

# Death in Veneto?

## European banking union and the structural power of large banks

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January 2020

Forthcoming in *Journal of Economic Policy Reform*

### ABSTRACT

We argue that the evolving preferences and power resources of large cross-border banks help explain the crucial political moves to European banking union. As they became larger and more European, these banks benefited from the supranationalization of supervision through reduced compliance costs and the effective opening of European markets. The political divergence in the interests of large international banks and small national ones eventually caused the German and the French governments' change of position in intergovernmental bargaining. Once in place, banking union accelerated balance sheet consolidation to the benefit of large banks that took over their weaker competitors.

### KEYWORDS

Banking supervision, banking union, European integration, European Union, Eurozone

## INTRODUCTION

It was only a matter of time before the nascent European Banking Union (EBU) framework would face its first major test. The reckoning of this ‘untried system’ (Mayes 2018) came earlier than expected, in June 2017. The Venetian medium-sized lenders Banca Popolare di Vicenza (BPVI) and Veneto Banca as well as the Spanish Banco Popular were resolved after the Single Supervisory Mechanism (SSM) deemed them ‘failing or likely to fail.’ In both cases, the resolution of these banks benefitted large cross-border banks (Intesa Sanpaolo and Santander), which took over substantial parts of the business or even the whole entity. In contrast, the struggling Tuscan lender Monte dei Paschi di Siena has been nationalized. This outcome of the first real operation of the EBU highlights its central political characteristic, which political scientists have until now underemphasized: the decisive role of large banks in the shift to banking union.

The EBU framework resulted from a gradual shift in the interests of key actors and a crisis moment in 2012. Observers writing from different theoretical perspectives concur that the banking union became possible when Germany, the most powerful member-state in the eurozone, agreed to the adoption of a series of institutional measures to oversee bank functioning and possible resolution (Howarth and Quaglia 2013, 2014, 2016b; Schimmelfennig 2015; Schäfer 2016; Glöckler, Lindner, and Salines 2017). This article makes a distinctive contribution to understanding the inception of the banking union and the downstream consequences of its design.

Liberal intergovernmentalists tend to emphasize Germany’s change of position as a response to the possible costs of break-up of the eurozone (Schimmelfennig 2015), with German interests dictated by the structure of its particular banking sector, notably the network of politically influential savings and cooperative banks (Howarth and Quaglia 2014, 2018). According to Schild (2018), EBU marks a rare departure from the common pattern of Franco-German co-leadership. He attributes this to the asymmetric distribution of (potential) financial and political costs and the diverging perceptions of who would benefit more from EBU. Those scholars drawing on neo-functional theory emphasize how spillover dynamics stemming from the eurozone crisis strengthened supranational authorities, in particular, the ECB and the Commission, and simultaneously weakened German reluctance to create a EBU (Epstein and Rhodes 2014, 2016, 2018; Niemann and Ioannou 2015; De Rynck 2016; Nielsen and Smeets 2018). In neo-functionalist theory interest groups are central actors because they can ‘cultivate’ functional spill-overs by building transnational alliances. Epstein and Rhodes (2016, 412) have argued that the delegation of banking supervisory competences was not automatic but followed a political process. Intense lobbying through the Brussels-based umbrella organizations of large cross-border banks enabled this process. Notably, the European Banking Federation (EBF) – the lobby

association of the largest private banks – was actively lobbying policy-makers with detailed position papers on all aspects of the EBU (European Banking Federation 2012; Epstein 2014a, 16). Jones, Kelemen, and Meunier (2016) even combine the two modes of explanation into what they characterize as a policy mode of ‘falling forward,’ in which lowest common denominator intergovernmental deals between powerful states give way to further neo-functionally inspired pressures for integration, which in turn result in new, incomplete intergovernmental deals. Howarth and Quaglia (2018) argue that the reason why the banking union has not been completed by creating a European deposit insurance scheme (EDIS) is due to the differing structure of the national deposit guarantee schemes, which are a mirror image of their respective banking system.

As intergovernmental accounts have stressed, national governments are responsive to dominant interest coalitions. What we observe, however, is that the power resources of the different members of national coalitions in finance in key countries have changed over time, and as a result the sort of influence they wield over government has altered. A shift in power resources within a sector – such as finance – can lead to a shift in national preferences over interstate bargaining. This, we argue, was the decisive change that led to the adoption of the institutions of the banking union. Across Europe, the deepening of financial integration led to a break-up of the coalition among large and small banks, as large, cross-border private banks based in the eurozone moved from a business model based on what Epstein (2014a) has called a regime of banking nationalism to one of banking Europeanism. This certainly does not mean that banks ceased to exercise influence at the national level. But the increasing market dominance and international exposure of large banks changed their relationship with national regulators and with smaller banks in their home country. Mügge (2010) has shown that ‘competition politics’ can be a driver of institutional change, as large firms with cross-border operations push for the supranationalization of regulation to gain a competitive advantage over their domestic competitors. The euro area crisis did not change the preferences of large banks for supranationalizing regulation, but it provided an opening for them to deliver a deathblow to their smaller competitors.

