The European Banking Union: Challenges ahead

by Howard Davies[49]

Abstract

This Q&A Section discusses the evolution of Multinational Banking in Europe, focusing on the halt to the integration process that occurred after the recent financial crises. How could institutions learn from the past and revitalize the integration process?

Questions on Multinational Banking and the Banking Union

How has multinational banking evolved in Europe since the EU Directives on financial market integration of the 1990s?

The single market programme in the 1990s gave a further boost to the integration of Europe's financial markets, which had been under way for some time. Cross-border acquisitions became fashionable, and banks began to use the European passport to open branches and take deposits in other member states.

Integration accelerated around the turn of the century and cross-border banking claims in Europe grew by 14 per cent a year from 1999 to 2007, to reach a peak of €5.7 trillion by the end of 2007. It seemed that the single financial market, long dreamt of by European Commission officials, was at last becoming a reality, in spite of the many obstacles of policy and practice put in the way of pan-European firms by member state governments and regulators.

49. Sciences Po, Royal Bank of Scotland.

المنارة للاستشارات

But it proved to be a false dawn. The financial crisis revealed serious flaws in the construction of the monetary union, in particular, but also of the single financial market. UK and Netherlands depositors in Icescave, owned by the Icelandic bank Kaupthing, found themselves unable to recover their funds for the Icelandic authorities (Iceland is part of the single market, if not of the EU). Investors in, and lenders to Greek banks found that their security was not as strong as they had believed, when the Greek government proved unable to back them.

These and other problems put the integration process into reverse. EU banks claims on other European banks fell from €5.7 trillion to under €3 trillion from 2007 to 2012, a drop of 8 per cent a year. In effect, EU banks would only lend to each other via the intermediary of the European Central Bank. In 2007 ECB cross-border flows were only 1 per cent of the total: By 2012 they were 35%. At the same time, banks began to sell or close their subsidiaries in other EU countries, so as to concentrate scarce capital on their home market.

The Banking Union was conceived as a response to this headlong retreat from integration. It was understood that one of the underlying causes was a lack of confidence in the regulatory system, which was still based on national regulators. They had been proved to be over-optimistic about the financial health of the institutions in their care. Objectivity was in short supply. Only a centralised pan-European supervisor, it was thought, could rebuild investor and depositor confidence.

The impact was not immediate, and was moderated by the fact that the Banking Union is not yet complete, there have been some signs of stabilisation, and cross-border lending is no longer in free-fall, but there is little indication yet that any movement towards the creation of genuine pan-European banks will re-emerge. The crisis has demonstrated the risks of trying to manage sprawling global or regional networks, and investors are rewarding simpler, more focussed institutions.

What have the major temporary and long-term effects of the global financial crisis on the integration of the European banking sector been? How did the operating costs and the business and regulatory risks associated to multinational banking activities in Europe change after the financial crisis?

It seems clear, therefore, that the Banking Union so far constructed will not in itself create the conditions for a fully integrated banking market, let alone a completed single financial market. While there is now a single supervisory mechanism based in Frankfurt, there is no resolution fund of a size that would be needed to

المنارة للاستشارات

cope with the failure of a large Eurozone bank. Perhaps more importantly, deposit protection remains a national responsibility, and it is little comfort to a depositor in a Greek bank to be told that she is backed by other Greek banks, all of whom in turn depend on a distressed sovereign, and one unable to create its own currency.

Filling these gaps is politically extremely difficult, but unless they are filled there is little chance that further banking integration will occur, and domestic banking markets will not be exposed to open competition.

So further efforts to complete the Banking Union are required. In a vivid metaphor, Nicolas Véron of the Bruegel institute has described the current structure as a 'timber-framed' union, while a steel frame will be needed to support a genuinely integrated banking market.

But we should recall another lesson from the crisis. Europe and especially European business, is very heavily dependent on the banking sector, perhaps unhealthily so. Banking assets total just over 300 per cent of EU GDP, against only around 100 per cent in the US (and about 180 per cent in Japan). By contrast, the total size of European equity markets equates to around 50 per cent of GDP, against around 150 per cent in the US. That is the background to the more recent initiative to promote a Capital Markets Union, championed by the financial market commissioner, Lord Hill.

He has put forward some sensible pragmatic proposals, to introduce standardised securitisation structures, for example. But the CMU will take far longer to establish than the BU. There are deep-rooted behavioural issues to address. For example, European savers on average hold 40 per cent of their financial assets in the form of bank deposits. American households have only 15 per cent of their assets in banks. So it will not be enough to work on the mechanics of the debt and equity markets, a major public education initiative will be required together, perhaps, with tax changes – always hard to agree at European level. It makes little sense to offer tax incentives to encourage saves to keep their money in banks, as some European countries do.

In summary, the long-term dream of an integrated European financial market remains alive, but it has endured a major setback in the financial crisis and its aftermath. We need to be realistic about what can be achieved in the next decade. Re-stabilising the banking system, and beginning a long-term process of diversifying funding sources for companies, to reduce Europe's vulnerability to financial crisis, may be the most realistic aims.

المنارة للاستشارات

Reproduced with permission of copyright owner. Further reproduction prohibited without permission.

المنارة للاستشارات