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Liberal economic nationalism, financial stability, and Commission leniency in Banking Union

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This paper demonstrates that protection and promotion of insolvent banks remains a high priority for national authorities in Europe, and the Commission partially accommodates these impulses in the desire to preserve national financial stability. Insolvent banks are kept alive despite Banking Union rules on resolution designed to facilitate their closure at the cost of private investors. Italian and Portuguese cases demonstrate that pressure to relax state aid rules is strongest where problems are the greatest. However, the long-term trend is still an incremental decrease in national leeway to protect and promote national bank ownership.

Keywords: Banking Union; resolution; state aid; protectionism; financial stability

1. Introduction

Banking Union was pursued to increase economic and financial resilience in Europe by eliminating the negative feedback loop between banking systems and national governments that emerged after 2008 (Howarth and Quaglia 2013, 2016; Leblond 2014). Supervision was supposed to identify non-performing loans and exposures, leading banks to write them down and raise capital to make them more resilient (Véron 2012). Resolution was supposed to restructure and wind down insolvent banks, rather than permitting national governments to take on massive debt in an attempt to prop them up (Howarth and Quaglia 2014). Deposit insurance was supposed to prevent financial panic and provide a widespread safety net that would ensure that closures could be confidently undertaken without initiating system-wide financial distress (Gros and Schoenmaker 2014). Although ambitions were raised to mutualise contributions to resolution and deposit insurance funds, and to create a strong resolution and supervisory authorities, only supervision emerged with strong European powers. Resolution retains strong national discretion to draft and execute resolution plans, and has limited mutual funds, while deposit insurance remains entirely national, based on common commitments to coverage made more robust in a 2014 directive.

This paper argues that the leeway provided for national authorities within Banking Union's (BU) architecture, coupled with additional accommodation from the Commission and Single Resolution Board (SRB) provides room for liberal economic nationalism (LEN). Governments promote and finance the persistence of locally owned banks threatened with closure by BU rules by providing patient capital, while the Commission permits rescues to preserve local financial stability in the absence of robust European

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resources. This means fewer resolutions than originally envisaged, continued state aid and poor prospects for a Single Resolution Mechanism (SRM) with full supranational powers. This meets LEN expectations of favouring domestic banks and promoting local self-sufficiency through state intervention.

These SRM adjustments take place in the context of strong supervision through the Single Supervisory Mechanism (SSM) over large banks (De Rynck 2016; Epstein and Rhodes 2016a; Henning 2015) that pressures national authorities and the Commission to adapt to new revelations about the size of non-performing loans (NPLs) and capital levels for banks. The push to revisit Banking Union rules is strongest where prolonged forbearance by national bank supervisors and national governments has been strongest in the European system (Quaglia and Royo 2015). Italy and Portugal are countries investigated in this paper where resolutions were late, incomplete and sought EU accommodation to slightly differing degrees, and which contrast sharply against countries like Spain and Germany that undertook early resolutions, accepted BU's rules on resolving insolvent banks and broke the negative feedback loop between banks and sovereigns (Deeg and Donnelly 2016; Donnelly 2018).

The rest of this paper is structured as follows. Section 2 provides background into the key mechanisms of Banking Union that were designed to strengthen resilience in the European banking sector and the LEN framework. It also reviews the literature on why the institutions developed as they did, taking note of successes and disappointments. Section 3 examines the loopholes provided in Banking Union's architecture to permit national authorities and governments to promote their own banks, and outlines the hallmarks of liberal economic nationalism. Section 4 examines each of the weaknesses outlined above and the reasons why. Section 5 concludes.

2. Banking Union's architecture and liberal economic nationalism

Banking Union was established to contribute to financial stability in two ways: by ensuring that bank failures would not lead to sovereign financial failures in the future (a renewed Eurozone crisis); and to contribute to general economic recovery by forcing banks to return to financial health under the guidance of European supervision and common rules. The first of these goals – breaking the link between states and banks – required tying the hands of national governments to prevent them from bailing out insolvent banks as they had in 2008 (or protecting them from pressure to do so). This was accomplished by the introduction of resolution rules that required private creditors rather than taxpayers to bear the biggest losses in the event of insolvency (bail-ins), and to do so before public assistance (bail-outs) could be considered. To ensure diligent application throughout the single market, the Single Resolution Board (SRB) was established to oversee the process for the EU's largest SIBs, and to coordinate and supervise the activity of national resolution authorities in the management of smaller cases (Baglioni 2016).

