

Should Denmark and Sweden Join the Banking Union?

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ABSTRACT

An important policy discussion on joining the banking union is currently taking place in Denmark and Sweden. In this article we review the pros and cons of joining. The main rationale for joining the banking union is the importance of cross-border banking in the EU internal market. Reviewing the banking systems, we find that banks in Denmark and Sweden have the same cross-border characteristics as those in the euro area countries, suggesting a similar rationale for joining the banking union. Moreover, both countries have large banks which may be too big to save at country level, but not at the banking union level. Nevertheless, there are some governance concerns. While euro area countries have an automatic and full say in all banking union arrangements, the non-euro area countries (the ‘out’ countries) lack certain formal powers in ultimate decision-making; however, we find that this may be less of a problem in practice. If necessary, the ‘out’ countries would have the ‘nuclear option’ of leaving the banking union.

KEYWORDS: cross-border banking; banking union; non-euro area countries; banking supervision; financial stability

I. INTRODUCTION

The euro crisis was the immediate motivation for the establishment of the banking union in Europe in 2012. The more structural reason behind the banking union is the creation of the internal market in banking, which facilitates cross-border banking. That raises the question whether countries that are outside the euro zone (the so-called ‘out’ countries) but that participate in the EU internal market should also join the banking union. With Brexit, this question has gained renewed interest for the remaining ‘out’ countries with large banks, such as Denmark and Sweden.

The ‘out’ countries have the option of joining the banking union, and in this article we consider whether Denmark and Sweden should join. The assessment is made from the perspective of a country that is a member of the EU but which has not yet adopted

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the euro as its currency. Essentially, the focus of this article is on whether it would be beneficial for Denmark and Sweden to join the banking union. It forms part of an emerging literature on the pros and cons of joining the banking union.¹

In this article, we consider the degree of cross-border banking in Denmark and Sweden. It appears that banks in both countries have the same cross-border characteristics as in the euro area countries, which suggests that the rationale for joining the banking union would be similar for Denmark and Sweden and for the euro area countries. 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. This may in practice 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 would have the 'nuclear option' of leaving the banking union.

II. CROSS-BORDER BANKING

The perceived need for a banking union in Europe has been widely motivated by 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. Therefore, 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.² With cross-border banking, there is a 'financial trilemma' stating that the three objectives of financial stability, cross-border banking, and national financial policy cannot be achieved at the same time.³ More generally, the interests of home and host countries of cross-border banks are likely to deviate in distressed 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 the host country of banks from country B. In order to provide financial stability in country A, the authorities in country A need information (about capital and liquidity positions of distressed banks) from the

- 1 Zsolt Darvas and Guntram Wolff, 'Should non-euro area countries join the single supervisory mechanism?' Bruegel Policy Contribution 2013/06; Pia Hüttl and Dirk Schoenmaker, 'Should the "outs" join the European banking union?' Bruegel Policy Contribution 2016/03; Thorsten Beck, 'Better in or better out: Weighing Sweden's options vis-à-vis the banking union' Committee on Potential Participation in the European Banking Union (Fi 2019); Karolina Ekholm, 'Pros and cons of taking part in the banking union' (2020) Nordic Economic Policy Review 229; Svend E. Hougaard Jensen, 'Comment on Karolina Ekholm "Pros and cons of taking part in the banking union"' [2020] Nordic Economic Policy Review 260.
- 2 Early papers include David Folkerts-Landau and Peter Garber, 'The European Central Bank: A bank or a monetary policy rule' NEBR Working Paper No 4016 (1992); Dirk Schoenmaker, 'Banking supervision and lender of last resort in EMU' in Mads Adenas, Laurence Gormley and Ian Harden (eds), *European Economic and Monetary Union: The Institutional Framework* (Kluwer 1997); Xavier Vives, 'Restructuring financial regulation in the European Monetary Union' (2001) 19 *Journal of Financial Services Research* 57.
- 3 Dirk Schoenmaker, 'The Financial Trilemma' (2011) 111 *Economics Letters* 57.

