# Europe's Forever *Unfinished* Banking Union

**By Klaus C. Engelen**

*Before the next downturn, there's little chance of a euro area system of deposit protection.*

The Deutsche-Commerzbank merger fiasco sheds light on how weak Germany's private banking sector remains a decade after the financial crisis, in a national market dominated by highly competitive customer-oriented savings banks and cooperative banks. On April 25, 2019, both banks announced that their management boards had come to the conclusion that a German government-supported merger would "not provide sufficient added value." German finance minister Olaf Scholz and his deputy Jörg Kukies, a former co-head of Goldman Sachs' German and Austrian operations, had pushed the merger to create a banking champion large enough to meet the needs of the country's globally operating companies. Since the German government holds a 15 percent stake in Commerzbank, a takeover of Commerzbank by Deutsche Bank would have been a smooth way to get rid of the government's exposure.

What happens to Germany's leading private sector banks in terms of earnings and market capitalization also points to the broader troubling weakness of European banks. In the eurozone, banks in nineteen member states are supervised and regulated with a "Single Rulebook" under the first pillar of the so-called "Banking Union," under which the supervision of larger banks was largely transferred from the national level to the Single Supervisory Mechanism at the European Central Bank.

Banks in Europe are struggling. The present head of the ECB, Mario Draghi, never raised interest rates in his eight-year-term and kept them close to zero through penalty charges for banks keeping euro deposits. In major countries such as Italy, banks are struggling under high amounts of non-performing loans. Some national economies are slowing down, and years of Brexit troubles past and future cause added insecurities.

No wonder that in reaction to the April 10, 2019, ECB Governing Council's decision to keep rates unchanged, Hans-Walter Peters, the

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president of the Association of German Banks and partner at Berenberg Bank, expressed the anger and frustration of the struggling banking industry. "With its negative interest rates, the ECB is stuck in monetary crisis mode, especially since it indicated six weeks ago that the negative deposit rate would remain in force at least through 2020. It's unacceptable that the ECB is the only major central bank in the world not to have at least mitigated negative interest rates by granting an exemption threshold for excess liquidity. Last year this 'special tax' on surplus reserves cost European banks around €7.5 billion. And every month the ECB puts off easing this burden adds a good €600 million to the bill for banks in the eurozone." The Association of German Banks estimates that the major U.S. banks last year, by contrast, earned about €40 billion on their Federal Reserve deposits.

## THE LAND OF THE LIVING DEAD?

"The land of the living dead: Fixing Europe's zombie banks," headlined *The Economist* on April 6, 2019. "Is there any more miserable spectacle in global business than that of Europe's lenders?" asked the magazine as Deutsche Bank's Christian Sewing and Commerzbank's Martin Zielke and their teams were still exploring the costs and benefits of a takeover of Commerzbank by Deutsche Bank.

"A decade after the crisis [the European banks] are stumbling around in a fog of bad performance, defeatism, and complacency," notes the magazine. "European bank shares have sunk by 22 percent in the past twelve months. Two Nordic lenders, Danske Bank and Swedbank, are embroiled in a giant money-laundering scandal. The industry makes a puny return on equity of 6.5 percent and investors think it's worth less than its liquidation value. Amazingly, many European banks and regulators are resigned to this state of affairs."

*The Economist* sees one reason for European banks' low profitability as "having been lamentably slow at cutting their costs." The magazine comes up with a rule of thumb that the cost-to-income ratios of efficient banks are below 50 percent, "yet almost three-quarters of European lenders have ratios above 60 percent" because of "redundant property, inefficient technology, and bloated executive perks."

## LEFT BEHIND

As the international accounting firm EY points out in a recent survey, European banks are being left behind by their U.S. competitors. Last year, the ten largest U.S. banks earned two and one-half times more than their European competitors. As the ten largest European banking groups reported earning gains compared to the previous year of €52 billion, up 35 percent, their respective competitor group on the other side of the Atlantic was reporting a year-to-year earnings jump of €138 billion, or 88 percent.

