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Banking Union in times of Covid

The Banking Union (BU) was launched at the peak of the euro crisis in 2012, involving the transfer of large parts of the regulatory and supervisory framework from the national domain to the euro area. The Covid crisis implied a significant fragmentation of EU financial markets, which threatened to take us back to the pre-banking union era. Fortunately, EU leaders reacted swiftly and decisively, especially with the Next Generation EU package, and the risks of a further strengthening of the bank-sovereign doom loop have diminished substantially. What is left to be done now is to complete the banking union, to avoid being again in a vulnerable position.

The completion of the Banking Union is a matter of consistency: a common regulation, supervision and resolution authority (and resolution fund) is incompatible with deposit insurance remaining in national hands. The incentives of such a scheme are not properly aligned. Decisions taken (and in its case mistakes made) by European authorities cannot be backed by national deposit insurance funds, and ultimately national taxpayers. EDIS is not only about risk sharing but also about risk reduction. It implies diversifying the safety net of bank failures to a much wider and diversified group, thus preventing financial contagion between interdependent banks and reducing the likelihood of spillovers.

Over recent years we have seen different proposals for a common deposit guarantee scheme, with different degrees of ambition. Recent proposals seem to focus on the so-called "hybrid model", which is based on the idea of coexistence of a central fund and national Deposit Guarantee Schemes. The design of the transition phase could rely on a combination of national and European funds, as was done in the case of the Resolution Fund. But in any case, the final objective of a fully mutualised EDIS should be made clear from the outset. Otherwise, the full scheme will lack credibility and national funds will continue relying on the implicit backing of national Treasuries, maintaining the banking-sovereign loop.

Another crucial element of the banking union that is missing is a European safe asset. The use of the German bund as a proxy is a source of fragmentation that needs to be corrected. Fortunately, the new EU recovery package includes a compromise to issue what should be the embryo of such common asset. Although the details of this issuance are yet to be decided, it is very likely that it will evolve to become a true European safe asset.

Another aspect that needs to be further refined is the application of the bank resolution framework. There is considerable dissatisfaction on its application to recent banking crisis, with very different approaches in different countries that imply an uneven playing field. Some recent proposals put the blame of this lack of consistency on the excessive automaticity of the bail in requirement. There may be improvements on a more flexible approach to the early intervention and recovery phases, including in the use of deposit guarantee schemes. But the absolute priority and a condition to further progress towards banking union should be to protect taxpayers' money.

In the Covid crisis the EU has shown once again its willingness to progress to a closer union and its capacity to overcome the difficulties. The decisions taken in recent months are bold and decisive. The remaining steps towards banking union are well identified and will be easier to adopt with the recently agreed recovery package. ●