STATENS OFFENTLIGA UTREDNINGAR

Utredningen om ett eventuellt deltagande i Europeiska bankunionen (Fi 2017:10)

Committee on Potential Participation in the European Banking Union

Better In or Better Out:

Weighing Sweden's Options Vis-à-vis the Banking Union

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[b] Rapporten är skriven på uppdrag av Utredningen om ett eventuellt deltagande i Europeiska bankunionen. Författaren har självständigt ansvar för rapportens metod, analys och slutsats. De åsikter som uttrycks i denna rapport är författarens egna.

The report is written on behalf of the Committee on Potential Participation in the European Banking Union. Responsibility for the report's method, analysis and conclusions lies exclusively with the author. The views expressed in this report are those of the author.

1. Introduction

The experience of the Global Financial Crisis across the European Union and across the globe has led to significant reforms in cross-border supervisory cooperation. Specifically, the failure of internationally active financial institutions, such as Lehman Brothers, and crossborder banks, such as Fortis, Dexia, or the Icelandic banks, and – even more – their chaotic resolution played a prominent role during the Global Financial Crisis. As much as these banks were global in life, their resolution had to be undertaken on a national level, given the lack of any tools to coordinate the resolution on a cross-border level.

As a consequence, there is a growing recognition that Memorandums of Understanding (MoU) and supervisory colleges[1], as designed before the Global Financial Crisis, are not sufficient to deal with large and systemically important cross-border financial institutions in times of distress. There have been multiple initiatives at the global level (with the FSB issuing best-practice papers as well as standards like the Key Attributes for Effective Resolution Regimes) on colleges and cross-border supervisory cooperation, on the level of the European Union through the Bank Recovery and Resolution Directive (BRRD)[2], and on the Eurozone level with the (incomplete) construction of the European Banking Union. Critically, there has been an increasing focus on the resolution stage in the cross-border coordination process. Supervisory colleges were complemented with resolution colleges and, within the EU, guidelines for cooperation in the preparation for and execution of resolution were designed. Within the Eurozone, the Single Supervisory Mechanism was complemented with the Single Resolution Mechanism.

The banking union was originally conceived and implemented as reaction to the Eurozone crisis and initially only Eurozone countries joined. Specifically, a currency union with crossborder banking activity and close bank-sovereign linkages is not sustainable with purely national banking regulation (while at the same time relying on one de-facto lender of last resort).[3] In theory, however, participation in the banking union is open to any EU member state, once the ECB has vetted the regulatory and supervisory quality of any applicant. In practice, several countries have explored joining the banking union, given strong cross-border banking links with Eurozone countries, including several Central European countries, as well as Denmark and Sweden. In the case of Sweden, a previous discussion led to a declaration to stay outside.

This paper assesses the economic rationale for cross-border cooperation among supervisors, resolution authorities and deposit insurers and supra-national institutional structures to support this cooperation. It offers a short assessment of the banking union adopted in the Eurozone a few years ago and reviews arguments for non-Eurozone countries in the European Union to join the banking union. Based on theoretical arguments and empirical observations, the paper argues for the need for a supra-national and full-fledged financial safety net for the Eurozone. In line with historic experience, however, one can also expect

[1] While there were some resolution colleges before the Global Financial Crisis, there were few and far in between.

[2] Including binding rules on supervisory cooperation within the EU and a binding mediation role for the European Banking Authority, EBA, on cooperation where it does not relate to fiscal expenditures.

[3] It is important to note that I do NOT claim that a supranational financial safety net makes the Eurozone a sustainable currency union. There are other important elements such as capital market, fiscal and, possibly, a political union, which are not the focus of this paper.

adjustments in the design of this financial safety net, based on experience but also the development of the banking system.[4] Most importantly, the paper argues that joining this financial safety net does not only provide benefits for non-Eurozone countries, but also shortcomings. While the paper does not make a clear case either way, it argues that the economic case for Sweden joining the banking union is not an obvious one and that there are many open questions. While the option to join the banking union is thus a valuable one, it is not clear that now is the right moment to exercise this option.

The remainder of this paper is structured as follows. The next section provides a conceptual framework for cross-border supervisory cooperation with a focus on the resolution stage. Section 3 discusses cross-border linkages of the Swedish banking system and supervisory cooperation within the Nordic-Baltic region. Section 4 presents details on the banking union structure, while section 5 discusses the experience so far and the implication the banking union has for EU members states that are not part of the Eurozone and thus the banking union. Section 6 finally, presents arguments in favour and against Sweden joining the banking union. Section 7 concludes, pointing to open question for non-Eurozone countries considering joining the banking union, both generally and specifically for the case of Sweden, but also discusses some criteria for the decision process.

2. From national to supra-national supervision and resolution: conceptual framework

Potentially sizeable externalities from bank failure, i.e., losses incurred by stakeholders not involved in direct or indirect decision-taking, are the main reason why the banking industry is among the most regulated sectors in most economies. Such externalities arise from the network effects across the banking system (interbank exposures, common asset exposures, informational contagion), the risk imposed on savers to suffer losses on their "safe" deposits, and the loss of soft information arising from relationships between borrowers and financial institutions, especially in the case of smaller firms. Given the constraints on market discipline in banking, domino effects and the central role of banks in modern market economies, bank failures not only impose wide-spread economic losses, but also affect other financial institutions and the economy at large; multiple bank failure or the failure of systemically important institutions often result in systemic banking crises, with large costs for the economy (Laeven and Valencia, 2018). These costs are the main rationale for financial safety nets, consisting of regulation and supervision of banks, lender of last resort liquidity facilities, deposit insurance and bank resolution frameworks. Box 1 discussed the structure of the financial safety net in Sweden. Such financial safety nets are traditionally purely national and in a world with mostly domestic banking systems and limited cross-border bank flows there is little if any need for cross-border regulatory or supervisory cooperation, at least from an externality viewpoint. As long as the externalities of bank failure are limited to domestic agents and domestic supervision is effective, there is no economic justification for cross-border regulation.[5]

[4] If one considers the development of the US banking system and its regulatory framework over the past 200 years, it is quite clear that such a financial safety net responds to changes in the banking system, learning effects, and, importantly, political changes.

[5] Domestic regulation, however, might create incentives for cross-border expansion. One notable example is Nigeria where forced consolidation of the domestic banking sector in the early 2000s resulted in excess

Box 1: Sweden's financial safety net

Sweden's financial safety is spread across a number of institutions, following reforms in the 1990s. Finansinspektionen (FI) is the bank regulator and supervisor (as well as responsible for regulation and supervision in other segments of the financial system and consumer protection), while Riksgälden (Swedish National Debt Office, SNDO) is the deposit insurer and bank resolution authority. The Riksbank is lender of last resort and responsible for monetary policy (but has no formal financial stability mandate besides to promote a safe and efficient payments system).

FI has both micro- and macro-prudential responsibilities. While not part of the SSM, it is part of the ESRB (as is the Riksbank), established in 2010 and housed at the ECB, which is responsible for macroprudential oversight of the EU financial system and the prevention and mitigation of systemic risk. Early 2016, the SNDO was designated as the bank resolution authority and the BRRD was implemented through the enactment of a new Resolution Act and a new Precautionary Government Support to Credit Institutions Act as well as amendments to banking and securities market legislation. In addition to extending emergency liquidity assistance (ELA), the Riksbank, jointly with FI, oversees the financial market infrastructure. The Financial Stability Council (FSC), which was created in 2013, is chaired by the Minister of Financial Markets, and includes representatives of all three institutions and is a forum for exchange of information on financial stability and discussing measures to prevent financial imbalances and crisis management measures, including crisis preparedness and exercises. However, it has no decision powers.