To elucidate this transformation within the financial coalition, we draw on the distinction between instrumental and structural power (Lindblom 1977; Culpepper 2015; Fairfield 2015). Instrumental power refers to the means, not necessarily related to core business activities, through which firms exercise political power, such as lobbying and privileged access to senior policymakers. Structural power refers to the exercise of political influence by banks through their primary economic functions as employers, investors, and providers of capital to the private sector (Culpepper and Reinke 2014; Young and Pagliari 2017). The euro area crisis has highlighted a neglected aspect of banks’ structural power as a provider of capital to sovereigns. By holding large amounts of domestic sovereign bonds

on their balance sheets the fate of ‘too big to fail’ banks and their sovereigns became closely intertwined.

*Over time, the structural power of large banks acting in the eurozone has overtaken the instrumental power exercised by coalitions of small and large banks at the national level.* Having structural power does not mean large banks are all-powerful – far from it. What it means instead is that both national and EU policymakers have shifted their emphasis from a strategy aimed at satisfying the expressed political demands of (often small) banks to a strategy that is consistent with the economic imperatives of large banks, partly because those imperatives have become closely intertwined with the economic well-being of states. We observe this concretely in the break-up of the German coalition between large and small banks, but it is also visible in the French government’s volte-face on the EBU, as the government was initially opposed to the EBU, but which later came around to support it in line with the preference of its systemically-important banks (Epstein and Rhodes 2016, 430; Epstein 2014a). Moreover, we find that intra-sectoral alliances are vulnerable to actors’ expectations about the future benefits of EU-wide regulation. The EBU held out the prospect of a fully integrated euro area banking market with one single supervisor, one resolution authority and one deposit insurance scheme. This vision was highly appealing to large cross-border banks and incentivized them to shift their loyalties to the European level. This meant that even though the configuration of the national banking system did not change, the centrifugal pressures facing the coalition between large cross-border banks and their smaller competitors intensified.

In the next section we demonstrate empirically how the general divergence of interests between large and small banks played out in the Spanish bank crisis, affecting the coalition among German banks, and how that reordering influenced the German position in intergovernmental bargaining. In the subsequent section we show how the literature on power makes a distinctive theoretical contribution. We then show how the rising interest of large banks in pursuing banking union led to a conflict of interests between large and small banks, even as it increased the structural power of large banks. The interpretation of the sovereign-bank nexus as a policy problem was in part a product of the increased structural power of large financial institutions in the eurozone. The final section reviews recent bank resolutions in Italy and Spain that emphasize the way in which large banks stand to gain from EBU.

## **THE 2012 SPANISH CRISIS AND THE FRANCO-GERMAN BANKING COALITION**

Liberal intergovernmental accounts of the eurozone crisis typically stress the Spanish crisis of the summer of 2012 as the critical juncture that led Germany to recalculate its preferences and opened the way for a European Council agreement on the banking union (Krampf 2014; Schimmelfennig 2015;

Glöckler, Lindner, and Salines 2017). As the crisis threatened to tear the eurozone apart, Germany and France altered their preferences because Spain was ‘too big to fail’, and German and French banks were highly exposed to Spanish and Italian banks (Krampf 2014). The direct recapitalization of Spanish banks via the ESM could occur under the condition that national regulatory forbearance would be eliminated in the future through the SSM (Glöckler, Lindner, and Salines 2017).

The explanation for the preference shift advanced in this article is compatible with standard accounts rooted in liberal intergovernmental reasoning. We argue that the Spanish banking crisis had political reverberations in Germany and France. Namely, it decided the ‘battle of the German banks’ over EBU in favor of the position held by the large cross-border banks. Similarly, the French government, which had been reluctant to fully embrace the banking union (Epstein and Rhodes 2016, 430; Epstein 2014a; Schild 2018), aligned itself with the interests of its highly concentrated banking sector that consists of a number of ‘too big to fail’ banks.