According to Claus-Peter Wagner of EY, European banks are suffering from the ECB's low interest rates and its policy of high penalties on deposits. In some eurozone member countries, banks are still suffering under legacy assets and weaker economic growth. Another factor that benefits U.S. banks, notes the EY survey, includes the U.S. Federal Reserve increasing interest rates, which boosted banks' interest income, a crucial source of higher earnings. Wagner also pointed to an important difference in how the U.S. government reacted to the 2007–2008 financial crisis: banks were forced to accept government rescue funds to strengthen their capital base, which speeded their recovery. More recently, the effects of the U.S. tax reform boosted U.S. bank earnings.

JPMorgan Chase topped the U.S. after-tax earnings list with €28 billion, and HSBC was the European bank with the highest after-tax earnings of €12 billion. Deutsche Bank, the only German bank in the EY survey, reported €267 million in after-tax earnings.

In "Global Risk 2018: Future-Proofing the Bank Risk Arena" by Boston Consulting Group, which measures the growth of banks' economic profit by world regions, meaning profit adjusted for risk costs, European banks are left behind.

"An assessment of bank results by region found that performance remains strongly divergent nearly a decade after the global financial crisis. European banks continue their struggle to recover, burdened by high volumes of non-performing loans that remain on their balance sheets," said the report.

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This has to be seen in the context of the overall finding. "After five years of growth, the banking industry has stalled on the road to recovery. The growth of banks' economic profit has weakened on a globally averaged basis for the first time in half a decade. Conditions that have eroded bank performance include persistently low interest rates, increased competition, digital disruption, and steadily rising operating costs. Waves of new and revised global and local regulations, as well as scrutiny, have also undercut banks' economic profit," according to BCG.

Further, the report indicates there is no hope that things will get better. "The twists and turns of regulatory change and oversight show no sign of receding. The flood of revisions averages 200 per day—three times the rate for 2011. Global banks must diligently monitor and implement change in three regulatory clusters: financial stability, prudent operations, and resolution."

### A MORE OPTIMISTIC NARRATIVE

Looking at the reports and speeches coming from the ECB and its supervisory arm, the Single Supervisory Mechanism, and from the outgoing European Parliament, there is a more optimistic narrative on Europe's banking world.

"Five years on, the benefits of European banking supervision are now evident," writes ECB President Mario Draghi in the ECB's 2018 annual report on supervision activities. "Supervisory practices have converged from nineteen national models to one European one. And more harmonized rules and increased transparency have led to a more level-playing field for banks in the euro area. Supervisors now have a more comprehensive view of the banking system. Banks across the euro area are now being compared with a large number of their peers, leading to effective benchmarking in terms of business models and risk profiles. At the same time, cross-border linkages and spillovers can also be monitored more easily, which has strengthened not only our understanding of bank-level risk, but also of systemic risk originating in the banking sector."

According to Andrea Enria, who succeeded Danièle Nouy in January 2019 as chair of the Supervisory Board at the ECB level, "the recent economic expansion in the euro area has helped to strengthen the resilience of euro area banks. Banks now have much stronger capital and liquidity positions than they did before the crisis. The quality of banks' assets has also improved, but the legacy of nonperforming loans (NPLs) is still weighing on a number of banks; it adversely affects their profitability and their ability to grant new loans."

Europe's new top bank supervisor began his career as an economist at the Bank of Italy, and was in charge of crucial bank tests as head of the European Banking Authority since 2011. Enria is hopeful that the supervisory framework for NPLs that the ECB developed to promote the active management of NPL portfolios will reduce legacy assets while preventing the buildup of new NPLs.

*European banks are being left behind by their U.S. competitors.*

But Enria is also realistic when he concedes that "tangible progress on financial integration is eluding us. In my discussions with European bankers, I sometimes sense a feeling of disillusion, a creeping resignation that our markets will remain segmented for a long time to come." He gives as an example, "If we really aim to have a truly European banking sector, we should allow banking groups to freely allocate their regulatory capital and their liquidity within the euro area. But there is still reluctance to remove existing barriers. I do understand the concerns of national policymakers. They fear that banks are still 'national in death' and that they might have to carry the burden when a bank gets in trouble."

