Global Counsel

The EU banking union 5 years on

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Summary

5 years have passed since the establishment of the banking union concept as the EU's three-pillar response to breaking the sovereign-bank "doom loop" behind the EU sovereign debt crisis. Those five years have seen some advances, especially in the creation of a new single supervisor for the EU's largest banks. Progress has been more uneven in creating a single European protocol for resolving failing banks and in pooling financial resources for protecting depositors and funding bank recapitalisation and resolution. The three pillars of banking union – supervision, resolution, deposit protection - are sometimes characterised as three steps of increasing political difficulty. But they are also three steps that mutually reinforce each other. The process has reinforced the variable appetite across the EU for pooling rulemaking, rule enforcement and, ultimately, risk itself. In that respect, it has been a microcosm of wider debates about the future design of the eurozone. The practical questions for banks and bank investors will be how stable and effective a partially completed banking union can be.

This summer will mark five years since the height of the banking crisis that became the sovereign debt crisis that created the EU's commitment to building a banking union. Over the last five years, the EU has advanced through a series of policy choices set out in that initial burst of enthusiasm for breaking the 'doom loop' between the EU's sovereigns and their banks. Banking supervision has been handed to the ECB for the EU's largest institutions; resolution protocols have been developed and adopted to impose the discipline of bail-in on bank shareholders and creditors ahead of taxpayers, and the concept of a bank-funded deposit guarantee scheme pooled at the EU levels has been proposed but then widely obstructed. These three pillars are interdependent, but have nonetheless been pursued somewhat separately and on different timelines.

However, almost as soon as the banking union idea was mooted in 2012 as a market calming solution to rising Spanish sovereign yields, the underlying tension between visions of how it should work were clear. Five years later, those tensions have taken their toll. The European Commission's recent stocktake of progress on banking union and reflection paper on the future of economic and monetary union overlap in important ways and are well worth a close read. Both raise the same complex questions about what is possible in terms of future EU integration, on what timeframe and on what political terms – questions that have also played out in the Capital Market Union agenda. They both raise the same question about the EU's variable appetite for pooling rulemaking, rule enforcing and risk. So, what should we make of the banking union's progress five years on? And what does the wider EMU debate tell us about where it goes from here? These questions lead us to consider the three banking union pillars, how easy each will be to build, and how well they can stand in isolation.

Two pillars up, one to go?

At one level, the achievements of banking union have been notable. That level is in Frankfurt, with the creation of the Single Supervisory Mechanism. Backed by the institutional weight of the ECB, and fortunate in having an effective and assertive senior management team, the pan-EU supervisor has largely succeeded in establishing its own credibility and its primacy over the national supervisors whose role it has, in important parts,

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replaced. This has, in some respects, been the most ambitious piece of European markets integration in years, albeit one that has passed well below the public radar. However, this has, in retrospect, been the easy part. While it has moved supervisory powers from NCAs to Frankfurt, this has not been a trade-off that has seriously troubled EU politicians who have already adapted to the centralisation of banking regulation at the EU level.

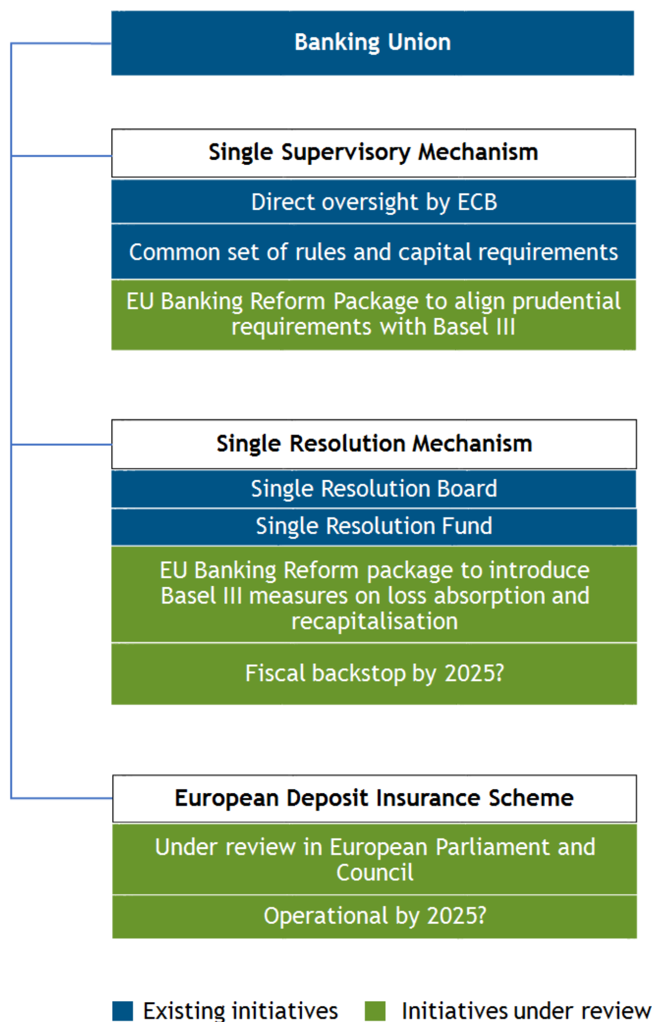

Fig 1. The three pillars of the banking union

The other two pillars of the banking union are more politically problematic. Pooling resolution authority and agreeing strict disciplines for bank creditors have both been progressed in principle, but in practice both mean shrinking national political space in decisions on saving banks in trouble and the people who hold their debt. Santander's 7 June announcement it would rescue Banco Popular demonstrated the SRM system working well enough in a relatively simple and smooth rescue with a willing buyer in place. The trickier test of the new resolution protocols in Italy last month suggest that EU authorities are going to strain to box in large member states who see a political imperative to drive a hard bargain with EU competition authorities when the Banco Popular solution is not available. Nervous about the growing popularity of Italy's populist 5 Star Movement, EU authorities permitted Italy to bend state aid rules to inject capital into Italy's Monte dei Paschi di Siena. This effectively treats the situation in Italy as "recovery" rather than "resolution" in the jargon of EU legislation, thus avoiding the need to involve the Single Resolution Mechanism, but also raising questions about the treatment of bondholders when their position is comparable to a retail depositor.