Resolution takes place in the context of two other components of Banking Union that give context to these decisions. The ECB has proven to be a strong supranational supervisor since 2014, uncovering capital shortages and NPLs that it pushes banks to rectify more strongly than some national regulators or the European Banking Authority. This increases the demand for resolution and funds. Meanwhile, those funds and related deposit insurance funds remain national in the absence of a mutualized European Deposit Insurance System (EDIS) (Donnelly 2014; Howarth and Quaglia forthcoming).

Technical assessments from the financial stability world noted that gap between what was required generally for financial stability, and then specifically in an economically diverse and politically fragmented policy space like the Eurozone. Students of European affairs focused less on the technical requirements of financial stability than on the progress made. Neofunctional analysts of European politics underlined that the EU had institutionalized far-reaching supervisory powers over banks and member states in response to threats to financial stability in Europe (Epstein and Rhodes 2016b; Ioannou, Leblond, and Niemann 2015; Jones, Kelemen, and Meunier 2016; Niemann and Ioannou 2015; Quaglia and Spendzharova 2017). The establishment of a single supervisor, the establishment of a resolution regime and the European Commission's related and belated abolition of state aid (in the first instance) to banks through EU competition policy were evidence that Europe was up to the task of overcoming economic nationalism by its member states in the banking industry. This assessment was tacitly shared by intergovernmental analysts, who focused more on the distributional and power conflicts underlying the distribution of costs for securing an outcome (Howarth and Quaglia 2016; Pisani-Ferry and Wolff 2012).

However, national responsibility and resources are continued features of the current regime, given reluctance of northern European countries to consider mutualized financial obligations, and the reluctance of southern European countries to accept a substantial downsizing of their banking sectors. Liberal economic nationalism (LEN) is not confined to southern Europe, and governments remain majority or minority owners of the vast majority of European banks (Véron 2017) but the acute need to act is present there to an extent not found elsewhere.

This result – in which the design of Banking Union continues to rely on national funds and preserve room for national authorities to move – can best be attributed to liberal economic nationalism – the understanding that national governments protect and promote their 'own' national champions within a broader system of open trade and investment (Clift and Woll 2012; Deeg 2012; Epstein 2014; Goyer and Valdivielso del Real 2014; Helleiner and Pickel 2005). This is not the same as outright mercantilism for two reasons: by virtue of the state's role as a facilitator for ensuring the safety, security, and identity of nationally-owned banks (rather than as a director in the sense of state-directed capitalism: see Wade 1990); and by virtue of those states (and companies) seeking to preserve the national identity, ownership, and control within an open, competitive environment (Clift and Woll 2012; Donnelly 2014; Epstein and Rhodes 2016b; Harmes 2012; Lee 2006; Pauly 2009). They reflect the importance of national governments also remain key in determining European legislation regulating that relationship (Howarth and Quaglia 2016; Quaglia 2010; Schimmelfennig 2015; Verdun 2015). Here, I relax the focus on national champions and focus on national ownership (state or private) or (significant minority) control of banks (Mérő and Piroska 2016). The primary effect is to position the state as the ultimate guarantor of local (national) financial stability, either as a provider of patient capital, or as a protector of depositors.

Persistent disparities in economic resources result in continued negative feedback effects between persistent (general) economic fragility, bank weakness and sovereign weakness (ECB 2016; IMF 2016). Supervision rules requiring a reduction in resolution rules requiring The design of Banking Union and EMU reforms have not resolved these issues. Following the original plans for Banking Union, state aid became difficult to deploy after 1 January 2016 without first initiating a bail-in of private investors, meaning that the primary strategy envisaged within Banking Union for cleaning up balance sheets is retrenchment through the reduction of NPLs, both present and future.