The French reversal on centralizing EU-level supervision was driven by the large financial conglomerates represented by the French Banking Federation. French banks are among the most internationalized entities and stood to gain from the competitive advantage and regulatory savings (Tibi 2016, 79). The fact that half of the ten largest banks by total assets supervised by the SSM in 2018 were located in France demonstrates the strong interest in supranationalizing supervision. In addition, the troubles in the Spanish banking sector shifted market scrutiny towards France’s fragile public finances. With rating agencies threatening to downgrade French bonds, the government faced strong incentives to swiftly regain market confidence and endorse a fully-fledged banking union, including direct bank recapitalizations. The ironclad ties among public and private actors in the French financial establishment – described as an ‘informal consortium’ (Jabko and Massoc 2012, 566) – helped to convince the government that EBU was in its interest. Ultimately, France was at the forefront of the banking union advocates strongly supporting a fully-fledged banking union based on a coherent position formed by its ‘too big to fail’ banks.

In the German banking sector, a long-standing split frequently rendered the German government’s negotiation position ambivalent (Lütz 2005). This split was evident in the financial governance reforms triggered by the 2008 Financial Crisis. ‘The large German commercial banks believed that there was no long-term alternative to a European supranational supervisory authority, at least for cross-border institutions. [...] By contrast the LB [Landesbanks], savings banks and co-operatives were more reluctant to accept a single European supervisor, although they softened their previously strong opposition’ (Buckley and Howarth 2010, 126). Prior to June 2012 the position of the German cooperative and savings banks – which are closely tied to local and regional politicians in Germany

through instrumental power – had proved politically decisive. But with the banking union large private banks came to dominate the discourse, aided by their structural power and the unfolding events in Spain. A particularly potent aspect of their structural power lay in their capacity to refinance the sovereign by holding large amounts of domestic bonds on their balance sheets. In contrast to EDIS, banking supervision and resolution were low salience issues in the German public debate that enabled large cross-border banks to get their way through ‘quiet politics’ (Cassell and Hutcheson 2019; Culpepper 2011). This additionally supported the change in Germany’s position regarding the question whether to go ahead with the SSM or to maintain the status quo. In other words, theoretical accounts that derive national preferences simply from the dominant interest coalition can be misleading, because interest coalitions are not stable over time. Intra-sectoral alliances can break down even if the configuration of the national banking system remains broadly unchanged, which is what happened in the case of the German banks.

As a result, public banks were on the defensive, having to fend off attacks by Deutsche Bank, which invoked the Spanish *cajas* analogy and the case of Bankia, formed from the fusion of seven *cajas* in 2010, to make its case for a broad supervision coverage of all euro area banks (Wilson 2012; Mallet and Johnson 2012; Fahrenschon 2012; German Savings Banks Association 2012). The Spanish savings banks played a pivotal role in fueling a devastating housing bubble that brought Spain to the brink of default, whereas the large banks Santander and BBVA emerged unscathed from the crisis due to their internationally diversified assets (Otero-Iglesias, Royo, and Steinberg 2016, 32). Like their German counterparts, the *cajas* maintained strong political ties to local politicians and were deemed to be systemically unimportant until they collapsed. Their demise and the sovereign-bank nexus put Santander and BBVA in the driving seat to determine the Spanish government’s position on banking union. The former head of Deutsche pressed the case in public shortly before the German decision (Taylor and Gould 2012):

‘Fitschen said it was illusory to believe problems could be avoided by monitoring only big banks like Deutsche, noting that Bankia had become a national problem for Spain and the broader euro zone, though it was not considered systemically important by international regulators. “No one had Bankia on the list to trigger a crisis,” he said.’

The position of Germany nicely emphasizes a fundamental analytical point for understanding banking union politics: national governments have been torn between the competing interests of their large and small banks. The latter pulled towards banking nationalism, while the former pushed for banking Europeanism. In contrast, the French government had to deal with a less fragmented coalition of

influential cross-border banks, which led to a more coherent position on all aspects of the banking union.

## **THE BANKING UNION AND STRUCTURAL POWER**

Howarth and Quaglia (2014, 2016a, 2016b) have been at the forefront of recent scholarship on the evolution of the banking union, and their perspective too is fundamentally intergovernmentalist, deriving national preferences for the banking union based on the configuration of the national banking systems and the 'reach of internationalization'. Their conclusions broadly concur with those of Spendzharova (2014), who finds that low levels of foreign bank penetration combined with highly internationalized domestic banks favour supranational banking supervision, whereas states with high levels of foreign bank penetration and low domestic bank internationalization want to retain domestic regulatory capacity.