Beyond these questions of converging practice, lurks the question of converging the means to pay for problems. Agreeing on a single deposit guarantee scheme and a single resolution fund both mean collectivising insurance for deposit holders (and taxpayers) across the union. Here, progress has been very limited indeed. When seen from this angle, the parallels with the bigger debates about economic and monetary union are clear. As in Greece and elsewhere, the basic question is what price in convergence and control creditor states in the EU want to levy, and whether they will, at any point, allow this to underpin pooling of risks or costs. Both sides see this as a question of solidarity. The debtor states want to see it being exhibited in the form of risk sharing, while the creditor states want to see it in promises of a stronger and more disciplined future. Each side views the other's willingness to bend as a sign of the type of concession that must be made in the name of pro-European unity.

In the initial phase of the banking union debate in 2012, most of the focus was on how the new union would respect the rights of states that chose not to participate (especially Britain), and to a lesser extent those that might consider joining if not for the fact that they would feel marginalised in the internal life of the ECB that housed the single supervisor (especially Poland). The former was addressed through a complex set of dual key voting systems that will now probably fade away. The latter still irks Warsaw, on which subject, more below. But the big issues for banking union are ultimately internal to the union itself. It comes back to the fact that political risk sharing looks highly unattractive to the creditor states who don't think they need it - at least not yet.

One pillar missing, two looking shaky?

The practical question for banks and bank investors - and indeed everyone - will be how stable and effective a partially completed banking union can be. The European Commission consistently sounds a note of urgency on this because it rightly

judges that the failure to complete banking union leaves the whole enterprise weak and unstable. The Commission's EMU reflection paper explicitly positions acceptance of risk sharing in the form of a European Deposit Insurance Scheme and a pooled Single Resolution Fund or EU-backed credit line for resolution as the keystone, and the image is an apt one. Banking union is sometimes presented as three sequential steps of increasing political difficulty – supervision, resolution, deposit protection. This is correct, but misses the point.

Banking union is also about three steps that mutually reinforce each other, essentially trading a pooling of political and supervisory prerogatives for a pooling of political risk. Fail to agree the latter and the instinct to do the former is going to flag. Fail to demonstrate that the former is working well and the step to the latter looks harder to justify. The European Parliament has explicitly argued that the step to pooled deposit protection cannot be taken until the resolution system is working properly. This is a hard test to pass, and also misses the political resistance to a fully harmonised system without the sweetener of collective liability.

This shows up in Warsaw's grumbling about ECB prerogatives over its banks without the backstop of a deposit guarantee scheme. It underpins Italy's willingness to stretch the credibility of the new resolution framework to protect retail creditors and the Commission's decision to concede a measure of political reality in trying to impose EU rules. Although such direct retail customer exposures were always going to be the toughest political test of any resolution framework, the lack of any genuine mechanism for risk sharing adds to Rome's incentive to go its own way. It is hard to conclude that weaker member states, feeling responsible for themselves, can be expected to abandon national resolution practices in favour of a "Pillar II" EU resolution framework designed for the banking union. But inevitably, the more that Germany and others can point to uneven discipline, the easier it is too hold off the final step to pooling risk.

Three pillars or bust?

For banks, and investors in banks, the implications are frustrating. The SSM has helped improve investor confidence in the comparability of supervisory discipline across the banking union's largest banks, and in areas such as asset quality assessments and stress test outcomes. But pricing in these new levels of comparability and the capital discipline that comes with the SSM can be undermined by uncertainty about whether the new resolution regime has actually standardised the way creditors (not to mention the managers of the banks they invest in) can expect to be treated. It is hard to price bail-in disciplines when they have a different meaning in different places and circumstances.

The uneven progress on the banking union agenda is likely to be reinforced by the policy changes still in the pipeline, which largely focus on shoring up banks against failure rather than pooling the resources to deal with them if they do. In the absence of concrete progress on risk sharing, the Commission's banking union plan stresses risk avoidance: especially the implementation of the new total loss absorbing capital levels agreed at the Basel level. This version of banking union is heavily skewed towards tougher and more centralised rules and supervision.

Is there any chance of this being resolved? The answer links to the bigger questions about risk-sharing in the eurozone. The Commission wants a deposit protection proposal and fiscal resolution backstop agreed by 2019, and in operation by 2025. But while recovery from the financial crisis remains unevenly distributed and banking sector weakness apparently localised - in both cases broadly along a line that appears to divide creditor and debtor states - the banking union debate is likely to remain divided along these same political lines. The European Commission will continue to exhort and banks will continue to make the case for breaking the sovereign-bank link, but without the political willingness to accept a degree of risk sharing, it is hard to see this happening. EU Monetary Affairs Commissioner Pierre Moscovici likes to say that "striking the right balance between responsibility and solidarity is a challenge". It is hard to sum up the problem more succinctly.

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