Table 1. Cross-border penetration of European banking

	Number of banks	Total assets in € billion	Percentage of total assets		
			Home country	Other EU countries	Third countries
Banking union	5516	30,836	84%	13%	3%
Non-banking union	1752	12,786	56%	19%	25%
European Union	7268	43,622	76%	14%	10%
United States	5643	12,360	84%		16%

Source: Jakob de Haan, Dirk Schoenmaker and Peter Wierst, *Financial Markets and Institutions: A European Perspective* (4th edn, CUP 2020).

Note: Total assets include banking assets in the home country, other EU countries, and third countries. Data as at end of 2018.

supervisory authorities of country B. However, country B may have reasons to hold back such information. Failure to get this information from the foreign supervisor, fully and on time, might (seriously) jeopardize the ability of the authorities in country A to deliver 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 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 whether the total banking assets of EU countries outside the euro area include a large component from other EU countries.

Table 1 seeks to illuminate this. Apparently, the foreign component of total banking assets is significantly larger in the EU 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 Denmark and Sweden are well represented by the average numbers for the non-banking union countries.

Table 2 offers a closer look at individual EU countries outside the euro area. Two observations leap to the eye. First, the magnitude of cross-border banking penetration in Denmark and Sweden is much lower than in non-banking union EU countries in Eastern Europe. Specifically, the ‘home’ share of total banking assets in Denmark and Sweden is 86 and 82 per cent, respectively.

Second, 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 whether there is a critical level of cross-border banking such that if a country’s cross-border banking exceeds a certain ‘threshold’ (eg 15 per cent), the country would benefit from joining the banking union.

III. CONSOLIDATED BANKING SUPERVISION AND BURDEN SHARING

Another aspect of joining the banking union is the effectiveness of national banking supervision. It is difficult for national home-based supervisors to monitor the foreign

Table 2. Cross-border banking penetration in non-euro area EU countries

	Total assets in € billion	Percentage of total assets		
		Home country	Other EU countries	Third countries
Bulgaria	59	24%	72%	4%
Czech Republic	312	16%	84%	0%
Croatia	59	17%	82%	1%
Denmark	1174	86%	14%	0%
Hungary	128	54%	41%	6%
Poland	484	56%	41%	4%
Romania	105	37%	63%	0%
Sweden	1296	82%	17%	1%
Non-euro area (without UK)	3617	70%	29%	1%
United Kingdom	9169	51%	15%	34%
Non-euro area (with UK)	12,786	56%	19%	25%

Source: Jakob de Haan, Dirk Schoenmaker and Peter Wierds, *Financial Markets and Institutions: A European Perspective* (4th edn, CUP 2020).

Note: Total assets includes banking assets in the home country, other EU countries, and third countries. Data as at end of 2018.

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,⁴ as witnessed in the global financial crisis. A major achievement of the Single Supervisory Mechanism (SSM) is the consolidated supervision of cross-border banks at the euro area level.⁵ Consolidated supervision in banking union enables the ECB, 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 as well as Denmark and Sweden.⁶ For illustration purposes, we have based our calculations on the assumption that Denmark and Sweden have joined 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.

The total banking assets of major banks in the banking union are located as follows: 62 per cent in the home country, 12 per cent in the enlarged banking union, 11 per cent in the rest of Europe, and 15 per cent in the rest of the world. The geographic spread of the major Danish and Swedish banks does not deviate much from that of the major

4 Schoenmaker (n 3).

5 Dirk Schoenmaker and Nicolas Véron, 'European Banking Supervision: The First Eighteen Months' Bruegel Blueprint 2016/25.

6 Patty Duijm and Dirk Schoenmaker, 'European Banks Straddling Borders: Risky or Rewarding?' Finance Research Letters (forthcoming).

Table 3. Geographic segmentation of major banks

Bank	Total assets in € billion	Percentage of total assets			
		Home country	Enlarged banking union	Other EU countries	Other world countries
BNP Paribas	1960	34%	38%	7%	22%
Crédit Agricole	1763	81%	9%	2%	8%
Deutsche Bank	1475	31%	18%	8%	43%
Banco Santander	1444	27%	5%	38%	30%
Société Générale	1275	73%	7%	11%	10%
BPCE	1260	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%
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%

(Continued)

Table 3. Continued.

