Analyses OSW

CENTRE FOR EASTERN STUDIES 24.06.2022 www.osw.waw.pl

The limits of integration. Germany is a brake on the finalisation of the banking union

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Due to the pandemic, the war in Ukraine and high inflation, the need to consolidate and strengthen anti-crisis tools in the eurozone is growing. An opportunity for this came at the beginning of May, when the head of the Eurogroup, Paschal Donohoe, presented a plan to complete the decade-long construction of the banking union. However, the proposal to create a common deposit insurance scheme (EDIS), the missing element in the entire structure, has been hamstrung due to resistance from eurozone member states. Germany in particular objected, fearing the transformation of EDIS into a transfer mechanism. The stalemate around the Banking Union means that upcoming crises will continue to be resolved mainly by the European Central Bank (ECB) and by ad hoc actions taken by the member states. It also clearly shows that the scope of financial solidarity between the countries participating in integration still determines the limits of integration.

The discussion on the eurozone's stability and resilience to crises is dominated by problems related to the ECB's monetary policy and the fiscal discipline rules of the Stability and Growth Pact (SGP). Meanwhile, the condition of the eurozone's banks is equally important. Their difficulties in one member state can, as the economic crisis of 2008–2009 showed, result in volatility across the entire monetary union.

There are many reasons why banking crises are contagious across borders. The eurozone's financial sector is interconnected through shares, bonds and joint transactions. This would mean that if, for example, Italian banks have liquidity problems, this can easily become an issue for their foreign partners holding e.g. their shares or bonds. Equally important, in the event of banking crises, governments often have to implement costly bailouts to avoid contagion effects across the economy. For large banks, however, the scale of the challenge may be so large that investors may start to question the financial stability of the state and demand a radically higher risk premium in the valuation of bonds. This would create conditions for an asymmetric crisis – a direct threat to the cohesion of the eurozone as a whole, meaning that one of the member states is in a fundamentally worse situation than the others, and the ECB is not able to pursue a monetary policy that is suitable for all members of the currency union. There is, therefore, a clear link between the condition of the banks and the stability of the monetary union as a whole, which justifies the need to adopt a single policy for financial institutions, i.e. to establish a banking union.

There are more drawbacks to shallow integration. The European banking market is divided into national niches, and its competitive position in regards to its most important global competitors is weaker than the size of the entire EU-economy would suggest. The creation

of a single area for the operation of financial institutions in the eurozone would foster competitiveness, mergers and the emergence of larger entities. The cost of access to capital is at stake here. This cost should not be higher than in the US or China.

Towards a banking union

The most important integration measures in this area were undertaken as a consequence of the financial crisis which began in 2007. The volatility in Spain's banking sector was an especially painful lesson. It showed the degree to which the problems experienced by banks can impact on the state's finances. In 2014, ECB supervision over the eurozone's largest banks was introduced. In turn, in 2016, a common mechanism for the orderly restructuring and resolution of failing banks began to function. It was expected it would prevent uncoordinated, often politically motivated attempts by national governments to rescue financial institutions.

However, attempts to introduce the third pillar of the banking union failed (this 'third pillar' refers to a common bank deposit insurance system). It was aimed at providing clients certainty that their deposits would be equally protected in all member states and was supposed to prevent depositors from frantically withdrawing funds from banks facing the risk of bankruptcy. The European Commission in 2015 proposed the introduction of the possibility of mutual financial support between national schemes within two years and to replace them with a common insurance fund by 2024. Neither this idea, nor subsequent, much less ambitious ones, managed to move beyond the consultation stage in the Eurogroup.

An attempt to break the deadlock

At the Eurogroup's meeting on 3 May, its president, (Ireland's Finance Minister Paschal Donohoe) put forward a proposal that was expected to serve as the basis for a political decision to finalise the banking union at the June European Council. The plan provided for two stages of EDIS implementation. In the first one, which was supposed to start in 2024, national insurance schemes would be linked by a reinsurance mechanism, i.e. mutually granted loans. The foundations of a common insurance fund would also be created then. Its financial resources would be built through contributions, the level of which would depend on the scale of risk in national banking systems. In the second phase, planned for 2028, the common fund would take over the function of the central deposit insurance institution in European banks. Resources from this institution would serve to provide loans that would be granted to national systems in order to carry out the necessary interventions.

