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Should Denmark and Sweden join the banking union?

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Executive summary

AN IMPORTANT POLICY discussion is ongoing in Denmark and Sweden on joining the European Union's banking union. Joining would bring pros and cons. A major issue is the supervision and resolution at the national level of large banks with a Scandinavian footprint. It is not evident that Denmark and Sweden would be able to resolve these large banks by themselves, if and when needed.

THE MAIN RATIONALE for joining the banking union is cross-border banking in the EU internal market. The banking systems of Denmark and Sweden have similar cross-border characteristics to euro-area countries, suggesting that the rationale for joining is similar. It would also be a choice in favour of increased cross-border banking and less national banking,

MOREOVER, BOTH COUNTRIES have large banks which may be too big to save at the national level, but not at the banking-union level. Next, joining banking union would put the large Danish and Swedish banks in a peer group of European banks. That would lead to more even-handed supervisory treatment and also facilitate comparative analysis by investors.

NEVERTHELESS, THERE ARE some governance concerns. While euro-area countries have an automatic and full say in all banking-union arrangements, the out-countries lack certain formal powers in ultimate decision-making. We find that this may in practice be less of a problem. Finally, the out-countries have the nuclear option of leaving the banking union.

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1 Introduction

The euro crisis was the immediate cause leading to the establishment of the banking union in Europe in 2012. The more structural reason for the banking union is the internal market in banking, which facilitates cross-border banking. That raises the question of whether out-countries that participate in the European Union's internal market should also join the banking union. With Brexit, this question has gained renewed interest in the remaining out-countries with large banks, in particular Denmark and Sweden.

The out-countries have the option of joining the banking union. But should they? We assess the question from the perspectives of Denmark and Sweden, which have so far not adopted the euro. We ask if it would pay for them to join the banking union[1].

We analyse the degree of cross-border banking in Denmark and Sweden. It appears that both countries have the same cross-border characteristics as the euro-area countries, suggesting that the rationale for joining the banking union would be similar. It would also be a choice in favour of increased cross-border banking and less national banking, with major economic and political economic consequences. But there are some governance concerns. While euro-area countries have an automatic and full say in all banking union arrangements, the out-countries lack certain formal powers in ultimate decision-making. In practice, this might be less of a problem than in theory, as the governing council of the European Central Bank (ECB) tends to rubberstamp decisions from the supervisory board, of which the out-countries are full members. Moreover, the out-countries have the nuclear option of leaving the banking union.

2 Cross-border banking

The perceived need for a banking union in Europe arises from concerns about the negative spiral that can result when banks hold sovereign bonds and governments bail out banks. This close link between banks and government solvency has, since the euro sovereign debt crisis, been seen as one of the biggest threats to financial stability in Europe. Creating a supranational supervisor and bank resolution regime seemed a logical response to this threat.

However, the academic literature has for a long time, and long before the euro sovereign debt crisis, pointed to the need for a banking union when there is cross-border banking. Early papers include Folkerts-Landau and Garber (1992), Schoenmaker (1997) and Vives (2001). With cross-border banking, there is a 'financial trilemma', according to which the three objectives of financial stability, cross-border banking and national financial policy cannot be achieved at the same time (Schoenmaker, 2011). More generally, the interests of home and host countries of cross-border banks are likely to deviate in difficult situations.

The key point can be illustrated as follows: suppose country A is not only the home country of banks from country A but also host country of banks from country B. In order to provide financial stability in country A, the authorities in country A would need information (about the capital and liquidity positions of distressed banks) from the supervisory authorities of country B. However, country B might have reasons for withholding such information. Failure to obtain this information from the foreign supervisor, fully and on time, might seriously undermine the authorities in country A in delivering financial stability in country A. So, there is a need for a supranational authority.

Against this background, the pros and cons of taking part in the banking union should be

1 Our analysis fits within an emerging literature on the pros and cons of joining banking union. See for example Darvas and Wolff (2013), Hüttl and Schoenmaker (2016), Beck (2019), Ekholm (2020) and Jensen (2020).

assessed in terms of the magnitude of cross-border banking. While it is widely agreed that a currency union does not work without a banking union, the question is if the total banking assets of EU member states outside of the euro area include large foreign components from other EU countries.

