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(When) should a non-euro country join the banking union?

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A B S T R A C T

We analyze the benefits and costs of a non-euro country opting-in to the banking union. The decision to opt-in depends on the comparison between the assessment of the banking union attractiveness and the robustness of a national safety net. The benefits of opting-in are for now only potential and uncertain, while costs are more tangible. Due to treaty constraints, non-euro countries participating in the banking union will not be on equal footing with euro area members. Analysis points out that reducing the weaknesses of the banking union and thus providing incentives for opting-in is not probable in the short term, mainly due to political constraints. Until a fully-fledged banking union with well-capitalized backstops is established it may be optimal for a non-euro country to join the banking union upon the euro adoption. Assessing first experiences with the functioning of the banking union and opt-in countries will be crucial for non-euro countries when deciding whether to opt-in.

1. Introduction

The global financial crisis exposed numerous weaknesses in the European safety net arrangements. The pre-crisis financial supervisory architecture was based on independent national competent authorities responsible for supervising financial institutions in their jurisdictions. As the European financial regulations were governed by minimum harmonization principle, national competent authorities often softened prudential requirements to ensure competitive advantage of domestic financial institutions. This forbearance resulted in very heterogeneous supervisory standards and practices across the EU. Free movement of capital within the single market induced regulatory arbitrage with concentration of capital inflows in high-risk countries with lax supervision and regulation, thus increasing contagion and systemic risk[1] in the EU. Moreover, the fragmented national supervisory frameworks were not adjusted to changes caused by the growing internationalization and integration in the EU financial system and thus strengthened and unified financial supervision became necessary.[2] The crisis also underlined the need for a macroprudential approach, encompassing more than safety of particular institutions, going beyond national borders and limiting contagion effects on an integrated single market (Szpunar, 2014).

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[1] More on the concept of systemic risk in De Bandt and Hartmann (2000) and Smaga (2014a).

[2] As the level 3 committees had weak legal powers (only non-binding recommendations), they neither effectively promoted common supervisory standards nor were able to undertake quick cross-border actions in the face of emerging crisis (Dobrzańska, 2012).

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All those institutional weaknesses called for a regulatory overhaul. Introduction of maximum harmonization together with the single rulebook principles should ensure uniform regulatory environment for all EU financial institutions, especially in the banking sector. However, the establishment of the European System of Financial Supervisors did not mark the end of institutional reforms within the EU. There is also a need for further strengthening resolution arrangements in the EU, especially for systemically important financial institutions (SIFIs). The issue of burden-sharing in case of cross-border bank insolvency is still not clearly resolved. Effective pan-European resolution is crucial because costs of financial crises are very high not only in terms of output loss[3] but also in terms of public deficit and debt increases, as evidenced by the exacerbation of the sovereign-bank nexus in the euro area countries. Establishing the banking union is thus a key reform to tackle those problems and strengthen the European safety net.

Banking union is targeted, in the first place, at euro area countries, as they were hit most severely by the crisis. In the nutshell, banking union foresees the transfer of so far national supervisory and resolution competences to the euro area level. However, in order to be effective, without creating competitive distortions and fostering development of the single market, banking union has to remain open for participation of the non-euro countries as well. This group of countries is very heterogeneous and with financial systems at different stages of development and convergence with the euro area. Yet, the financial and economic interlinkages between non-euro area and euro area countries are strong and cannot be disregarded. It is therefore necessary and mutually beneficial to invite and encourage non-euro countries to participate in regulatory reforms at the level of the euro area, as many non-euro countries in CEE are EU Member States with a "derogation".[4] While there is no doubt that further European integration is a natural direction for them, not all aspects of the banking union might be beneficial from their perspective and the question of opting-in to the banking union remains open.

The aim of this policy paper is to analyze and assess both advantages and disadvantages of opting-in to the banking union for non-euro EU countries, focusing on the example of CEE countries. We analyze the position of non-euro countries which can establish close cooperation with the ECB, i.e. join the banking union without simultaneously joining the euro area and thus become opt-in countries ("opt-ins"). The analysis covers the banking union in its current shape – the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM), and the proposal for European Deposit Insurance Scheme (EDIS), having in mind that opting-in means participation in all of those mechanisms.

The decision to opt in should on the one hand, take into account the assessment of banking union's construction with all its weaknesses and strengths and on the other hand, the robustness of a national safety net as well as the structure and stability of the domestic banking system. The main research question is whether it pays for a non-euro country to opt-in to the banking union in its current shape? What would be the optimal choice: opting-in now or joining the banking union when entering the euro area?

The literature on evaluation of opting-in to the banking union is still very scarce. To our knowledge for the time being only Berglöf, Haas, and Zettelmeyer (2012), Darvas and Wolff (2013), Kisgergely and Szombati (2014), IMF (2015) and Hüttl & Schoenmaker (2016) analyze opting-in from the perspective of CEE countries. We also use banking union assessments provided in reports by central banks or by official government bodies from non-euro countries. Our contribution to the literature is threefold. First, we build upon those findings and attempt to provide a comprehensive assessment of attractiveness of all aspects of banking union pillars from the perspective of a non-euro Member State. Second, unlike the previous studies, we go beyond just analysis of banking union and outline practical policy proposals to encourage opting-in. Third, on the basis of economic underpinnings we evaluate current willingness of each non-euro country to opt in.

The article is structured as follows. In the next section, an overview of aims of the banking union and the rules of "opt-in option" are presented. Then we analyze potential benefits of joining the banking union for opt-ins, which are mostly the same also for euro area banking union members.[5] The following section discusses risks for opt-in countries connected with their limited rights, risks stemming from the deficiencies in the banking union construction and issues related to specific features of opt-ins' (especially CEE) financial systems. Having juxtaposed both benefits and risks, the subsequent section outlines some policy implications and regulatory proposals to strengthen the banking union, counter the identified disadvantages, and thus encourage opting-in. The final section concludes.

2. Principles of the banking union

The banking union is a milestone in European financial integration, comparable to the introduction of the euro. The banking union can be regarded as a hitherto missing element of the financial integration. The banking union is a part of vision of a stable and prosperous EMU, as laid out in Van Rompuy's report (2012) encompassing integrated: financial framework, budgetary framework, economic policy framework, while ensuring democratic legitimacy and accountability.

There are several objectives of establishing the banking union, yet their achievement, at least in the short run, remains debatable (Smaga, 2014b):

[3] For crises in all countries over 1970-2011 the median output loss reaches 23% of GDP (Laeven & Valencia, 2012).

[4] At the time of their EU accession, they haven't meet the convergence criteria for entry to the euro area, therefore their Treaties of Accession allow them time to make the necessary adjustments. They are obliged to join the euro area at some point, when all the convergence criteria are met.

[5] In the paper we don't include detailed descriptions of the banking union pillars as those can be found in e.g. Wymeersch (2014) for SSM and Junevièius and Puidokas (2014) for SRM. The description of SSM and SRM pillars and their overall assessment is also provided by Smaga (2016).