The Swedish model of a supervisory entity that is separate from the Central Bank was introduced after the crisis in the 1990s and other countries in Europe (most prominently the UK in the late 1990s) and around the world have followed it. More recently, however, many countries, including in the EU (again most prominently the UK), have moved back to a model where bank supervision is part of the Central Bank and/or there are close interconnections between these two responsibilities. This in light of post- Global Financial Crisis insights that monetary and financial stability are not independent policy goals, that monetary policy has implications for financial stability (by, e.g., affecting risk-taking incentives of banks) and that macro-prudential policies targeting systemic (as opposed to bank-level) stability are important.

2.1 Cross-border externalities of bank failure

However, in a world where banks deal with banks and markets in other countries and where banks expand their activities across borders, distortions arise from a national supervisory process, as we will explain in the following. One can distinguish between different externalities from cross-border banking:

- *Ownership linkages*: First, cross-border externalities arise from cross-border activities of specific financial institutions and are not taken into account by domestic supervisors who – by law – are focused on domestic stakeholders and domestic financial stability and are accountable to domestic governments and taxpayers. The failure of a bank that

capital, which fuelled an expansion trend by these banks across the continent. Alternatively, a "bank-friendly" regulatory approach might aim at attracting foreign banks into the country.

has foreign assets will impose costs on borrowers abroad by leading to lower credit availability to foreign firms. Similarly, the cost of foreign depositors losing access to savings is not internalized by home country supervisors, leading to inefficient decisions. Cross-border activities thus result in a mis-match between the supervisory perimeter and the perimeter of banks' activities.[6] Specifically, some of the losses from bank failure (such as foreign borrowers losing their lending relationships and foreign depositors losing savings) fall outside the supervisory perimeter, lowering national supervisors' willingness to intervene promptly to thus limit these losses; on the other hand, the benefits of allowing banks to continue – potentially betting for resurrection with risky investment strategies – fall partly outside the supervisory perimeter as it will be foreign equity holders that benefit, which increases national supervisors' willingness to act promptly. As we will discuss below, this linkage is highly relevant for Sweden, given the close integration of banking systems across the Nordic-Baltic region.

- *Market linkages*: Second, cross-border externalities can arise even if there is no direct cross-border bank presence in a country, but through financial market integration. Specifically, direct interbank exposures can result in negative crossborder externalities from a bank failure (see, for example, Niepmann and SchmidtEisenlohr, 2013). Such cross-border spillovers can also be due to fire-sales of fragile banks and common asset exposures, but also informational contagion among investors (such as seen in September 2008, as described in Brunnermeier, 2009). Exposure by banks to the same asset markets as the failing bank in another country is sufficient for this type of externality to occur.[7] The more financially integrated financial systems are the higher is this exposure. Given the close integration of the Swedish financial market with European and global markets, this is certainly a concern.
- *Regulatory arbitrage*: Third, cross-border externalities can arise from regulatory arbitrage. Banks have incentives to move to jurisdictions with lighter regulation and such jurisdictions benefit from an inflow of banking business (in the form of jobs and tax revenues). However, this can result in negative externalities for other countries, if and when lighter regulation leads to bank fragility or failure. Altogether circumvention of supervisory oversight due to regulatory arbitrage, e.g. as regards licensing requirements, reporting standards and observance of prudential regulations, can have a pervasive impact on the solidity of the banking sector, and is a major concern particularly in less developed and smaller economies where supervisory capacity is limited.
- *Currency unions*: Finally, within monetary unions specific externalities arise due to the fact that a country cannot simply devalue its currency to regain competitiveness following a shock and hence may need to tap the resources of other countries in some form or other.[8] The costs from asymmetric shocks that affect members of a currency

[6] Beck, Todorov and Wagner (2013) show that banks' cross-border activities distort supervisory incentives as evidenced by actual intervention decisions during the recent Global Financial Crisis. Specifically, cross-border banks with a high share of foreign deposits and assets were intervened at a later, more fragile state by their home country supervisors, while cross-border banks with a high share of foreign equity were intervened earlier at a less fragile state. These findings are consistent with the costs of bank failure being borne by foreign depositors and borrowers thereby providing the incentive for home country supervisors to delay intervention by exercising forbearance.

[7] Sales of assets of a weak bank to gain liquidity or deleverage might depress asset prices, which has negative repercussions for banks that hold the same asset and have to mark it to market.

[8] See Farhi and Werning (2017) for a theoretical analysis.

union to a different extent are thus much higher in monetary unions.[9] Further, relying on a common lender of last resort might result in a tragedy of commons problems, as it is in the interest of every member government with fragile banks to “share the burden” with the other members through, e.g., drawing on liquidity support by the joint lender of last resort (Tornell and Westermann, 2012). It is important to note that this externality applies on the systemic level, rather than just for individual institutions. The costs arising from this potential burden-sharing, or rather, burden-shifting, across countries in monetary unions increases in line with the overall size of the banking systems and the interlinkages across borders within the union.

These four types of cross-border externalities have a number of implications for regulation and supervision. The high-level implication for international regulation from the first type of externality is straightforward: in order to avoid these distortions, the geographic perimeter of the responsible supervisor should match the geographic footprint of the bank. While home country supervisors supervise on a consolidated basis, their mandate is primarily focused on the interests of domestic stakeholders, not on foreign stakeholders. Obviously, an alignment of supervisory mandates and footprint of banks is hard if not impossible to implement in practical terms, given the size of banks’ geographic footprints, their variability over time and the fact that banks based in the same home country can be active in different countries and regions. The second type of externalities has taken on an increasingly important role over the past decades with banks being increasingly exposed to market-traded assets and relying more on market-based funding, even though this trend might have reverted somewhat after the 2008 crisis. The third externality has arisen again and again in recent financial history with banks locating in the jurisdiction with the lightest regulatory touch. This is hard to avoid, even in light of regulatory standards, as such standards are voluntary and not legally binding and can be implemented with different degree of rigour.[10] Finally, the fourth externality might be especially relevant for smaller countries in currency unions and for countries with oversized (relative to their overall economy) banking systems. Cyprus is such an example during the Eurozone crisis. Another example are countries that are completely eurorized, such as Montenegro or Kosovo as they effectively cannot exercise their lender of last resort responsibility. We will discuss this fourth externality in more depth in section 4.

Both domestic and cross-border externalities of bank fragility become most evident and relevant during the failure stage of banks and systemic banking crises. The experience of the Global Financial Crisis has therefore shifted the emphasis of both national supervision and cross-border supervisory cooperation towards the resolution stage. With few if any European countries having bank resolution frameworks before the Crisis (thus either applying corporate insolvency frameworks with drawn-out procedures resulting in market freezes as in the case of Lehman Brothers or deciding for a bail-out), resolution frameworks were put in

[9] A similar need to tap common resources might arise if the banking system is too large relative to fiscal revenue, and thus becomes too-big-to-save, as again the examples of several countries within the Eurozone have shown (Bertay, Demirguc-Kunt and Huizinga, 2011).

