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EC329 Assignment

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Financial Union:

In response to the recent financial crisis, the European Commission pursued a number of initiatives to create a safer financial sector for the single market. These initiatives form a single rulebook for all financial actors in the 28 EU countries. They include, among others, stronger prudential requirements for banks. This, and in line with Basel III, forced a recapitalization of the banking system and aggravated the crisis - according to some economists.

In this context, critically assess previous problem and answer the following questions: What have been the process of the banking union in the EU? What are its implications in the banking system? And in the single market? What have been the results? Critically asses the recapitalization of the banking system and provide solutions (if needed) to the problems derived from this process. Support your analysis with different articles, technical reports and data.

1. Introduction

The financial union (or banking union) was first devised in response to the global financial crisis, after it became apparent that a lack of uniform rules and regulation existed across the European union, further amplifying considerable financial shocks. The European Commission defines the financial union as “a single rule book for all financial actors in the EU 28 countries” (Europa European Commission) and together with the fellow presidents of the Euro Summit, Eurogroup, European Central Bank and European Parliament commissioned the Five Presidents Report which further detailed what this will entail. The report states that “single bank supervision, single bank resolution and single deposit insurance” (Juncker, 2015) are the essential ingredients to minimise economic divergence across member states. Such divergence was a major cause in the propagation of contagion in the banking system among member states during the global financial crisis; hence the need for closer union in the EU has been called for.

The following analysis will begin with a snapshot of the process of implementing a full banking union in the EU, followed by a deeper look into its implications for both the wider banking system and the single market. We shall look to evaluate the results of this implementation of common rules and regulations and seek to provide possible areas of improvement to solve such issues. Concluding remarks will provide a critical assessment of the success or failure for the single rulebook on the financial industry.

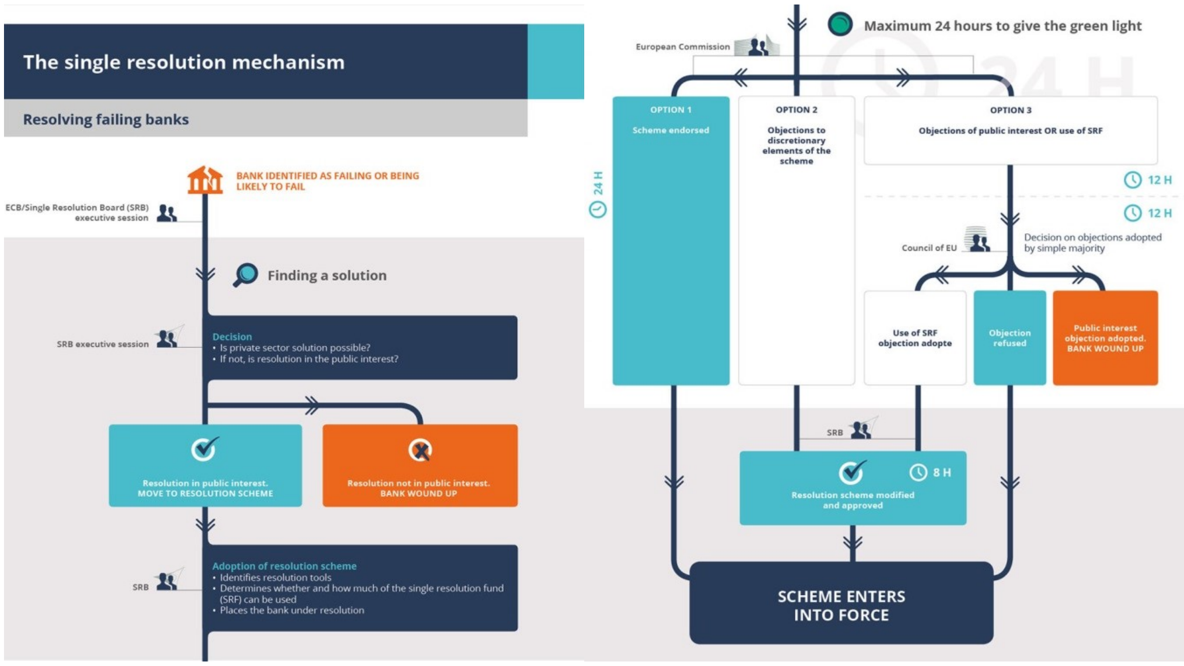
2. History, Implementation and Processes

Since the formation of the European Union, this single rule book for financial services has long been sought after by policymakers, even pre-dating the global financial crisis (GFC). Čihák and Decressin (2007) discuss potential charters and the forms they would take in their working paper, where a single prudential regime is put forward as a potential route to greater integration. They suggested implementation through EU regulation for which a consensus would need to be achieved and exemptions avoided to ensure banks across the EU-28 group would operate on a level playing field.

