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Banking union and its implications on European Integration

Position Paper by
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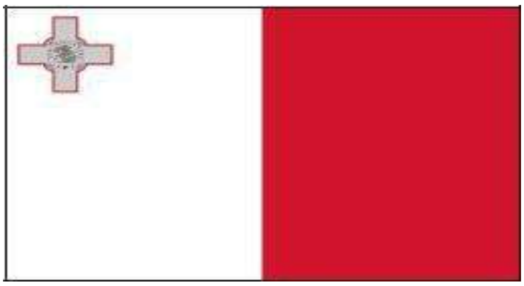

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Abbreviations

BU	Banking Union
EA	Euro area
ECB	European Central Bank
EDIS	European Deposit Insurance Scheme
EU	European Union
MS	Member State
SEM	Single European Market
SSM	Single Supervisory Mechanism
SRB	Single Resolution Board
SRM	Single Resolution Mechanism

1 Introduction

European Union’s (EU) priority is economic growth and job creation. For this reason EU has been developing the Single European Market (SEM), “an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured” (Single European Act, article 13). This definition of SEM indicates that fully functioning single market and economic and monetary union as a whole must encompass integrated financial markets. Integrated financial framework is often labelled as a banking union. In other words, single market and banking union (BU) are mutually reinforcing processes (European Commission, 2012, p. 4). Financial market integration would be an insurance mechanism easing the adjustment to asymmetric shocks that ripple throughout the EU.

Global financial and economic crisis and subsequent Eurozone sovereign debt crisis have highlighted weaknesses of a single market for banking and financial services which were based upon the principle of minimum harmonization and mutual recognition (Cappiello, p. 423). It was obvious that *status quo* of financial markets was not sustainable and did not guarantee economic stability and growth.

Banks are dominant financial institutions in the EU, because they are major creditors (Gros and Schoenmaker, p. 529). However, integration processes of banking sectors at a retail level have been relatively slow since the introduction of the common currency in 1999. This was mainly due to the burdensome national legislations, which in turn curbed the cross-border bank mergers. As a consequence of this, decentralized national regulations impeded the integration of the banking sector in the euro area (EA) (De Grauwe, pp. 230-1). Fully fledged banking union would contain the systemic effects of bank failures at the EA level (Gros and Schoenmaker, p. 530).

Highly interconnected euro area members face specific risks such as cross-border spill-over effects in the event of bank crises. Thus EU sought to place the banking sector in a stronger position and restore confidence in the euro as part of the economic and fiscal integration agenda. In order to strengthen the common currency’s credibility and sustainability European Commission together with the European Central Bank (ECB) and crisis-afflicted Member States (MS) decided to cut the link between sovereign debt and bank debt. This link has previously led to massive bank bail-outs in Ireland, Greece, Cyprus, Portugal and Spain financed by taxpayer money (European Commission, 2012, p. 3).

Banking union initiative that started in 2012 with “A Roadmap towards a Banking Union” issued by the Commission is a crucial part of achieving stability in the euro area and represents a surrender of national sovereignty from the EA Member States to the EU’s supranational institutions, namely ECB. The BU is based on the completion of the common regulatory framework for the single market, the so-called single rulebook (European Commission, 2012, p. 4). In 2010 the EU has established the European Banking Authority (EBA) together with European Securities and Markets Authority and the European Insurance and Occupational Pensions Authority to build the single rulebook and to ensure its uniform application across the EU (Cappiello, p. 425).

Fundamentally, banking union would have two stages, namely a preventive one and a crisis management one. Figure 1 displays the set-up of the banking union and its key elements. The first step, or the first pillar, of the banking union was the creation of the Single Supervisory Mechanism (SSM) as a preventive measure. The second step, or second pillar, was the creation of the Single Resolution Mechanism (SRM). The third anticipated step, or third pillar, is the creation of European Deposit Insurance Scheme (EDIS). Therefore, a single rulebook would be there to harmonise regulatory standards in the financial sector.