[10] One can interpret the move of Nordea from Swedish to SSM supervision as such a move. In 2016, according to the press and public statements by Nordea´s chairman, the bank made an offer to take over Dutch state-owned bank ABN Amro. The potential transaction was justified by the possibility of some regulatory relief, since the combined bank would be in the Netherlands and, consequently, the consolidating supervisor would be the SSM. However, the transaction was not successful. Similarly, in 2007, when British Barclays bid to take-over Dutch ABN Amro, it announced it would shift headquarters to the Netherlands, which was seen as a move to change the regulator.

place across the EU, under the umbrella of the BRRD. At the same time, there has been the political intention to move away from bail-out expectations (thus effectively extending the safety nets to all creditors of a financial institution) to creating bail-in expectations, where taxpayer money can only be used after not only shareholders claims are written down, but debt claims of a certain amount are either written down or turned into equity claims on the resolved banks. To facilitate such a bail-in Total Loss Absorbing Capacity (TLAC) in the case of Globally Significant banks, G-SIBs, (as per recommendation of the FSB) and Minimum Requirement for Own Funds and Eligible Liabilities (MREL) have been introduced for other significant institutions in the European Union, O-SIIs, (as per CRD IV). At the same time, resolution plans are to be drawn up to facilitate the swift resolution of a financial institution to thus avoid contagion effects and disruption in financial markets.

2.2 Consolidated supervision and conflicts of interests between home and host supervisors

The traditional tool to regulate and supervise cross-border banks has been consolidated supervision, i.e. the regulation and supervision of the overall group with all its branches and subsidiaries. Consolidated supervision puts the home country supervisors in a privileged position, as it has more knowledge and thus also more power than host country supervisors. Consolidated information, however, relies on cooperation between home and host country supervisors, especially for the exchange of soft information. Memorandums of Understanding (MoU) have typically been used to facilitate the flow of information on a continuous rather than ad hoc basis and authorize supervisors to exchange confidential information, even though they are not legally binding. Supervisory colleges serve as mechanisms for increasing cooperation, coordination, and flow of information between home and host supervisors to thus enhance the effectiveness of consolidated supervision of cross-border banks. However, the protection of financial and national interests as well as asymmetric information availability across home and host country supervisors can skew decision-making processes in favour of home and at the expense of host supervisors and their respective economies.

Beyond the information asymmetries, there are other asymmetries in the interests and relative powers of home and host country supervisors. The diverging interests become even clearer during times of distress (D'Hulster, 2012). If the problem arises in the parent bank, the home country supervisor has strong incentives to delay and minimize information sharing (especially if the host country subsidiary is of material importance for the parent bank), while the host country supervisor has strong incentives to ring-fence and thus prevent local assets to be upstreamed to offset losses in the parent bank's financial position or in other parts of the group. If the problems arise in the subsidiary, on the other hand, the home country supervisor has incentives to share information with the host country supervisor (if the subsidiary is of material importance for the parent banks), while the host country supervisor has incentives to overstate the problem vis-à-vis the home country supervisor (possibly triggering capital and liquidity support from the parent) but also to ring-fence. Ultimately, in times of distress the interests of home and host country supervisors are not aligned.

And while the host country supervisor can try to ring-fence the subsidiary in times of distress, this is often difficult to do given the organizational interdependence (such as common IT platforms and centralized back offices) across the bank. Ringfencing is effectively im-

possible in the case of branches that are fully integrated (both financially and operationally) into the parent bank or one of the subsidiaries. In addition, the relative power of home supervisor visà-vis host supervisor is even stronger in the case of branches.

One critical issue in resolution planning, especially in the context of cross-border banks is the discussion between Single Point of Entry (SPOE) vs. Multiple Point of Entry (MPOE) resolution strategies. The choice between SPOE and MPOE influences how a cross-border banking group would be resolved. Under the SPOE, losses are expected to be allocated to bondholders and creditors of the parent bank irrespectively of where the losses are originated. To ensure that losses in the subsidiaries can be up-streamed to the parent entity, an amount of loss absorbing capacity is prepositioned on the subsidiaries' balance sheet (internal TLAC/MREL). Under the MPOE, losses would be borne by the bondholders and other creditors of both the parent entity and one or several subsidiaries ("points of entry"). Each point of entry should be separable from the rest of the group and, for this reason, should be resolvable independently. Consequently, the TLAC/MREL should be provided mainly by third-party investors in each point of entry, i.e. the parent company and the subsidiaries identified as points of entry. MPOE is generally suitable for groups made up of selfsufficient, autonomous financial subgroups and subsidiaries operating in different countries. So far, MPOE has been selected as a resolution strategy in only a relatively limited number of Global Systemically Important Banks (G-SIB) (e.g., Santander and HSBC).

3. Sweden's cross-border banking links

Sweden's banking system is closely interlinked with other banking systems in the Nordic-Baltic region (see Map 1, which shows the countries where Swedish banks have subsidiaries or branches). Four (since October three) of the six largest Nordic banks are headquartered in Sweden. Most of the cross-border banking activity in the Nordic region is done by Nordic banks and banks from outside the region generally have low market shares. The four largest Swedish banks have presence – in the form of either branches or subsidiaries – in neighbouring and other European countries. Specifically, Nordea (the result of a merger of four large national banks in 2001) has a presence in Denmark, Finland and Norway, with the headquarters until October in Sweden and thus under the supervision of FI. While originally subsidiaries, in April 2018, they were converted into branches, while other part of the bank across the Nordic region (insurance, mortgage bank, investment banks) continued as subsidiaries. As of 1 October 2018, Nordea redomiciled to Finland, which turned the Swedish operations of Nordea into a branch of Nordea Finland (supervised by SSM). Swedbank has wholly-owned subsidiaries in Estonia, Latvia, and Lithuania, all countries that form part of the banking union. Handelsbanken is present in UK, Denmark, Finland, Norway, and the Netherlands, but all in form of branches (though the one in UK is about to be transformed into a subsidiary). Finally, SEB has subsidiaries in Estonia, Latvia, Lithuania, Denmark, Finland, Germany and Norway. The SEB and Swedbank subsidiaries are considered significant institutions by the SSM and thus directly supervised by the ECB, given their dominating position in the three Baltic countries, while Nordea is considered a significant institution, because of its dominant role in the Finnish banking system. These strong crossborder links give rise to externalities as discussed in section 2, but concentrated in European and especially in the Nordic-Baltic countries. Box 2 discusses these externalities in a more systematic way, comparing Sweden and the Nordic-Baltic countries with other country groupings in Europe and across the globe.

The strong cross-border links across the region have resulted in supervisors across the Nordic-Baltic region cooperating and coordinating closely with each other.[11] The shared constituency in the IMF/World Bank helped form the base for supervisory cooperation. In 2001, the merger of four large national banks into the Nordea bank (which was designated as a G-SIB by the Financial Stability Board in 2011) resulted in the establishment of the Nordea College, considered to be the first supervisory college in the EU; the college was extended to the Baltic countries as Nordea expanded into these markets. Cooperation in this college has been much more intense than in other colleges (meeting four times rather than the minimum of once a year), including joint supervision missions and crisis prevention planning. In addition to formal cooperation there is also quite some informal cooperation among regulators and ministries of finance in the region. In 2003, the Nordic central banks adopted a Memorandum of Understanding (MoU) on the ”Management of a financial crisis with crossborder establishments”. In 2010, the Nordic-Baltic countries adopted an MoU, which included the establishment of the Nordic-Baltic Stability Group (NBSG) to ensure that the parties are prepared to deal with financial crisis situations by agreeing in advance on procedures for cooperation, sharing of information and assessments. This broader MoU, also including the ministries of finance, was signed with an explicit focus on crisis management and resolution, as well as specific burden sharing agreements. A Crisis Management Group for Nordea was established in 2012 after its designation as G-SIB (which also effectively replaces the resolution college, mandated under the BRRD). Finally, in 2011, the NordicBaltic countries established the Nordic-Baltic Macroprudential Forum (NBMF) to complement bank-level supervisory cooperation with systemic stability cooperation, an informal forum with no formal decision powers. Finally, there are arrangements between the central banks of Denmark, Norway and Sweden on utilisation of central bank deposits at one of the central banks as collateral for intraday liquidity lending in another of the three central banks (Scandinavian Cash Pool).