### A "BANKING PACKAGE" FOR BANKING UNION

Since the beginning of the financial crisis a decade ago, the European Parliament has been challenged to come up with tougher regulation and supervision for banks. There was a sigh of relief—not only among EP members—that in the final stretch of the eighth EU Parliament in April 2019, the long-debated "banking package" to underpin and strengthen the European banking union was adopted. "This banking reform package," says the European Commission in a fact sheet, "represents an important step towards the completion of the European post-crisis regulatory reforms." The Commission continues, "For banks in the euro area and those that would like to join the Banking Union, the regulations on the Single Supervisory Mechanism and the Single Resolution Mechanism have further harmonized the way in which banks are supervised and resolved. All these elements have led to reinforcing the EU institutional and regulatory framework for banks, resulting in a substantial reduction of risks in the banking sector."

What seems to be especially crucial is that the "banking package" updated the framework of harmonized rules established in the wake of the financial crisis, the so-called "Single Rulebook." This ensures that banks have enough capital to cover unexpected losses and are prepared to withstand economic shocks; bank failures are resolved with the use of funds provided by banks, with minimum impact on taxpayers; depositors' savings are protected at a uniform level of €100,000 across EU member states; and bankers have fewer incentives to take excessive risks.

Some European Parliament members especially praise the long-negotiated banking package because it brings more differentiation and balance in regulatory requirements for smaller and larger banks. Smaller banks are supervised nationally while larger banks are supervised by the Single Supervisory Mechanism on the ECB level.

### PROGRESS ON THE SECOND PILLAR

After the first pillar of banking union—the Single Supervisory Mechanism—took up its authority in 2014, the Single Resolution Mechanism as the second pillar went into full operation on January 1, 2016. The latter, says the EU Commission, "is a system for effective and efficient resolution of non-viable financial institutions. It is made up of the central resolution authority, the Single Resolution Board, and a Single Resolution Fund. The Fund is to be used in cases of bank failures and is financed entirely by Europe's banking sector."

On the way to deepening European monetary union, EU leaders made progress on the second pillar of banking union by agreeing to use the Luxembourg-based European Stability Mechanism as "backstop" for a credit line to support the Single Resolution Fund in case of need.

The European Stability Mechanism was set up as an international financial institution by the euro area members to help euro area countries in severe financial distress. It provides emergency loans on the condition that the country undertakes reforms. Together with its predecessor, the European Financial Stability Fund, it can lend a total of €700 billion.

Before the planned "backstop" can be put in place, the Intergovernmental Agreement on the European Stability Mechanism would have to be changed, which will need further discussions. What has been agreed upon is that the financial means of the Single Resolution Fund must be exhausted first, that the backstop (European Stability Mechanism credit line to the Single Resolution Fund) must not exceed the Single Resolution Fund target funding, that the backstop facility may be used for all bank restructuring purposes (including liquidity needs, which was a controversial issue), that funds provided by the European Stability Mechanism to the Single Resolution Fund will have to be paid back by banks (through the bank levy) within five years, and that the backstop facility may be activated by eurozone member states within twelve hours. In Germany, most likely its Parliament, the Deutscher Bundestag, would need to be involved.

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## Why SRF and EDIS Are Dangerous

A veteran expert on European banking union, Roland Vaubel of Mannheim University, thinks that the Single Resolution Fund and the envisioned European deposit insurance scheme are dangerous.

He makes the point that according to the EU Commission's latest report on the reduction of non-performing loans, the share of gross non-performing bank loans and advances differs enormously among the countries in the eurozone. For example, it is highest in Greece (44.9 percent), Cyprus (28.1 percent), Portugal (11.7 percent), and Italy (10.0 percent), and lowest in Luxemburg (0.6 percent), Finland (1.1 percent), Germany (1.7 percent), and Estonia (1.8 percent).

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According to the Basel Committee on Banking Supervision, claims on the government as a share of total bank assets also differ widely among eurozone countries: 18 percent in Italy, 13 percent in Spain, and 12 percent in Portugal, but only 6 percent in France. These claims are treated as riskless in the risk management of banks despite the Greek haircut of 2012.

Yet neither the share of nonperforming loans nor the share of the banks' claims on their government is among the risk indicators used to calculate the banks' contributions to the eurozone's Single Resolution Fund. The same is to be expected for EDIS because EDIS would also be a eurozone institution.