Bank	Total assets in € billion	Percentage of total assets			
		Home country	Enlarged banking union	Other EU countries	Other world countries
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)	1349	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 Danmark	118	98%	1%	1%	0%
Total Denmark	785	71%	17%	11%	0%

Source: Patty Duijm and Dirk Schoenmaker, 'Data on cross-border exposures of 61 largest European banks' (2020) 30 Data in Brief 1.

Note: Major banks are defined as banks with total assets of more than €100 billion. Total assets are divided over the home country, other enlarged banking union (BU) countries, other EU countries, and the rest of the world ('other world countries'). The enlarged banking union includes the banking union countries, Denmark, and Sweden. Data as at end of 2017.

European banks. The proportion within the enlarged banking union is even larger for both countries (17 per cent) than for the banking union countries (12 per cent). For the two Scandinavian countries, the case for joining the banking union on this front is even stronger than that of the existing banking union countries.

Furthermore, the banking union allows countries to share the burden of resolving ailing banks.⁷ 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,⁸ which constitutes burden sharing between ESM countries.

If Denmark and Sweden join the banking union, they will not also join the ESM unless they become a member of the euro zone at the same time. Under the common backstop arrangement for the SRF, they would set up a 'parallel credit line'. They would participate in the common backstop on equivalent terms and thus join the burden sharing mechanism.⁹

By contrast, outside the banking union Denmark and Sweden will be on their own if and when they have to resolve one of their major banks. The stability of a banking

7 Charles Goodhart and Dirk Schoenmaker, 'Fiscal Burden Sharing in Cross-Border Banking Crises' (2009) 5 International Journal of Central Banking 141.

8 Article 18A of the draft revised text of the treaty establishing the European Stability Mechanism as agreed by the Eurogroup on 14 June 2019.

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

Table 4. Potential fiscal costs for selected countries (as a percentage of GDP)

Countries	Assets in \$ billion	Recapitalization in \$ billion	Fiscal costs as % of GDP
Top 3 banks China	8991	405	3.7%
Top 3 banks US	6287	283	1.6%
Top 3 banks Japan	6023	271	6.6%
Top 3 banks euro area	5785	260	2.3%
Top 3 banks UK	5288	238	8.4%
Top 3 banks Switzerland	1989	90	13.5%
Top 3 banks Sweden (incl. Nordea)	1349	61	10.5%
Top 3 banks Sweden (excl. Nordea)	920	41	7.2%
Top 3 banks Denmark	942	42	12.1%

Source: Expanded from Dirk Schoenmaker, 'Resolution of International Banks: Can Smaller Countries Cope?' (2018) 21 *International Finance* 39.

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, recapitalization cost is standardized at 4.5 per cent of total assets. The fiscal costs represent the potential fiscal costs of recapitalizing the largest three banks as percentage of GDP. Data as at 2015 and for Sweden and Denmark 2017.

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 a credible fiscal backstop 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 per cent of Danish GDP and 10.5 per cent of Swedish GDP, if the respective government needed to recapitalize the largest three banks. We calculated an indicative hurdle rate for fiscal costs of 8 per cent of GDP.¹⁰ 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 (eg a national housing market shock), these economies are highly exposed to their large banks. The Swedish government has introduced tax increases and extra regulation for its large banks. Moreover, for the sake of its investors, its largest bank, Nordea, wanted to be in a peer group of European banks instead of Swedish banks. Apparently, these pressures are behind the recent relocation of Nordea from Sweden to Finland.¹¹ Also the United Kingdom and Switzerland, with potential fiscal costs above the hurdle rate of 8 per cent of GDP, have adopted policies aimed at downsizing their banking system. We suggest that Denmark should consider how it would deal with a banking system that is too big to save.

10 Dirk Schoenmaker, 'Resolution of International Banks: Can Smaller Countries Cope?' (2018) 21 *International Finance* 39.

11 Richard Milne, 'Nordea to move its headquarters to Finland' *Financial Times* (London, 6 September 2017).

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 banking union. The calculation of these benefits is very important for assessing what Ekholm¹² reports as the clearest cost of joining the banking union: the loss of regulatory and supervisory independence. However, the size of that cost may be small in a world where financial markets are highly integrated.¹³ With a sufficiently high degree of financial interdependence, the scope for regulatory and supervisory independence at the national level may cease to exist.¹⁴

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.

