EU BANKING UNION – ONE STEP FORWARD, TWO STEPS BACK

A View on Europe

On June 20, the Eurogroup took a key step towards breaking the dangerous cycle between governments and banks by permitting the European Stability Mechanism (ESM) to directly recapitalise banks. Two days later, European finance and economy ministers (EcoFin) failed to agree on rules for the European Union’s (EU) nascent banking union. The contrast between this success and failure highlight the “one-step forward, two-steps back” type of progress we have witnessed throughout the crisis. As markets begin to doubt the capacity of the European Central Bank (ECB) to bear the full burden of backstopping the European Monetary Union (EMU), we feel that policy makers should be proactive and move swiftly towards completing the banking union.

Despite the length of the journey, our view remains that EU policy makers are committed to further integration, including the banking union. As this union slowly grows from pieces into a whole, markets and ratings should reflect the growing mutualisation of risk.

Vague language, a lack of distinct parameters and a complicated time line for implementation are likely to challenge direct recapitalisation, and could hinder implementation when national parliaments are asked to support the open-ended directive. Only a week prior to the announcement of the ESM’s new capacities, the German constitutional court heard high-profile testimony as it examined the legality of German participation in the original ESM. This demonstrates the tough environment at the national level for EU policy.

Furthermore, the ESM will only be able to provide direct recapitalisation to banks after the European Parliament passes the Bank Recovery and Resolution Directive (BRRD), all national level scrutiny has been completed and the Single Supervisory Mechanism (SSM) is in force. Both face delays. EcoFin failed to produce the essential BRRD rulebook that the European Summit was expected to approve during its 27 - 28 June meeting. And while the SSM’s details are significantly developed, the ECB still must conduct an asset quality test (possibly in the first half of 2014) and the European Banking Authority will conduct a stress test (possibly in the second half of 2014) before the SSM takes over from national authorities. Therefore, we have at least 12 months before the ESM could begin to recapitalise banks directly.

European policy makers are playing a dangerous game with the clock. We’ve previously discussed that whilst markets remain calm and convinced of the ECB’s ability to manage the crisis, policy makers do not feel rushed to commit to new and often politically difficult policy. After the ECB’s rate cut in May, President Draghi spoke repeatedly of traditional and non-traditional measures such as quantitative easing, but there has been little concrete discussion and even less faith that additional measures will flow through to the economy. Without further development on the banking union, the only pillar of support is an increasingly ineffective ECB.
Despite these various challenges there have been significant positive developments from the ESM announcement. The ESM recapitalisation instrument will be able to address legacy assets and can be used retroactively upon review and mutual agreement, addressing concerns about how helpful the mechanism would be to countries that have already increased the sovereign debt levels to bail out national banks. Opposition initially raised by Germany, Finland and the Netherlands concerning already-troubled banks seems to be fading. While actions are still beholden to mutual agreement, it is promising that Ireland and Spain could receive some assistance, given their determined efforts to improve their banking sector to the detriment of the sovereign balance sheet.

This past week’s announcements demonstrate the continuing challenges involved in Europe’s movement towards further integration. The positive developments on the ESM are tainted by the failure to reach consensus on the rulebook for bank resolution. The market is still anchored by the ECB’s actions, and steadying of the economic environment has temporarily avoided any significant upward pressure on government bond yields. Yet without further integration on the banking union, Europe will slide back into the crisis with limited credibility about its ability to address the shortcomings of the EMU. Markets may reflect that unsettled sentiment via higher yields.

About the Author

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