holdings of sovereign liabilities continues to be lacking. This perpetuates the ‘doom loop’ between banks and sovereigns. In the following sub-sections, we deal with each of these issues.

2.1 Significant competences remain at the national level

There have been major advances on common supervision and, to a lesser extent, resolution. The Single Supervisory Mechanism (SSM) Regulation was adopted in 2013, followed in 2014 by the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRMR), which established the Single Resolution Board (SRB) in 2015. This framework sets out a banking union-wide procedure to resolve failing banks outside inherited national insolvency regimes. It also requires banks to issue additional loss-absorbing instruments (including debt earmarked to be converted into equity or written down at the request of the resolution authority), and mandates plans for coping with the failure of an individual institution, including its market exit, without triggering fatal consequences for other institutions and financial stability as a whole. These reforms came on top of global regulatory initiatives, including Basel III, which strengthened the quality and quantity of regulatory capital and introduced liquidity requirements and macro-prudential capital buffers. This overhaul of the capital framework was implemented in the EU through the Capital Requirements Regulation (CRR) and the revised Capital Requirements Directive (CRD IV), first enacted in 2013, which formed the core of the newly introduced Single Rulebook, a single set of harmonised prudential rules that financial institutions throughout the EU must respect, and a major step towards a single banking market.

An important caveat is that the more advanced elements of banking union, in supervision and resolution, apply primarily to the largest 100-plus banks in the euro area, known in EU jargon as the significant institutions (SIs) and including all those with consolidated balance sheets exceeding €30 billion. All other banks are known as less significant institutions (LSIs), including those, such as cooperative banks or savings banks in Germany or Austria, that are organised in financial networks or groups with mutual support arrangements that entail regulatory advantages and are known as Institutional Protection Schemes (IPs) (Haselmann *et al*, 2022). National authorities remain responsible for most supervisory tasks in relation to LSIs, even though the European Central Bank takes the most important decisions, such as the granting or withdrawal of the banking license. The ECB also steps into crisis management and resolution decisions if an LSI is found to be failing or likely to fail. The favourable treatment of IPs and their member banks is particularly notable because they represent the majority of LSIs and about half of total LSI assets (Lehmann and Véron, 2021), and because the networks share common features with large SIs in terms of systemic importance.

Finally, despite many proposals – including from both the European Commission and some of the authors of this Policy Contribution (Krahnen, 2013; European Commission, 2015; Beblavý *et al*, 2015; Bénassy-Quéré *et al*, 2018; Schnabel and Véron, 2018) – there has not been any progress on supranational deposit insurance.

Crisis-management competences thus remain divided between the supranational and national levels. Compounding this problem is institutional fragmentation at the supranational level. For example, resolution decisions taken by the SRB may need the consent of other authorities, including the European Commission’s competition directorate-general and the Council of the EU. At the implementation stage, input from national resolution authorities is needed. Such a fragmented architecture effectively creates numerous veto players and makes

efficient decision-making difficult, as special interests and their political backers have many places to turn to in their lobbying efforts.

2.2 The supranational resolution framework has not been applied in practice

The policy changes associated with the banking union, especially the BRRD and SRMR, were supposed to prevent bank bailouts by home-country authorities, including by making banking fragility less likely, by permitting national bailouts only in exceptional circumstances, and by ensuring that failed banks could be resolved without fiscal support and without creating a financial disaster. In turn, this was expected to prevent contagion from banks to sovereigns and from sovereigns to banks, and to facilitate the development of a pan-European banking market and the formation of pan-European banks, thus preventing the concentration of country-specific risk on the balance sheets of national banks. It was also meant to facilitate bank exit in overbanked economies.

By and large, these aims have not been realised. There have been few exits. The euro-area banking system remains fragmented, with banks exposed disproportionately to their national sovereigns. Solutions to banking problems remain predominantly national. With very few exceptions⁵, the SRB-led resolution option has been circumvented in most recorded cases of ailing or failing banks, and national practices for dealing with banking crises have continued to diverge significantly. Thomas Huertas's famous quote still holds: global (or for our purposes here, European) banks are "*international in life, but national in death*"⁶.

