Making the Banking Union effective

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Banking Union: how to overcome the existing fragmentation of the EU banking sector

The great financial crisis from 2008 onwards was not only a financial and a sovereign debt crisis, but in particular a banking crisis. One element to weaken the link between banks and their national sovereign in the Euro area, was the political agreement of 2013 to create a Banking Union. While its first two pillars, the SSM and the SRM have been established, the third pillar of the Banking Union, a common system for depositor protection – the European Deposit Insurance Scheme (EDIS) – still waits for a consensus on design and implementation.

A staggered approach seems to be the most pertinent to bridge the current impasse that prevails in the EDIS debate.

Both the non-implementation of EDIS, as well as a premature and ill designed implementation imply costs. Without EDIS, fragmentation of financial markets is likely to persist, resulting in higher costs of financial intermediation for households and companies alike. However, a poorly implemented EDIS with wrong incentives could easily increase moral hazard and thereby lead to unfair risk sharing with the danger of unwarranted cross-subsidization across countries and hence political tensions across the entire Banking Union.

Undeniably, substantial progress has been achieved on the risk reduction side over the last years including an ongoing shift to new business models with more sustainable lending practices. Risk reduction has also happened against the backdrop of a benign macro environment and discussions on the need to address structural elements (especially related to national insolvency regimes and the treatment of sovereign exposures) persist.

Liquidity provision is crucial for the trust in deposit guarantee systems. The currently proposed, yet controversial next step is the introduction of the first phase of EDIS, whereby national deposit guarantee schemes would have to deplete their own funds first, before they can receive liquidity through a loan from EDIS that has to be repaid afterwards. An alternative approach would be to directly introduce the fully-fledged European system of deposit guarantees, an insurance scheme funded with risk-based contributions at bank level without a layer of national pulling.

When it comes to a fully-fledged EDIS, harmonization of national insolvency regimes and the regulatory treatment of sovereign exposures to account for the home bias of Euro area banks are highly important issues.

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>>> Another often cited element when discussing the effectiveness of the Banking Union are regulatory barriers across countries. While the Banking Union has made significant progress in the harmonization of national options and discretions since its inception, achieving the right home-host balance remains a contentious issue. In fact, the home-host debate is closely related to the EDIS discussion - the protection of national depositors has been a strong argument for ring-fencing measures in the past. The latter bias would disappear under a genuine European deposit insurance scheme.

Allowing for the free flow of capital and liquidity within cross border banking groups would make the Banking Union more effective. However, it has to be ensured that these banks are not only multi-national alive, but also in death. While the SRM has achieved significant progress in this regard, the functioning of the current resolution regime for large cross border banking groups begs a number of questions which have not been fully addressed at this juncture – think of the SPE-implementation across borders in a time when MREL is just building up gradually. The issue of liquidity in resolution would be another case in point. Here too, a staggered approach focusing on a fully functioning resolution regime including the implementation of the Single Resolution Fund (SRF) backstop could lay the basis for future advances in the field of home host cooperation and thus render the Banking Union more effective.

The European banking sector is at the crossroads. Protracted profitability below the cost of equity, the challenge of technological change and digitalization, issues of overcapacity in a number of markets and a more challenging macro environment looking ahead make it all the more important that the regulatory framework operates smoothly in a non-distortionary way – progress in completing the Banking Union is therefore needed. This progress should however be stepwise avoiding misguided incentives. ●

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Overcoming the fragmentation of the EU banking sector

In the year that we celebrated the 20th anniversary of the euro, we have to admit that the progress in financial integration, one of the criteria for joining the euro area and one of its goals, has not been as fast as we might have hoped. If anything, the banking sector has become even more fragmented in the years since the financial crisis. This leaves EU lenders unable to compete with bigger and more efficient global peers, which makes it worrying that the political momentum behind completing the banking union seems to be fading and that a considerable number of national rules hinder cross-border consolidation.