These predictions from conventional LI theory run into two empirical puzzles. First, the outcome of the negotiations over the SSM and the SRM do not reflect the preferences of creditor countries to the extent one would have expected, given the LI prediction that fiscally sound countries such as Germany should determine the institutional outcome (Schäfer 2016). Indeed, Germany and other northern European countries created a Single Resolution Fund that is gradually mutualized over eight years. Schimmelfennig (2015, 192) concedes that his LI explanation cannot account for large German concessions during the banking union legislative process. Second, the elegant accounts of Howarth and Quaglia fail to provide a convincing rationale for the shift of the German and the French position during 2012.

We posit that what looks like a product of intergovernmental muddling through in response to small bank pressure in fact reflects the changing interests of large private banks. The ECB indirectly supervises all non-significant banks in the euro area and can take charge of supervision over any credit institution if it deems it necessary to do so. This 'face-saving' compromise allowed the German government to claim that it successfully defended the interests of its savings banks. We share with conventional LI analysis the perspective that domestic interest coalitions often play a decisive role in determining national positions. Where we propose a theoretical innovation to LI analysis is in not equating national positions with national bank structure, but instead in locating the taking of national positions in a dynamic process of interest representation. Following Epstein (2014a), we contend that it was the changing orientations, loyalties, and business strategies of large banks that eased the path towards EBU. By promoting national bank champions through banking nationalism (Véron 2015), the largest banks in the eurozone became 'too big to fail'. As the revenue base of these banks in their

home countries shrank in relative terms, their loyalty towards their national supervisors decreased in equal measure. At the same time, this growth put their future policy preferences in direct conflict with those of their erstwhile small banking allies.

The distinction between structural and instrumental power provides a useful way to summarize the salient political consequences of the expansion of ‘too big to fail’ banks. Banks such as Deutsche Bank increased so drastically that Germany became simply one market among others for them. By 2007, Deutsche Bank generated only 27 percent of its revenue within Germany (Culpepper and Reinke 2014). This reduced dependence on the German market enabled Deutsche to defy German regulators with impunity. This represents an increase in their structural power, because it is bargaining power that results entirely from their economic profile. The increased structural power accruing to Deutsche contrasts with more conventional strategies of influence peddling and lobbying – which are known as instrumental power – because that lobbying depends on the resources expended to exert influence, rather than on economic structural change alone (Culpepper 2015).

Small bank networks, which depend on political protection through instrumental power, witnessed the decrease of their structural power in recent years. The number of employees of the savings banks alone has declined from 251.400 in 2008 to 224.671 in 2016, and their market share by business volume in Germany dropped to 16.8% at the end of 2016, slightly below the 18.5% of big banks (Savings Banks Finance Group 2017, 33). While they often lobby together with large banks on issues of common concern, small banks are highly dependent on their relationship with regulators. This relationship is their sole protection against adverse rules – one that they were not shy to draw upon once banking union was put on the political agenda. This explains why these banks fought adamantly to safeguard the involvement of the national authorities in the supervision of small banks (Steen, Wilson, and Barker 2012). In their lobbying effort, the savings banks benefit from their ability to ‘portray themselves [...] as small and systemically irrelevant where it suits – but enjoy large benefits from being considered in other circumstances as part of large, closely linked network. “Sometimes they are one of the biggest financial groups in the world and sometimes they are just 400 simple little banks”’ (Wilson, Wiesmann, and Barker 2012). The German co-operative banks have collaborated with the savings banks in their lobbying efforts by issuing joint statements (BVR/VÖB/DSGV 2012) but have also mobilized via their own European umbrella association (European Association of Co-operative Banks 2013). Thus, the savings and cooperative bank’s instrumental power was effectively deployed in the short run to obstruct the creation of EDIS and ensure the involvement of the national supervisory authorities. At the time of writing, EDIS has still not been implemented due to German opposition (Donnelly 2018).



However, Germany has further softened its position and seems willing to introduce EDIS under certain conditions (German Finance Ministry 2019).

As the interests of large banks in banking union grew and their structural power was bolstered by the sovereign-bank nexus, this divergence in the position of large international banks and small national ones eventually caused a rupture in the German banking coalition. It is this rupture, we maintain, that partially accounts for the German change of position during intergovernmental bargaining in 2012. The Spanish bank crisis created a window of opportunity for large banks within Germany to undermine the narrative of the powerful German savings banks and to impose further costs on them, which then paved the way towards banking union. Similarly, the French government aligned its position on banking union with that of its large systemically important banks. We acknowledge that the high politics quid-pro-quo (SSM in exchange for ESM direct bank recapitalization) was decisive for the shift towards banking union. However, we maintain that this outcome would have been unattainable in the absence of the relative empowerment of large cross-border banks.