Table 1 shows this. In fact, the foreign component is significantly larger in the European Union countries outside the euro area (non-banking union) than in the countries within the euro area. From this perspective, the case for joining the banking union is strong. The question is whether the numbers for Denmark and Sweden are in line with the average numbers for the non-banking union.

Table 1: Cross-border penetration of European banking (end of 2018)

	Number of banks	Total assets in € billions	Of which: *Home*	*Other EU*	*Third country*
Banking union	5,516	€30,836	84%	13%	3%
Non-banking union	1,752	€12,786	56%	19%	25%
European Union	7,268	€43,622	76%	14%	10%
United States	5,643	€12,360	84%		16%

Source: De Haan *et al* (2020). Note: Total assets are divided over the home country, other EU countries and third countries.

Table 2 offers a closer look at individual EU countries outside the euro area. Two observations stand out. First, cross-border banking penetration in Denmark and Sweden is much lower in magnitude than in non-banking union EU countries in eastern Europe. Specifically, the home shares of total banking assets in Denmark and Sweden are 86 percent and 82 percent, respectively.

Table 2: Cross-border banking penetration in non-euro area member states (end of 2018)

	Total assets in € billions	Of which: *Home*	*Other EU*	*Third country*
Bulgaria	€ 59	24%	72%	4%
Czech Republic	€ 312	16%	84%	0%
Croatia	€ 59	17%	82%	1%
Denmark	€ 1,174	86%	14%	0%
Hungary	€ 128	54%	41%	6%
Poland	€ 484	56%	41%	4%
Romania	€ 105	37%	63%	0%
Sweden	€ 1,296	82%	17%	1%
Non-euro area (minus UK)	€ 3,617	70%	29%	1%
United Kingdom	€ 9,169	51%	15%	34%
Non-euro area (with UK)	€ 12,786	56%	19%	25%

Source: De Haan *et al* (2020). Note: Total assets are divided over the home country, other EU countries and third countries.

The pattern found for Denmark and Sweden does not deviate much from what is found for members of the euro area (see Table 1). Therefore, the degree of cross-border penetration of Scandinavian banking is likely to be high enough to constitute a strong case for joining the banking union. Yet, in future work, it would be interesting to study more closely if there is a critical level or threshold of cross-border banking (say, 15 percent), beyond which the country would benefit from joining the banking union.

3 Consolidated banking supervision and burden-sharing

Another aspect of joining banking union is the effectiveness of national banking supervision. It is difficult for national home-based supervisors to monitor the foreign operations of large banks. National supervisors typically rely on supervisory colleges of home and host supervisors based on memoranda of understanding (MoUs). However, these MoUs are voluntary.

Moreover, supervisors lack incentives to cooperate and share information in times of crisis (Schoenmaker, 2011), as seen in the global financial crisis. A major achievement of the Single Supervisory Mechanism (SSM) is the consolidated supervision of cross-border banks at euro-area level (Schoenmaker and Véron, 2016). Consolidated supervision in banking union enables the European Central Bank, as central supervisor, to have an overall view of a bank's euro-area operations.

Table 3 shows the cross-border operations of the major banks (with total assets of more than €100 billion) in the banking union countries and in Denmark and Sweden (Duijm and Schoenmaker, 2020a). For illustration purposes, we base the calculations on the assumption that Denmark and Sweden join the banking union, which we label the enlarged banking union. The geographic spread of the major banks' activities is divided between the home country, the rest of the enlarged banking union, the rest of Europe and the rest of the world.

For the major banks in the banking union, 62 percent of assets are in the home country, 12 percent in the enlarged banking union, 11 percent in the rest of Europe and 15 percent in the rest of the world. The geographic spreads of the major Danish and Swedish banks do not deviate much from those of the major European banks. The proportion in the enlarged banking union is even larger for both countries (17 percent) than for the banking-union countries (12 percent). The case for the two Scandinavian countries joining the banking union on this front is even stronger than that of other banking-union countries.