Looking forward this means reducing credit as well to avoid NPLs in the future, which impinges on economic recovery. The result is that adjustment remains possible in the banking sector in Europe, but not without further economic contraction in the weakest links of the euro zone economy (Hall 2014). The economies remain so fragile and the prospect of systemic contagion so prominent under those conditions that the system remains stuck.

Allowing LEN state aid cushions local financial stability against such declines. Rather than bringing the European banking sector back to health with widespread bail-ins, economic contraction or a sale of banks to foreign owners, governments, especially in southern Europe, continued to offer state aid and organize buyouts and aid from other (preferably national) investors to keep local banks afloat. The rules of the BRRD do not forbid these practices, but make this provision of state aid cheaper by deploying bail-ins first. Commission lenience extends the scope further in resolution cases. In the extreme case of Italy, the status of retail depositors as junior bondholders in a previous attempt to capitalize banks without resorting to outside ownership, this cost reduction strategy remained politically unfeasible, putting greater demand on public contributions to keep banks afloat than elsewhere. However, the continued room to maneuver is consistent with southern European countries voting for the BRRD because ways could be found around its preference for resolution.

While this continued reliance on public funds meets political demands to keep banking national in southern Europe, it entrenches further financial instability there. This results in persistent pressure on banks to downsize, political pressure on governments to resist, and Commission pressure to accommodate rule bending to square cleaning up banks with local financial stability and limited public backstops.

2.1. National administrative resources

In the early days of Banking Union's construction, a two-tier system of national and European supervision and resolution was envisaged. That gave way to a more robust European supervisory system in 2014. Nevertheless, national bank supervisors are involved in much of the work that Banking Union accomplishes. This works in two different ways. First, national supervisors must work closely with the ECB and the SRB if the bank is on the ECB's list of 128 E-SIBs, which restricts their capacity to apply Banking Union differentially. But they are still the first line of communication with the bank, provide EU bodies with data, and work out resolution plans. Supervision therefore varies, with possible implications for the quality of implementation. Second, national authorities supervise all other banks directly. Here, the potential gap between the intent and implementation of EU law is greater. Above all, the room to move creates more opportunities for moral hazard and poor governance by banks, coupled with supervisory forbearance, to continue unabated until the bank collapses. The choice to forbear can be made by different institutional actors – the Italian Ministry of Finance was remarkably dovish on supervision in comparison to the Bank of Italy, for example, leading to a number of notable failures, while the Bank of Portugal exercised forbearance on a number of cases, including Banif bank, which failed in 2015 to the surprise of the government (*Portugal News* 2016).

In the context of LEN, a consequence of relying on national resources as a public backstop to the banking system is that it is difficult to ensure financial stability during periods of financial distress without also providing national governments with considerable leeway and responsibility for sorting out banks that have failed or are close to

doing so. Indeed, the Juncker Commission appears to have taken this into consideration in relaxing resolution and supervisory rules. This in turn means increased pressure to accept forbearance for non-performing and risky assets, delay or shelve increases in capital and insurance contributions, waive restrictions on recapitalization from the public sector, and use state aid to save rather than wind banks down. Taken individually, such measures may be seen as incremental, ad hoc adjustments to a regime that is designed to promote safe banking and allow failing banks to be wound down in an orderly fashion, but they are more properly seen as part of a pattern of relaxing the original intent of Banking Union's framers.

The next sections test the argument that Banking Union is subject to adjustment to compensate for weak links in application of the bail-in rules of the Bank Recovery & Resolution Directive. It shows that there indeed appear to be weaker links in the Eurozone economy that lead to national and then European regulators to step back from uniform European application of banking regulation, given the inherent instability of those economies, banks and sovereigns (trifecta). In this context, the ECB's provision of public backstop facilities (Richter 2016) have been key to preventing the collapse of bank stocks in Europe (Quijones 2016).

