Luiss
School of European Political Economy

German political earthquake may have consequences on the banking union and the ESM

Carlo Bastasin

Policy Brief

LUISS

November 28, 2019

German political earthquake may have consequences on the banking union and the ESM

Carlo Bastasin

A change of leadership in the Social Democratic Party (SPD), the junior partner in the German coalition government, may have severe consequences on the process of deeper economic integration in the euro area that Finance Minister Olaf Scholz was fostering.

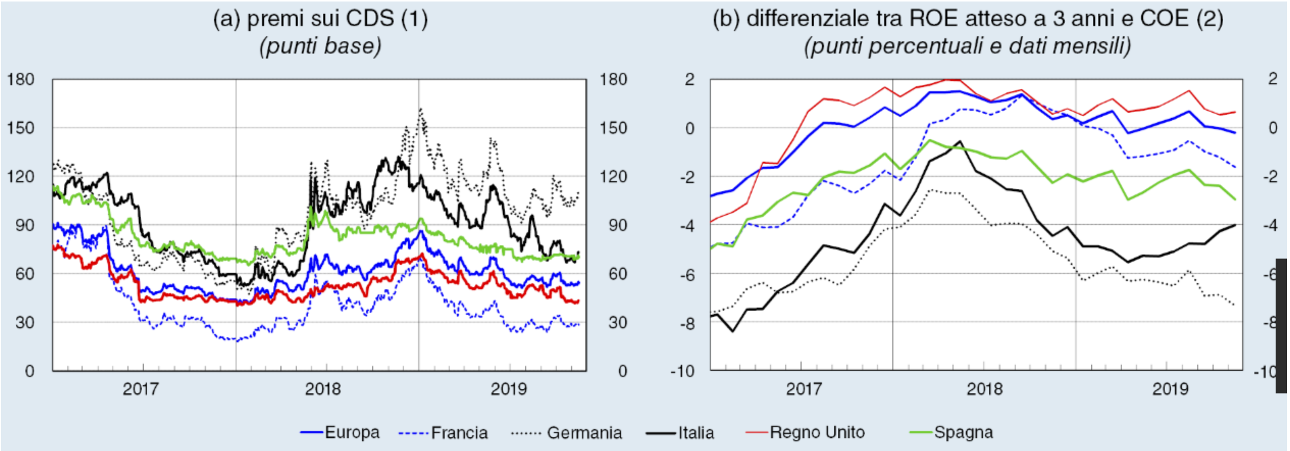
In a development that shook the Berlin political establishment, the SPD announced on Saturday the election of co-leaders Norbert Walter-Borjans and Saskia Esken. They will replace Scholz at the helm of Europe's oldest party, weakening the party's old guard. Walter-Borjans and Esken have pushed for a renegotiation of the alliance between the Social Democrats and Chancellor Merkel's Christian Democrats, which has governed Germany for 10 of the past 14 years. The new leftwing leadership team might plunge Germany into political uncertainty and reduce the margins for a compromise at the European level on the reform of European economic governance.

Scholz emerges as the clear loser and his policies, including a surprising desire to complete the banking union for the euro area, may be hampered a few days before a critical EU summit. Chancellor Merkel should take responsibility, preventing Germany to shy off from its leading role in the future design of the euro-area architecture.

On November 5, Germany's finance minister wrote an op-ed in the Financial Times to relaunch the process of the banking union. He offered an opening for other governments, praising the idea of the pan-European deposit insurance, a form of risk-sharing that had long been resisted by the German authorities. According to the German minister, the negotiations on the banking union could be taken to completion before the end of this year.

Scholz illustrated the need to end the deadlock in the banking union process in a wider picture: "I am calling on the EU to act now to strengthen Europe's sovereignty in an increasingly competitive world. Now that the UK, home to London's capital markets, is on the verge of withdrawing from the bloc, we must make real progress. Being dependent for financial services on either the US or China is not an option".

In the perspective of a stronger and better integrated European economy, Scholz is right. However, his surprising initiative and the time warping acceleration of a notoriously crawling project may also have other explanations. The German banking system is seriously deranged. Its weakness looms particularly awkward in the context of a strong national economy. In order to survive, national credit institutions may need to merge with foreign banks, primarily from other euro-area countries, with Italian or French banks being the likeliest candidates. However, the expected wave of cross-country mergers and acquisitions, as well as the creation of pan-European financial institutes, has been put on the backburner until regulatory uncertainty surrounding the banking union in Europe is dispelled.

