CONFRONTATIONS EUROPE

Revue 134 – Spéciale 30 ans – Juin 2022

The banking union, a real priority! Badly shared?

By Pervenche Berès, MEP from 1994 to 2019 and board member of Confrontations Europe

Confrontations is 30 years old, the Banking Union is 10 years old. It was born out of the Great Financial Crisis (GFC) in 2007 which led to the adoption of a new body of rules and then, within the European Union in 2010, out of the sovereign debt crisis, where a fragile banking sector - given its exposure to this debt - risked, in some Member States, being swept away, leading to the creation of strengthened and unified governance.

It was born from the objective of ensuring the effectiveness of monetary policy, financial stability, the prevention of banking crises through increased supervision and the protection of the taxpayer through the creation of an instrument for the bail in of banks by their shareholders. and their creditors, rather than by creating a budgetary pillar and a borrowing capacity of the Economic and Monetary Union (EMU). While it is the banks that create most of the money, the sovereign crisis has shown that the credit risk of States and banks, observed in 2012 in Italy and Spain, later capital controls in Cyprus and Greece, implied that the value of a (banking) euro in these countries was not the same as in Germany or France; the euro money supply was fragmented, which negated the very principle of monetary union.

On the initiative of the President of the European Central Bank (ECB), Mario Draghi and the report of the President of the European Council, Herman van Rompuy "Towards a genuine Economic and Monetary Union"[1], the banking union was imposed at the Euro area Summit of June 2012 to "break the vicious circle between banks and sovereigns" and at the European Council of December 2012[2] .

Others were added to the initial objective also because the conditions for implementing these decisions were not sufficient to restore cross-border confidence broken by the euro area crisis and to prevent a fragmentation contrary to the spirit, letter and efficiency of the internal market. This is the question, never or poorly asked, of the European banking architecture which leads to opposing models. However, what the European Union needs to optimize the financing of its economy is, as in the United States, a dual system with globally competitive universal banks and a solid local banking network. This requires that for all of them, the

[1] "Building on the single rulebook, an integrated financial framework should have two central elements: single European banking supervision and a common deposit insurance and resolution framework."
[2] "The European Council urges the co-legislators to agree on the proposals for a Recovery and Resolution Directive and for a Deposit Guarantee Scheme Directive before June 2013; the Council for its part should reach agreement by the end of March 2013. Once adopted, these Directives should be implemented by the Member States as a matter of priority."

sustainability of their business model, of risk-taking be verified, a debate that must be conducted beyond the one on proportionality. To do this, it is necessary to be able to defuse the opposition between the home and the host, while a vicious circle leads those who do not want a European deposit guarantee to rely on its absence to oppose the reduction of banking groups obligations! A true banking union should facilitate this home-host relationship by removing cross-border ring-fencing of liquidity and capital and by authorizing waivers on the capital requirement for institutions established in different countries of the same banking group thus increasing the circulation of capital and liquidities and allowing the development of European groups.

The Capital Markets Union (CMU), launched from 2015, requires consolidated banking players able of meeting the challenges of financing the European economy, carrying out investment operations with a European dimension and long term.

Brexit has added the challenge of a continent whose savings are abundant but partly transformed into an offshore financial center, London, which poses a triple problem of efficiency (the round trips between the single market and London are as much friction), stability (even assuming regulations that would remain aligned, British supervisors will always give priority to macro-financial stability in their country), and sovereignty (the Union must be able to steer the allocation of long-term savings to support its industrial and environmental priorities). Ideally, the UMC should address all three of these challenges.

The Covid crisis and the war in Ukraine have added to an awareness by Europeans of the issues of sovereignty or strategic autonomy, the application of which on the financial markets refers to the ability of Europeans to be the main suppliers of capital to meet the need for investment and the development of their economy.

More fundamentally, the question posed is that of a contribution from the private sector to financing the investment needs of the European economy even though the Union has adopted the NGEU (Next generation EU) plan which created European public debt, "high-quality, low-risk European assets, allowing for a rebalancing of sovereign bonds on banks' balance sheets and helping to reduce the doom loop between banks and sovereigns"[3] and a European Green Deal strategy which must mobilize significant long-term financing.

