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Research Report

Time to address the shortcomings of the banking union

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Time to address the shortcomings of the banking union

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Abstract

Discussions about the banking union have restarted. Its success so far is limited: national banking sectors are still overwhelmingly exposed to their own countries' economies, cross border banking has not increased and capital and liquidity remain locked within national boundaries. The policy letter highlights that the current debate, centered on sovereign exposures and deposit insurance, misses critical underlying problems in the supervision and resolution frameworks. The ECB supervisors' efforts to facilitate cross-border banking have been hampered by national ringfencing. The resolution framework is not up to its task: limited powers of the SRB, prohibitive access conditions and limited size of the Single Resolution Fund limit its effectiveness. A lack of a coherent European framework for insolvency unlevels the regulatory field and creates incentives to bypass European rules. The new Commission and European Parliament, with the new ECB leadership, provide a unique opportunity to address these shortcomings and make the banking union work.

¹ A version of this text was published in Italian in the Corriere della Sera on 23 December 2019.

Blow up, Michelangelo Antonioni's 1966 thriller movie, featured in its concluding scene a group of mimes playing tennis without ball. The protagonist – a formidable David Hemmings – looks on, puzzled; then picks up a non-existent ball and throws it back into the court. Fiction and reality, the metaphor suggests, mix up.

This scene came back to my mind as I reflected on Europe's banking union. Five years after the ECB assumed responsibility for supervising the eurozone's banking sector, a debate has restarted on the reform's shortcomings and on what to do to make it work. The debate is timely: the new EU Commission headed by Ursula van der Leyen has put the banking union's reform high up in its priority list; the new European Parliament and the European Central Bank (also with a new leadership) share an interest, and will be involved in any reform initiatives. If any time has been well-suited for seriously reconsidering the whole dossier, that time is now.

The record of the banking union so far is mixed. Progress has been made in recapitalizing the banks and especially in cleaning up their accounts from non-performing loans and other risky exposures. This would have happened anyway to some extent, as a result of better economic conditions and tighter global standards. But the pressure of the ECB supervision has accelerated the process. Other key objectives, however, are not even remotely in sight. National banking sectors are still overwhelmingly exposed to their own countries' economies and governments. Cross border banking has not increased; capital and liquidity remain locked within national boundaries, preventing the rise of efficient and competitive pan-European banking groups. Some weak banks have gone bankrupt but others remain in business. Bank bail-outs financed by taxpayers, or indirectly by users of bank services, continue unabated more or less like in the old times. Given this scarcely encouraging picture, it is no surprise that financial markets remain skeptical: the stock market value of eurozone banks is below its level five years ago, while in the meantime listed US banks have increased their dollar value by over 50 percent.

Discussions on remedies center on two opposing visions, one calling for a European deposit insurance, the other for measures to limit the concentration of the banks' domestic sovereign exposures. The two camps bounce their arguments back and forth; Olaf Scholz, the German finance minister, recently offered a compromise. The trouble is that, as in the movie, the ball isn't there. Even if, against all odds, both a common deposit insurance and limits to sovereign portfolios were implemented now, progress in the banking union's performance would be unlikely. The reason is simple: deposit insurance is the ultimate protection offered to depositors in case of a bank's resolution – the process through which ailing banks are restructured or wound down. But resolution itself is, under current rules, very difficult to undertake. As to sovereign exposures, given the central role that government bonds play in financial markets, limits on bank holdings under any conceivable scenario would have to be so gradual that it would take years, if not decades, for the banks' home-biased portfolios to be altered in a significant way. Both measures may well be advisable, but neither is panacea.

Reshaping the banking union requires addressing head-on the problems of supervision and resolution. The ECB's supervisory powers need strengthening to break national barrier and facilitate a freer and safer flow of resources across national borders. Resolution should support supervision by ensuring that banks can exit the market smoothly and securely. In a banking sector which is still congested and contains unviable banks, stronger supervision requires a smoother resolution process. You cannot increase pressure in a crowded room while locking the exit door at the same time.

The resolution framework introduced in the European Union in 2014-15 contains critical flaws. The Single Resolution Fund, a pool of resources provided by the banks, is virtually unusable, due to a mix of prohibitive access conditions, limited size and lack of open-ended and readily usable public

backstop. The powers of the Single Resolution Board are limited, as actual operations are conducted mainly through national authorities. By contrast, the Federal Deposit Insurance Corporation in the United States has ample powers, internal structures and financial ammunition to act as receiver of banks in resolution, ensuring that asset values are maximized in the sale process. Europe's competition rules and practices have compounded the problems by adopting an overly strict approach to state-aid control at first, only to relax it later. Finally, no European framework exists for normal insolvency, the resolution regime applied to smaller banks which make up for the vast majority of bank failures. Liquidation practices vary across jurisdictions and permit state-aid with milder bail-in provisions, a clear incentive to bypass European rules.

In 2013, in inaugurating its new supervisory arm, the ECB foreshadowed a new era for eurozone banks, made up of greater investor confidence, open door to bank failures if necessary, and public backstops to maintain financial stability. Those goals remain largely unfulfilled. Europe should use the opportunity of its new parliament, new executive and new central bank leadership to fix this problem.