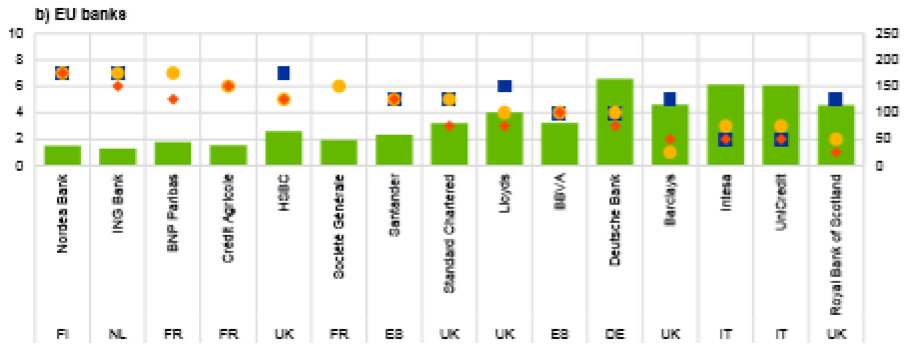


In the graphs above, taken from the recent "Rapporto sulla stabilità finanziaria" published by the Bank of Italy on November 22, the situation of the German banking system appears particularly fragile even when compared with the Italian one.

Since 2018, the premia that Deutsche Bank and Commerzbank must pay on 5ys credit default swaps have made those banks the two outliers among the largest banks of the European financial system. Similarly, the differential between the 3-year expected return on equity and the cost of equity is the lowest in the considered panel. On average, the German return on asset and return on equity are lower than those of Cypriot and Portuguese banks and only better than Greek banks among the banks of the EU countries. According to calculations published this year by the European Systemic Risk Board, the average cost-to-income ratio for German banks lies over 80% versus an Italian ratio between 60% and 65% (other European institutions see the ratio of the two national banking systems much closer to each other).

Financial markets have given a clear assessment of the situation of Deutsche Bank, whose shares have lost around 74% in the last four years. In the last ten years, J.P. Morgan's capitalization has grown almost 20 times vis-à-vis Deutsche Bank. Merging German banks with American institutes would imply for the former the complete loss of control over their business. The net profits posted by JP Morgan are almost 2/3 of the total net profits of the ten largest European banks.

A merger of German banks with Italian banks, whose stock capital still discounts a price for the "country risk premium", or French banks would not present the same unbalance of capitalization. In the graph below, the European Systemic Risk board illustrates risk pricing - the CDS spreads with green bars (right-hand scale) - and credit ratings - the colored symbols show the credit ratings by the major agencies (Fitch, Moody's and S&P). Deutsche Bank's CDS spread is the only one above the Italian ones, with a credit rating that is completely misaligned with the German sovereign rating.



Sources: S&P Global Market Intelligence and ESRB Secretariat calculations.
Notes: In both panels the coloured dots indicate how far in notches (left-hand scale) the current credit rating (as assigned by Fitch, Moody's and Standard & Poor's (S&P)) is above the highest non-investment-grade rating. The columns (right-hand scale) represent five-year CDS premia for sovereign debt (panel a) and for banks' senior unsecured debt (panel b). The latest observations are for 28 March 2019.

In his op-ed, Scholz mentions the risk that Europe's banks may become dependent on American (or Chinese) finance, highlighting the urgent need for cross-country mergers in the euro-area in the nearest future. A restructuring of Europe's banking system needs to occur rapidly enough to rebuild profitability. Only higher profits can ensure that the European banking system has the resources that are needed to invest in technology and resist the coming wave of "fintech barbarians", led by Google-Apple-Facebook-Amazon and the likes, pushing at the gates.

As said, European cross-country mergers are hardly imaginable unless the distortions and the bad legacies left from the crises of the past twelve years are not sidelined. The euro-area banking union has made huge strides since June 2012, when the EU Council embraced the project, in part opening the way to Mario Draghi's rescue of the euro. Even though the Juncker Commission has not achieved major legislative steps towards a more complete banking union, there has been progress in the past five years. Common banking supervision at the ECB has been a success, five years since its November 2014 start date. Likewise, ECOFIN was able to build a framework for handling failing banks. Deposit insurance is the big missing link and the opening step by Scholz is a significant one. A deposit insurance, whereby a common framework would ensure that up to €100,000 in any bank is as protected as any other in the monetary union, is a necessary step in the direction of cross-country mergers.

Since the financial crisis, banks have become much safer but still face structural challenges and could benefit from stronger integration. EDIS will create trust among savers, proving that they can count on a deposit insurance which is able to cover even extreme failures in a country's banking system. Deposit insurance would then be performed at the same level as supervision and resolution, dissipating fears of unequal treatment, increasing European responsibilities. The risk sharing intrinsic to deeper integration would also reduce the possible impact of bank failures on sovereigns and weaken the "doom loop".