The EU crisis-management framework provides critical escape routes which allow supranational decision-makers (the SRB and the European Commission, which is formally involved in the resolution process) to shy away from implementing EU-level resolution schemes that would generate legal risks and might be perceived as not aligned with certain national interests. Admittedly, all banking authorities are confronted with a difficult balancing act between the ex-ante risk of imprudently committing public funds to the bailout of ailing banks, thereby creating moral hazard, and the ex-post risk of liquidating viable financial institutions, thereby destroying economic value. A problem specific to the EU is that the lack of a common fiscal capacity has helped tilt the balance towards a very harsh and arguably unrealistic bail-in regime, which in turn feeds incentives to avoid EU-level resolution and to keep banks and their crisis management under national control, in order to facilitate bailouts.

For bail-in to fully develop its influence on creditor behaviour, the logic of the BRRD needs to be revisited. Under the BRRD framework, putting an ailing bank into resolution entails applying a stringent 8 percent minimum private sector loss-bearing requirement⁷. To escape that strict discipline, supervisors and resolution authorities can either muddle through (supervisory forbearance) or send the bank into liquidation under normal (national) insolvency procedures, which vary significantly across member states. Both alternatives to resolution allow for rather generous injections of public funds instead of bailing-in investors in bank capital. 'Muddling through' includes the possibility of precautionary recapitalisation by a member state, as was done with Monte dei Paschi di Siena in mid-2017, a case that demonstrated the existence of a lot of potential wiggle room for forbearing authorities⁸.

5 Banco Popular Español rescued in June 2017, and the Croatian and Slovenian subsidiaries of Sberbank Europe in March 2022.

6 First formulated in Huertas (2009).

7 BRRD Arts. 56(1), 37(10)(a) prescribes that at least 8 percent of an institution's total liabilities be bailed-in before any government support in the form of a capital contribution can be extended or the bank is nationalised under BRRD Arts. 57, 58; similarly, BRRD Art. 44(5) and SRMR, Art. 27(7) require a minimum bail-in of the same proportion before national resolution financing arrangements or the Single Resolution Fund (SRF) can take any losses.

8 BRRD, Arts. 32(1)(a) and (4)(d) and SRMR, Arts. 18(1)(a) and (4)(d) permit extraordinary public support without triggering resolution "*to remedy a serious disturbance in the economy of a Member State and preserve financial stability*", if the support is not "*used to offset losses that the institution has incurred or is likely to incur in the near future*" and the recapitalised institution is solvent.

The euro-area banking system remains fragmented, with banks exposed disproportionately to their national sovereigns

National insolvency proceedings have continued to apply to most small and medium-sized banks, leading to an uneven playing field

Further down the line, if a bank has been deemed to be failing or likely to fail, the SRB can deny a public interest and thus avoid triggering resolution, if it determines that the resolution objectives laid down in Art. 31(2) of the BRRD and Art. 14(2) of the SRMR, respectively, can also be achieved in a proportionate manner under normal insolvency proceedings (BRRD, Art. 32(1)(c) and (5); SRMR, Art. 18(1)(c) and (5)). In both instances, the European legal framework relies on standards that are too vague, concede significant leeway to supranational authorities in determining the scope of the European resolution regime, and ultimately defeat the proclaimed objective of avoiding bailouts.

To date, only three troubled institutions have been judged to meet the conditions for supranational resolution. The economically most significant case remains Banco Popular Español, which was taken over in June 2017 by Santander for the symbolic price of one euro. As a result of the takeover, which provided a potent private-sector backstop⁹, there was no need to enter into the more contentious parts of the resolution framework, including the write-down of either subordinated or senior unsecured debt¹⁰. Yet, even in this relatively straightforward case, more than 100 cases of aggrieved capital holders were brought to local and European courts.

The litigious nature of resolution with bail-in (Avgouleas and Goodhart, 2015) also highlights another reason why the supranational resolution framework is not applied in practice, even though EU-level resolution would be efficient from a welfare point of view. The ‘no creditor worse off’ principle, enshrined in SRMR, Art. 14(1)(g), 29 and BRRD, Art. art. 34(1)(g), 73, requires resolution authorities to make sure they pick resolution schemes and actions that do not impose greater losses on bailed-in creditors than these would have incurred in normal (national) insolvency proceedings. The uncertainty introduced by the no creditor worse off principle, which requires resolution to be compared with a hypothetical insolvency procedure, has contributed to a fear among many responsible authorities, particularly the SRB, that they could overstep their mandates, rendering true bail-in a risky endeavour from the perspective of resolution authorities. There may always be a counterfactual, deemed achievable by some court, that supports the view of an infringement of creditor rights, which in turn may lead to reputational damage and even liability. As a consequence, regulators face additional incentives to avoid harsh bail-ins.