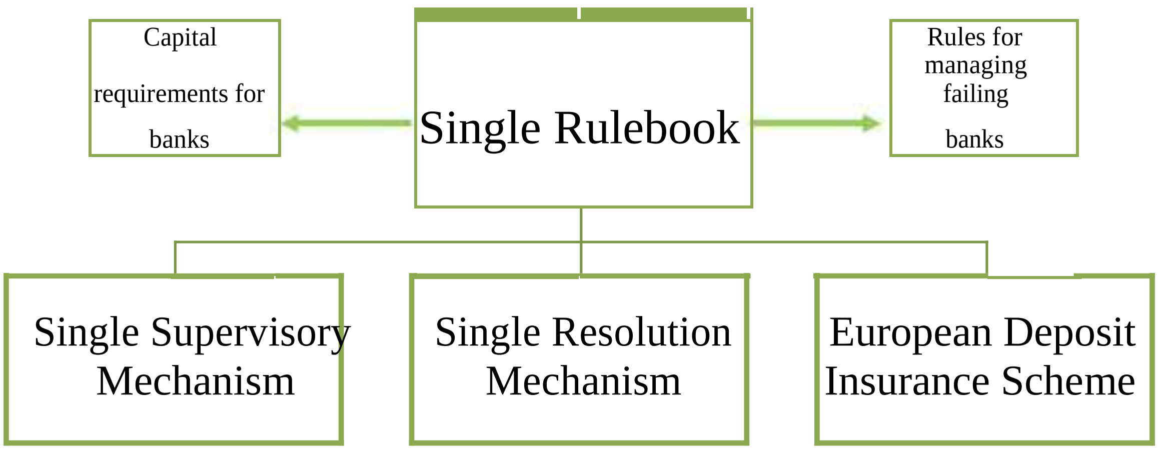

Figure 1. Key elements of the banking union.

2 The emergence of the banking union

2.1 Single Supervisory Mechanism

Single Supervisory Mechanism was established in 2012 prevailing over the German opposition to the centralized supervision and regulation (Epstein and Rhodes, p. 422). Under the SSM, the ECB is a direct central prudential supervisor of more than 100 largest banking groups in the EA as of 2014, while national supervisors are responsible for smaller banks falling outside the remit of ECB (European Council, 2013, article 6). ECB, however, remains an indirect supervisor of all the banks in the Eurozone.

Centralization of power in the banking union since the very beginning was strongly opposed by a faction of a German government lead by finance minister Wolfgang Schäuble. On the other hand, Angela Merkel has voiced her support for the banking union and single supervisor. Finance minister Schäuble argued that single supervisor, namely ECB, does not have the capabilities to oversee more than 6,000 European banks (Financial Times, 2012). The Irish finance minister Michael Noonan, nonetheless, argued that “the single supervisor is the core element of banking union and a vital step in breaking the vicious link between the banks and the sovereigns” (Financial Times, 2013).

2.2 Single Resolution Mechanism

The European Commission proposed the creation of the Single Resolution Mechanism in 2013 and it became fully operational in January 2016 in order to ensure that newly adopted EU-wide rules on recovery and resolution of credit institutions across banking union are taken effectively and efficiently. Decisions are taken by the Single Resolution Board (SRB) which utilizes Single Resolution Fund to finance the restructuring of failing credit institutions. SRB has the power to determine when to recommend to the Commission to place a bank or a group under resolution.

The objective of this resolution is to ensure the continuity of the bank’s critical functions, to protect financial stability, to minimise reliance on taxpayers’ money and to protect depositors. Importantly, state-aid control of the Commission would be preserved in all circumstances.

One of the conditions of the SRM is that shareholders and creditors need to be bailed in before any public support is provided. Bail-in is a "far-reaching instrument which describes a new power of public authorities to decide to impose losses of failing banks on shareholders and creditors through write down or conversion, carried out in an administrative procedure different from normal insolvency proceedings" (Wojcik, pp. 94-5).

The EU banking sector now operates under the SSM and SRM, based on the single rulebook. However, there are a number of legal, institutional and political difficulties to overcome before EU banks can operate in the BU in the same way as it operates in its domestic market.

3 The future of the European banking union - European Deposit Insurance Scheme

A genuine single currency calls for a single deposit insurance system. Therefore, in November 2015 European Commission in its five presidents' report has proposed a common insurance scheme for bank deposits in the euro area – European Deposit Insurance Scheme. EDIS is the only pillar of the BU that is not operational yet. The Council presided by the Maltese government, the European Commission and the European Parliament are currently discussing its design and scope at technical level while aiming to advance on the risk reduction measures in the banking proposals. The Council is working towards regulation which would enter into force by 30 June 2017 (Government of Malta, p. 20).