#### **THE INTERESTS OF LARGE BANKS IN BANKING UNION: COMPETITIVE ADVANTAGE, REGULATORY SAVINGS**

Large banks compete both in an international market, against other large banks, and in a home market, against other small banks. Centralized banking supervision and resolution helps the strongest large banks on both these fronts. Internationally, it provides incentives for the further consolidation of large banks by creating a single set of supervisory practices that will make it more difficult for national governments to protect weak banks from market pressures. At the same time, the existence of a single set of rules provides a further weapon for large banks to use in their long-running fight against what they view as the politically protected position of small cooperative and savings banks (Lütz 2005). By serving these two objectives, the banking union kills two birds with one stone for the eurozone's strongest big banks. A closer look at the history of US banking deregulation is instructive in this regard. The interest group configuration of small banks pitted against their larger competitors was broadly similar to the one prevailing at the state level before the US Congress lifted the restrictions on interstate bank branching (Kroszner and Strahan 1999). This shift resulted in an increase in mergers across state borders and a declining market share for small banks.

Thus, banking union should be understood as 'competition politics' (Mügge 2010, 25) because more stringent supervision will inevitably crowd the weakest players out of the market, making them more susceptible to takeover. As large cross-border banks benefit from bank consolidation through an

increased market share, their smaller competitors are ultimately left without political protection. A first wave of competitive consolidation took place under the rubric of banking nationalism (Véron 2015, 39). Notable attempts at cross-border mergers, such as by the Spanish BBVA of the Italian UniCredit, failed due to the intervention of domestic regulators (Vives 2001). If banking union significantly transformed the ownership structure of large banks, this would introduce an additional element of cross-border risk-sharing into EMU and, thereby, enhance resilience towards idiosyncratic financial shocks. As a result, large northern European banks would be more exposed to potential losses encountered by southern European banks.

In a regime of decentralized banking supervision, national regulators can distort competition either because the rules are not uniform or because uniform rules are interpreted or implemented differently across countries, as banking associations have repeatedly pointed out to regulators (European Financial Services Round Table 2013, 13; Deutsche Bank Research 2000, 4; UniCredit Group 2009). In addition, competition can be adversely affected because regulators react at varying speeds or because regulations enter into force with a considerable time lag. ‘Competitive neutrality’ – the elimination of regulatory arbitrage based on the principle of ‘same risk, same regulation’ – has long been a prime concern among large cross-border banks (Deutsche Bank Research 2001, 2). The SSM is more likely to achieve a level playing field than would a fragmented supervisory system. Thus, it further limits a state’s capacity to shield its savings and cooperative banks from unwanted liberalization (Deeg and Donnelly 2016).

In the scramble for capital to satisfy the more stringent requirements entailed by banking union, the strongest large banking groups enjoy a clear comparative advantage over their weaker competitors. BNP Paribas revealed the strategic interest behind the banking union project. When asked about its consolidation effects, CEO Jean-Laurent Bonnafé replied that

‘the strongest part of the banking system could be part of some form of consolidation — either through an acquisition or through organic development plans. In the end, consolidation will just take out the weaker players who were unable to strengthen their positions either because of their own situation or because of their jurisdiction’ (Fildes 2013).

From now on the SSM grants and withdraws bank licenses and is also in charge of mergers and acquisitions. Banks with expansionary ambitions therefore stand to gain from banking union. Emilio Botín, former chairman of Santander, opined that ‘banking union is an ambitious, complex and difficult process, both operationally and politically, but we cannot afford to postpone it’ (Botín 2012). Five years later his daughter and successor Ana Botín declared, after having snatched up Banco Popular for a symbolic €1, that this deal is ‘good for Spain and good for Europe’ (Buck 2017). It goes without saying

that it was a good deal for Santander. Santander's domestic rival BBVA had also strongly supported a fully-fledged banking union (BBVA Research 2013, 2014).

Large banks had long lamented that the liquidity controls imposed on foreign branches by the host country's supervisory entity contradicted the principle of home country supervision, because it often served as a pretext for the host supervisor to extend *de facto* surveillance (Deutsche Bank Research 2000, 6; European Financial Services Round Table 2013, 4). Another oft-used strategy by host supervisors was to demand that the foreign bank sets up an independent subsidiary, which would then fall under its own supervisory remit (Association for Financial Markets in Europe 2013). In this way the supervisor could effectively 'quarantine' the subsidiary of a foreign bank from any contagious effects caused by failure of its parent company. More importantly, it empowered itself to prevent the recapitalization of a parent company by its subsidiary (as attempted by Santander UK in May 2012) through ring-fencing the funds (Donnelly 2014, 995).