As a result, normal (national) insolvency proceedings have continued to apply to the large majority of small and medium-sized banks. This leads to an uneven playing field for investors across countries, and significant variation in funding conditions for banks even within the banking union. The various options for injecting public funds into non-viable institutions can lead to zombie banks and put a drag on credit-funded growth.

Even if the SRB could get its way, it may lack the financial firepower to interfere with the business model of large banks in resolution, because of impending liquidity and subsequent solvency risks. The SRB has neither direct access to central bank money nor a sufficiently large fiscal backstop that could provide the capital and liquidity required to stabilise an ailing very big bank. The financial link known as ‘backstop’ created between the Single Resolution Fund (SRF) and the European Stability Mechanism (ESM) provides some relief, but the credit line capped at €68 billion is too small and suffers from governance structures that make its immediate availability in times of crisis questionable, thus adding to the decision-making problems already mentioned. Being short of liquidity and capital funds, the SRB may not become the bold player it otherwise could and should be.

⁹ The resolution of the Croatian and Slovenian subsidiaries of Sberbank Europe in March 2022 followed the same pattern under a sale-of-business strategy.

¹⁰ Core equity tier 1 (CET1) and additional tier 1 (AT1) instruments were written down and tier 2 (T2) instruments were converted into equity and transferred to Santander (SRB, 2017).

The effect of bank fragility on sovereign debt sustainability can only be addressed by supranationalising the resolution process

2.3 The bank-sovereign nexus has not been addressed

There is still a strong home bias among financial institutions in their sovereign bond holdings across the euro area, a bias that is stronger in countries with higher debt/GDP levels. This compounds the above-described biases in the BRRD towards national solutions that further exacerbate the bank-sovereign link.

Over the past decade, different proposals have sought to address the home bias. One idea is to introduce positive risk weights for all sovereign-bond holdings of banks, as is already required for holdings of non-OECD sovereign bonds. But, aside from the fact that there is no global consensus about them, such risk weights might introduce cliff-edge effects for countries that are about to be downgraded, and where such a downgrade could trigger a substantial increase in risk weights. This problem would arise not only in a transition period but would be a permanent feature of a credit-risk-centric approach to regulatory treatment of sovereign exposures. Concentration limits or, to avoid other cliff effects, sovereign concentration charges, have therefore been suggested as alternative, together with transition arrangements (eg Bénassy-Quéré *et al.*, 2018). Because they are tailored to the unique circumstances of a monetary union, such concentration charges, if properly calibrated in order to constrain exposures to individual euro-area countries but not aggregate euro-area sovereign exposures, would not introduce competitive distortions between euro-area banks and their global peers.

Limiting the home bias in sovereign bond holdings and thus the exposure of banks to their home-country government, can reduce the effect that sovereign fragility has on banks' balance sheets. Conversely, the effect of bank fragility on sovereign debt sustainability can only be addressed by supranationalising the resolution process and countering the national bias in favour of bailouts.

2.4 Why do national interests continue to trump European ideas?

Why has the banking union not lived up to expectations? The short answer is that the regulatory and institutional architecture that was first put in place between 2013 and 2015, and has been lightly amended since, is still not powerful enough to offset a national bias that dominates banking sector policy. Most member states still wish to maintain control over their banking systems, limit cross-border exposures to liquidity needs in times of crises, protect national or regional banks against foreign competitors, and leverage their domestic banking systems to facilitate government financing in times of stress. Despite the successful adoption of common rules and standards, pivotal responsibilities in bank crisis management still remain at national level. It should also be recalled that the reform package enacted in 2013-2014 is not yet fully implemented. In particular, the minimum requirements for own funds and eligible liabilities (MREL), which compel banks to build up sufficient loss-absorbing capacity, will only become fully loaded in 2024, in the meantime leaving the available private-sector funding for resolution uneven across member states.

More substantially, until and unless a genuine European deposit guarantee scheme is established, deposits will not have identical value to depositors in different member states. The impending imbalances may trigger damaging fragmentation dynamics in scenarios of serious crisis. Even with phased-in MREL, extraordinary liquidity or even capital needs to tackle ailing banks may still emerge, for which no resources exist at the supranational level in the current banking union design. Therefore, national fiscal means and responsibilities will continue to play a pivotal role in crisis management and will shape the incentives of decision makers. Understandably, national taxpayers' money may not be made available to rescue an ailing bank abroad; in other words, banks headquartered in a given member state cannot expect to receive a helping hand from national taxpayers of another member state. The national bias in this framework, of course, also explains the rarity of truly European banks and the limited extent of cross-border banking consolidation.

