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Shaping the Banking Union and allowing for diversity in the EU's banking sector

Europe is experiencing an unprecedented economic shock. Its future development is still highly uncertain, including its eventual impact on the banking sector. Throughout this crisis, it will be crucial that banks maintain their lending activities to the real economy. As with the Global Financial Crisis of 2009, regionally focused institutions play a crucial role in supplying credit to SMEs, proving once again the great value of diversity in the EU banking sector. Maintaining this diversity has to be a guiding principle for every step taken in further shaping the Banking Union, be it with regard to supervision, crisis management, or depositor protection.

The European Commission's proposal for a European Deposit Insurance Scheme (EDIS) from November 2015 prominently failed to account for diversity – and this did not change with its later communication from October 2017. The Deposit Guarantee Scheme Directive (DGSD), which already completed the Banking Union, recognises Institutional Protection Schemes (IPSs) that have been used for decades by small and regional credit institutions, such as the German Savings Banks. IPSs are vital for independently governed credit institutions as they offer an overarching element allowing for network building and economies of scale. EDIS, a tool of centralization and transfers, would draw all financial resources from national guarantee funds and IPSs to the EU level, rendering their continued existence economically non-viable.

Being limited to providing depositor compensation only in the event of insolvency, EDIS would be unable to perform any of the fundamental tasks of an IPS. Institutional protection measures are a form of early restructuring to prevent insolvency through liquidity loans, equity injections, and potentially transfers of assets or a merger.

The current economic shock also shifts the focus on the negative systemic effects inherent to EDIS: creating moral hazard and ignoring effects of national economic policy on banking stability by mutualizing the resulting financial consequences; increasing contagion risk due to closer interconnectedness; decoupling risk and responsibility, thereby encouraging high-risk affinity of credit institutions – at the expense of banks with less risky business models.

Nonetheless, several steps remain to further improve the effectiveness of the Banking Union potentially, including:

- Increasing the predictability and credibility of the EU crisis management framework is important. A key component will be a sufficiently large and readily available backstop that provides liquidity in resolution. There is also further room for clarity regarding the interplay of different national triggers for bank insolvency.
- It is almost inevitable that the ratio of non-performing loans will increase. A sustainable solution to keep NPLs from burdening banks' balance sheets and disrupting lending must be found.
- Solving the so-called "home-host issue" does not need EDIS, as restrictions on the free flow of capital and liquidity are set by supervisors out of a prudential perspective. An improved and more equal regulatory treatment of parent-subsidiary-structures and parent-branch-structures in deposit insurance could be discussed to ensure a level playing field in this area.
- Backstop mechanisms for national deposit insurance funds could be considered, e.g. via the ESM. It has to be emphasized however that this must not be a starting point for mutualisation.

EDIS would stand in sharp contrast to the harmonized requirements put in place via the DGSD, which allow for the coexistence of IPSs and ensure common standards for depositor protection in every Member State of the EU.

EDIS would eliminate diversity in the EU's banking sector, increase contagion risk and moral hazard. Going forward, the debate should turn to improving the proper functioning of the Banking Union and focus on how to maintain the diversity of the EU banking system and its stabilizing effects in times of crisis. ●