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Stress tests highlight flaws in EU’s banking union

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The headquarters of Monte Dei Paschi di Siena © Getty Images

When the eurozone crisis started, in spring 2010, the question was often asked why the problems affecting Greece, a country representing less than 2 per cent of the area’s gross domestic product, could have such huge negative repercussions on the financial markets. The answer was a combination of contagion effects and the institutional shortcomings of the eurozone.

Investors’ main concern was that the debt restructuring in an advanced economy, the first for many decades, would directly affect the value of the other countries’ debt. Given the prevailing uncertainty, markets experienced a sell-off of government bonds and an outflow from eurozone investments. The contagion was stopped when a combination of public sector and monetary policy backstops was put in place, in the form of the European Stability Mechanism and the European Central Bank’s “Whatever it takes” strategy, respectively.

The publication last week of the stress tests organised by the European Banking Authority and the recapitalisation plan for the Monte dei Paschi di Siena seem to have triggered a very similar contagion effect in the financial markets, affecting all banks in the EU. Without a clear backstop and a mechanism to avoid contagion, the European banking union appears to be incomplete.

That the banking union lacks key features is well known to policymakers and observers. While it has a single supervisor and a Single Resolution Board that can draw on a Single Resolution Fund, the latter will be filled up over eight years and the union is still missing the third leg: a European deposit insurance scheme. A few weeks ago the finance ministers of the EU publicly recognised that it would be a long time nefore such a scheme was in place, which has certainly not reassured bank investors.

However, as the stress tests and the plight of MPS have shown, there is still more missing to ensure the banking union’s sustainability.

First, while there are well-specified bail-in rules, which define the pecking order in which bank creditors should contribute where public money is used to recapitalise a bank. But while such rules

provide escape clauses in case of systemic crises to avoid contagion, it is not clear who is responsible for triggering such clauses. Too much time may be wasted trying to find out and, as contagion is very hard to predict, it may develop in the markets before the exception is called.

Second, while public money should be the last resort, the European banking system appears to be too fragmented to co-ordinate the rescue of a bank through private funds. The role of co-ordinating private investors was traditionally played by national central banks in the member countries. But the latter are now discouraged from doing so by the European Commission's interpretation of state aid regulation, which considers the use of private funds inappropriate if a public institution is involved, even only in co-ordinating the process.

What Europe seems to lack is somebody of the authority of John P. Morgan, who in 1907 shut his colleagues into a room until a solution was found to avoid the bankruptcy of The Trust Company of America and stop the prevailing panic. In those days, however, the Federal Reserve did not exist. It was founded in 1913, precisely to address such problems.

Third, eight years after the global financial crisis, it is still not clear what the final regulatory framework will look like. The greatest uncertainty is about the new global Basel rules. The authorities' earlier commitment not to raise capital requirements significantly does not seem to be in line with the technical work that has been conducted so far. If implemented, the latter would have a major restrictive impact on banks' activities and on their ability to provide credit to the private sector, especially in Europe which cannot rely on an integrated capital market as the US can. Just weeks before the Basel IV rules are announced in early November, it is still unclear how the authorities' commitment can be met. This uncertainty weighs heavily on the markets' appreciation of the recent stress tests.

Fourth — and closely related to the previous point — two years after the start of the banking union, European authorities have yet to sort out their system of representation in international regulatory forums, and it remains fragmented, in particular in the context of the Basel Committee.

Finally, monetary and supervisory policies seem to be pulling in opposite directions in the eurozone, with perverse effects on bank profitability, and thus on its fragility. While negative rates increasingly bite on banks' margins, higher capital requirements have not significantly brought down the cost of capital, making it difficult for banks to cover this. The fear is that if the current environment persists over a long period,the single supervisor would be tempted to raise capital requirements even higher.

To sum up, the way in which markets reacted to the publication of the stress tests suggests that something is still missing from the banking union, in terms of either the institutions being developed or the way in which the framework is being implemented. Like it or not, a large part of the European economy's financing is still heavily dependent, and will continue to depend, on the banking system. When investors turn away from the latter, sooner or later the former is bound to feel the consequences.

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