Even supranational decision-making, where it currently exists, is not immune from national bias. National competent authorities together represent a majority of voting members of the ECB's Supervisory Board, the key decision-making body of the apex institution

within the SSM. At the SRB, structures that lend member states' representatives a dominant role in critical supranational decision-making are in place when individual cases are considered (Tröger and Kotovskaya, 2022). Home member-state representatives have strong incentives to make themselves heard, form coalitions and organise opposition to supranationally devised draft decisions precisely because, if a bank is in default, the home fiscal authority is the party ultimately liable for uncovered losses¹¹.

2.5 The result: fragmentation risk and fragmented financial services along national lines

The result is a regime in which resolution and liquidation are either avoided or happen under national rules. This continued de-facto national responsibility undercuts the intent of the BRRD and SRMR and stands in the way of the objective of creating a single banking market. There are recurring instances of regulatory 'ringfencing' along national borders, even though such decisions are not necessarily made public. A prominent example was the application of the ECB's recommendation for restrictions on profit distributions during the COVID-19 pandemic on the national (ie subsidiary) level, rather than EU or group level, in several EU countries. In some instances, national competent authorities restricted cross-border upstream transfers even within the EU, which were permissible under the ECB's recommendation that applied on the consolidated level (ECB, 2021)¹². These interferences with free capital flows within the single market were justified by national authorities on the basis that fiscal support measures (which benefitted banks at least indirectly) were taken at national rather than European level.

The consequence is that even within the banking union, the market for financial services remains fragmented along national borders, with very few cross-border mergers and very limited cross-border competition. Banks therefore continue to concentrate risk at the national level, perpetuating a major vulnerability of the euro area that banking union was meant to remedy.

3 Options for reform

Reform options should relate back to the objectives the banking union project was intended to address:

- First, the repeal of implicit government guarantees and the return of private liability in banking;
- Second, breaking the bank-sovereign nexus which, in crisis situations, turns into a vicious circle that was revealed in 2011-2012 to be an existential threat to the euro area;
- Third, moving closer to a genuine single European banking market with its advantages in terms of credit allocation and value-for-money for firms and households.

Banking union reform could thus have three different possible levels of ambition.

First, we acknowledge that the round of Council negotiations that came to a close in June 2022 has endorsed a plan to improve the crisis-management and deposit-insurance framework while not attempting, at this stage at least, to further reduce the bank-sovereign vicious circle. While we are unsure to what extent the former can be achieved effectively without the latter, we take the plan seriously and characterise it as an 'incremental deal'.

¹¹ In Germany, for example, the financial supervisor BaFin is not an independent institution but an agency under the control of the finance ministry.

¹² For a similar EU-wide assessment, see ESRB (2020).

Second, we outline what we view as an achievable ‘real deal’ that would break the bank-sovereign vicious circle, even though it would not eliminate all national idiosyncrasies that contribute to the fragmentation of European banking markets across national borders.

Third, we sketch a vision of full market integration, which we view as desirable but much more distant and long-term, and therefore label as the ‘cosmic deal’.

3.1 The incremental deal: Improve the crisis-management and deposit-insurance framework

A first approach would be to adjust the legal and regulatory framework to improve the effectiveness of crisis management, alongside better supervision, and to establish resolution as general practice in cases of failing or likely to fail banks. This approach is explicitly intended to match the plan alluded to in the Eurogroup statement of 16 June 2022. It consists of six recommendations.

