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A European banking charter can make the banking union work

Ignazio Angeloni: The banking union faces regulatory obstacles to its completion – nonetheless there are ways to move the pan-European project forward

In 2012, the European Union launched the banking union. It had two purposes. The first was to make banks sound and resilient, preventing new devastating upheavals like the euro area sovereign debt crisis. The second, complementary aim was to build a truly European banking sector, including few pan-continental banks capable of competing on a global scale.

If we look back at what has been done, a paradox becomes apparent. The banking union was successful on the first purpose; in the main, banks are now more solid and stable than they were. However, this task – consisting essentially in recapitalizing the banks, cleaning up balance sheets from dubious assets, improving transparency and business conduct – is one which could, and actually should, have been achieved equally well by the national supervisors. Fixing banks is the mission of all supervisors, not only European ones.

Where the banking union so far has failed, instead, is in building a European banking sector. This is something that only a pan-European project could have done. But it didn't. Eight years on, banks in the euro area are as national as they were, if not more. Troubled lenders have sought survival by shedding foreign operations. No relevant cross-border combinations have taken place. Banks with global ambitions are turning inwards, to the relief of domestic politicians. Meanwhile, continental banks have lost global market shares in key areas like investment banking and advisory. All have scaled down or closed their US operations. Their market valuation has fallen relative to competitors, reflecting the fact that the sector remains fragmented and unprofitable.

Cross-border activities are still unattractive

Yet, opportunities for attractive cross-border combinations among euro area banks do exist. Large gaps in price-to-book values make certain acquisitions attractive. Synergies exist from certain potential mergers, for example between banks with large distribution networks and those with an edge in creating innovative financial instruments. The uneven performance of the euro area economy still promises benefits from geographical diversification. Not least, the digital transformation requires large investments that only large banks can afford.

The obstacles are regulatory. The ECB supervisor was created, but the barriers which make cross-border activities unattractive are still there. Banks acquiring foreign subsidiaries or creating new ones face heavy macroprudential requirements, because cross-border participations are still treated as foreign even though they are under the same supervisory and legislative umbrella. The law forbids intra-group cross-border capital movements. National ring-fencing hampers efficient liquidity management. Credit ratings contribute to the hurdle, penalising subsidiaries if the parent company is located in a country with a lower sovereign rating.

There are ways to revive the banking union. The European Commission may re-open the dossier once Covid-related concerns become less pressing. Even so, cross-border barriers are unlikely to disappear any time soon. In the absence of a mutualised deposit insurance scheme, countries will retain strong control over their banking sectors. A dispute on the treatment of sovereign exposures is blocking agreement on such a mechanism. But there is no need for sweeping regulatory changes involving banking union as a whole. Not all banks aspire to become continental or global players. For the handful that do, a bespoke regime may be the easiest solution.

A pan-euro status at group level

A possible scheme would use a European regulation to create a legislative niche for banks that reach, or plan to attain as a result of a merger, critical thresholds in terms of size and cross-border diversification. Banks applying successfully for pan-euro status would have privileges as well as obligations. They would need to meet all capital requirements (micro as well as macroprudential) set by the European Central Bank, at group level, on a fully-loaded basis. The group would follow, within the banking union, a single-point-of-entry structure, with losses up-streamed to the head company. The latter's liability structure would meet all loss-absorbing requirements set by the Single Resolution Board, in line with global standards. Loss-absorbing rights and obligations across borders would be set by directly applicable European law.

Dedicated deposit guarantee and resolution schemes would be carved out, administered by the SRB and backstopped by the European budget. As a result, credit ratings would become country-blind. Pan-euro groups would be eligible to macroprudential requirements calculated by considering the banking union as a single jurisdiction. They would would be allowed to move capital and liquidity within the group, subject to vetting by the supervisor. Preferably, their assets would be subject to a harmonised area-wide insolvency regime.

National laws could, at least initially, govern taxation and labour relations. Their impact on banks' profitability and cross-border functionality would need to be assessed over time, but once business can be allocated flexibly within the group, the relevance of these aspects would likely diminish.

This scheme would complete the banking union, not undermine it. European directives and regulations would still provide the umbrella for further bank harmonisation. ECB supervision would continue to contribute to a sound banking sector, based on common and transparent supervisory practices. In such an environment, mid-size banks wanting to grow further could more easily go for the final step, applying for membership in the pan-euro 'club'.

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