Table 3: Geographic segmentation of major banks (end of 2017)

Bank	Total assets in billion	Of which: Home	Enlarged BU	Other EU	Rest of world
BNP Paribas	€ 1,960	34%	38%	7%	22%
Crédit Agricole	€ 1,763	81%	9%	2%	8%
Deutsche Bank	€ 1,475	31%	18%	8%	43%
Banco Santander	€ 1,444	27%	5%	38%	30%
Société Générale	€ 1,275	73%	7%	11%	10%
BPCE	€ 1,260	91%	1%	1%	7%
ING	€ 846	29%	39%	16%	17%
UniCredit	€ 837	43%	37%	17%	3%
Intesa Sanpaolo	€ 797	84%	5%	7%	4%
Crédit Mutuel	€ 794	90%	5%	3%	2%
BBVA	€ 690	49%	2%	1%	48%
Rabobank	€ 603	73%	5%	2%	21%
DZ Boank	€ 506	85%	8%	2%	5%
KfW	€ 472	81%	0%	11%	8%
Commerzbank	€ 452	53%	3%	30%	14%
ABN AMRO	€ 393	73%	14%	3%	11%
CaixaBank	€ 383	81%	10%	5%	5%

continues

Bank	Total assets in billion	Of which: Home	Enlarged BU	Other EU	Rest of world
KBC	€ 292	55%	10%	30%	4%
LBBW	€ 238	72%	11%	8%	9%
La Banque Postale	€ 231	99%	0%	1%	0%
Banco de Sabadell	€ 221	74%	0%	17%	9%
Erste Group	€ 221	44%	9%	46%	1%
Bayerische Landesbank	€ 215	82%	7%	6%	6%
Bankia	€ 214	91%	0%	8%	0%
Belfius	€ 168	72%	11%	14%	2%
NORD/LB	€ 165	86%	7%	2%	5%
Banco Popolare	€ 161	95%	0%	3%	1%
Landesbank Heleba	€ 158	78%	0%	13%	9%
NRW Bank	€ 148	80%	0%	20%	0%
BNG Bank	€ 140	83%	0%	17%	0%
Monte dei Paschi di Siena	€ 139	95%	4%	1%	1%
OP Financial Group	€ 137	86%	7%	5%	2%
Raiffeisen Zentralbank	€ 135	20%	17%	50%	12%
UBI Banca	€ 127	95%	0%	3%	2%
Bank of Ireland	€ 123	70%	0%	30%	0%
SNS Reaal	€ 111	98%	0%	2%	0%
Total banking union	€ 19,296	62%	12%	11%	15%
Nordea Bank	€ 582	29%	51%	19%	1%
Svenska Handelsbanken	€ 282	59%	15%	22%	4%
Skandinaviska Enskilda Banken	€ 260	67%	23%	6%	4%
Swedbank	€ 225	81%	13%	4%	2%
Total Sweden (with Nordea)	€ 1,349	51%	32%	15%	2%
Total Sweden (without Nordea)	€ 767	68%	17%	11%	3%
Danske Bank	€ 475	55%	27%	17%	0%
Nykredit Holding	€ 192	95%	2%	3%	0%
Realkredit Denmark	€ 118	98%	1%	1%	0%
Total Denmark	€ 785	71%	17%	11%	0%

Source: Duijm and Schoenmaker (2020b). Note: Total assets are divided over the home country, other enlarged banking-union countries, other EU countries and other world. The enlarged banking union includes the banking-union countries, Denmark and Sweden.

Furthermore, the banking union allows countries to share the burden of resolving ailing banks (Goodhart and Schoenmaker, 2009). The Single Resolution Mechanism (SRM) resolves ailing banks at the banking-union level with access to the Single Resolution Fund (SRF). The reformed European Stability Mechanism (ESM) Treaty provides a backstop facility to the SRF[2], which constitutes burden sharing between ESM countries.

Denmark and Sweden will not join the ESM if they join the banking union, unless at the

2 Article 18A of the draft revised Treaty establishing the European Stability Mechanism.

same time they become members of the euro area. Under the common backstop arrangement for the SRF, they will set up a 'parallel credit line'. They will participate in the common backstop on equivalent terms and thus join the burden-sharing mechanism[3].

By contrast, Denmark and Sweden are, if outside the banking union, on their own should they have to resolve one of their major banks. The stability of a banking system ultimately depends on the strength and credibility of the fiscal backstop. While large countries can still afford to resolve large banks on their own, small and medium-sized countries have difficulties providing credible fiscal backstops to any large cross-border banks they host.

Table 4 shows that the potential fiscal costs of a severe systemic crisis could amount to 12.1 percent of Danish GDP and 10.5 percent of Swedish GDP, should the respective government need to recapitalise the largest three banks. We calculated an indicative hurdle rate for fiscal costs of 8 percent of GDP (Schoenmaker, 2018). Below that rate, countries were able to resolve a financial crisis without external assistance during the global financial crisis. Above that hurdle rate, countries needed external support from the International Monetary Fund (IMF) or the ESM.