Further, to calculate a bank's contribution, the SRF does not use the actual average of the bank's risk indicators, but the bank's rank regarding its average risk indicator. This favors outliers such as Greece, Cyprus, Portugal, and Italy at the expense of the others. Also, the range of the average of the risk indicators is artificially restricted so that the average of the risk indicators of the riskiest bank must be less than twice (2:1) the size of the average of the risk indicators of the least risky bank. By contrast, the U.S. Federal Deposit Insurance Corporation admits a range of 18:1. The narrow range in the eurozone favors the countries with the riskiest banks at the expense of the others. If individual banks can shift a large part of their liability to others, they have an incentive to take more risk.

*—K. Engelen*

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### MASSIVE RESISTANCE

In November 2015, the EU Commission proposed—as part of a broader package to deepen the economic and monetary union and complete the banking union—to set up a European deposit insurance scheme (EDIS) as the third pillar of the banking union. The EDIS proposal builds on the system of national deposit guarantee schemes. This system already ensures that all deposits up to €100,000 are protected all over the European Union.

For Germany and other members of the Eurogroup, the pressures on progressing with EDIS have been building up for years. For a senior German finance official, it's the "elephant on the Brussels reform stage" when talking about deepening economic and monetary union.

As Jürgen Stark, the former board member of the Bundesbank and the European Central Bank, argued in the Winter 2019 *TIE*, "A eurozone deposit insurance scheme is … ill-advised at this time, given the scale of non-performing loans in many member states."

As for the position of the Bundesbank, President Jens Weidmann said in a speech earlier this year:

> *The proposed single deposit guarantee scheme could well increase the credibility of depositor protection in Europe and thus reduce the risk of a bank run. However, several conditions need to be met in order to align action and liability and to avoid moral hazard.*
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> *First and foremost, the legacy risks lurking on European banks' balance sheets need to be eliminated. For example, many banks are still sitting on a huge mountain of non-performing loans.*
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> *While it is true that the average non-performing loans ratio has fallen considerably in Europe since 2014, the problem largely concerns individual, hard-hit countries. In more than one-third of EU countries, the non-performing loans ratio is still above 5 percent—in some cases, well above it. Just for comparison purposes, the figure in the United States and Japan is around 1 percent. What's more, banks' risk provisioning to date is nowhere near enough to cover all losses that could result from non-performing loans.*
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> *Looking at government bonds, the situation isn't much better. Many banks hold large stocks of domestic sovereign bonds that are backed by little to no capital, thereby chaining themselves, as it were, to the solvency of their national governments. For instance, holdings of domestic government bonds currently account for around 10 percent of Italian banks' total assets, which is actually in excess of their capital levels.*
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> *There is a risk of unsound public finances taking their toll on banks, ultimately resulting in the deposit*

## Bad News for Weber?

**Manfred Weber:** *potential European Commission president?*

The results of the European elections were bad news for Manfred Weber, the German-backed candidate to succeed Jean-Claude Juncker as European Commission president.

For the first time since 1979, when EU elections began, the center left and the center right lost their absolute majority. The European People's Party, supporting Weber, got 179 seats in the new 751-seat EU legislature, down 38 seats from the previous election. The Progressive Alliance of Socialists and Democrats won 153 seats, down 34.

Before the EU leaders met in Brussels to discuss the top jobs after the European elections, Weber, who got the EPP's backing as leading candidate, or *Spitzenkandidat,* for the next Commission presidency, was faced with a massive diplomatic counter-offensive by the French.

At the EU exploratory summit after the elections, Merkel strongly backed Weber. But she also reminded her colleagues not to open too many wounds in the coming selection process, since the member countries will need to come together again to negotiate the coming huge EU financing plan.

EU leaders charged Donald Tusk, the Council president, to consult with EU member governments in the coming weeks on a list of appointees with the aim of having two woman candidates among the top EU jobs.