3. National lobbying, commission acceptance of national leeway

The introduction of the Bank Recovery and Resolution Directive (BRRD) signaled the intended transition from a permissive environment on state aid to banks that had prevailed from 2008 to 2016 to a restrictive one. Those new rules permitted state aid to failing banks only if private creditors had already been subjected to a bail-in procedure imposing heavy losses on them. The BRRD, having been the subject of hard bargaining over whether state aid should be permitted, and how much of the bill of saving or winding up a bank should fall on taxpayers, had been decided in favor of those countries seeking to limit state aid and impose maximum cost on the private sector. Accordingly, private investors would have to take a haircut on the value of their investments and loans until at least 8 percent of the bank's assets had been compensated in this way. This formula was the basis by which proponents contended that the negative feedback loop between insolvent banks and insolvent governments could be broken – by breaking the expectation that governments would always step up and be liable for the losses of the banking sector.

By mid-2016, this expectation had been replaced by new Commission decisions that rolled back bail-ins of private investors and the provision of state assistance to banks (Guarascio 2016a). Those were accomplished on the basis of lobbying by national governments (considering the impact of applying rules on their own banks) and a European Commission considering the implications financial disruption, particularly without mutualized public backstops that might have been able to serve as guard rails for the European banking system. Commission-instituted relaxation was possible regarding bail-in requirements as preconditions for public backstops and state aid. Each is covered in its own section below, followed by illustrations from the Italian and Portuguese cases.

3.1. Bail-ins

The BRRD's rule on state assistance for insolvent banks (effective 1 January 2016) was that there could be no bail-out with public money without a bail-in of private investors of at least 8 percent of core equity capital. The threshold and the universal application was a condition of the German finance minister for signing on to the

directive. The directive in turn was a condition for Germany to approve the use of funds from the European Stability Mechanism as a backstop to national governments requiring financial assistance in the event of a banking crisis, and to support a modest Single Resolution Fund that would act as the first line of emergency backstop financing before the ESM (Guarascio 2016b).¹ The two weakest links outside of Greece, Italy, and Portugal rushed to resolve banks and avoid bail-ins in late 2015, lest investors get worse terms under the new regime.

Bail-ins coupled with closure (where public funds were insufficient after a bail-in) were viewed by Germany, the Netherlands, Finland, the SRB and ECB as a necessary firewall between failed banks and healthy ones, rather than as a means of simply reducing the magnitude of state financial assistance for failed banks. This intent was demonstrated before the BRRD's entry into force in resolving Cypriot banks in 2013. To do this, bail-ins would sometimes need to impose haircuts not only on junior bondholders, but also senior creditors as well to increase loss absorption. The loss of superior legal protection in the event of a bank insolvency undermined the readiness of senior creditors to fund fragile banks at lower interest rates, leading to self-fulfilling bank runs in fragile economies and an increased likelihood of closure (Brundsen and Barker 2016; Fitch Ratings 2016). Accommodating state aid to keep a bank afloat would have worked against their understanding of the legislation. ECB Chief Economist Praet underlined on 17 May 2016 that adhering to the rule was important for the proper functioning of the SRM, and therefore, Eurozone financial stability, but that it was still unclear whether the application of the bail-in rule would succeed (Guarascio 2016C).

However, in June 2016, SRB head Elke König opened the door to relaxing the bail-in rules. She maintained that bail-in rules could be waved or significantly adjusted to cover smaller amounts for smaller banks. This would have implications for the amount of core equity capital a bank would have to hold in order to fulfill its regulatory requirements – reducing it, in fact. This figure would determine how much private capital was available to compensate for losses in the event of insolvency. However, this did not mean that she expected state aid to rise as a result. Rather than expect taxpayers to pick up the difference, König pointed out that in return for lower capital requirements, the banks would have to be closed if they became insolvent and the profitable assets transferred to another institution (Guarascio and Jones 2016).

Despite this relaxation, Italian pressure to go further persisted. Bank of Italy Governor Ignazio Visco pleaded in June 2016 for the EU to stop implementation of bail-in rules on the grounds that they would unleash systemic crisis within the country if applied (Novak 2016). Visco had previously argued that national state intervention in the banking sector was necessary to stop contagion in time of crisis given the lack of compensating European institutions within Banking Union. This included the use of deposit insurance funds to bailout four insolvent banks in November 2015, which the European Commission had blocked (Za 2016).