Prior to the banking union, large banking groups were not in the position to reap the full benefits of cross-border expansion due to national variations in capital and liquidity requirements. For example, the *FT* reported that the SSM would free up €7bn of capital for Italian UniCredit from its German subsidiary HVB. The ring-fencing measure by the German competent supervisory authority requiring UniCredit to hold an additional capital buffer was grounded in a lack of trust (Mackintosh, Ross, and Sanderson 2013). Thus, it is not surprising that UniCredit's chief economist strongly supported the banking union (Nielsen 2012). Austrian banks with operations in central and Eastern Europe faced a similar problem from the national regulator, which imposed lending targets on these banks (Epstein 2014b). Instead of relying on traditional capital controls during periods of intense financial stress, regulators often reacted with macro-prudential oversight or restrictions on the operation of foreign banks to the displeasure of large banks with cross-border operations (BBVA Research 2013, 2014).

The harmonization of banking supervision was therefore expected to liberate excess capital for banks with substantial cross-border operations (Jenkins 2012). The additional capital could then be moved from over-capitalized to less well-capitalized markets, thereby improving a bank's overall capital efficiency. Moreover, working under the surveillance of national regulators created pressures on capital allocation, either from lending targets imposed by a national supervisor during periods of stagnant growth or due to implicit pressures to stock up on the home country's sovereign bonds. In short, the move to the SSM meant that capital that had previously been tied up could flow into higher yielding activities (Epstein 2014a, 5).

Even as it removed regulatory impediments to reaping economies of scale, the move to banking union also offered big banks a regulatory means to establish a level playing field that would allow them finally

to crack down on the business model of the cooperative and savings banks. Already in the early 1990s, the German association of private banks tried to limit the competitive advantage of the latter. When they failed to resolve the issue at the national level, they turned to the European Commission for additional support (Smith 2001, 529). In 1999 large European banks attacked the business model of the German Sparkassen and Landesbanken by filing a case with DG COMP in which they alleged unfair state aid (Grossman 2006; Smith 2001). The banking lobby group EBF took issue with the fact that the Sparkassen benefited from public guarantees. The EBF argued that this special treatment led to a distorted competition, because Sparkassen were able to refinance themselves more cheaply than other banks that were not backed by an implicit state guarantee. The conflict ended in 2005 with a first victory of the large private banks. The agreement between the German government and the Commission phased out local and state government guarantees by 2015 for Sparkassen and Landesbanken that were teetering on the brink of insolvency (Deeg and Donnelly 2016, 592).

Despite this defeat, during the negotiations of the Capital Requirements Directive in 2005, the German cooperative and savings banks succeeded in achieving a zero risk-weighting for the treatment of intra-group exposure, which allowed them to operate with lower capital requirements than other competitors (Christopoulos and Quaglia 2009, 187). The IMF has argued that this special treatment might lead to ‘a de facto underestimation of capital requirements’ and could encourage excessive risk-taking (IMF 2011, 11). Unless specifically required by the national supervisory authority, savings and cooperative banks remain exempted from the statutory national deposit insurance scheme (Howarth and Quaglia 2016b, 150). However, a harmonization of the various German deposit insurance schemes has thus far been prevented through the use of instrumental power facilitated by the ‘unwavering support of German politicians’ (Deeg and Donnelly 2016, 587). It remains to be seen whether a European deposit reinsurance scheme as proposed by German finance minister Scholz (2019) would leave national deposit insurance schemes intact or would result in further harmonization pressures for national deposit schemes.

## **STRUCTURAL POWER AT THE HEART OF THE SOVEREIGN-BANK NEXUS**

The logic of the sovereign-bank nexus posits that any failure of a large cross-border bank in any euro area country could set in motion a doom loop that would eventually drive a country into default, because the failing bank’s balance sheet might hold a multiple of assets in comparison to the country’s GDP (IMF 2013). The breaking of the nexus became the overarching goal that justified the move towards banking union and the yardstick against which to measure its success. The positive correlation between sovereign and bank funding costs reflected the so-called ‘home bias’, which describes the

large exposure of banks to the sovereign debt of their home country (Acharya, Drechsler, and Schnabl 2014). Arguably, this was the main driver of the negative feedback loop between rising borrowing costs of sovereigns and their banks. As such, the sovereign-bank nexus that emerged in the sovereign debt crisis is the clearest expression of the newly reinforced structural power of the eurozone's large cross-border banks. By holding large amounts of their home country's sovereign debts on their balance sheets, large banks intertwined their fate with that of the government, effectively insuring themselves against resolution. Large banks did not have to remind governments of their shared interests; merely watching the moves of markets made such a link manifest.