One of the stumbling blocks to completing the banking union is the weakness in the banking sector, which is demonstrated by the relatively low returns on capital and the length of time it has taken for banks to clean their balance sheets after the last crisis. In more recent years, the banks in most EU countries have managed to reduce considerably the share of non-performing loans (NPL) among their total stock. However, this progress has been held back by the chronically low profitability of the majority of EU banks and the still substantial stock of NPLs, which in turn reduces profitability. The revenue earned by banks has been too small to cover the losses incurred in the past 10 years. This gap is especially stark in the euro area, where, mainly because of overcapacity in the banking system, net interest income is smaller and the cost-to-income ratio is higher than for the banks in non-euro area countries. This suggests that the banks' resilience to >>>

>>> a macroeconomic downturn in the future may be limited, even if their capital ratios have improved in recent years. The key question here concerns not deficiencies in regulation but the sustainability of the business models of EU banks in an environment of overcapacity.

We have been building the banking union for five years and we still haven't agreed on the blueprint for its third pillar, common deposit insurance. Without this however, the incentive will be greater to use resolution tools for failing banks rather than to close them down. We have built up sizeable funds in the SRF for resolution, but at the same time many national deposit insurance schemes remain underfunded. There is an obvious need for a European deposit insurance system with ex-ante funding and decision-making at the EU level, as we have already agreed upon European-level supervision and resolution mechanisms. But it is also understandable that reaching an agreement on this requires all the member states to be comfortable that the relative risks in their banking systems have been brought to a comparable level. We need to work hard to get there as soon as possible.

Macroprudential supervision meanwhile should remain at the national level as a policy tool for mitigating country-specific risks. It is unfortunate then that the creation of a proper macroprudential toolbox in host countries is hampered by the fears of home countries about ring-fencing. Measures taken by macroprudential authorities are applied equally for local banks and for foreign subsidiaries. Several macroprudential policy instruments are in place but using them can sometimes be complicated. There are also several gaps in the toolbox, as more targeted measures would for example be warranted for addressing the cyclical risks of individual exposure categories like mortgage loans. Moreover, the current framework also lacks the tools it needs to mitigate the risks related to the expanding activities of non-bank financial intermediaries.

The Nordic banks have not only been more profitable but have also been regionally more integrated than the EU average. Some Nordic-Baltic banking groups have efficient cross-border branches in the region instead of subsidiaries. Having cross-border branches eliminates many of the home-host problems that are being debated among EU regulators. The preference for establishing subsidiaries may be a missed opportunity in financial market integration. Some of the energy we spend on arguing about whether regulation should apply at the solo or group level could be better spent on thinking about why banks are using subsidiaries instead of branches. ●

José Manuel González-Páramo

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The Banking Union, as it stands, remains unfinished. What next?

Much work has been done in the European institutions over the last few years to create a single and centralized banking regulation, supervision and resolution framework to develop a credible Banking Union. The last milestone achieved at the beginning of the summer was the finalization of the risk reduction banking package (the so called CRD V) which marked an important step in lowering the risk of bank failures and ensuring public money will not be used to fund bailouts.

Despite these achievements, the Banking Union is far from complete and work remains to be done. An evidence of this is that the European banking market continues to be largely fragmented across national borders and that the Banking Union is failing to deliver the degree of financial integration expected in its early stages. Distrust among Member States lies at the root of this, resulting in barriers to the free flow of capital and liquidity across the EU, preventing the diversification of risk and the risk sharing and therefore introducing systemic weaknesses.

The 2019 elections of the European Parliament indicated a renewed interest in Europe among citizens, with the highest turnout in 20 years. The coming institutional cycle in the European Commission is expected to take >>>

>>> an ambitious pro-European approach. Thus, the new leaders of the European Union should be able to provide a fresh impetus to the Banking Union project, as the President of the European Commission said, this is "A Union that strives for more".

"Achievements in the Banking Union mark a significant milestone for Europe."

