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Time to complete the Banking Union for a strong recovery

The EU institutions have thus far responded adequately and in a timely fashion to the economic and financial challenges stemming from the impact of the Covid-19 health crisis and the resulting social distancing measures. The Commission quickly adopted a flexible interpretation of the Stability and Growth Pact in order to allow for the use of more expansionary fiscal policies by member states. In addition, it spearheaded the process of building support for national unemployment insurance (through SURE) and presented a revision of the Multiannual Financial Framework (MFF), supplemented by the Next Generation EU (NGEU). Furthermore, the European Stability Mechanism established a Pandemic Crisis Support instrument, based on its Enhanced Conditions Credit Line, available to all euro area countries, by which to cover direct or indirect expenses derived from the pandemic, but still unused until now. In addition, the EIB has broadened its program of guarantees to support the efforts of the national development banks. All of these fiscal efforts have been backed by the ECB, particularly through the Pandemic Emergency Purchase Program (PEPP), which, together with previous asset purchasing programs, has allowed for the financing, at the end of the day, of public deficits through the secondary market.

In one way or another, the short-term response to survive the confinement economic impact have included direct financing by member states, with European coverage, as well as, starting in 2021, additional efforts to stimulate the economic activity financed directly and more thoroughly by the EU (MFF + NGEU). That said, the health crisis is lasting longer than expected and has been deepened by the subsistence of structural problems that already existed in the pre-pandemic world, thus likely leading to structural changes in our economy. This prolongation of the crisis is making difficult the functioning of previously planned support policies, which, in turn, is pushing member states to create new solvency support instruments.

However, the longer the health crisis endures, the bigger the public intervention needs to be in order to avoid an economic collapse. At the same time, underlying structural changes will happen more rapidly and will lead to necessary reforms in some sectors. Thus, the stretching of the health crisis makes it more difficult to implement micro programs that are more adjusted to the medium-term. This environment would therefore impede the so-called Schumpeterian concept of 'creative destruction'.

This being true, the current situation is also hampering a sufficiently 'micro' approach to the deployment of support measures. As such, we will observe an increase in the amount of Non-Performing Loans in the upcoming months that, at this moment, is difficult to measure. This will impact on bank's balance sheets and, for that matter, the stability of the entire financial system.

The EU has proposed certain measures to slow this impact through the Capital Requirements Regulation (CRR) 'quick fix' revision. Predictably, the revision of the CRR/CRD (Capital Requirements Directive), which stems from the implementation of the Basel Framework, should become more flexible to allow banking entities to absorb the increase of bad loans. This adaptation should also affect the management framework for banking crises, the BRRD, whose reform proposal is foreseen for late 2021.

At this time, the final impact of this recession upon the banking system remains unclear, with medium-term return rates currently unsustainable. For all of these reasons, the EU must swiftly prepare itself and invigorate the debate for the construction of the European Deposit Insurance Scheme, facilitating the implementation of a European crisis management framework. The Union must, among other things, revise the definition of "public interest" in order to facilitate access to European funds in case of a bank resolution or liquidation. Priority must be given to a strategy of "business for sale", thus reducing national discretions within the banking union.

Until now, the banking sector has been key in supporting the European economy, making part of the European solution. However, the prolongation of this health crisis will heighten the risk of a spillover into the financial sector. It is now in our hands to avoid this and to finally complete the banking union.