Map 1: Countries with presence of Swedish banks

[11] For the following, see more detailed discussion in RGC (2016).

Box 2. Cross-border linkages of Sweden and the case for cross-border supervisory cooperation

While the externalities discussed in section 2 clearly create biases in decisions in national supervisory decisions, which might be mitigated by supra-national structures, Beck and Wagner (2016) argue that there are both benefits (stemming from these externalities) as well as costs from supervisory cooperation. These costs stem from heterogeneity across countries in, among others, (i) the importance of banking and the market structure in banking, (ii) political, legal and regulatory structures, and (iii) societal risk preferences, which in turn leads to differences in supervisory decisions, especially in the resolution phase, and thus again suboptimal decisions if taken by a supranational supervisor. Beck and Wagner show theoretically that (more intensive) cooperation across borders is optimal the higher the externalities of cross-border banking and the lower the heterogeneity across countries. They also show, however, that even where (more intensive) cooperation is optimal, it might not happen if only one of the two countries benefit. And as already discussed, asymmetry in the importance of a specific subsidiary for the host country and its overall importance in the parent's balance sheet and thus home country might bias supervisors against (close) cooperation.

Beck, Buston-Silva and Wagner (2018) use hand-collected data and show that countries are indeed more likely to cooperate and to cooperate more intensively if there are higher cross-border externalities, as measured by (i) cross-border ownership links, (ii) stock market correlation as proxy for capital market integration, (iii) sharing a G-SIB and (iv) sharing a currency or a fixed peg. On the other hand, countries are less likely to cooperate if they are more different along the three dimensions discussed above. The Nordic-Baltic region has seen more than a doubling in cross-border externalities over the past 20 years, from an average of 0.1 to an average of 0.25.[12] At the same time, Sweden's banking system shares many characteristics with that of its neighbouring countries, especially in the Nordic region. Banking systems in the region experienced banking crises in the 1990s, following financial market liberalisation. They are all characterised by high concentration and high focus on mortgage lending (with high levels of household indebtedness). Beyond similarities in banking structure, the Nordic countries share strong historic, linguistic and cultural links. All of this makes heterogeneity across the Nordic-Baltic region (especially across the Nordic) region very low, in line with more intense cooperation even before the Global Financial Crisis.

Map 2 illustrates the differences in externalities and heterogeneity across the Nordic region, the Nordic-Baltic region and the European union from the Swedish viewpoint. Specifically, the average cross-border externality of the Swedish banking system with the other four Nordic countries is 0.38, while the average is 0.31 with the Nordic-Baltic region and 0.25 with the European Union.[13] Across a sample of 92 countries across the globe, the average externality is only 0.13. This significantly higher cross-border externality within the Nordic and Nordic-Baltic regions is driven by ownership linkages rather than market linkages (which do not vary between the Nordic, Nordic-Baltic and European markets). It is important to stress that these linkages are even underestimated as they do not take into account branch presence, due to data limitations. In terms of heterogeneity, the ranking is exactly the reverse, with heterogeneity of Sweden with the average Nordic country being lowest (0.30), followed by the Nordic-Baltic region (0.38), the European Union (0.48) and the global average (0.55).

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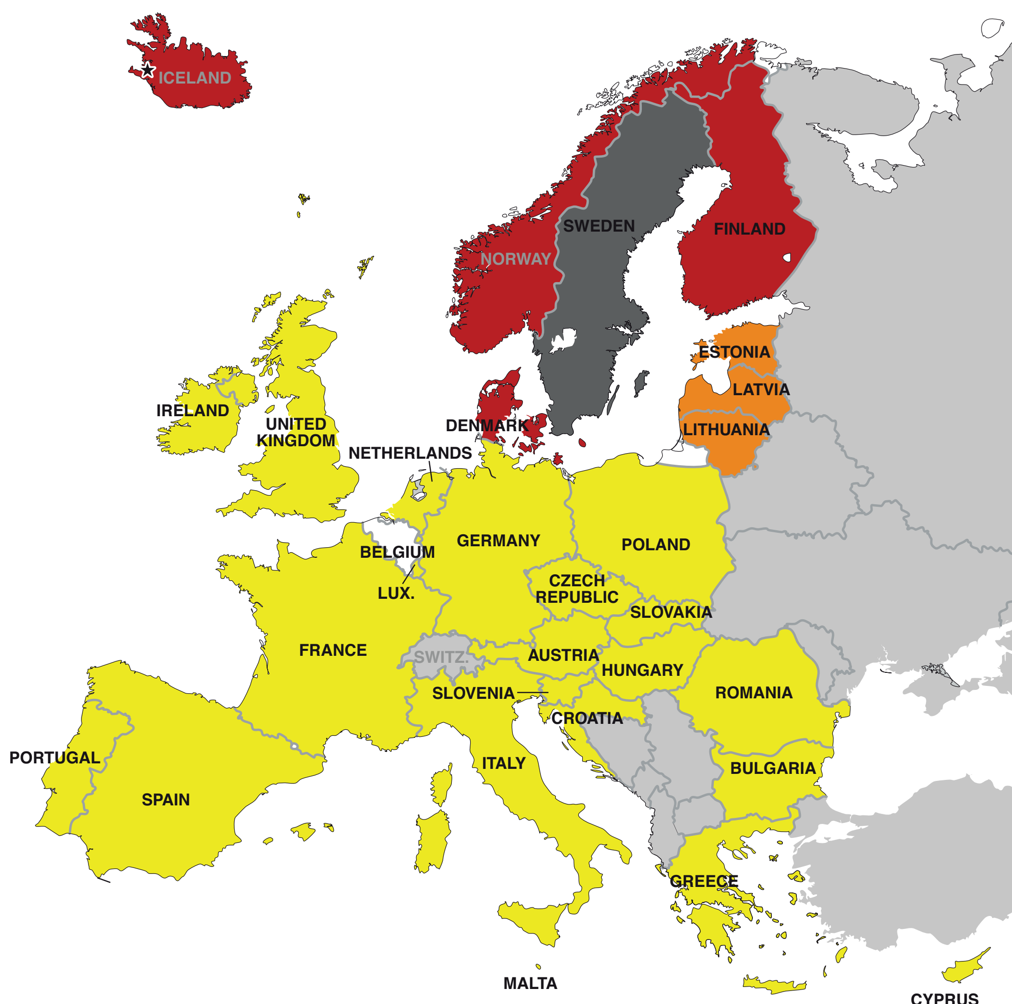
[12] By construction, the externality measure can vary between zero and one. Across a sample of 93 countries, Beck et al. find variation between zero and 0.85.

[13] Again, both externality and heterogeneity measures are normalised between zero and one, with higher values indicating higher cross-border externalities between two countries and higher heterogeneity.

