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Covid-19 reinforces the case for the completion of Banking Union

For the banking sector, Covid-19 again shows the importance to break the link between sovereigns and domestic banks – in order not to amplify the divergent forces at play in the Eurozone. The Banking Union urgently needs to be concluded, by creating a European deposit guarantee scheme and a truly single market for banks with harmonised European rules.

While Covid-19 is an unprecedented symmetric shock, its effects differ per country. Within Europe, some countries had to impose more severe lockdowns than others. Moreover, lockdowns hit some sectors more than others. As the sectoral composition of economies differs across countries this too results in diverging economic effects.

Likewise, NPL developments will differ per sector, and given sectoral composition differences, will diverge across countries. NPL effects will take time to materialise, also given generous govt aid packages and regulatory arrangements. This gives both borrowers and lenders welcome time to prepare for absorbing the losses caused by Covid-19.

It is unfortunate that Eurozone countries with weaker starting positions, in terms of economic resilience, unemployment and fiscal room, appear to be more severely hit by Covid-19. As such, Covid-19 lays bare and adds to the inherent instability of the Eurozone, which is based on the different economic and fiscal profiles of its constituent member states, combined with insufficient mechanisms to counterbalance these divergent forces at Monetary Union level.

The Eurozone continues to have underdeveloped tools for Eurozone-wide public sector stabilisation, while Banking Union and Capital Market Union could be further enhanced to facilitate private sector stabilising flows.

The response to Covid-19 from the ECB and other EU authorities has been swift and strong; the regulatory and supervisory flexibility aimed at increasing banks' capacity to continue financing the economy demonstrated Europe's ability to act in a joint manner.

However, for the banking sector Covid-19 again clearly shows the importance to break the link between sovereigns and domestic banks – in order not to amplify the divergent forces described above. The Banking Union urgently needs to be concluded, by creating a European deposit guarantee scheme.

The prioritisation by the Germany Presidency of this topic is therefore most welcome. In addition, a truly single market for banks with harmonised European rules in all major areas, ranging from prudential to AML and digital ID must be achieved. As EBA has stated, increased levels of cybercrime, Covid-19 -related frauds were observed, these can only properly and effectively be addressed by a European approach.

Furthermore, it has been clear for a long time that a Europe-wide safe asset would help the process of reducing home bias in bank sovereign bond holdings. A deep and liquid market for a risk-free EU asset would allow banks to diversify their holdings. The European Recovery and Resilience Fund is a welcome step in this regard. It – temporarily – makes the EU the third-largest sovereign issuer after Germany, France and Italy by 2021.

Of course, the Covid-19 crisis and recovery are not primarily about banks. Primary concern is helping businesses and households recover. Banks are instrumental in this and are able to play that role thanks to sufficient buffers going into the crisis, and helped by regulatory relief measures that were quickly arranged. But bank loans, while an important source, cannot solve all funding issues.

European business equity also needs to be repaired. Therefore, policymakers should consider equity participation as well. While some initiatives are taken in this direction at country level, this is par excellence an opportunity for a Europe-wide approach. Unfortunately, solvency support was scrapped in the package agreed in July by the EU Council. ●