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What are the costs and risks of a delayed compared to a half-baked completion of the Banking Union?

Against the background of the current coronavirus pandemic and its economic impact the importance of joint initiatives to complete the Banking Union in a sensible manner is once again highlighted.

In response to the economic and financial crisis of 2008 the European Commission initiated the project of creating a three pillared Banking Union back in 2012 in order to reinforce financial stability by reducing financial fragmentation and by breaking the link between banks and their national sovereigns.

While it was possible to achieve progress on the first two pillars in a relatively short period of time with the establishment of the SSM in 2014 and the operationalization of the SRM in 2016, the finalization of the third Pillar – EDIS – is still in the making. Despite progress in the Banking Union, fragmentation is still a defining feature of the EU banking market. Fragmentation certainly has commercial motives - depressed bank valuations, the declining value of banks' retail franchises and many IT legacy issues discourage consolidation within and across borders. Even more so, policy makers have to contribute their part in completing the banking union. At this juncture, it must be understood however, that both inaction with respect to the completion of the Banking Union, as well as "face saving" half-baked compromises in this regard can entail risks and costs for the Euro area.

Let us turn to the costs of a delayed completion of the Banking Union first. In a truly integrated banking market banks would face a single set of rules and the free flow of capital and liquidity would contribute to lower costs of financial intermediation. This would in turn embolden the ability and willingness of banks to expand across borders and reap optimal returns to scale, thereby increasing the capacity of the system to absorb shocks and supporting banks' profitability. Given that European companies, in particular the large SME sector, rely heavily on bank lending to finance investment and working capital this clearly also has macroeconomic implications.

This brings us to the risks of completing the Banking Union in a way that is unfit to address the underlying challenges. These challenges relate to ensuring the right balance between home and host supervisors, achieving swift further risk reduction and breaking the bank sovereign nexus. What could go wrong? Consider cross border banking groups, whose intragroup capital and liquidity cannot flow freely today. Allowing capital and liquidity requirements to be waived could create significant externalities, as the current ring fencing comes for a specific reason - banks are still "global in life" but "national in death". Risk reduction is another case in point. If we fail to implement the right incentives to ensure a lasting effect of risk reduction on banks' balance sheets, risk sharing could prove to be the bedrock for future risk taking. A similar argument could be made with respect to EDIS. The lack of progress on EDIS is grounded on the fact that the level of riskiness differs across countries' banking systems, as does the extent to which banks finance their own sovereign.

All this shows that any solution that does not tackle the afore mentioned issues will lead to a clearly suboptimal completion of the Banking Union. The current situation caused by the coronavirus underlines the necessity of finding a coordinated answer to this problem. The immediate focus has to be on enabling the banking and financial systems to fulfil their vital role in financing the real economy also in turbulent times. Once the corona crisis has gone by, we however will have to put in place a number of requirements in order to allow an integrated functioning of banking groups while at the same time addressing legitimate concerns of home and host authorities. Banks should continue their pre-coronavirus activities to address pockets of vulnerability, build up loss-absorbing capacity and reduce undue concentration in sovereign exposures. Member States and public sector authorities should establish and enforce credible liquidation regimes for banks with predictable and fair outcomes for creditors at the different levels within a banking group. They should also introduce a last resort fiscally neutral liquidity provision mechanism for bank resolutions, enhance depositor protection in all Member States through the staggered introduction of EDIS and smooth differences in the legal practice of corporate and private insolvencies thus facilitating recoveries. In addition, alternatives to internal MREL within banking groups, e.g., cross-border guarantees based on EU law, could be explored. Progress on all these areas is interdependent.

To conclude, we need to complete the Banking Union and we need to do this in the right way. As the impact of the corona crisis teaches us, taking coordinated action and finding a common European answer is key in this regard. Otherwise financial market fragmentation in the EU will persist leading to higher costs for financial intermediation, limiting the free flow of capital and liquidity across borders, ultimately affecting economic growth and missing out on reaping the benefits of a truly single market. But we also have to take into account, that there are underlying reasons for the currently existing fragmentation in the European banking market, which need to be tackled.