Italian opposition to the BRRD came not only from the central bank, but from the office of Prime Minister Renzi as well, which had embarked on a broader, more ambitious plan to clean up the Italian banking sector in 2015. The proposals are discussed below, as they focus on the permissibility of state aid.

3.2. State aid

A further adjustment of Banking Union rules was a relaxation of rules on state aid to banks. The BRRD was negotiated and legislated to make state aid a thing of the past,

leading to the closure of insolvent banks. However, the option for states to provide capital injections remained, even before the relaxation of bail-in rules, provided the 8 percent threshold had been met. A national government would have to have the borrowing capacity to provide state aid, of course, a capacity which remains asymmetric within the Eurozone. Germany had demanded the involvement of private creditors as part of a rescue or resolution plan in return for establishing any emergency fund to provide cross-border financial assistance during a systemic bank crisis, such as the one that prompted the fund's establishment in 2012 to deal with the Spanish financial crisis. Loans, not transfers were to be made (Münchau 2013). This applied particularly to the Single Resolution Fund.

There were two adjustments to the permissibility of state aid after the BRRD's entry into force. First, the Commission proved willing in 2016, on the request of the Portuguese Government, to exclude money borrowed by a state to provide capital injections to insolvent banks from deficit calculations in the Eurozone's Excessive Deficit Procedure (European Commission 2016). Second, it refined its interpretation of public financial assistance to banks so that it would tolerate long-term loans and state ownership. As long as the state would profit from the loan at going market rates, the transaction would be deemed admissible. This would not allow all interventions, but cleared more room for national governments to consolidate their national banking sectors and minimize the introduction of foreign ownership (below). The result is that state-enhanced market economies in the Mediterranean region retain more leeway to use state aid to keep their financial systems intact than the original design of the BRRD would have been expected to allow. Italian and Portuguese lobbying played a key role in challenging the Commission to accommodate.

3.3. Restructuring, resolution and state aid in Italy

The remaining restrictions on state aid, and the implications for Italian citizens led to further political pushback on the resolution regime, which in turn brought the question of state aid back to the European policy table. Italian opposition to the BRRD came not only from the central bank, but from the office of Prime Minister Renzi, which had embarked on a broader, more ambitious plan to clean up the Italian banking sector in 2015. The tools were well-known by then but the window of EU willingness to allow the use of those methods had closed with the introduction of the BRRD.

In 2015, the Bank of Italy floated the (last minute) idea of a bad bank that would purchase NPLs and other assets from Italian banks, but was rebuffed by the Finance Minister, who feared a loss of market confidence in the Italian banking sector. This was despite the fact that the model had been used successfully in Germany, Spain, and Belgium to renovate their own banks. Prime Minister Renzi overrode that decision later in the year, but had run out of time before the BRRD entered force on 1 January 2016. A bad bank that purchased NPLs from commercial banks would henceforth be considered state aid and be impermissible.

On 26 January 2016, the Italian Government nevertheless won Commission approval for a more modest plan of government guarantees on senior tranches of non-performing debt that Italian banks wished to offload by selling to other investors. The government's fees to the banks would ensure that it served as an insurer of last resort in a non-profit/non-loss way (Politi and Brunsden 2016), meaning that it would not be considered state aid. Further room for the Italian state to make concessions to banks was not forthcoming from Commissioner Vestager, nor by Germany or the Eurozone (Brunsdn and Barker 2016).

The Commission's leniency on state aid failed to satisfy the Italian Government. Guarantees for senior tranches still left Italian banks saddled by large holdings of junior and mezzanine (middle) tranches of bad debt, which would normally be bailed in first, and then second respectively to help insolvent banks out of their difficulties. This problem was magnified by the fact that banks had sold Italian household depositors junior (subordinated) debt in place of savings accounts in previous years in an attempt to raise capital domestically. Instead of being covered by deposit insurance, many Italians would have seen their savings wiped out first in a resolution, even if the state had intended to provide financial assistance afterward (Barnabei and Za 2015). Indeed, customers at Banca Etruria, Banca Marche, CariFerrara, and CariChieti were first left with nothing in late 2015 after a resolution-based restructuring destroyed these ersatz deposits, leading to political outcry. The Renzi government ended up paying social compensation to many of these lossholders separate from the actual resolution, a move which Nicolas Véron described as unwillingness to play by the bail-in rules in spirit, even if they were legal. Indeed, the timing of the resolutions was to avoid even harsher terms in 2016 (Politi and Sanderson 2015). The effect of this was to increase Italy's status as a weak link in the Eurozone's financial stability.

