Leibniz Institute for Financial Research SAFE

# SAFE Finance Blog

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# The future of the banking union between dreams and reality

The measures to develop the Eurogroup's banking union are a step forward but do not address important factor

The financial crisis of 2007 to 2009 and the subsequent euro crisis of 2010 to 2015 prompted reforms in banking regulation and supervision at the level of the European Union as well as the creation of the European banking union along with uniform, common rules, and central institutions. The current crises and insecurities are affecting financial and banking markets, but so far without any dislocations comparable to those seen in the last decade.

Nevertheless, the reform process has not yet been completed. In particular, the close ties between sovereigns and their domestic banks need to be dissolved to be prepared to withstand the next difficult test and avoid triggering another domino effect.

On June 16, 2022, the Eurogroup presented its Development Plan for the Banking Union, which addresses important points. Together with Thorsten Beck, Philippe Martin, Franz Mayer, Jean Pisani-Ferry, Beatrice Weder di Mauro, Nicolas Véron, and Jeromin Zettelmeyer, we take this plan as an opportunity to identify three deals that are advancing the banking union project at different paces and speeds. In addition to the political commitment to reform, whether fundamental changes are made to the Treaty on the Functioning of the European Union (TFEU) or whether only banking supervision and regulatory laws need to be amended is crucial to the success of the respective deals.

### The banking union is far from complete

The banking union primarily aims at restoring private liability in the banking sector and thus abolishing implicit state guarantees. It is designed to eradicate the linkages between banks and sovereigns so that bank failures do not affect a sovereign's debt as they did in 2011. Furthermore, the banking union is a prerequisite for creating a genuine European single banking market, which will bring advantages in lending for companies and private individuals.

To achieve these goals, however, national authorities still have too many competencies when it comes to crisis management in the banking sector. Furthermore, resolving banks at the EU level must actually be put to use. Despite the supranational framework, member states continue to resort to national solutions with the tacit approval of European authorities, rendering the European resolution mechanism virtually ineffective. Lastly, the close ties between states and their domestic banks must be cut.

Even though the Eurogroup is striving for progress – once the June proposals have been implemented, the Banking Union would still be far from complete.

### The incremental deal

From the Eurogroup statement, we derive an “incremental” deal with concrete measures, without being able to infer these specifically from the political memorandum. This deal would primarily improve crisis management and deposit insurance – but it does not address the bank-sovereign nexus. More precisely, the incremental deal includes six steps that do not require changes to the EU Treaty, while almost all require changes to secondary legislation. They include

- the creation of a harmonized crisis management framework for all EU banks - including small and medium-sized institutions,
- stricter rules on government aid to largely shut down taxpayer-backed liquidations,

- autonomous data access rights for the European resolution authority SRB so that it can better assess which institutions are failing or likely to fail (“failing or likely to fail” status),
- the publication of raw data from credit institutions so that investors and creditors are better informed,
- the recognition of institutional protection schemes as “conglomerates” when smaller constituent banks act as stand-alone institutions or holding companies,
- the introduction of a general deposit preference – beyond the minimum requirement for own funds and eligible liabilities (MREL), all deposits rank equally. In addition, the loss-absorbing capacity of bail-in eligible capital must be improved.

### The real deal

The “real deal” entails a broader reform for the banking union and ensures that the overly tight linkages between banks and their sovereigns are cut as well. As such, a more sustainable safety net for maintaining financial stability in the euro area can be achieved.

In addition to new laws, an amendment to the EU Treaty would be worth considering to consolidate the actual decision-making authority of the SRB and thus ensure effective crisis management beyond national vested interests. The necessary measures to achieve this are

- the pooling of all crisis management decisions at the SRB, the EU's Single Resolution Mechanism, which should maintain local offices in all member states to this end. As a result, the institutional conditions for independently enforcing the European rules of the Recovery and Resolution Directive and the SRM Regulation would be met;
- the funding of an efficient rescue mechanism for the revamped SRB to enable it to act,
- the implementation of concentration surcharges for government bonds in banking supervision law to deal with the bank-sovereign nexus,
- the creation of a mandatory European deposit insurance scheme that is modeled after a waterfall, according to which the deposit insurance costs remain at the national level or with the institutional protection schemes up to a certain level. The SRB decides on alternative measures to avoid triggering this deposit insurance scheme.

### The cosmic deal

The third deal involves measures to create a single, integrated European banking market. To achieve this, it is necessary to complete the banking union as well as to unify

- the taxation of banks,
- the insolvency regime for companies and private individuals,
- and the legal framework for real estate financing.

What sounds like a radical idea is legally possible and does not even require amendments to the TFEU, because harmonization would “have as its object the establishment and functioning of the internal market” (TFEU Art. 114).

### Unraveling the bank-sovereign nexus

The reforms, which vary in scope, are not mutually exclusive. Above all, they need different amounts of time for implementation. The incremental deal, which aligns with the Eurogroup's aspirations, could be implemented during the current legislative term of the EU Parliament, but it would not separate banks from their home countries. The reform process is thus not yet complete. We believe the cosmic deal is ideal, but it does not seem realistic in the foreseeable future. The “incremental deal” takes the decisions of the Eurogroup into account but falls short. We strongly advocate for at least implementing the “real deal” so that the nexus between banks and sovereigns gets disentangled as well – preferably before the next crisis.

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