Moreover, EBU had an additional noteworthy feature that appealed to both large banks and governments: it redefined the denominator of 'too big to fail' by moving the issue of bailouts to the eurozone level. During the financial crisis, many large banks had been deemed 'too big to fail'. The size of their balance sheets looked huge as a multiple of member state GDP. Post-crisis, euro area member states faced a stark choice between 'cutting banks down to size' through enacting bank structural reform, which would have reduced the power of banks, and between further pushing financial market integration by creating a banking and capital markets union. Instead of cutting banks down to size, banking union meant deeper integration of European financial markets and thus served the interests of large European banks. As a result, the size of a bank's balance sheet would not be measured in terms of its home country's GDP, but would be compared to the pooled resources of all eurozone member states. Large banks can as a result operate completely insulated from the legal, political, and fiscal environment of their home countries – and potentially dangerous doom loops – at the same time the European taxpayer backs up their balance sheets. In a non-paper the German Finance Ministry advocated for the creation of a European legal form for banks and argued that 'to build business models that are sustainable in the long term, German banks will need to further expand in other EU countries' (German Finance Ministry 2019).

### **BANKING UNION'S PREMATURE DEATH IN VENETO?**

The resolution of the Spanish Banco Popular and of two smaller Italian lenders, Veneto Banca and BPVI, provided a first credibility test for the EBU. A mixed picture has emerged from these bank closures (Mayes 2018). While some pundits argued that the banking union's credibility has been severely damaged because loopholes in the BRRD were exploited to avoid a fully-fledged bail-in (Reichlin 2017), others are more optimistic, highlighting the progress that has been achieved compared to the pre-banking union era (Sandbu 2017; Merler 2017). Despite the use of Italian taxpayers' money to

smoothen the economic impact of the failure of Veneto Banca and BPVI, shareholders and junior debt were subject to bail-in.

In the case of Veneto Banca and BPVI, toxic assets were separated from good ones, with Italian taxpayers indirectly shouldering a substantial part of the burden through the private sector funded *Atlante* bailout fund. Intesa Sanpaolo snatched up the high-quality assets and the retail business of these banks at a deep discount of a symbolic €1. Prior to agreeing to the deal, Italy's second biggest bank had secured conditions that would insulate it from any negative contagion of non-performing loans (NPLs) on its balance sheet. For that purpose, the Italian state offered Intesa a sweetener of €12 billion in guarantees against any potential losses from the takeover on top of a €4.8 billion cash injection to shore up its capital ratio and to fund restructuring operations.

The first EBU test cases provide confirmatory evidence for our claim that large banks had a strategic interest in the new regulatory framework and will continue to benefit from it. The acquisition of Banco Popular turned Santander, one of the most-outspoken advocates of banking union, into Spain's largest bank with an overall market share of approximately 20 percent. It also bolstered its competitive position in the Portuguese banking sector. The liquidation of Veneto Banca and BPVI and the ensuing take-over of their good assets and retail business by Intesa Sanpaolo will likewise bolster its market share in Italy. In all cases, the take-overs will lead to a higher concentration in the Italian, Spanish and Portuguese banking sectors, to the benefit of the largest banks. The Herfindahl index – a measure of market concentration, in which higher numbers equal higher market concentration – shows that since the SSM became operational in 2014, concentration in the latter three banking sectors has increased (see Table 1). Thus, the empirical evidence supports our hypothesis that in countries strongly in favor of banking union (i.e. France, Italy, Spain) the largest banks stood to gain from the banking union through increased market share.

Table 1: Herfindahl index for credit institutions in the EU and share of total assets of 5 largest credit institutions