Suggestions such as these became top of policymaker agendas following the global financial crisis. As the largest global recession took hold, its roots in global finance quickly became clear. Europe’s increasingly fragile financial system and lack of uniform regulation meant that some member states suffered a much greater burden. The European Parliament (2018) identifies several reasons for this, the main of which focuses around the moral hazard that exists in the banking sector. This is identified as banks who were found to be taking very high risks prior to the GFC with little reserves and low asset ratios to secure them. Many spectators attribute this to the ‘too big to fail’ mentality, which is rooted in the knowledge that governments will not allow large banks to default, using taxpayer money to insure against this.

The first process to be implemented to combat such issues was the Single Supervisory Mechanism (SSM) in 2014. Controlled by an independent division of the ECB, its main purpose was to “transfer the power to grant or withdraw banking licenses” and the “related supervisory duties” from national bodies to the ECB (Véron, 2015, p.10). The SSM applies to “banks that are considered significant under pre-determined criteria” which was last estimated to be “123 banking groups” (Véron, 2015, p.12). The mechanism intended effect is to unify individual supervisory bodies of member states to better monitor the state of the banking system as a whole. This is particularly useful in the EU as many banks operate across borders through the union, meaning supervision by a single nations authority may not be sufficient to capture the success or failure of an institution.

The second major pillar of the banking union, the Single Resolution Mechanism (SRM) was completed and implemented from 2015. The mechanism would operate in tandem with the SSM and, as described by Schäfer (2016), would work to restructure or resolve failing banks whilst minimising cost to the taxpayer. The mechanism works closely with the European Commission and Council, whereby any intervention in bailout plans for banks covered by the SSM are voted on whether they are deemed in the public interest at the cost of the taxpayer (Figure 1).



(Figure 1: Resolving Failing Banks Infographic, Europa European Council.)

Despite stiff opposition from the German government during its creation and implementation, the SRM became fully operational in 2016. The main concern was that the devolving of national powers to an independent institution was a step too far in the ever-closer union, as nations faced reduced power in domestic banking supervision. Despite this concern, 26 of the 28 EU member states are governed under the SRM, with the UK and Sweden under exception. The SRM draws funding from the Single Resolution Fund (SRF), which is made up of 1% of all deposits in the 'significant' banks, as determined by the SSM. With the SRF at its disposal, the SRM can choose to intervene and place a failing bank into resolution, where it is limited on what actions it may take until its balance sheet can be restore to good health.

The final pillar of a fully integrated banking union is a Single Deposit Insurance (SDI), of which will applicable to all citizens of EU member states. Eisenbeis and Kaufman (2006) discuss policy surrounding the issue of a fully integrated SDI prior to the global financial crisis as well as potential policy routes to achieving the target. They offer in depth discussion into the existence of the Deposit Guarantee Schemes Directive (DGS), which offered basic framework for the banking union to be built upon. It created a common policy for all member states to adopt, which was to offer up to twenty thousand euros per citizen (later increased to one hundred thousand euros) to be covered in the event of a banking collapse. However, unlike the banking union proposals today, this was to be decentralised from EU governance. Modern proposals feature greater emphasis on having the authority lie with the SRB, to avoid misreporting or lack of intervention from member states.

Today, both the SSM and SRM are fully implemented and functioning independently. At time of writing, an SDI is yet to be implemented, with no fixed timeline to enact the scheme amid concerns from Germany that fellow member state banks are not yet in line with the low level of risk at the Bundesbank. Gros and Schoenmaker (2014) discuss at great length as they summarise the situation. They describe how the EU focus remains on "harmonizing existing national deposit guarantee schemes without any common funding" and that any attempt to revise the current DGS is "entirely blocked". A suggested solution was to form a combination of institutions working closely with the SSM and the future SRM coupled with a safety net to protect citizens in the event bank failures. This would require ratification in each member state, as well as commitment from the ECB as the lender of last resort and added protections from the fiscal backstop to ensure that large scale crisis such as the GFC can be managed effectively across the union.

3. Implications for the Banking System and Single Market

The ultimate objective of the three-pillar approach to an integrated banking union was to "restore public confidence in the financial markets" following "huge losses to the banking sector" and a loss of "confidence in sovereign debtors" (Wymeersch, 2014, p.4) due to the global financial crisis. This occurred due to the huge costs incurred to member states in the bailouts of failing banks, something that could have been avoided had stricter supervision and resolution of banks existed. The implications of seeking to eliminate any potential speculation that intervention from sovereign states in the banking sector, is likely to alleviate Europe's sovereign debt crisis. This will occur as confidence is restored in the macroeconomic performance of the EU states and their ability to remain solvent in sovereign debt. For the banking sector however, more stringent regulation and capital requirements, as well as a more risk averse behaviour has the potential to reduce profit margins and performance. This could translate into a tougher financial environment for individuals and businesses as credit restrictions may tighten to counter act increased regulation.