This banking union is based on three pillars of which only the first two have been created. The Single Supervisory Mechanism (SSM) set up in November 2014 under the responsibility of the European Central Bank (ECB) covers 200 institutions (with assets of up to 30 billion euros or 20% of the GDP of the country of origin) representing 75% of European assets, contrary to the Commission's initial broader proposal. It was supplemented by a Single Resolution Mechanism (SRM) in January 2016 with the creation of the Single Resolution Fund (SRF) on the basis of funding fed by contributions from banks gradually pooled over a period of 8 years based on harmonizing the handling of defaults and defining a crisis management framework with the Bank Recovery and Resolution Directive (BRRD) which introduces bail-in against the use of taxpayer money.

However, the Banking Union remains shaky, unfinished. The European Stability Mechanism (ESM), which was initially supposed to be able to directly recapitalize the banks, will finally intervene from 2022 as a backstop for the SRF.

[3] European Parliament resolution of 7 October 2021 on banking union – annual report 2020 (2020/2122(INI)), Paragraph 40

To set up the third pillar, that of a European deposit guarantee, the Commission made an EDIS (European deposit insurance scheme) proposal in 2015, which seven years later is still on the table. The obstacles have long been well identified without being reduced, on the contrary... The Germans wish to preserve their Institutional Protection Scheme (IPS) from which the Sparkasse (Savings Bank) are parties; the Italians fear any changes in the treatment of sovereign debt held by banks or of non-performing loans as desired by others in the context of risk reduction prior to the introduction of risk sharing such as EDIS. French banks do not want to contribute to a European deposit guarantee considering that in 2022 they will pay 34% of the SRF – while they represent 35% of the major banks subject to the direct prudential supervision of the ECB end of 2020 - which should reach in 2023 1% of the amount of guaranteed deposits up to 100,000 euros. Others remain in ambush, fueling an endless debate.

These obstacles in the way blind to the overall goal. With their eyes on the handlebars, Member States, in a vicious circle, distort their vision of the common objective either by highlighting only their fears or by alternating their priorities between completing the banking union and reforming the fiscal rules. This is even more so as the immediate risk to financial stability has receded and negotiation fatigue has set in, a weariness that does not help to overcome blockages. Should we therefore be surprised that this question was not one of the priorities of the French Presidency of the European Union or was not mentioned in the conclusions of the work of the Conference on the future of the EU?

It is true that the existence of the banking union, even at its stage of development, has borne fruit and demonstrated its usefulness by playing a stabilizing role in the face of the Covid-19 crisis and the outbreak of the war in Ukraine. The ECB, given the room for maneuver thus created, was able to intervene with rapid, innovative, and significant unconventional measures to support the European economy.

But what will happen in the event of an increase in rates or a tightening of the conditions for the intervention of national public expenditure? This in-between constitutes a point of fragility for what has been put in place and the progress made by the creation of a single surveillance. Incompleteness threatens the existing. As the Commission says, doing nothing may well cost more than doing.

During the acquisition of Banco Popular by Santander, in the event of a resolution of Banco Popular, the Portuguese did not see why they should ensure payment of the deposit guarantee triggered by a resolution decision taken at European level.

More generally, the practice leads to a drift of the system. The decisions taken within the framework of the supervision and the resolution[4] to be able to initiate the procedure of a bank "failing or likely to fail (FOLTF)" often seem timid or complicit with national authorities seeking to protect their banks as in the case of Monte dei Paschi. They give the impression of a Resolution Council sitting on a pile of euros where much is being done to avoid the use of the SRF and the participation of bondholders in the bail in of banks, yet provided for by the BRRD. This leads to a return to national solutions and therefore to a mobilization of the State aid system through a “precautionary” recapitalization under the control of the Commission. In addition to the local or national political hyper-sensitivity of these situations, which may

[4] https://www.srb.europa.eu/en/cases

explain, if not justify, this reluctance, there are gaps in the BRRD legislation which lead to perverting the treatment of certain cases. As a result, the Banking Union is in great danger of losing the benefit of what led to its creation; the desire to reduce the banks' dependence on States through their debt is transformed into the banks' dependence on States through their aid. There is therefore an urgent need to revise the management of banking crises and therefore the BRRD in order to have an ex-ante system and a resolution framework everywhere in proportion to the size of the bank making it possible to circumvent States ready to pay for save "their" banks. In this sense, the European Parliament considers "it necessary to make resolution work for more banks, which requires a review of the public interest assessment in order to increase transparency and ex ante predictability with regard to its expected outcome, and thus allow resolution tools to be applied to a broader group of banks, in particular medium-sized banks, and to provide the clarity needed to ensure more coherent and proportionate MREL[5] levels"[6].