As *Eurointelligence* sums up: "[Competition Commissioner] Margrethe Vestager at the Commission might leave open the possibility of both a German and a French president of the ECB. We have some trouble believing that Merkel would accept a combination of a liberal as head of the Commission and a French central banker at the ECB and no German in any key position. The Germans have no candidate for the European Council. So, we ask ourselves: what will Germany get from such a compromise? No matter how we turn and twist this, we always come back to the conclusion that the chances of Weber at the Commission and current Bundesbank President Jens Weidmann at the ECB are inversely related. And Weber's chances are falling."

*—K. Engelen*

*guarantee scheme having to come to the rescue. For that reason, it is not just about cleaning up banks' balance sheets to get rid of legacy assets in the here and now. We also need to prevent an excessive amount of risk from ever building up again in future—risk that would then be transferred to other countries through a single deposit guarantee scheme.*

*The sovereign-bank nexus thus needs to be severed once and for all in order to pave the way for a single deposit guarantee scheme. Banking regulation lies at the heart of the problem. Up to now, government bonds have been given preferential treatment over loans to the private sector and households.*

*On the grounds of prudence, this special treatment is not warranted and needs to be stopped. After all, the debt crisis clearly refuted the notion that government bonds are risk-free.*

German negotiators in Brussels point out that "the EU Commission failed to convince euro area member states that the preconditions for EDIS have been fulfilled. … The name 'EDIS' is now damaged. Another attempt will probably not carry this name anymore."

Currently there is a high-level working group co-chaired by Jörg Kukies, the deputy German finance minister. The discussion will now focus on political issues, including a vision of the ideal banking union in which large cross-border banks would no longer need to maintain liquidity or capital for decentralized entities, that is, subsidiaries. This "pooling" of capital and liquidity is not accepted at this point, as host supervisors insist on safe and sound subsidiaries in their host jurisdictions.

According to the German government, this does not change their demand for a solid foundation before a deposit guarantee system could share risks or liquidity. These

*There is no hope that things get better.*

conditions include a further reduction of non-performing loans in some countries, such as Italy, and a solution for addressing the risks in sovereign bonds. Some parties believe that a form of Eurobonds such as ESBies could be a solution. However, this will meet strong resistance in countries such as Germany, the Netherlands, and Finland. Other options such as harmonization of insolvency and enforcement laws—in Greece, for example, enforcing a mortgage right by selling the pledged real property is virtually impossible, and in other countries it takes many years—cannot be considered as practical solutions.

*Bundesbank President*
**Jens Weidmann:**
*On banking union, thoroughness before speed.*

Arguing that "banking union has already been completed with regard to deposit protection," the largest German banking groups—the savings banks and cooperative banks with their heavy political clout—have been preparing for the EDIS battle for years.

"From an objective point of view, there is no need to further regulate the protection of deposits by way of centralization," argues the German Savings Banks Association. "In July 2015, a common set of rules was introduced EU-wide with regard to the level of guaranteed deposit and the manner in which the schemes function at national level. As a result, all depositors in Europe enjoy the same standard of protection. Under these rules, all countries are obliged to fill their guarantee schemes to the required levels and to organize them well, so that they are able to act in the event of an emergency. However, if EDIS provides the opportunity to 'pass on' risks to the European level, this opportunity will also be utilized."

The position paper on EDIS goes on: "Mutualization will not create additional safety; instead, it will create incentives for banks to take risks."

The message to the Brussels EDIS promoters from the German savings and cooperative banks is loud and clear: Savings banks and cooperative banks should not be forced to make contributions to a single EU-wide deposit insurance scheme.

The prospects for getting a risk-sharing EU-wide deposit protection scheme through the German Bundestag for a German government do not look good.

With the right-wing nationalist Alternative für Deutschland as largest opposition party in the German Parliament, things have changed dramatically.

In 2013, when the coalition government under Chancellor Angela Merkel pushed through a measure to transfer bank supervisory powers from the German Federal Financial Supervisory Authority (BaFin) to the Single Supervisory Mechanism at the ECB, it was done shortly before midnight—in only forty-five minutes of debate—with the Social Democrats and Greens on board and by quieting the speeches of a few courageous dissenters.

Sharon Bowles, a British Liberal Democrat, who at that time headed the European Parliament's Economic and Monetary Committee, considered what was happening in a historic perspective as "a bigger loss of national sovereignty than with the introduction of the euro." ◆