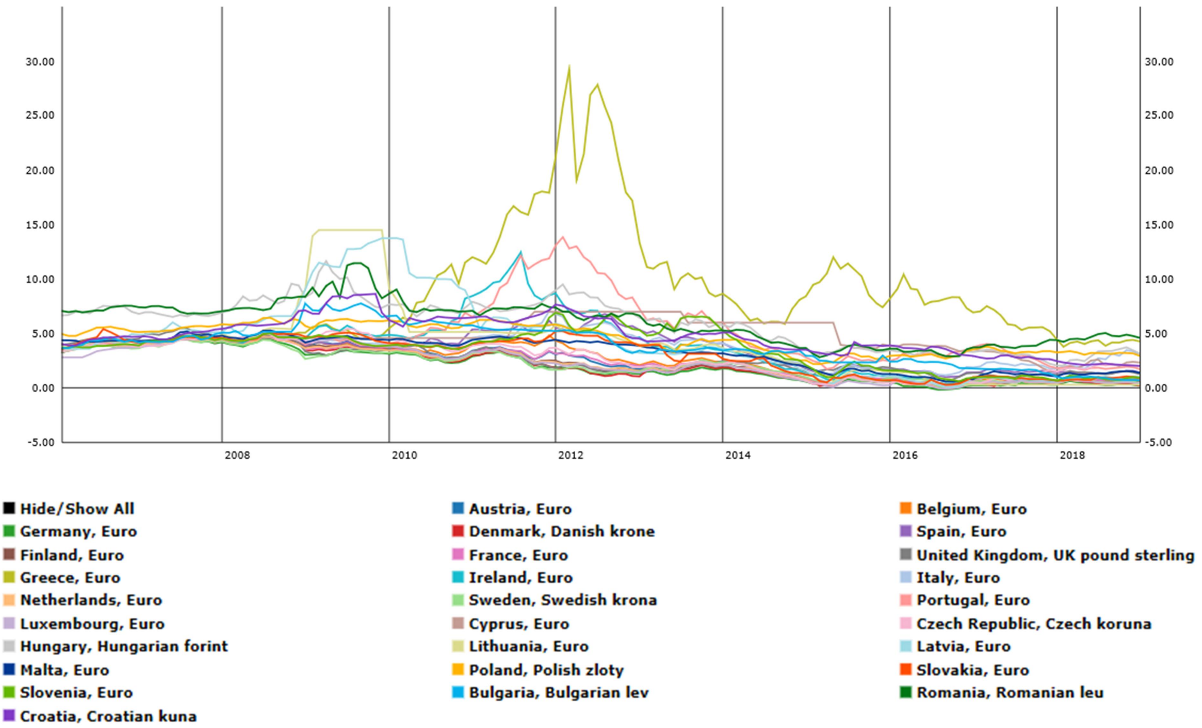
To minimise the impact on the banking system in the EU, the banking union so far is designed to apply to all major financial players in the union so that a level playing field is established. This will reduce the level of distortion to the financial markets and ensure fair competition. Concerns persist, as discussed by Elliott (2012), with regards to the level of power the arm of the ECB will be given, and the potential for collusive policy making to achieve ECB objectives. Elliott stipulates that the ECB already garners significant power with limited democratic accountability, and that monetary policy decisions could be influenced by their supervisory role. In response to this, the SRB was set up as a separate entity to the ECB, with strict autonomy to act in its duty to proactively identify and resolve potential risks to the financial system.

The success of the banking union for Europe's financial sector is shown by Sandbu (2017) in a recent financial times article, in which he describes two situations in which the Spanish bank, Banco Popular, and two smaller banks in Italy's Veneto region were identified by the SSM and the nation's authorities were forced into action. For Spain, the country offered little resistance to the intervention of the Single Resolution board, so the bank was placed into resolution in line with EU rules without cost to the Spanish tax payer. On the other hand, Italy resisted any intervention by the SRB and chose instead to pour in billions of Euro's to cushion losses. As a result, Italy effectively rewarded failure and continued to worsen their fiscal position. The Spanish case prevails as the most beneficial for citizens, however the funding for this 'bail-in' of failing banks must be sourced through other EU countries, which may be a net loss to the northern surplus EU member states and cause political unrest.

For the EU's single market, the banking union can be considered a major step towards full integration of the 'four freedoms' across member states. Implementation of the single rulebook on financial transactions will allow free movement of capital more efficient as regulation becomes standardised across the union. The goals of such a rulebook are describe by the European Banking Authority (EBA) as harmonisation of prudential rules to achieve a more resilient, transparent and efficient European banking sector (Europa EBA). As well as capital, free movement of goods and services will also become simpler as transfer of services such as financial and insurance sectors becomes cheaper and simpler and payment for goods will not be subject to several banking regulations. Such harmonisation will assist in minimising the risk of contagion across the rest of the single market in the event of further financial crisis.