Pressure persisted afterward to find ways within the rules to allow Italian banks in distress to continue without being wound down or sold abroad. Without a legal right to intervene directly, the Finance Ministry organized contributions from relatively healthy Italian banks to weaker ones through the private Atlante fund in April 2016. This generated 4.25 bn in contributions, half of which had been used by December 2016 to purchase NPLs from two banks (Banco Popolare di Vicenza and Veneto Banca) against a total estimated NPL exposure of 350 bn for the entire sector (Jewkes and Landini 2016).

The private alternative to a state bailout could not save the greatest bank problem of the year, however. The Atlante fund could not save Banco Monte dei Paschi dei Siena (BMPS). BMPS initially required 5 bn euros in financial injections, exceeding the 2 bn left in the Atlante fund, and had been unable to raise it elsewhere. This led the government to approve state aid from a special 20 bn euro fund announced right before Christmas 2016. The requirement for a bail-in would be formally met by requiring junior bondholders to convert to shares, which then would be converted to senior debt, which would be protected under the previous deal with the Commission. This effectively circumvented the bail-in rule (Traenor and Kirchgassner 2016).

The way in which the Italian Government handled the assistance favored the Commission over the ECB regarding information and consultation, and revealed Commission accommodation for bending the rules to the breaking point. This announcement was made by decree on Friday, 23 December, and shared with the ECB as Single Supervisor only on Tuesday, 27 December, not only late but during the Christmas–New Year break, leading the ECB to underline that proper procedures had not been followed in its review of the conditions required to approve the measure. Ultimately, the ECB allowed the precautionary recapitalization of MPS on the basis that there was a serious disturbance in the Italian economy and that intervention was required to preserve financial stability in the country (ECB 2017). But the Italian Government had lobbied the Commission from late 2016 to be allowed to protect junior bondholders reimburse them for their losses out of public funds. The Commission accommodated the demand on the grounds that junior bondholders could be reimbursed in the case of banks mis-selling bonds as regular deposits (Romano 2016).

In the months that followed, the ECB and Commission differed on how and what to approve, which affected the degree of rule leniency. The ECB increased its estimate of the shortfall requiring recapitalization from 5 to 8.8 bn euros (meaning a greater cost to Italian taxpayers to ensure the bank's stability), and waited for the Commission to discuss restructuring with BMPS, while the Commission apparently waited for the ECB to work out a deal with BMPS first to decide whether it was permissible (Barker, Jones, and Sanderson 2017).

The Commission eventually set out new conditions for approving state aid, without abandoning restrictions on state aid. If banks could raise outside capital equivalent to the value of a bail-in, the state could then help (Ferrando and Davi 2017). Investors, particularly other Italian banks, stayed away, however, so that the recapitalization of BMPS was still unsecured at the end of May 2017 (Ferrando 2017). In mid-2017, Italian banks signaled unwillingness to contribute more money, leading government to look for new solutions at the time of writing (Bernabei 2017; Semeraro and Za 2017). These turns of events outlined a weakness of the Single Resolution Mechanism, which appeared to be nowhere evident, as it would have been in a robust system. As a result, the doom loop between banks and sovereigns persists in Italy.

Italy's political opposition to the BRRD's restrictions continue as a result, in an attempt to rescue its own banking system using Italian resources, both public and private. Its government notes that the EU allows for extraordinary public financial support "to remedy a serious disturbance in the economy of a Member State". The late 2015 compensation troubles show that the Renzi government prefers to avoid a bail-in in the first place rather than compensate depositors after the fact (Merler 2016). Instead, the Italian Government would keep the banks more secure and intact with state aid.