1. Extend the crisis-management framework, as developed in the SRMR and the BRRD, to small and medium-sized banks, relying on Article 114 TFEU, thereby enforcing a harmonised crisis-management framework for all banks throughout the EU. Much of this can be achieved through a mere reinterpretation of the resolution triggers, in particular the public-interest assessment methodology, which should not be construed in a way that resolution is only for the few. The threshold for public-interest determination should be lowered compared to SRB practice since 2016 or, even better, eliminated (as is the case in the United States, where all failing banks are subject to the Federal Deposit Insurance Corporation’s exclusive resolution authority). This would eliminate the option of normal (national) insolvency proceedings for credit institutions, and would also abolish any need for a ‘no creditor worse off’ assessment (with the additional advantage of removing a major current source of litigation risk).
2. Tighten state-aid rules to remove possibilities for providing state-aid of the type that was extended in the liquidation of two Veneto banks in June 2017¹³.
3. Provide the SRB with autonomous access rights to data collected under the Common/ Financial Reporting Framework (COREP/FINREP), as specified in detail by European Banking Authority (EBA)-drafted Implementing Technical Standards (ITS). The emphasis is on *autonomous* access rights, which differs from today’s dissemination practice, allowing the SRB to conduct its own risk assessment, so that it is better prepared when a financial institution approaches failing-or-likely-to-fail status.
4. Following the US example, explore the disclosure of reported raw data to the public. That way, creditors and investors would be better informed about individual institutions, and independent benchmark studies could be carried out, potentially improving the pricing of debt – in particular, bail-in debt – in the cross-section of all banking institutions issuing such instruments, thereby enhancing market discipline. Making detailed COREP/FINREP data, or parts thereof, available to the public is a step in the direction long taken in the US regulatory system, where Call Reports, the equivalent to COREP/FINREP, are made publicly accessible through the supervisory agency’s website (the Federal Financial Institutions Examination Council portal)¹⁴.
5. Treat small banks that coordinate through Institutional Protection Schemes as ‘conglomerates,’ essentially asking them to either operate as single institutions without competitive self-restraints, or as single bank holding companies.
6. Introduce general depositor preference – the principle that all deposits rank equally – for

¹³ Banca Popolare di Vicenza and Veneto Banca were closed by the Bank of Italy under the special insolvency regime of *liquidazione coatta amministrativa*, with much of their prior activity taken over by Intesa Sanpaolo.

¹⁴ Needless to say, the supervisory agencies’ own assessments of the raw data, CAMELS reports in the US, and Supervisory Review and Evaluation Process reporting in Europe, are not/should not be disclosed to the public, although they may be shared among supervisory agencies.

all deposits beyond the MREL, eliminating the differentiated levels of seniority among depositors. Additionally, require further enhancement of the loss-absorption capacity of bail-in capital to minimise the risk of imposing losses on uninsured deposits or other runnable short-term funding sources of banks¹⁵.

None of these proposals requires treaty change, although most would require changes in secondary law.

3.2 The real deal: breaking the bank-sovereign vicious circle

A higher level of ambition would aim at a more comprehensive reform of the current framework, which would address its main shortcomings and build a more sustainable financial safety net for the euro area.

1. Consolidate crisis management decision-making under a single European resolution agency (namely, the SRB), with offices in all member states, and establish reporting lines that are consistent with a common European regime, thus enabling impartial and uniform enforcement of BRRD and SRMR rules. This would entail integrating under the SRB the responsibilities currently belonging to national resolution authorities and to recognised national deposit guarantee schemes. Merging the full mandatory deposit guarantee system into the SRB to create a single institution, similar to the Federal Deposit Insurance Corporation (FDIC) would reflect the functional interdependence of resolution and deposit insurance.

This proposal, which would keep primary prudential supervision (the ECB and national competent authorities within the SSM) and crisis management (the SRB) institutionally separate, reflects the division of competences in the US system. While the Federal Reserve (Fed) and the Office of the Comptroller of the Currency serve as the primary federal supervisors for larger US banks and banking groups (bank holding companies), the FDIC has a 'special examination authority' that allows it to exercise a 'backup' oversight, ideally in collaboration with the Fed and the Office of the Comptroller of the Currency, when a larger institution poses an unusual risk to the deposit insurance fund¹⁶. In our view, the FDIC practice of carrying out independent risk assessments under its Large Insured Depository Institution programme, and sharing its reviews with the primary federal supervisors for consideration in their examination planning, can serve as a template for productive division of labour in the banking union¹⁷. The SRB would bolster scrutiny at vulnerable institutions that pose a significant threat to insured deposits, and could also raise prudential supervisors' awareness of problems at specific banks. In principle, this is already possible under Art. 36 of the SRMR and would thus require a change of operational practice, including staffing, rather than of legislation.

2. Create a common financial backstop for the new institution, as the room for manoeuvre of the expanded SRB would otherwise be limited by resource constraints. This could build on the existing ESM backstop to the SRF, relying on either the ESM or the EU budget. The latter would send a better signal of joint liability of EU member states for the protection of deposits even in extreme tail-risk scenarios, even though the backstop cannot be explicitly unlimited in the absence of a fiscal union¹⁸.
3. To break the link between sovereigns and banks, the EU Single Rulebook should include sovereign concentration charges, with prudent calibration and transitional arrangements.