Map 2: Externalities and heterogeneity between Sweden and other countries



Note: lighter colours indicate lower externalities and higher heterogeneity

4. The European banking union – crisis response and a fundament for banking in Europe

4.1 The Crisis as starting point

The discussion in section 2 pointed to externalities specific to currency unions. These externalities came out clearly during the recent Eurozone crisis. Specifically, in the absence of any bail-in regimes, large non-performing loan (NPL) exposures and consequent bank losses (resulting in turn from high private overindebtedness and a turning housing price cycle) were taken on by governments, which in turn resulted in a non-sustainable sovereign debt position, as in the cases of Ireland and Spain. In Cyprus, overinvestment in highyielding Greek government debt resulted in the insolvency of several large Cypriot banks after the restructuring of Greek government debt. In all cases, losses were too great

for national governments to burden. In Greece, sovereign overindebtedness and consequent debt restructuring had a negative impact on Greek banks' solvency position given their exposure to these bonds. In Italy, a triple recession resulted in high NPLs. Many of these distress episodes had their roots also in national regulatory and supervisory failures – lack of macroprudential regulation and resolution regimes, but also supervisory forbearance.[14] This clearly makes the case for supranational supervision to improve both quality of supervision, but also reduce the risk of regulatory capture. In addition, the de facto role of the ECB as a common lender of last resort also results in a tragedy of commons problems, as it is in the interest of every member government with fragile banks to "share the burden" with the other members through, e.g., drawing on liquidity support by the joint lender of last resort, while avoiding timely and swift resolution of failing banks, thus increasing losses further. Further, shocks across the Eurozone hit different countries differently, which makes a strong case for deposit insurance as risk sharing tool and to ensure that a euro has the same value across countries.[15] Similarly, monetary policy transmission can become clogged in case of widespread bank fragility that cannot be addressed on the national level. In summary, the Eurocrisis has clearly shown the case for (i) tightening market discipline, (ii) improving supervisory stringency, but also (iii) risk sharing across the Eurozone.[16]

The crisis has also shown that asymmetric interests of national regulators during times of distress can undermine the Single Market in banking, in line with the discussion in section 2. During crisis times, national regulators have the incentives to ringfence, i.e., encourage banks to keep liquidity in the respective jurisdiction, thus undermining the Single Market in banking and thus efficiency in capital allocation. This externality became especially clear at the height of the Eurozone crisis in 2011/12, when regulators across the region tried to ringfence local subsidiaries and parent banks in light of denomination risk. For example, the subsidiary of an Italian would not be allowed to transfer funds to its parent bank in Italy, while German supervisors were also pushing German banks with subsidiaries in Italy to source funding locally (Gros, 2012).

The creation of the banking union with its different institutions is thus directly a result of the Eurozone crisis and – not surprising - while in principle open to all EU members, up to this moment only Eurozone countries have joined the banking union. While the banking union is a child of the Global Financial and Eurozone crises and has thus primarily a stability focus, a second important objective is to create a "truly" European banking system or a Single Market in banking. This argument is obviously based on the assumption that having a Single Market in banking brings large benefits for the EU, in terms of higher competition, and for the Eurozone better risk diversification.[17] A Single Market in banking also implies

[14] The comprehensive assessment of 2013/14 has provided evidence for this tendency towards regulatory forbearance by national supervisors. For example, more than 20 per cent of the reviewed debtors were reclassified as non-performing in Greece, Malta and Estonia. Slovenia even saw a 32 per cent reclassification, with one bank hitting 43 per cent. These high numbers in some countries suggests that this is not simply due to different national loan classification regimes but rather a high degree of regulatory forebearance if not regulatory capture.

[15] After Cyprus introduced withdrawal restrictions on its banks in 2013, Wolff (2013) was one of the first to argue that this effectively resulted in a euro having different values across countries of the Eurozone.

[16] For a more general argument on the combination of risk sharing and market discipline in the Eurozone, see the recent 7+7 proposal (Benassy-Quere et al., 2018).

[17] This argument is empirically backed up by evidence from the U.S., where inter-state branch deregulation allowed for greater risk sharing and thus lower volatility across states (see Berger and Roman, 2018, for a literature survey).

the possibility to resolve banks on the supranational level with a focus on maintaining as much of the failing bank's franchise value as possible rather than liquidating the entire institution, while resolution faces limitations in small financial systems, where the options to merge a failing bank with a healthy bank are often few. In addition, in smaller financial systems banks are more likely to co-vary in their performance, so that one failure comes rarely alone – being able to resolve banks in the framework of a larger economic area can thus be helpful.

4.2. The components of the banking union: SSM and SRM

The banking union in its current form consists of the Single Supervisory Mechanism and of the Single Resolution Mechanism. A single supervisory mechanism (SSM) was established when the European Central Bank (ECB) took over responsibility for bank supervision (directly for the largest, indirectly for all banks) in the Eurozone in late 2014, following a year-long 'comprehensive assessment' effort to assess capital positions across the largest banks in the euro zone and apply stress tests to these capital positions to establish their resilience.

The SSM is now direct supervisor of 118 significant Eurozone banks and the responsible authority for all banks in the Eurozone. It relies heavily on the resources of national supervisors through Joint Supervisory Teams (JSTs) tasked with the day-to-day supervision of banks and banking groups, comprising both SSM staff and staff of national supervisory authorities. Hence, the national host supervisors retain access to relevant information, even though they have lost decision power in practice. The SSM is now also the responsible body for ensuring that distressed banks are addressed in a timely manner. and reviews the annual Group Recovery Plan, demanding an adequate coverage of all the material legal entities included in the group regardless if they are located in or outside the EU.

By late 2014, European authorities had also agreed on the second pillar of the banking union, a single resolution mechanism (SRM), to come into effect in 2016. The SRM is a coordination mechanism on top of national resolution mechanisms that also involves the European Commission, the European Council, the ECB and national resolution authorities. No centralized solution has been established so far for deposit insurance.

The BRRD has also mandated the establishment of resolution funds through the European Union, which in the case of Eurozone countries are to reach the target level of at least 1% of the amount of covered deposits of all credit institutions within the Banking Union by 31 December 2023. In the case of banking union members, these resolution funds are to be linked into a Single Resolution Fund, with steps towards full mutualisation until 2024.

In resolution, however, a strong role for national authorities in the execution of resolution decisions as well as in the planning phase remains. That said, the SRB is less driven by consensus-oriented decision making of its constituents than the ECB and the SRM model relies more heavily on work performed by national authorities than the SSM. The national resolution authorities are deeply involved in drafting resolution plans, resolvability assessments, communicating with banks, engaging with them, answering to their doubts, but in accordance with the general policies and criteria approved centrally by the SRB. All the Eurozone national resolution authorities, together with the SRB make up the Internal Resolution Teams (IRTs).

5. The European banking union — the experience so far and future development

This section discusses both the experience with the banking union so far, but also the impact of the banking union on non-Eurozone EU member states, such as Sweden.

5.1 The experience with the banking union

The experience with SSM and SRM has been positive in a technical sense, even though political constraints still restrict the banking union from being more effective. The SSM has to work with different national banking acts and different accounting and auditing standards, which might not only throw sand into the wheels of its own procedures but also hamper the development of a level playing field in regulation and supervision. Further, there could be arbitrage possibilities when it comes to monitoring banks that are directly supervised by the ECB and those that are not. In addition, the question of the regulatory perimeter will arise for the SSM as much as for other bank regulators and thus the challenge of potentially expanding regulation and supervision towards non-bank segments of the financial system closely interconnected with banks. It remains to be seen how easy it will be for the SSM legally and politically to redefine its regulatory perimeter.