The EDIS would gradually insure national deposit guarantee schemes, which were established under the Deposit Guarantee Scheme Directive (DGSD)[1]. EA-wide deposit insurance scheme would comprise of national deposit guarantee schemes and a European Deposit Insurance Fund and would be built gradually over 8 years and become fully operational by 2024. In this way EDIS would diminish reliance on financial support from national governments.

The proposed design is anticipated to have three successive stages: a reinsurance scheme, a co-insurance scheme and a full insurance scheme. EDIS would apply to deposits below €100,000 of all banks in the BU. Reinsurance scheme lasting until 2020 would

[1] Directive 2014/49/EU which evolved from prior Directive 94/19/EC.

provide limited funding (for resolution proceedings) for the national schemes after they have exhausted their own resources. The co-insurance phase lasting until 2024 would progressively take on larger amounts of the losses incurred by the national deposit guarantee schemes in bank resolution or pay-out cases. During the final phase EDIS would cover all liquidity needs as well as losses related to bank resolution schemes or pay-outs (Council of the European Union, 2017). Lastly, European Stability Mechanism acting as a fiscal backstop to EDIS would complete the banking union. European Stability Mechanism is an international financial institution provides access to financial assistance programmes for EA MS in severe financial distress. So far ESM has utilized two out of seven of its lending tools, namely loans within a macroeconomic adjustment programme and loans for indirect bank recapitalisation (European Stability Mechanism, 2017).

In order to break the vicious link between the banks and governments some form of risk-sharing referred to repeatedly by the German government and other supportive Member States has to be incorporated into the framework of the banking union. Germany has argued that single fund and SRM would be prone to triggering a moral hazard for both sovereigns and banks.

4 Conclusions and recommendations

The creation of a European banking union is considered one of the most significant initiatives of the European integration since the establishment of the economic and monetary union. A banking union complementing economic and monetary union will have extensive effects for European integration because it entails a vast sharing of sovereignty. However, the creation of the banking union alone won’t fix all the problems that financial markets face in a modern EU. First of all, the Union needs to stimulate cross-border capital market activity by creating true capital markets union. A capital markets union together with banking union in turn will help the processes of risk-sharing between Member States. Secondly, the EU should progress further towards the completion of single market in services and towards a more collaborative line of action to macro-economic policy in Eurozone.

We can recognize substantial progress made towards full integration of financial markets. SSM and SRM are both fully functional and in turn further strengthen the

Eurozone and its economies. However, there is still much to do. For example, the rapidly pressing issue of non-performing loans has to be addressed within the forum of a banking union. Non-performing loans pose a problem at micro- and macro-economic level, as they reduce bank profitability, pose a risk for the viability of banks with levels of non-performing loans, erode bank’s liquidity and tie up capital in banks without providing return. Swift adoption of EDIS is a necessary step to boost Europe’s competitiveness and financial resilience. *Status quo* of the credit risk that is currently under the national competence is clearly not a sustainable set-up.

A fully fledged banking union could potentially improve confidence in the financial markets, break the link between banks and state finances, reverse fragmentation, alleviate moral hazard, and reduce the risk of bail-outs funded by public money.

It is recommended that the momentum gained while establishing SRM and SSM would be maintained and further utilized to establish common deposit guarantee scheme in order to break the so-called “doom loop” between banks and sovereigns and in turn bring back confidence in financial and banking sector. European Union faces increasing competition from other financial markets across the globe. Thus, stakeholders should include urgency as one of the driving forces in creating a fully functional banking union. Furthermore, pooling insurance would be the best-value-for-money scenario for the entire banking union. Once all three pillars are operational they will reinforce each other.

Nonetheless, the banking union must go forward only if adequate risk-reducing measures are taken up. In-depth impact assessment of EDIS would shed some light on the issues like moral hazard, raised by German, Finnish and Dutch governments, and specific design elements still in question. Furthermore, this impact assessment would facilitate the inter-institutional agreement required before EDIS could become operational.

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