So, Denmark and Sweden cannot provide a credible fiscal backstop to their large banks. These countries have to manage this large and undiversified risk. In the case of an asymmetric shock to the Danish or Swedish economy (such as a national housing market shock), these economies are much exposed to their large banks. The Swedish government has introduced tax increases and extra regulation for its large banks. Moreover, its largest bank, Nordea, wanted to be in a peer group of European banks instead of Swedish banks, which would facilitate comparative analysis by investors. These pressures were reportedly behind the relocation of Nordea's headquarters from Sweden to Finland[4]. Also the United Kingdom and Switzerland, with potential fiscal costs above the hurdle rate of 8 percent of GDP, have adopted policies to downsize their banking systems. We suggest that Denmark should consider how to deal with a banking system that is too big to save.

Table 4: Potential fiscal costs for selected countries (as a % of GDP)

Countries	Assets in $ billions	Recap. in $ billions	Fiscal costs as % of GDP
Top 3 banks China	8,991	405	3.7%
Top 3 banks US	6,287	283	1.6%
Top 3 banks Japan	6,023	271	6.6%
Top 3 banks euro area	5,785	260	2.3%
Top 3 banks UK	5,288	238	8.4%
Top 3 banks Switzerland	1,989	90	13.5%
Top 3 banks Sweden (incl. Nordea)	1,349	61	10.5%
Top 3 banks Sweden (excl. Nordea)	920	41	7.2%
Top 3 banks Denmark	942	42	12.1%

Source: Expanded from Schoenmaker (2018). Notes: The largest three home-country banks (those headquartered in the home country) are chosen for each jurisdiction. Based on bank rescues during the global financial crisis, recapitalisation cost is standardised at 4.5 percent of total assets. The fiscal costs represent the potential fiscal costs of recapitalising the largest three banks as percentage of GDP.

Summing up, the level of inward banking from other banking-union countries and the level of outward banking to other banking-union countries determine the benefits of joining the banking union. The calculation of these benefits is very important for assessing what Ekholm (2020) reported as the clearest cost of joining banking union: the loss of regulatory and supervisory independence. However, as also noted by Ekholm (2020), the size of that cost

3 Article 13 of the draft guideline on the backstop facility to the SRB for the SRF.

4 See Richard Milne, 'Nordea to move its headquarters to Finland', *Financial Times*, 6 September 2017, available at https://www.ft.com/content/1ed979fe-9318-11e7-a9e6-11d2f0ebb7f0.

may be small in a world in which financial markets are highly integrated. With a sufficiently high degree of financial interdependence, the scope for regulatory and supervisory independence at the national level may cease to exist (Schoenmaker, 2011).

A move to banking union is a structural choice for cross-border banking. Banking policies are then set and executed at the European level. This has both economic and political consequences. Governments will face European Central Bank scrutiny if they try to use their banks for national directed lending. There will also be less scope for national banking policies.

4 Monetary union, monetary policy and decision-making

The banking union was introduced in 2012 to address the bank-sovereign 'doom loop.' The rationale for centralised supervision in this case arises partly because of cross-border externalities from sovereign default that are sufficiently large to justify cross-border transfers. Whereas the euro would be at stake for members of the euro area, for small stand-alone countries, including Denmark and Sweden, the risks associated with a doom loop may be much smaller. In principle, their central banks are not constrained in the same way to act as lenders of last resort to the government as is the ECB in relation to the governments in the euro area.

While Sweden pursues inflation targeting, Denmark pegs the krone to the euro; therefore, stability of the euro area is more important for Denmark than for Sweden

This insight might weaken the case for Danish and Swedish membership of the banking union, as there is no currency union for them to defend and their access to lender-of-last-resort activities seems more straightforward. However, there is a substantive difference between the two countries' exchange rate policies, potentially implying a (big) difference in the pro-versus-con calculation. While Sweden pursues inflation targeting, Denmark pegs the krone to the euro, as part of ERM-2. The peg is a cornerstone of Danish economic policy and there is widespread support for the fixed exchange rate policy (Bergman *et al*, 2015). It implies that monetary policy interest rates are solely used to keep the Danish krone stable against the euro, while other considerations are not taken into account. Therefore, stability of the euro area is more important for Denmark than for Sweden.