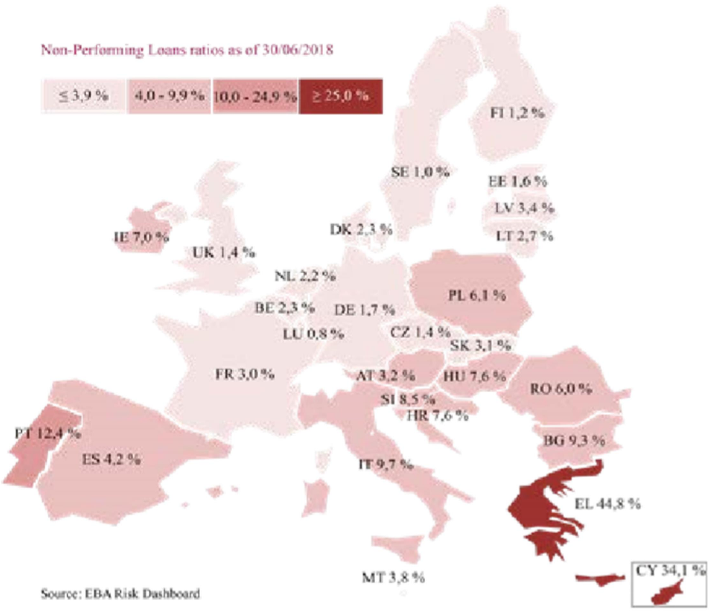
4. Results

In 2014, the SSM became fully operational in its supervision of financial bodies in euro-area countries with the option for non-euro EU member states to join in the future. In 2016, the SRB also became operational, covering the same member states with the power to enact resolution packages to any major financial institution deemed to be failing. Figure 2 shows the long-term interest rates for each individual member state of the EU from 2006 to 2019. The interest rate is on sovereign bonds with a maturity of 10 years, hence reflect the risk facing foreign investors seeking to invest in EU member state debt. It is clear from the graph that since the peak of the sovereign debt crisis in 2012, a downward trend toward a stable rate of between 0-5% has been achieved, with all member states having stabilised by 2018. The restoration of confidence in EU sovereign debt due to the progress of the banking union is likely to have been attributed to this, as well as an improvement in global financial environment.



(Figure 2: Long-term Interest Rates for EU Member States, Source: ECB Statistical Data Warehouse)

Despite this progress made towards restoring confidence in the union's financial system, a new concern has risen in the post-crisis years. The level of Non-Performing Loans (NPLs) in the EU has been considerably higher than other major economies and has been highlighted in recent years as a potential risk to the banking system as profitability can often be risked if NPLs are not considered. This is discussed by Deslandes *et al* (2018), who describe NPLs as loans that are more than 90 days unpaid or deemed unlikely to be repaid in full. They show NPLs as a considerable drag on economic activity due to a loss of profitability through higher funding costs as well as tying up bank capital. NPL ratios vary widely across the EU, as seen in figure 3 below, hence has become a priority for the major European institutions to deal with. Most notably, the European Commission announced plans in 2017 to introduce new regulation assist in lowering these ratios, which included great level of supervision, an expanded secondary market and added measures to protect secured creditors (Europa European Commission, 2017).



(Figure 3: Non-Performing Loan Ratios in EU Member States, Source: Deslandes et al, 2018)

5. Conclusion

The case for a banking union in the EU receives overwhelming support in Brussels in the pursuit of an ever-closer union, but as with any directive in the union, the theory only functions given unconditional support by all states. Although the roll out of the SSM and SRM has been successful, one could argue the impact they will have on the banking system at large is minimal, with great issues arise from the need of financial institutions to recapitalise to meet high capital requirements. This could cause profit margins to decrease, and an under-performing banking sector can lead to growth concerns as seeking finance becomes more difficult due to bank credit restrictions. It falls to the argument of interventionism and whether the true cost of such action is yet to be seen. However, the incomplete nature of the banking union raises the question of whether the true benefit will be seen once a European Deposit Insurance Scheme comes into effect. This, coupled with the ESM, will form a safety net around member states and ensure that risk is managed across member state countries.

Going forward, it’s safe to say that the banking system in the EU is still in a fragile state. The continued existence of the NPLs and unpredictability of the political economy in nations such as Greece is likely to create more uncertainty in the future, something which the union has historically struggled to contain to individual member states. A fully-fledged banking union across the Eurozone is essential to securing the future of the Euro and keeping stability in the long-run.

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