Before the introduction of the fund, i.e. the second phase, banks would be 'tested' for stability and risk exposure. This concerns, in particular, the level of so-called non-performing loans (NPLs) and the concentration of government bonds on balance sheets, which exposes banks to problems in the event of a downgrade of countries' ratings. Importantly, the results of the review would be subject to approval by all member states, which would in fact amount to a veto. In the meantime, there would also be a far-reaching harmonisation of national insurance schemes and clarification of the provisions which establish the rules on bank failures and state aid.

Donohoe's ambitious attempt, however, was unsuccessful due to resistance from the governments. Ministers from smaller countries raised concerns as some of the proposals

indicated the growing influence of large foreign banks on their markets. In turn, southern countries, in particular Italy, were critical of the reduction in the role of government bonds in banks' balance sheets. The greatest resistance was presented by Germany, which traditionally acts as a brake on attempts to finalise the banking union.

Germany, the main opponent

The government in Berlin has been critical of attempts to implement EDIS for years. Regardless of political affiliation, successive finance ministers have repeated the mantra that it is first necessary to reduce the level of risk in the banks in the southern member states. Unless this condition was met, EDIS would become – according to Berlin's representatives – a wide transfer channel to countries that cannot efficiently manage their banking sectors.

The current cabinet is no different. Although it is more difficult to accuse Italian banks of having an excessive level of NPL today, demands are still being made for the concentration of government bonds to be limited. According to Germany, it is not only financially risky, but also creates dangerous dependencies between the banking sector and the government. Finance Minister Christian Lindner (FDP) would also like the owners of banks to assume greater responsibility for restructuring them than before, and for taxpayers to be burdened only in exceptional situations. Without taking into account the above points, it is difficult to discuss a common fund. For this reason Lindner treated Donohoe's proposals as "an opportunity to exchange views" at best.

To some extent, Germany's position can be explained by a conservative fiscal approach. However, the opinion of German banks, in particular, small public and cooperative entities, is also of great importance. For years, their associations have been emphasising the advantages of having their own deposit insurance system, which has been built up over decades, and they see no reason to give it up and replace it with an EU solution. They are also worried about their competitiveness against large, cross-border giants from France, Italy, Spain and the Netherlands. Germany's private banks and the representatives of fintechs (digital platforms offering financial services) are less critical as the finalisation of the banking union would offer them an opportunity for expansion, increased security of trading and a better rating.

An 'incomplete' banking union

The failure of Donohoe's initiative shows the essence of the dispute over the direction of economic integration in the eurozone. This regards the limits of the member states' financial solidarity when faced with crisis. France, Italy and other Southern European countries believe that they should be outlined as broadly as possible. Otherwise, it is difficult to imagine a stable functioning of the monetary union. Germany, and in fact the entire north of the eurozone, has a different vision, believing that solidarity cannot mean a 'transfer union'. Redistribution mechanisms must be preceded by a convergence of economies in terms of productivity and resilience to shocks.

This dispute was ameliorated in the decade following the crisis as a result of the improving economic situation and the expansionary monetary policy of the ECB. It was also possible to avoid controversy when planning the pandemic recovery fund: the camp reluctant to share responsibility for risk was satisfied with the promise that it was a one-off aid

mechanism. With the deteriorating economic situation and rising inflation, the ‘how much solidarity?’ dilemma is returning to the debate about the future of integration. The unsuccessful attempt to push through EDIS is an important signal in this context. It is also possible that it will end the struggle to create a full banking union. The banking union will therefore become a project with a supervision and restructuring mechanism as its foundation which, in the coming years will be supplemented by the harmonisation of certain rules, e.g. regarding bank failures. This may have consequences for the functioning of the eurozone, especially in the face of crises. EDIS could be seen as a signal to the markets that the monetary union is strengthening and has another institutional backstop in the event of volatility. Its absence means that the responsibility for responding to possible financial shocks rests primarily on the shoulders of the ECB and the member states, which, like a decade ago, will be forced to make ad hoc decisions in the arduous process of political negotiations.

The slim chances of finalising the banking union also have consequences for the entire integration structure in the EU. Politically, this is not bad news for the non-eurozone countries that feared a rapid consolidation of the monetary union in response to the pandemic and the war in Ukraine and a greater divide between the eurozone countries and those outside it. A banking union within a monetary union would adversely affect the competitiveness of their banking sectors and would very likely force them to adjust to the rules introduced by the eurozone countries. The failure of EDIS postpones this scenario and opens up the opportunity to accelerate work on a broader concept of the capital markets union which would cover the whole of the EU. A project of this kind would inhibit the diversification of integration and the actual transition to a ‘multi-speed Europe’ being put forward by some countries, e.g. France.