- JOSÉ MANUEL GONZÁLEZ-PÁRAMO

To achieve these goals, it is important that legislators move to further economic and monetary union integration addressing reforms in three main fields. First, the development of a backstop for the Single Resolution Fund (SRF), the creation of a European Deposit Insurance Scheme (EDIS), a true Capital Markets Union with harmonized insolvency and tax regimes and a European safe asset would pave a fully operative Banking Union. Second, a single harmonized insolvency regime for banks managed by a single authority (SRB) and with a single creditor hierarchy would help to harmonize the European resolution framework. In addition, it is crucial to establish a funding in resolution mechanism with a robust and credible public backstop. The last regulatory field for reforms would be the reduction of regulatory fragmentation, so that EU banks' competitiveness is preserved, especially in view of the close finalization of Basel III.

Achievements in the Banking Union mark a significant milestone for Europe. Now it is high time that regulators finalize it in order to further underpin the credibility of the project. Besides, this it is only one step in a longer journey towards the future of Europe where fiscal, economic and institutional discussions are yet to come. The broader political and economic challenge for the EU is to reconcile its vision of economic integration with a sustainable framework to define and defend the European public interest through adequate rules and institutions. ●

Diederik van Wassenaer

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Cross-border banking and national impediments to free flow of funds

Economic prosperity grows when there is optimal allocation of funds. In the Eurozone the integration is under much pressure Member States use the flexibility in the regulatory framework to restrict intragroup cross-border free flow of funds. This reference to national discretion impacting free flow of funds covers aspects of liquidity, capital and the large exposure regime.

Proponents of a true banking union, amongst which ING, believe that the development of the SSM, SRM, SRB and EU recovery and resolution framework have made national arguments for ring-fencing capital and liquidity less appropriate than they were before and during the crisis. The EC also promoted this view as was reflected in the first CRR2 draft from 2016 which offered amendments that could ease cross-border flow of funds.

"To achieve a truly integrated Banking Union national discretions should be removed."

- DIEDERIK VAN WASSENAER

But many host countries still see the need to protect shareholders, creditors and taxpayers in their countries by ring-fencing capital and liquidity using measures that exceed the prudential standards that were agreed upon at the global level. Their key argument so for is that the Banking Union is not yet complete because it lacks a fully integrated safety net including a single deposit guarantee scheme.

As a result, the post-crisis European banking landscape remains fragmented across national borders. While integration has recovered from the trough in 2011-12, most indicators of financial integration (including quantity-based ones, such as the share of cross-border loans, and price-based ones, such as the dispersion of rates between countries) have not recovered to pre-2008 levels.

For example, 83.6% of loans by Eurozone banks to households and businesses is lent in the home country. Only 6.1% is lent to households and businesses on a cross-border basis elsewhere in the Eurozone. Lending across borders within the Eurozone did increase from 2.3% in 1997 to 5.2% in mid- 2008, but progress has come to a virtual standstill since then. In the deposit taking market, a retrenchment to home markets can be observed since 2008. In mid-2008, 47.1% of bank deposits were collected domestically, and another 21.1% from elsewhere in the Eurozone. Today, 54.1% is collected domestically, while the share from elsewhere in the Eurozone has declined to 19.2%.

One could argue that before 2008, there was too much "wrong" financial integration within the Eurozone: the system seemed stable but wasn't. But we can be pretty sure that today, we have too little of the "right", stability-increasing, financial integration. Cross-border banking groups are not able to efficiently allocate internal capital and liquidity as they face limitations that block resources from flowing to where they are most in demand from businesses and households. This leaves them unable to compete with bigger and more efficient global peers. It could also explain the absence of major European bank mergers in the last decade, as well as the increasingly excessive exposure of European banks to home countries (approx. 60%).

Therefore, to achieve a truly integrated Banking Union, in parallel to building EDIS, national discretions should be removed to the extent that they impede the efficient allocation of fund. ●