What to do? An alternative and two complements.

The alternative is between the roadmap proposed by Paschal Donohoe, President of the Eurogroup[7], and a radical solution leading to unraveling the MRU and giving up EDIS to adopt an approach based on the model of the FDIC (Federal Deposit Insurance Corporation) the United States.

The roadmap presented on 3 May 2022, by Paschal Donohoe, the result of significant political investment that takes everyone's fears into account, is a balanced text that proposes an approach around the definition of 4 areas of work to resolve in parallel interdependent issues: improving management of a banking crisis, including the BRRD reform mentioned above, creation of a European deposit guarantee system, deepening integration of the single market for banking services, treatment of sovereign risk. The proposal is based on two phases over a period of five years with, during the first, a common European guarantee fund in addition to the national systems, then, after a political assessment of the progress made on the 4 axes, a second phase with a fund reinsurance (EDIS) covering the losses of the national funds.

In absence of an agreement on this roadmap, it would be necessary to resume work at the base and to go back to the division, for historical reasons, between the FRU and EDIS on the model of the FDIC which guarantees the deposits to the States United from banks contribution and intervenes in the resolution of failing banks. Some national authorities have taken a clear position along these lines: "We should move to using one credible fund that would cover all the crisis management measures of banks that are failing or likely to fail. Following the same logic, if and when EDIS is implemented, it should merge with the SRF to form a single fund."[8]

The first complement to the completion of a banking union was proposed by the President of the SSM, Andrea Enria, convinced that a political agreement and an institutional approach

[5] Minimum requirement for own funds and eligible liabilities: European standard, which applies to all banks, of capital requirement and 8% minimum of eligible liabilities during internal bailouts.
[6] European Parliament resolution of 7 October 2021 on banking union – annual report 2020 (2020/2122(INI)), Paragraph 60
[7] https://aeur.eu/f/1G6
[8] "Why not have one, neutral and integrated safety net system for resolution and deposit guarantee?" Tuija Taos, Finish financial stability authority Director general, SRB blog, 28 October 2021

would take a long time to obtain and implement, he calls on the players of the banking sector so that they act without delay by material progress thanks to "industrial"[9] solutions. According to him: "Calculations by ECB Banking Supervision show that, in the absence of cross-border liquidity waivers – as is currently the case – the combination of these European and national provisions prevents around €250 billions of high-quality liquid assets from being moved freely within the banking union. (...To progress, one way) would be for banks to review their cross-border organisational structure more actively, while keeping in mind the aim of banking sector integration. I am referring in particular to the possibility of relying more extensively on branches and the free provision of services, rather than subsidiaries, to develop cross-border business within the banking union and the single market. (... This requires the removal of) a specific impediment in European banking legislation that particularly affects credit institutions with a large deposit base. I am referring to Article 14(3) of the Deposit Guarantee Schemes Directive, which only allows contributions made in the preceding 12 months to be transferred to a new deposit guarantee scheme (DGS). In fact, all contributions made before that period would be lost when the deposits of a credit institution leave a specific DGS to join another one, for example when a subsidiary is transformed into a branch of a credit institution established in another Member State. (...) The fundamental Treaty freedoms of movement and establishment are also there for the banking sector. "

This would allow banks to take their share of the NGEU by creating new alliances on concrete projects. Behind this proposal, it is also the capacity for cross-border consolidation of the European banking sector which is at stake, while national consolidation has reached its limits everywhere and without massive investment, the question of the future of the banking sector is posed (in particular investments in digital technology, data processing, support for the digital euro, etc.).

The second complement is that of the fiscal pillar of the EMU. There is a risk that in a context of Covid crisis, war in Ukraine, great economic and social uncertainty and obligation to deal with both the future of the European Union's debt capacity and the management of the public debt of the Member States that the political energy of those responsible will be concentrated on this complement rather than on the banking union itself, contrary to what had been started in 2012 whereas the two must be carried out simultaneously. That would be a mistake; the banking union is part of a true EMU.

[9] “How can we make the most of an incomplete banking union?” Speech by Andrea Enria, Chair of the Supervisory Board of the ECB, at the Eurofi Financial Forum, Ljubljana, 9 September 2021