While the SSM can use macro-prudential tools covered under the CRR and CRD IV (including counter-cyclical capital buffer), it cannot use other macro-prudential tools, which will remain exclusively under national authority. Given that not only micro- but also macro-prudential decisions have externalities beyond national borders, the lack of macroprudential policy coordination seems another gap in the banking union. The ESRB, which does not have any formal powers beyond issuing warnings and recommendations, cannot completely fill this gap.

The SRM – with all the caveats stated below – is an important first step. In its current form, however, it is still mainly a country-based framework, with supranational support only kicking in at a second stage. In addition, it is a rather complicated coordination mechanism, which involves several players. The European Commission and the ECOFIN[18] have de facto veto rights on SRB (draft) resolution schemes (though not on resolution planning actions and decisions), which raises serious concerns on whether decisions can be taken quickly enough and whether political and non-stability concerns will reduce the efficiency of the decision process. One area where the SRB faces clear constraints is decisions that affect fiscal expenditures; in particular, it cannot make decisions or take actions that either require Member States to provide extraordinary public financial support or impinge on the budgetary sovereignty and fiscal responsibilities or the Member States. Overall, there has been much less progress made in the resolution than in the supervision side.[16]

In terms of specific actions, 2017 saw several bank failures and actions by the SRM. First came the resolution of the Spanish bank Banco Popular, taken over by Santander while its equity and junior bondholders' claims were wiped out. No taxpayer money was used; rather, Santander decided to finance the takeover with a capital raising of 7 billion in the

[18] Legally, it is the Council of the European Union, but de facto the Economic and Financial Affairs Council, which includes the economics and finance minister of the EU.

market. Second came the resolution of two smaller Italian banks, Veneto Banca and Banca Popolare di Vicenza, declared to be "failing or likely to fail" by the SSM on the 23rd of June. As in the case of Banco Popular equity and junior bondholders' claims were wiped out; unlike in the case of Banco Popular, the Italian government had to put in 17 billion Euros; Intesa Sanpaolo took over the good assets of the two banks for a symbolic one euro and with a 5.2 billion Euro government subsidy. The bad assets are put into a bad bank to be liquidated, backed by 12 billion Euros state guarantee. Against the letter and spirit of the BRRD, senior bondholders were made whole. Shortly later, the European Commission approved the resolution of Banca Monte Paschi di Siena (MPS) to be done outside the bail-in framework, through a precautionary recapitalisation and government-funded recapitalisation, even though shareholders and junior bondholders (though not senior bondholders) suffered losses as well. While the resolution of Banco Popular went relatively swiftly, the final decision on the Italian banks was a protracted affair, with long negotiations between the European Commission and the Italian government. As the BRRD does not allow to use taxpayer money for bank resolution before senior bondholders are bailed-in, an exception had to be made. In this case, the Single Resolution Board decided that the two Venetian institutions do not constitute a financial stability risk and can therefore be resolved on the national level. The Italian government, in turn, argued that bailing in junior debtholders and liquidating the banks would inflict economic damage on the region, as this would have implied calling in loans, with the European Commission ultimately agreeing to state aid for the bank liquidation process. Some observers pointed out that the government would have had to pay 10 billion Euros anyway if it had bailed in senior bondholders as these bonds came with a government guarantee (granted several years earlier). In the case of MPS, it was argued that its failure constituted too much of a financial stability risk, thus justifying government support. These political manoeuvres to get around the spirit if not the letter of the new bank resolution framework and mindset in the Eurozone drew immediate criticism, especially in Germany.

The experience with the Italian bank failures, however points to one critical issue with the banking union, the fact that a forward looking supranational financial safety net arrangement has been implemented before legacy problems have been properly addressed. Further, several important elements of a fully functioning banking union are still missing, including a stronger public backstop and links between the deposit insurance schemes. The ECB would have to play a significant role in such a public backstop mechanism (either directly or indirectly by serving as backstop to, for example, the European Stability Mechanism, ESM).

There are currently discussions under way, on the highest political level, to deepen the banking union further, including through an establishment of a European Deposit Insurance Scheme and having the ESM as backstop. The ESM was established by a treaty among the eurozone states in 2012 and in its current form is limited to Eurozone countries. There is a recent agreement in principle that ESM should be the backstop to the Single Resolution Fund, in the form of a credit line, which is not bigger than the target level of the SRF of €55 billion (or 1 per cent of covered deposits in the participating Member States). There has been less progress on the establishment of a European Deposit Insurance Scheme (EDIS), mainly for political reasons and in spite of a large amount of technical preparatory work (e.g., Carmassi et al., 2018).

Many observers have argued that a common deposit insurance scheme and a backstop are

critical to the long-term sustainability of the Eurozone. Specifically, the failure of (several) larger banks might stretch the resources of the single resolution fund (even is some of this might be recovered later). Lack of the necessary, immediately available funding, in turn might make supervisors/resolution authorities more reluctant to intervene. The case for a common deposit insurance is based on creating trust across the Eurozone that a Euro is as valuable in any of the member countries. The cases of the Cypriot and Greek bank account freezes have shown that a national deposit insurance scheme within a currency union is only as reliable as the government backing it is solvent. The working hypothesis of this author would be that the banking union will eventually be complemented by these missing elements.

5.2. A new relationship between EU non-Eurozone supervisors and the banking union

Beyond the establishment of the SSM and SRM, there have been several EU-wide initiatives, which are relevant for non-Eurozone EU member states; further, the move towards the banking union has implications for non-Eurozone EU supervisors of cross-border banks as I will discuss in the following. Specifically, the establishment of SSM and SRM has changed the role for non-Eurozone EU supervisors of cross-border banking groups, both in their role as home and host supervisors. Most importantly, their counterpart for Eurozone-based parent banks (subsidiaries/significant branches) is now the SSM as home (host) supervisor

Cross-border banking groups in the EU - including parent banks located outside the Eurozone - are subject to a regulatory framework that mainly includes; (i) a Single Rulebook of regulations and directives, (ii) a harmonized supervisory framework, including common methodologies and approaches to perform risk assessment and require supervisory measures, and (iii) requirements for cross-border cooperation and coordination, including the establishment of supervisory and resolution colleges and joint decisions in some relevant areas, subject to binding EBA meditation if they do not involve fiscal expenditures. Specifically, joint decisions are to be taken in a number of relevant areas, including (i) institution-specific capital requirements, (ii) institution-specific liquidity requirements, (iii) validation of internal models and approving significant changes in them, (iv) assessment of the significance of a cross-border branch in the EU, (v) drafting of a Group Recovery Plan, (vi) authorization of a group financial support agreement, and (vii) authorization of actual group financial support (non-binding). Except in cases where noted, home and (more likely) host supervisors can refer to the EBA for binding mediation.

While traditionally branches were almost exclusively under the supervision of the home supervisor, from the viewpoint of host supervisors (and thus in the future FI for Nordea) there has been an improvement of the supervisory host regime for EU branches. The introduction in 2009 in the Solvency Directive of the concept of “significant branch”, gave host supervisors the right to participate in the supervision of the branch, and to receive timely information from the home supervisor. This amendment defines a number of criteria to determine when a branch is significant and creates a joint decision process to declare a branch significant. This regime has been strengthened by the new concept of a “significantplus branch”, that requires a deeper involvement from both the home and the host supervisor in the oversight of the activities performed through the branch as well as a specific risk assessment for the branch. However, the rights and obligations

of home and host supervisors with regard to branches still appear unbalanced compared to the rights of home and host supervisors in the case of subsidiaries. Host supervisors, however, do not have direct authority to challenge a cross-border bank when it wants to convert a subsidiary into a branch.