¹⁵ The policy rationale of a bail-in maximum that precludes imposing losses on runnable bank debt is explained in Götz *et al* (2017).

¹⁶ Federal Deposit Insurance Act § 10(b)(3), 12 U.S.C. § 1820(b)(3) (2022).

¹⁷ For a detailed description of the procedures and their historical evolution, see FDIC (2017).

¹⁸ Even in the United States, the backstop provided to the FDIC by the "full faith and credit of the United States", though unlimited in principle, has only declarative status and is not enshrined in legislation as a specific financing mechanism.

Such concentration charges are preferable to credit risk-based adjustments, such as risk weights based on credit ratings, which can result in destabilising effects.

4. Create a genuinely European mandatory deposit guarantee scheme, with a waterfall of loss-making (national and IPS compartments), including SRB-level decision making for any alternative measures. This would imply that deposit guarantee costs up to a certain aggregate level would be kept at the national or IPS level (though covered by a levy on the banks within the compartment's scope, not by national fiscal resources), whereas losses beyond a single compartment's capacity would be upstreamed to the supranational level.

New secondary legislation would obviously be needed to implement these proposals. Whether treaty change should be part of the package is less obvious. In our analysis, a treaty change is not required, but may be desirable. Under the *Meroni* doctrine, the exercise of discretionary powers by a European agency not originally established in the founding treaties is restricted¹⁹. Although the European Court of Justice has taken a more permissive stance in recent decisions²⁰, some legal uncertainty about the extent of admissible delegation of powers remains. Just like in the current framework²¹, concerns could be overcome by requiring the European Commission to confirm SRB crisis-management decisions. However, this may prove operationally inefficient and therefore calls for amendments to the founding documents.

3.3 The cosmic deal: a single, seamless, fully integrated European banking market

Completing the banking union is a necessary but not sufficient condition to create a truly single market in banking, in which national banking champions are replaced by European large banks, while smaller, regionally, if not locally focused, financial institutions are maintained. For such a single market to emerge, further conditions would have to be met, including:

1. A single system of bank taxation,
2. A single system for corporate and personal insolvency and
3. A single framework for housing finance and mortgages.

Such harmonisation would enable easy cross-border provision of financial services within the euro area.

While radical, these reforms may not require treaty change. The EU can harmonise tax laws under TFEU Article 114 insofar as this serves “*the establishment and functioning of the internal market*”. Since we propose the uniform system of bank taxation to foster the single market for financial services, treaty change would not be required (although, per Art. 115 TFEU, a unanimous vote in the Council would be). Legal issues are also unlikely to arise in relation to the proposed harmonisation of insolvency law and the real-estate framework. These would also aim at achieving the single market and thus fall within the EU competence under TFEU Art. 114²². This said, the test of whether an EU-level measure can be justified by the “functioning of the internal market” has recently been applied more strictly by some national courts²³. Therefore – as in the case of the reforms proposed as part of the ‘real deal’ – treaty change may be prudent, to avoid overstressing Article 114.

Although the ‘cosmic reforms’ are legally feasible, the political appetite for such radical reforms is likely to be low. And even if it were present, such reforms would take a long time, probably decades.

19 *Meroni v. High Authority* [1958], ECR 11.

20 Case C-270/12 *United Kingdom v. Parliament and Council* EU:C:2014:18; Case C-911/19 *Fédération bancaire française (FBF) v Autorité de contrôle prudentiel et de résolution (ACPR)* EU:C:2021:599

21 SRMR, Art. 18(7) subpara. 2.

22 In fact, such harmonisation efforts are being pursued under the Capital Markets Union (CMU) agenda.

23 See, for example, German Constitutional Court, Recital 252 of the Banking Union decision of July 2019,

http://www.bverfg.de/e/rs20190730_2bvr168514en.html.

The three levels of ambition we identify do not represent mutually-exclusive reform trajectories, but correspond to different presumed timelines. The ‘incremental deal’ may be achievable in the course of the current EU parliamentary term, but is not sufficient to address the challenges revealed during the euro-area crisis. The ‘real deal’ is what we strongly advocate, while being aware that – unless precipitated by a new crisis – it will not be seriously considered by policymakers before the mid-2020s at the earliest. The ‘cosmic deal’ will remain aspirational for the foreseeable future, but some of the reforms on the way to the deal may not be.

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