IV. MONETARY UNION, MONETARY POLICY, AND DECISION-MAKING

The banking union was introduced in 2012 to address the bank-sovereign ‘doom loop’. The rationale for centralized 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 can be at stake for members of the euro area, for small stand-alone countries, such as 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 ECB vis-à-vis the governments in the euro area.

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 exchange rate policy of the two countries, 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.¹⁵ 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 takes us to discuss the role of decision-making in the banking union.¹⁶ The point is that the location of the supervisory authority in the banking union is ultimately

12 Ekholm (n 1).

13 Ekholm (n 1).

14 Schoemaker (n 3).

15 Michael Bergman, Michael Hutchison and Svend E. Hougaard Jensen, ‘Shaping the fiscal policy framework: Lessons from fiscal consolidations in Denmark and Sweden’ in Torben Andersen, Michael Bergman and Svend E. Hougaard Jensen (eds), *Reform Capacity and Macroeconomic Performance in the Nordic Countries* (OUP 2015).

16 For an excellent overview see Nicolas Véron, ‘Europe’s Radical Banking Union’, Bruegel Essay and Lecture Series 2015.

in 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, the countries that join the banking union on a voluntary basis will be represented at the ECB's supervisory board, which prepares the supervisory decisions.¹⁷ In that way, Denmark and Sweden would de facto be part of decision-making, as the governing council typically rubberstamps supervisory board decisions.¹⁸ Clearly, Denmark and Sweden would prefer the SSM to be located outside 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.¹⁹ In practice, 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 a representation in the governing council. Apparently, membership of the decision-making bodies has not proven to be decisive with regard to 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 important benefits in terms of financial stability.

Another example where it could make a difference if a country is a member of not only the banking union but also the euro area is resolution. Suppose Denmark joins the banking union and a Danish bank—eg Danske Bank—runs into big trouble. In the first round, decisions about resolution would be taken by the SRM, a body where Denmark has representation.²⁰

Resolution 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, which ensure that countries joining banking union without joining the ESM will be informed and involved equivalently in the decision-making for the backstop arrangements.²¹

Thus, ultimately, in this scenario 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

17 See Arts 2, 7, and 26 of Council Regulation (EU) 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, [2013] OJ L287/63 (the SSM Regulation). It is interesting to note that currently one of the four ECB representatives on the supervisory board is from Sweden, namely Kerstin af Jochnik who was earlier vice-governor of Sveriges Riksbank.

18 Schoenmaker and Véron (n 5).

19 Michael Bergman, Svend Hougaard Jensen and Øystein Thøgersen, 'Fiscal policy in the Scandinavian countries' in Peter Nedergaard and Anders Wivel (eds), *The Routledge Handbook of Scandinavian Politics* (Routledge 2018).

20 See Art 4 and 43 of Regulation (EU) 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Reg (EU) 1093/2010, [2014] OJ L225/1.

21 Article 18A(10) of the draft revised text of the treaty establishing the European Stability Mechanism.

and Sweden—of knowing in advance whether their treatment would be the same as for members of the euro area.

V. FINAL CONSIDERATIONS

The main rationale for joining the banking union is the importance of cross-border banking in the EU internal market. Reviewing the banking systems, we find that banks in Denmark and Sweden have the same cross-border characteristics as those in the euro area countries, which suggests that they will have a similar rationale for joining the banking union.

There is an (often neglected) area where we find the case for joining the banking union particularly strong: the SSM. Indeed, the SSM already has significant resources and will over time gain extensive experience in supervising different types of institutions.²² The fact that it is located far from most of the institutions that it supervises may also reduce the risk of regulatory capture.

The SSM, based in the ECB, is not only able to attract talent at the junior level but is also able to develop and retain senior staff, thereby having a very experienced and highly competent staff. Financial supervisory authorities in smaller countries, such as 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 in order to match the expertise available in commercial banks. To us, this 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.²³ An equal distribution of the gains as well as full participation in decision-making are crucial for a lasting membership. Maybe a 'flexible' membership should be considered, which would allow countries to join now and exit later without major costs if membership does not live up to expectations.²⁴

22 Beck (n 1).

23 See also Ekholm (n 1).

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