Overall, Italian banks remain fragile (for internal reasons of general economic weakness) and vulnerable to external shocks (like Brexit and a general rise in interest rates globally after the 2016 American election), without room to promote and protect the continuity and Italian ownership of the Italian banking sector (Za and Bernabei 2016). Government has prevented collapse and sale to outside investors, preferring the sale of local savings banks to their Italian commercial counterparts, and lobbied hard to preserve the state as a public backstop to these ends. All told, the BRRD has not fallen over and allowed a free-for-all in state aid to resume, but the instability of Italian banks raises issues of demand on state finances, and therefore, of a resumption of the negative feedback loop between banks and the state.

3.4. Restructuring, resolution, and state aid in Portugal

Portugal continues to experience banking sector instability as well, and supported a change in BU rules along similar lines to Italy's. The government used state bailouts when possible, a bad bank to restructure banks (but for individual institutions, not for the sector as a whole, which has impeded its effectiveness), and of course a resolution authority and fund. In the attempt to reconcile the need for raising capital and keeping national control, it has found itself slipping back to increasingly tenuous forms, but has not given up yet.

Banco Espírito Santo (BES), a private bank heavily involved in lending to local governments, received multiple bailouts and was eventually split into a good bank (Novo Banco) and a bad bank and received a loan from the Bank of Portugal (so that the bailout 'does not cost taxpayers a thing') in August 2014. The loan was in the form of convertible bonds (cocos) that were to be paid back within 5 years. Investors were

left with assets in the bad bank and sued for compensation (Arnold and Wise 2014). In 2015, the Portuguese Government further burned some bridges to the foreign investment community when it transferred bonds of Novo Banco in 2015 held by foreign investors to the bad bank of Banco Espírito Santo, which then lost their value.

In 2016, in a more acute state of distress than Italy, the Portuguese Government and sought out leniency on state aid from the Commission and offered compensation to burned foreign investors in 2016 (Beardsworth and Lima 2016). Under the new BRRD regime, BES should have been subjected to a bail-in before receiving any additional financial assistance. In April 2016, however, the Portuguese Government proposed a new injection on top of the original loan, which had not yet been repaid (and therefore could have potentially been considered state aid) (*Algarve Daily News* 2016a). The SSM reportedly responded on 13 June that a capital injection would be 'normal'. It would require a review by the *Portuguese* competition authorities on state aid (*Algarve Daily News* 2016b).

As with the Italian cases, the European Commission re-entered the fray by setting conditions on the provision of future aid, under more lenient terms. State aid would be legal provided Novo Banco would be sold by August 2017 to raise capital. Shortly, thereafter in April 2017, the Portuguese Government announced the sale of the bank to the American private equity firm Lone Star for 1 billion euros, with the Portuguese resolution fund retaining a 25% stake in the bank. Lone Star stepped up with the greatest willingness to accept the risk of default, but also by placing its claims on the bank ahead of two other investors who were still suing in court at the time of writing (Hale and Wise 2017). Foreign money had been brought in to comply with Commission, but government involvement retained.

These conditions relaxed even further by March 2017 in terms set for Caixa Geral de Depósitos (CGD). Faced with the collapse CGD in 2015, the Portuguese Government, itself in an excessive deficit procedure with the Commission, won approval for a 2.7 billion euro capital injection, converting 960 million of coco bonds, transferring 500 million euros of government shares and raising 1 billion in subordinated debt for a total of 5.6 billion. Investors viewed the latter unlikely since the transfer of bonds at Novo Banco) (Wise and Arnold 2016). The state share was later increased to 4.1 and then 3.9 billion and approved because it was on market terms (European Commission 2017). It required a cost-cutting exercise to reduce salaries in return for permission for state recapitalization (Joao Gago 2017).

The Lone Star sale, coupled with the 25% Portuguese stake, and previous financial transactions, suggest an attempt to ensure Portuguese control over the firm, to increasingly small degrees.

The intent of Portugal was indeed to set a broader precedent for national responsibility for financial stability, regardless of ability to pay. Finance minister Mario Centeno saw the agreement as a blueprint for wider recapitalization of Portuguese banking sector to tune of 30 billion euros. The return of the state as protector and promoter of the Portuguese banking sector would take place, however, within new contours of state aid policy, under conditions that force the state into a role 'identical to...that of a private investor' (Wise and Arnold 2016). Key for the Commission was that the aid would not involve any long-term costs for the state. If not, it would not be considered state aid that distorted the market. The deal meant negotiating with the Commission that the 2016 investments would not count as deficit spending in the Excessive Deficit Procedure of EMU (Khalip and Bartunek 2016).