	Herfindahl index for credit institutions (based on total assets)					Share of total assets of five largest credit institutions				
	2014	2015	2016	2017	2018	2014	2015	2016	2017	2018
Belgium	981	998	1,017	1,102	1,218	65.8	65.5	66.2	68.8	73.4
Bulgaria	836	919	939	906	939	55.0	57.6	58.0	56.5	59.7
Czech Republic	966	994	1,016	1,039	1,069	60.9	62.5	63.9	63.7	64.5
Denmark	1,190	1,180	1,224	1,123	1,069	68.1	67.8	68.3	65.7	64.5
Germany	300	273	277	250	245	32.1	30.6	31.4	29.7	29.1
Estonia	2,445	2,409	2,406	2,419	2,698	89.9	88.6	88.0	90.3	91.0
Ireland	673	672	636	658	632	47.6	45.9	44.3	45.5	46.1
Greece	2,195	2,254	2,332	2,307	2,304	94.1	95.2	97.3	97.0	96.8
Croatia	1,364	1,396	1,405	1,387	1,554	72.3	72.7	73.0	72.8	79.4
Spain	839	896	937	965	1,138	58.3	60.2	61.8	63.7	68.5
France	584	589	572	574	664	47.6	47.2	46.0	45.4	47.8
Italy	424	435	452	519	579	41.0	41.0	43.0	43.4	45.6
Cyprus	1,445	1,443	1,366	1,962	2,378	63.4	67.5	65.8	84.2	86.9
Latvia	1,001	1,033	1,080	1,235	1,578	63.6	64.5	66.5	73.5	80.8
Lithuania	1,818	1,939	1,938	2,189	2,278	85.7	86.8	87.1	90.1	90.9
Luxembourg	330	321	260	256	261	32.0	31.3	27.6	26.2	26.3
Hungary	792	763	787	802	801	49.3	49.4	49.8	49.6	50.0
Malta	1,648	1,620	1,602	1,599	1,518	81.5	81.3	80.3	80.9	77.5
Netherlands	2,131	2,104	2,097	2,087	2,178	85.0	84.6	84.7	83.8	84.7
Austria	412	397	358	374	370	36.8	35.8	34.5	36.1	36.0
Poland	656	670	659	645	683	48.3	48.6	47.7	47.5	49.5
Portugal	1,164	1,215	1,181	1,220	1,202	69.2	72.3	71.2	73.1	72.9
Romania	797	860	903	915	965	54.2	57.4	59.1	59.5	62.1
Slovenia	1,026	1,077	1,147	1,133	1,020	55.6	59.2	61.0	61.5	60.8
Slovakia	1,221	1,250	1,264	1,332	1,383	70.7	72.3	72.7	74.5	75.6
Finland	3,630	3,160	2,300	1,700	2,570	89.7	88.0	80.5	73.5	81.6
Sweden	880	866	845	914	785	58.5	57.8	56.3	58.2	54.3
United Kingdom	462	438	422	453	353	38.9	37.0	35.5	36.9	31.8

Source: ECB (2019)

## CONCLUSION

Most compelling theoretical accounts have explained the creation of the banking union by analyzing intergovernmental bargaining (Howarth and Quaglia 2013, 2014; Schimmelfennig 2015), the political entrepreneurship of supranational institutions (Epstein and Rhodes 2016; De Rynck 2016; Nielsen and Smeets 2018) and ordoliberal ideas (Schäfer 2016). The weak point of the dominant European integration theories has long been the portrayal of the character of domestic interest coalitions as static, as though preserved in amber. Businesses are more agile than governments and can rapidly update their preferences in response to changing parameters in the regulatory, political and economic environments. We have shown that banking interests have gradually diverged between small and large banks, and that this divergence has changed national interest definitions.

At the beginning of the banking union process, there was an alliance of convenience between the large banks, which wanted elements of banking union to go forward, and the savings and co-operative banks, which wanted to defeat the EDIS proposal (German Banking Industry Committee 2012). From the large bank perspective, the intra-sectoral alliance had to remain stable – at least temporarily – in order to persuade the national government to follow through and create at least the first pillar of the banking union. Once this was achieved and the exit option for large banks had been created – through the adoption of the SSM – the incentives to cooperate ceased to exist, and the strategic intra-sectoral

alliance of German banks split. The incentives for large private banks to support the cooperative and savings banks in their endeavor to prevent EDIS had vanished, and those large banks reacted accordingly. In November 2019, the German finance minister admitted that ‘an enhanced banking union framework should include some form of common European deposit insurance scheme’ (Scholz 2019).

Large cross-border banks will continue to benefit from supranationalized supervision through reduced compliance costs related to regulatory requirements that previously tied up resources, and through takeovers of weaker competitors. In contrast, small banks operating in a single national environment can expect neither cost saving nor competitive advantage from centralized supervision (Hennessy 2014; Howarth and Quaglia 2013; Epstein 2014a). Instrumental and structural power are key variables that explain how those banks exercised influence in banking union politics. Incorporating insights about how domestic coalitions evolve over time can add to our understanding of dynamic interest-based accounts. This approach can enrich LI and neo-functional theory and help to explain the changing institutional architecture in Europe and beyond.

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