However, the German Finance minister has also set several preconditions before putting together a package to complete the banking union. The first, common insolvency and resolution procedures for banks, building on the example of the US Federal Deposit Insurance Corporation, are reasonable and easy to agree upon. The really controversial condition is that risk reduction must be further accomplished before risk sharing can take place: "This means further reducing the number of non-performing loans and tackling the risks associated with sovereign debt. Sovereign bonds are not a risk-free investment and should not be treated as such." According to the minister, banks would have to make provisions for risks arising from sovereign debt within an appropriate transition period. Scholz envisages the introduction of capital requirements reflecting credit and concentration risks from sovereign exposures on banks' balance sheets in a careful, gradual manner without threatening financial stability. "Over time, banks all over Europe would build up more diversified portfolios of sovereign bonds. Doing so would enhance their stability. This approach would help countries with weaker credit ratings."

Risk reduction through the decrease of bank holdings in sovereign debt is the most relevant precondition for countries wary of any mutual risk sharing. The euro area would depart from international standards by penalizing banks who hold lots of government bonds, but proposals exist that entail decorrelating banking credit from sovereign credit through the adoption of "concentration charges" or similar steps that can be achieved without a treaty change.

However, the financial and sovereign crisis of the recent past has demonstrated that national banks have provided their countries – and themselves – with a buffer of stability when they purchased government bonds in times when other investors were shunning them. Market disruptions in government bond markets can also occur for reasons that have little to do with debt sustainability. In this context, the national bias of local banks can have a function of stabilization. Once concentration charges or risk weights reduce the margins for banks' intervention, who else should step in? And would sovereign fragility – and fragmentation - be helpful for building cross-country European banks or even for the Single Market?

The interconnection between different reforms is a relevant feature in the design of better European economic governance. Benefits for financial stability are expected from the creation of a common backstop to the Single Resolution Fund (SRF) that will be provided by the European Stability Mechanism (ESM) as of 2024 at the latest. However, the ESM Treaty, whose reform is currently on the table of the EU Council, is subject to severe criticism in Italy. The heightened risk attached by the ESM Treaty to sovereign bonds, more explicitly subjected to the risk of restructuring, relates to Scholz's conditions for progress in the banking union.

Currently, regulation accounts only to a limited extent for the exposure of banks to sovereign risk. The Basel III regulation as implemented in the EU does not embed specific incentives to reduce banks' exposure to sovereign risk. The EU implementation of the international framework in the Capital Requirements Regulation (CRR) allows EU banks to permanently apply the standardized approach (STA) instead of the internal ratings based (IRB) approach. Under the standardized approach, banks can apply a zero percent risk weight to sovereign exposures denominated and funded in the domestic currency of that central government. In addition, sovereign exposures are exempted from the large exposure framework. Within the Supervisory Review and Evaluation Process (SREP) assessment, sovereign risk is part of the credit risk and market risk assessment but without strict quantitative criteria. Where there is high sovereign risk, supervisors can take bank-specific action, including additional Pillar 2 requirements. Also, supervisory stress tests incorporate risks from sovereign holdings.

A constructive compromise could be a game changer for Germany and Italy, opening the way to an integrated banking system in the euro area. In this perspective, Italy could overcome its doubts about the approval of the reformed ESM Treaty and request a clearer design in the overall governance. First of all, the ESM is still an intergovernmental institution based on a memorandum of cooperation that weakens the role of the European Commission and the accountability to the European Parliament. It should be integrated in the EU Treaties, as it was foreseen, and develop into a real provider of financial stability in case markets jeopardize the financial stability of countries whose debt-to–GDP ratio would be sustainable in normal financial conditions. The ESM governance is so cumbersome that approval of emergency credit would require the vote of national governments or parliamentary committees, preventing any timely use of financial aid. In fact, for the time being, the ESM precautionary credit line would not be accessible to countries like France, Italy or Finland. A development of the ESM towards more accountability and better functionality would reduce the risks of applying "concentration charges" on the sovereign holdings of euro-area banks. The parallel introduction of a safe asset would complement the architecture. Italy should promote a change along these lines.

Such a compromise will only be possible if the German government has the gumption to refute the common narrative about risk reduction preceding risk sharing. Needless to say, a weakened finance minister would not be in the position to pay a high political cost. It is thus time for Angela Merkel to endorse Scholz's position and take responsibility for an ambitious and definitive reform of the European economic governance.