Beyond the pandemic: Eight proposals to revive the banking union

Ignazio Angeloni 26 May 2020

In 2012, at the peak of the euro crisis, the leaders of the EU launched the banking union, involving the transfer of large parts of the banking regulatory and supervisory framework from the national domain to the euro area. This column introduces a new report which takes stock of this reform so far and proposes policy measures to improve its performance. It identifies three strategic goals for regulatory and supervisory action aimed at reviving the banking union: reduce overbanking among weaker players; favour consolidation and enhance efficiency among the stronger ones; strengthen balance sheets further, while encouraging area-wide diversification. The proposed measures cover, among other areas, the crisis management mechanism, with a revamp of the instruments and functions of the Single Resolution Board; banking supervision, to enhance the ECB's action in the micro and macroprudential fields; and the state-aid controls in the banking sector.

In 2012, at the peak of the euro sovereign and banking crisis, the leaders of the EU launched a reform involving the transfer of large parts of the bank regulatory and supervisory framework from the national domain to the euro area: the banking union. The project, matching in ambition previous European milestones such as the single market and the monetary union, aimed at reinforcing the institutional architecture of the euro and strengthening the euro area's banking industry, both put to a severe test by the crisis (e.g. Beck 2012).

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In essence, the banking union is an exercise in risk diversification, achieved by pooling banking risks and regulatory controls among euro area countries. The strategy involved three interrelated lines of action: strengthening the solvency of banks; enhancing their efficiency; and fostering area-wide diversification and integration of the banking industry. Drawing on international best practice and especially the US example, the roadmap contemplated three steps: expanding the ECB to include a banking supervisor (which became operational in November 2014); creating a separate resolution authority (operational since January 2015); and launching a banking union-wide deposit insurance scheme (this part of the reform was never implemented). The legal umbrella rested on two bodies of European legislation: the Capital Requirements Regulation (directly enforceable on the banks), and the Capital Requirements Directive (requiring, to be in force, incorporation into national law in each member country).

In 2019, five years after the inauguration of the ECB supervision, the time seemed ripe for an assessment of the new construct. I started working on a new report with the aim of taking stock of the situation and examining possible policy actions (Angeloni 2020). It was clear that, in spite of significant progress in a number of areas, the banking union was incomplete and underperforming; observers' and policymakers' views, however, differed sharply on policy recommendations. The debate stalled between the position of those who called for more risk sharing – notably by creating a pan-euro deposit insurance scheme - and those advocating more risk reduction by putting limits or charges to concentrations of sovereign exposures. Then Covid-19 struck. While the long-term effects of the new crisis are not yet foreseeable, its influence under all three criteria mentioned above – solvency, efficiency and integration – is likely to reverse part of the progress made. When the economy recovers and the supportive monetary and fiscal measures are lifted, the pre-existing the banking sector will come back to the fore, magnified.

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The structure of the report reflects this discontinuity in the underlying conditions: while the first part uses information from prior to the health emergency, the last section contains an early high-level assessment of the impact of the virus and the related policy measures.

I begin by examining the performance of the banking sector over the 2014-2019 period against the three above criteria. Significant progress is found in the first one (solvency), particularly due to a sizeable increase in the capital base and the offloading of large amounts of non-performing and other dubious assets. Progress was uneven across banks and countries, however, and the sector remains fragmented and overbanked, with a number of weak banks still in the market. In the other two areas – efficiency and integration – progress was more limited. Banks under ECB supervision remain largely unprofitable, both by historical standards and relative to global competitors. Many banks are overburdened by excessive costs. Poor profitability and lingering doubts about the sustainability of business models depress stock prices well below book values. Cross-border banking – in the form of direct provision of services, cross-border establishments, or mergers or acquisition – has not picked up; the benefits of the banking union in terms of risk diversification are not being felt. All in all, while euro area banks are clearly sounder and more resilient than they were when the project was started, and in the euro area the quality of supervision (in terms of its transparency, accountability and even-handedness) has improved, the central objectives of the banking union remain elusive, and euro area banks are struggling to prove their worth in the global competitive playing field.

There should be no illusion that banking regulation alone can solve everything: euro area banks are suffering powerful headwinds from the underlying economic conditions – low economic growth and zero or negative interest rates – which have prevailed for over a decade. Yet, the regulatory environment plays a role in the current predicament and can, if properly amended, contribute to a recovery going forward. Regulatory and supervisory action aimed at reviving the banking union can be based on no more than a few strategic goals: reduce overbanking among weaker players; favour consolidation and efficiency among the stronger ones; strengthen balance sheets further; while encouraging cross-border diversification.

In synthesis, the report recommends the following:

1. Overhaul the crisis management framework, granting the Single Resolution Board (SRB) responsibilities and instruments comparable to those of the US Federal Deposit Insurance Corporation.

2. Assign to the SRB the responsibility to resolve, as a rule, all failing banks under direct ECB supervision ('significant banks').

3. Enhance the flexibility of the Single Supervisory Mechanism removing legislative limits to Pillar II supervision and explicitly recognising the benefits from cross-border bank diversification.

4. Adopt a proactive and coordinated macroprudential stance especially with regards to counter-cyclical tools.

5. Harmonise the liquidation regime for smaller banks under national direct supervision ('less-significant banks'); the SRB would oversee national insolvency proceedings to ensure adherence to the harmonised regime.

6. Allow state support and the use of the Single Resolution Fund with less stringent bail-in requirements under certain conditions (e.g. definitive exit from the market, or thorough clean-up of the balance sheet based on an Asset Quality Review and Stress Test).

7. Ensure that national resolution authorities/deposit guarantee schemes are funded, properly staffed and functionally independent, and promote mutual support schemes along the lines proposed by the Commission.

8. Encourage a gradual cross-border diversification of bank sovereign exposures, in coordination with other jurisdictions and the international standard setters.

References

Angeloni, I (2020), *Beyond the Pandemic: Reviving Europe's Banking Union*, CEPR Press.

(2012), *Banking Union for Europe - Risks and Challenges*, a VoxEU.org eBook.

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