The EU home supervisor (within the Eurozone the SSM) is responsible for establishing a supervisory college. In addition to the EU consolidating supervisor, members of the college are: (i) the competent authorities responsible for the supervision of subsidiaries, (ii) the competent authorities of host Member States where significant branches are established, (ii) central banks of Member States that are involved in accordance with their national law in the prudential supervision of legal entities, but which are not competent authorities, and (iv) the EBA.

Resolution colleges are the main instruments in the EU for cross-border cooperation in resolution, both for preparation and for the execution of resolution actions. EU hosts of both subsidiaries and significant branches have the status of members of the college, which means they are entitled to attend the physical meetings of the college, receive the information shared within the structures of the resolution college and participate in joint decisions regarding resolution. Within the resolution colleges, the Group-level resolution authority (either SRM or – in the case of non-Euro countries – a national resolution authority) and the other resolution authorities (i) exchange information required for resolution planning purposes, (ii) develop the group resolution plan, including the joint decision on the plan, (iii) discuss the group resolvability assessment, including the joint decision, (iv) discuss the measures to remove the obstacles to resolution, including the joint decision on their adoption, and (v) discuss MREL requirements.

Concerning cross-border banks, the SRB is considering all branches and subsidiaries within the Eurozone as the same point of entry, with repercussions for MREL in Eurozone subsidiaries. This does not necessarily apply to non-Eurozone countries, even within EU, as we will discuss below. Specifically, external MREL (i.e., bailinable instruments held by external investors), has to be held only at the parent-bank level, while only internal MREL (i.e., intergroup claims that allow losses to be upstreamed in the case of a failure) is necessary on the subsidiary level. National supervisors and resolution authorities (even in the home country) are no longer responsible on a stand-alone basis (rather in the Joint Supervisory Teams and Internal Resolution Teams), but this function is taken on by the SSM and the SRB. For subsidiaries and significant branches outside the Eurozone, however, including within the European Union, the national supervisors and resolution authorities participate in supervisory and resolution colleges. So, in the case of Nordea after its move to Finland, the home supervisor (SSM) and the Group-level Resolution Authority (SRB) will invite FI and SNDO to the supervisory and resolution colleges, respectively. As college member FI will participate in all major planning. As college members, they are granted access to group-level information, which is very valuable for resolution planning purposes, and, at the same time, they participate in the joint decisions that are taken within the college, including those with regard to resolution plans, resolvability assessments, and MREL requirements.

The main institutional change for host supervisors in non-Eurozone EU countries (as well as outside the EU), is that they have to deal with the SSM or the SRB instead of doing so with national authorities. This change has some advantages for non-Eurozone authorities as it might reduce the number of counterparties. However, this transition has also brought

a potentially more unbalanced situation where smaller host authorities have to deal with bigger and more powerful institutions, which are less specialized in dealing with the issues their subsidiaries are facing.

There are also some concerns on the resolution colleges. On resolution planning, resolvability assessments and MREL, the resolution colleges have been useful to both share information between authorities and to exchange views on resolution planning and MREL, having become a conduit for the spreading of best practices across the EU. The participation of the EBA in these colleges and the fact that a significant amount of colleges has been organized by the SRB have contributed to a certain degree of harmonization across EU countries. The involvement of the colleges in coordinating and facilitating cooperation of resolution cases, however, is still to be tested, since no relevant cross-border bank failure has taken place since bail-in entered into force.[19] In addition, there is significant room for improvement with regard to the content and the dynamics of the resolution colleges organized by the SRB. Every part of the resolution planning process can be improved in terms of information shared, technical developments, policy issues, etc. (European Court of Auditors, 2017).

While all subsidiaries and branches within the Eurozone are considered a single point of entry for resolution purposes, subsidiaries outside the Eurozone might or might not be considered separate points of entry. This has implications for MREL at the subsidiary level. For example, host resolution authorities may consider that a separate point of entry implies independent funding and treasury functions, while the SRB may allow for more leeway when defining those interconnections. On the other hand, the SRB does not consider it acceptable if a subsidiary is considered a separate point of entry with the MREL provided by the parent company. External MREL is thus required, which might pose problems in jurisdictions with shallow capital markets.

6. In or out: The case for/against Sweden joining the banking union

Several non-Eurozone host countries have analysed the possibility of joining the European Banking Union even without being part of the Eurozone. More concretely, in Central Europe Romania, Bulgaria and Croatia are considering applying for Banking Union membership. It should be noted that these countries are also seeking Eurozone membership. However, other countries in the same region (Poland, Czech Republic and Hungary) remain opposed to join the European Banking Union. Both Denmark and Sweden have been exploring joining the banking union.[20] For these countries the high ownership and market linkages provide strong arguments in favour of joining the banking union, though there are also strong arguments against. The discussion above on the different externalities as well as the structure and the development of the banking union allows use to present these arguments more clearly.

Arguments in favour of joining include:

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[19] Spanish-based Banco Popular, resolved in 2017 by the SRB, had one banking subsidiary in Portugal and another one in the US. However, no resolution college had been set up to deal with the bank, since both Spain and Portugal are Eurozone Member States and Banco Popular did not have any subsidiaries in other non-Eurozone EU Member States.

[20] There is also the option for non-Euro countries of exiting the banking union after three years. I would see

- *A seat at the table*: Joining the banking union would be consistent with the high ownership linkage of the Swedish banking sector with other countries in and outside the Eurozone. Joining the Eurozone, FI and SNDO would more closely coordinate with SSM and SRB, respectively and could thus help influence policy-making and the overall development of the banking union. Participating would imply influencing. This is especially relevant for the case of Nordea, where FI staff might be able to form part of the JST for this institution.
- *Stronger supervision of SIFIs*: Swedish domestically-owned significant institutions may benefit from being subject to supervision by the Eurozone authorities, as the SSM collects significant experience across the member countries and different types of institutions.
- *Shifting bail-in of subsidiaries upstream*: If Sweden enters the banking union, the SRB would adopt a Single Point of Entry approach to any subsidiaries in Sweden, resulting in the ”de facto” guarantee of the subsidiary's external creditors by the parent bank. Currently, however, this might not be as relevant, given that the Nordea presence in Sweden is through a branch and non-Swedish subsidiaries are not of prominence. This might, however, change in the future.
- *Avoiding supervisory divergence*: A negative argument (against staying outside the banking union) would be that there might be supervisory and resolution divergence between banking union and other EU countries over time. While the legal basis for supervision and resolution is the same across the EU, the actual implementation might very well vary. If it comes to such a divergence process, then Sweden would either have to adopt to the banking union "style" without being able to influence it or the divergence might increase frictions in the cross-border cooperation and coordination between supervisory and resolution authorities.
- *Joining your neighbours*: Finland and the Baltic countries are part of banking union, while Norway as non-EU country does not have the option to join, though by being a member of the EEA it is part of the Single Market in banking, participates in the ESRB, and is subject to all EU legislation and directives in the financial sector. This changes the dynamics within the supervisory and resolution colleges, as Nordea, for example, will be supervised by SSM rather than by the Finish authorities. A more institutionalised cooperation might also better allow dealing with spill-over effects of credit booms than the current arrangements in the Nordic-Baltic region.
- *Participating in Single Market*: Joining the banking union would allow Sweden to be more closely integrated into the Single Market in banking, with possible positive repercussions for competition and efficiency.[21] However, this has to be balanced visà-vis a further trend towards branchification and thus further loss of supervisory oversight. However, it is not clear whether the trend towards branchification can be countered being outside the banking union, as obvious from the case of Nordea.
- *Still some independence left*: even if Sweden decides to join the banking union, its macroprudential authority FI is still in charge of identifying systemic institutions and

such a move initiated by the non-Euro country as rather unlikely, though, given the negative market signals it would send.