The Commission still upheld restrictions on the use of state aid to attract a buyer for an insolvent bank, but they were restricted to ensuring that the search for new owners would take place in an open and impartial way – and that the resulting sale would not depend on further state aid. In one case this compelled the Portuguese Government to allow the insolvent bank Banif – Banco Internacional do Funchal – to be sold to the Spanish banking group Santander rather than a Portuguese bridge bank in December 2015 (European Parliament 2016). While national politicians cried unfair treatment, Competition Commissioner Vestager underlined that the Banif decision had been decided on a neutral technicality that worked against Banif. There had been no pre-existing banking license for the proposed bridge bank to aid Banif. This meant the state would have had to capitalize one from the start, in the absence of a private initiative like the Atlante fund. Vestager added that it is not for the EU to set resolution plans but to ensure that national plans are in accordance with EU rules. That includes banking licenses for bridge banks, which was a national resolution matter, and lacking in the Banif case (Paiva Cardoso 2016).

Overall, Portugal has lobbied hard to have the Commission relax state aid definitions, and found a receptive ear, but with conditions. This leniency has not eliminated the doom loop, however, but extended it. The IMF (2016) confirms in Article IV consultations that Portuguese banks lag behind the curve in getting rid of NPLs and raising capital, and undertaking structural reforms to return them to profitability. It also noted the continued tendency of Portuguese banks to lend on the basis of “non-commercial criteria”.

4. Conclusion

This paper started out by outlining Banking Union’s mission to end the negative feedback loop between states and sovereigns – with particular attention to resolution in the BRRD. Governments were meant to resist the temptation to provide state aid to failing banks – by first making investors pay through bail-ins – and then by allowing the banks to fail if national public backstops were insufficient. Given long-term economic decline in southern Europe of both public and private finances (Gambarotto and Solari 2015), this implied closure of a number of banks there.

This paper provides an answer as to why this turned out differently. National governments in Portugal and Italy lobbied the Commission for additional room to provide state aid, largely by re-defining what it constitutes, and to arrange national solutions for failing banks within the rules. It found a Commission, and a Single Resolution Board, partially willing to accommodate those demands. Local (national) financial stability mattered greatly to the Commission in its reasoning. While local ownership did not appear to be worth promoting or protecting to either Commission or SRB, it was to national governments, and both Commission and SRB admitted that national resolution plans were largely the business of national authorities within the BRRD structure. States may provide aid, provided the banks agree to pay it back, and provided that foreign owners are not formally barred from consideration. However, the existence of rules on state aid and resolution mean that southern European Governments have less room to protect and promote their own banks than they used to. And when all attempts at securing national investors fail, foreign ones are accepted on an ad hoc basis, in the view that foreign-owned banks are better than no banks at all. Portugal has moved further down this road than Italy, due to the lack of alternatives. The Portugal–Italy comparison further suggests that incremental change away from national ownership

emerges as a side-effect of efforts to restructure and clean up banks rather than close them down in resolution. As Italy follows Portugal, this enhances the likelihood of increased foreign ownership.

Overall, Banking Union still relies significantly on *national rather than European administrative and financial resources* to ensure local financial stability, so that *resilience remains asymmetric*. Southern European countries in particular share a trifecta of mutually reinforcing features: the inherent instability of the national economies, banks, and sovereigns that the ECB's (2016). Financial Stability Review underlines as the most important challenge to tackle. Thanks to Portuguese, Italian lobbying and Commission willingness to compromise, modifications to state aid rules and resolution in Banking Union prevent massive bank closure or sales to foreign investors, and retain states as significant bank owners within their jurisdictions.

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Note

1. Note that the Commission also needed all countries to fully implement the BRRD before Germany would agree to talks proposed by France and Italy over using the ESM as a backstop to the Single Resolution Fund.

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