4. Banking union: necessary, positive and offering great potential

The global financial crisis that has lasted since 2008 until today has also had positive consequences. One of these has been making it clear that neither banks nor European institutions were prepared for a shock of this magnitude. Since then, the European banking sector has witnessed one of the greatest transformations in its history, which has included the creation of Banking Union.

Banking Union is a key element of Economic and Monetary Union (EMU), harmonising regulation and assigning responsibilities in terms of supervision, resolution and credit. If EMU involves coordinating economic and budgetary policy, why wasn't the response to the banking crisis coordinated, bearing in mind the important budgetary repercussions that were at stake? Furthermore, if monetary policy were truly common, how could the regulation and supervision of banks – the main agents of this policy – be so different across the member states?

At the time of the crisis the banking system had significant shortcomings which made Banking Union necessary. A good example of the fragmentation that characterised banking in the EMU was the evolution of liquidity. One of the main effects of the arrival of the financial crisis to Europe was the practical disappearance of activity on the European interbank market, including between central countries, which was replaced by ECB liquidity.

Doubts regarding the banks that were most affected by the crisis also spread to the retail banking segment, with a number of institutions fearing capital flight. In order to prevent this, a number of European countries announced that they would be increasing the cover limit for each depositor and bank through the national deposit guarantee funds, generally up to one hundred thousand euros.

Some supervisors tended to increase the protection afforded to banks, even requiring that parent banks in some countries reduce the liquidity given to their foreign subsidies and branches, generally in eastern Europe, making the launch of the Vienna Initiative necessary.

In terms of solvency, neither the pre-crisis situation nor the evolution of capital ratios over the following years could be said to be similar. The initial reaction of some countries was to tighten up requirements, at least for certain kinds of institutions. The banks themselves also made an important effort to increase their capital ratios. However, in the case of peripheral countries, this was more difficult given the battered state of their economies and the hit that markets took.

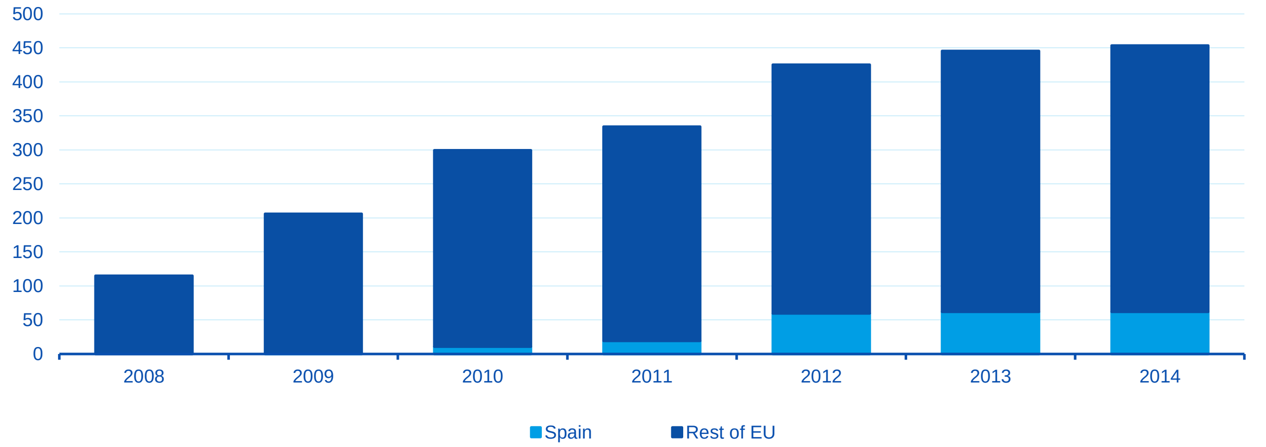
Occasionally, banks were the recipients of public recapitalisation that helped them achieve their solvency targets; again, this differed from country to country. Initially, bank rescues were decided on a case-by-case basis at the so-called “resolution weekend ” by local authorities without any common criterion.

In short, the European financial system at the start of the crisis seemed more like a plethora of domestic systems than a single European system. In such conditions, conflicts did not take long to materialise, further highlighting the need for an important change that would reduce fragmentation and increase stability in European institutions.

One of the main aims of Banking Union was to make a further financial crisis less likely and limit any possible consequences. Its impact can be clearly seen in the lower level of market fragmentation. It was not until 2012, with the introduction of Banking Union and the ECB's announcement that it would do "whatever was necessary" to defend the euro, that fragmentation started to moderate.

Figure 1

State aid during the crisis: Recapitalisation (€ billion, accumulated since 2008)



Source: European Commission

One of Banking Union's successes has been the reduced contagion of banking crisis among the various European countries. An example of this can be seen in the two Greek financial crises, where there was no contagion on peripheral banks during the second crisis.

The reduction in European fragmentation can also be illustrated by the convergence of interest rates, thanks to the reduction of rates in peripheral countries from 2012 onward, when the vicious circle of banking-sovereign risk began to ease off.

The carrying out of common stress testing by European authorities and the unification of supervisory practices, especially since the ECB became the single European supervisor, have helped to ensure that the perception that markets had of institutions now depended more on their fundamentals than on the countries in which the parent banks were based.

While Banking Union has been a significant step forward for European banking systems, some of its effects will cease to be noted when all pending measures have been implemented (such as the creation of common deposit insurance for the Banking Union), when a certain time has passed to allow the measures in force to bear fruit or when economic recovery means that all benefits can be reaped.

Ideally, real banking union would include transnational bank mergers. If the obstacles to setting up in other countries could be reduced and the regulatory framework standardised, it would be reasonable to expect that those banks in the best situation would want to expand in order to operate in other markets.

In summary, the financial crisis made it clear that Banking Union was needed, the effects have been positive and we can expect they will be even more so in the future.

DISCLAIMER

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