[21] As already mentioned above, the experience from the U.S. has shown the benefits from financial integration.

setting Other Systemic Important Institutions' (O-SII) buffers. Similarly, other macro-prudential tools stay in national responsibility. It is important to note, however, that in the development of the banking union, these responsibilities might also be shifted to a central authority (in line with the arguments discussed above).

Nevertheless, there are also arguments against joining, which include:

- *Loss of regulatory and supervisory independence*. Nordea stated as one of the reasons for its move to Finland (and thus under the supervision of the SSM) the more rigorous supervisory approach in Sweden – however, this supervisory approach might reflect Swedish preferences in terms of capital and liquidity buffers. A move into the banking union with the SSM as direct supervisor for SIs (which would include at least the remaining three large banks in Sweden plus possible several other banks) might thus not necessarily reflect Swedish preferences. More specifically, FI would largely lose its power to impose higher institution-specific capital and liquidity requirements, among others, under the SREP and Pillar 2 rules. On the other hand, forthcoming regulation, as reflected in the so called 'Banking package', would most likely lead to a convergence in Pillar 2 practices across the EU. Another concern is that FI cannot oppose the granting of cross-border liquidity and, where legally possible, capital waivers for their subsidiaries across the banking union, since granting such waivers are within the SSM´s powers.
- *Move towards branchification*: Since all the supervisory and resolution powers are transferred to the Eurozone authorities, there is an increasing probability of further branchification of the financial system, especially when the banking groups are headquartered in the Eurozone, as this would involves cost synergies for the banks. This could take the form of other Swedish banks with significant presence in other Nordic countries shifting their headquarters into the banking union and turning the Swedish operation into a branch. Beyond the move towards branchification, Swedish authorities would no longer be able to apply the multiple point of entry approach to any of its institutions, even in the case of subsidiaries of systematic banks headquartered in nonEU member countries. While this might seem irrelevant with the current structure of the Swedish banking system (given the absence of any systemically important subsidiaries of foreign banks in Sweden), it might become relevant in the future.
- *Being a small member*: There is the fear, taking into account the relatively small size of the Swedish banking system when compared with others in the Eurozone (Germany, Italy, France or Spain), that the SSM, despite provisions of non-discrimination laid down in the SSM Regulation, would not pay enough attention on Swedish banks, compared to the national supervisor, FI.
- *Governance challenge*: One important constraint is the governance structure within the ECB – in case of disagreement between the Supervisory Council (which Sweden would be part of) and the Governing Council (which Sweden as non-Eurozone country is not part of), the Governing Council would have the final word. This limits the influence of Sweden and puts it at a relative disadvantage to Eurozone members of the banking union.[22]

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[22] However, there is the option of appealing to the European Court of Justice or start the expedited exit from the banking union.

Critically, as the banking union is a project still "under construction", many open questions remain:

- First, there is the issue of *funding*. While it has been agreed that the Single Resolution Fund will be a shared pool after 2023, the question of a common funding of deposit insurance is still open. Most importantly and the biggest concern in this context for many "creditor countries" are the legacy losses in several Southern countries of the Eurozone, most prominently (especially in absolute terms) in Italy.[23] While the sequencing of establishing common supervision, common resolution and common funding has been seen as a guarantee to exactly avoid this problem, the recent experience with the failure and resolution of several Italian banks has not been in line with that.[24] Related to this is the question on the ultimate backstop. Given the character of the ESM as Eurozone rather than EU institution, what would be the relationship between Sweden and the ESM? How and on which terms would Sweden contribute to and use the backstop?
- Another big question for non-Eurozone countries that ponder whether to join the banking union is *access to liquidity from the ECB*. The Riksbank functions as lender of last resort and -as mentioned above - there are reciprocal arrangements in place with the central banks of Norway and Denmark. What would be the arrangement in the case of Sweden joining the banking union?
- Given the *close cooperation in the Nordic-Baltic region*, what would be the implication of Sweden (and possibly Denmark) joining the banking union for this cooperation. There might be a risk that being part of the banking union might undermine this rather close cooperation, given that SSM and SRB would replace national supervisors and resolution authorities.

Out of these concerns, the future expansion of the banking union towards including a joint deposit insurance scheme and backstop seems the most relevant one, given that it has the potential to directly affect fiscal policy autonomy of Sweden. This is clearly a political rather than a regulatory question, on which wide political consensus would have to be achieved.

7. Conclusions

This paper described the current state of the banking union and the relationship between Swedish authorities and the SSM and SRB as banking union authorities. It then discussed arguments in favour and against Sweden joining the banking union.

The discussion on whether non-Eurozone EU member countries should join the banking union can only be answered on a case-by-case basis. For Sweden, one critical element to take into account is the close interconnectedness with other countries in the Nordic-Baltic region and the already close cooperation between supervisory and resolution authorities in the region. What would be the gain from joining the banking union compared to the gains from the current close cooperation?

[23] It is important to stress that this relates to the legacy problems rather than forward-looking, as Carmassi et al. (2018) show that there is not really a concern of cross-subsidisation in such a fund.

[24] While not directly related to the question at hand, this author has advocated strongly for resolving the legacy losses before moving to a pooled insurance scheme (Beck and Trebesch, 2013).

While the author of this paper does not want to take a firm stance on whether or not Sweden should join the banking union, I would like to offer some criteria for the decision process. It is important to stress that the answers to these criteria are not static but might develop over time.

- Financial stability in the Swedish banking system has been benefitting from NordicBaltic cooperation, while at the same time benefitting from the efficiency of crossborder banking in the region – *compared to the status quo, what additional benefits are there to be gained from joining the Banking Union?* Critically, one of the least developed part of the Nordic-Baltic cooperation seems to be crisis resolution and burden sharing (RGC, 2016); this, however, is also the least developed part of the banking union.
- Would the situation change *if Denmark joins as well and at the same time as Sweden*? Would that change the possible negotiations for joining and the possible position of both countries as non-Eurozone countries. Might a joint approach result in a more favourable structure of banking union membership for both countries?
- *How would supervision of significant institutions*, including SEB, Swedbank and Handelsbanken, *be dealt with now as compared to within SSM/SRM*? This question arises not so much in terms of the legal requirements and rules on the book, but in terms of supervisory practices.
- *How would banks in Sweden react to the structural change in supervision and resolution*? Would it influence their cross-border expansion strategy? Would it affect their organisational structure? Vice versa, would a negative decision on applying for banking union membership result in a reaction by banks, such as in the case of Nordea?

Sweden cannot isolate itself from development in the Eurozone given its close integration with banking systems of the currency union. Joining the banking union would be a quantum jump and one that is to be considered carefully. Having the option to join the banking union is valuable; it is less clear whether now is the optimal time to exercise this option, especially given the incomplete structure of the banking union.

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