This leads us to discuss the role of decision-making in the banking union (see Véron, 2015, for an excellent overview). The point is that the supervisory authority in the banking union is ultimately the ECB. This may well present a challenge, as Denmark and Sweden have no representation on the ECB's governing council, which is the ultimate decision-making body on supervisory decisions. Nevertheless, countries that join the banking union on a voluntary basis will be represented on the ECB's supervisory board, which prepares the supervisory decisions[5]. In that way, Denmark and Sweden would *de facto* be part of decision-making, as the governing council typically rubberstamps supervisory board decisions (Schoenmaker and Véron, 2016). Clearly, Denmark and Sweden would prefer a location for the Single Supervisory Mechanism (SSM) outside of the ECB, but this is hardly realistic at this stage of development of the banking union. Also, as monetary policy and macroprudential polices are intertwined, it can from a broader point of view be debated whether a separate location for the SSM is desirable.

Again, a difference between Denmark and Sweden can be pointed out (Bergman *et al*, 2018). Denmark has two decades of experience with taking part in such an arrangement, by being *de facto* in the euro area when it comes to monetary policy but without having representation on the governing council. Apparently, membership of the decision-making bodies

5 See Arts. 2, 7 and 26 of the SSM Regulation (EU/1024/2013). It is interesting to note that at time of writing one of the four ECB representatives on the supervisory board is from Sweden, namely Kerstin af Jochnick, who was previously vice-governor of Sveriges Riksbank.

has so far not proved decisive for reaping benefits in terms of macroeconomic stability. In the same vein, participation in the banking union, without joining the euro area, could be a combination likely to generate significant benefits in terms of financial stability.

Resolution is another area where it could make a difference if a country is not only a member of the banking union but also of the euro area. Suppose Denmark joins the banking union and a Danish bank – such as Danske Bank – runs into big trouble. In the first round, decisions about resolution would be taken by the SRM, a body in which Denmark has representation[6].

As for resolution, this might happen in a situation where resources would need to come from the ESM, the fiscal backstop for the SRF. The ESM is an intergovernmental institution of the euro-area countries. Nevertheless, as discussed above, there are commitments in the draft revised ESM Treaty and the draft backstop guidelines, ensuring that countries joining banking union without joining ESM will be informed and involved equivalently in decision-making over backstop arrangements[7].

Thus, ultimately, the decision about resolution of Danske Bank might have been taken by a body without direct Danish representation. Admittedly, this might be regarded as a rather extreme case, but it illustrates the importance – for Denmark and Sweden – of knowing in advance whether their treatment would be the same as that of members of the euro area.

5 Final considerations

The main rationale for joining the banking union is cross-border banking in the EU internal market. Reviewing the banking systems, we find that Denmark and Sweden have the same cross-border characteristics as euro-area countries, suggesting that the rationale for joining is similar. It also means a structural choice for cross-border banking and less national banking.

There is an (often neglected) area where we find the case for joining the banking union particularly strong. The SSM already has significant resources and will over time gain extensive experience in supervising different types of institutions (Beck, 2019). The fact that it is located far from most of the institutions that it supervises might also reduce the risk of regulatory capture.

The SSM, based in the ECB, would not only be able to attract talent at the junior level but also to develop and maintain senior staff, thereby having a very experienced and highly competent staff. Financial supervisory authorities in smaller countries, including Denmark and Sweden, typically have high turnover rates, with the best and most ambitious staff moving to the private financial sector. The point is that supervision is complex, and makes heavy demands on skills to match the expertise available in commercial banks. To us, access to expertise is a key benefit of joining the banking union.

Overall, we consider that the clearest economic benefit of enlarging the banking union is the prospect of more efficient resolution of cross-border banks at the banking-union level (see also Ekholm, 2020). An equal distribution of the gains and full participation in decision-making are crucial for lasting membership. Maybe a 'flexible' membership should be considered: joining now and exiting later without big costs if membership does not live up to expectations[8].

6 See Arts. 4 and 43 of the SRM Regulation (EU/806/2014).

7 Article 18A(10) of the draft revised Treaty establishing the European Stability Mechanism.

8 Art. 7(6) of the SSM Regulation (EU/1024/2013) allows non-euro countries that join banking union on a voluntary basis also to terminate their 'close cooperation'.

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