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The Missing Pillar of the Banking Union: German Scepticism and the European Deposits Insurance Scheme

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Negotiations on the creation of common bank deposit insurance for the EU have been underway for more than three years. The deadlock is mainly due to Germany's reluctance, afraid of the creation of a new financial transfer mechanism at the expense of its own economy. An opportunity for compromise is the December Euro Summit. If an agreement is reached, it would mean the finalisation of the banking union—a key area for the future of the eurozone.

One of the priorities for the euro area's reconstruction after the financial crisis has been to deepen integration in the banking sector. Joint supervision of financial institutions, the single resolution mechanism (SRM) for banks, and the European deposit insurance scheme (EDIS), known as the banking union as a whole, are intended to reduce vulnerability to crises and facilitate a joint response to them.

Since 2015, the construction of the new structure has been stuck in place. Admittedly, the supervision and resolution mechanism were created, but there is still the third pillar missing: deposit insurance. Its absence cements the fragmentation of the banking market in the EU and makes the risk of a sudden withdrawal of deposits (bank run) in the least resilient economies of the euro area still real.

EDIS is being blocked primarily by Germany. The first initiative by the European Commission (EC) in 2015 was halted by the opposition of Finance Minister Wolfgang Schäuble and German banks. Proposals for the quick creation of mutual financial support between national systems and a common European fund by 2024 went too far for Germany. Although the EC withdrew the ideas and proposed more cautious solutions, the negotiations stalled. The Euro Summit in December will be an opportunity to break the deadlock, probably the last chance before the elections to the European Parliament.

Discord on EDIS. Germany's main problem on the way to joint deposit insurance is the high level of so-called non-performing loans (NPL) held by euro-area banks. According to European Central Bank (ECB) estimates, in the first quarter of 2018, this category amounted to 3.9% of loans for a total amount of almost €780 billion. This is a better result than three years ago (6.8% at the end of 2015, €1.12 billion), but the concentration of NPL in the southern EU countries is inducing further anxiety. Italy and Greece are considered the countries most exposed to the problem of at-risk loans.

Germany is worried that the creation of a joint guarantee would lower incentives for restructuring weaker banks in the Union's south and finally lead to a transfer of funds from the stable financial systems of North European countries. Therefore, Germany is conditioning its consent on a clear reduction in the level of NPL to 1–2%. This could take many years, however, which would mean the postponement *ad acta* of the joint insurance plan for deposits.

The high NPL level is not Germany's only argument in the negotiations. EDIS is also being blocked by the concentration of government bonds on banks' balance sheets, especially bonds issued by "own" countries. They are favoured because of their advantageous treatment on balance sheets: banks do not have to hedge them with additional reserves. As a consequence, a toxic relationship has emerged. Fiscal problems and falling ratings would hit the banking sector in a specific country or two and then—through EDIS—spread the financial responsibility to all members. Therefore, Germany states it is first necessary to end the special treatment of these bonds on bank balance sheets. For the indebted states of the EU's south, however, this condition is unacceptable.

In addition to the above reservations, Germany continues to raise the need to harmonise bankruptcy laws and increase the liability of creditors for bank losses. However, concerns about the competitiveness of its own financial sector may also explain the dislike of EDIS. Smaller cooperative and public banks, who have their own solid deposit insurance, don't want to share that advantage with competitors from abroad. A certain role in the German calculations may also be fears of a wave of mergers in Europe caused by the completion of the banking union. Germany would not play a leading role in it since the Italians, Spaniards and French all have larger banks, and they could be the biggest beneficiaries of the unification of the financial market in Europe.

Counterarguments. There are, however, many factors that may lead Germany to make concessions on EDIS. First, are the concerns about the future of European integration. The issue of deposit insurance intensifies the disputes with the southern countries, particularly with Italy, which accuses Germany of ignoring the progress so far in the reduction of the NPL and forcing its own financial interests. The Conte government may see further blocking of EDIS as a pretext for triggering a political dispute, for example, around public finance discipline, which would affect the stability of the eurozone. Relations with France are also complicated: it accuses Germany of blocking the EU reforms previously proposed by President Emmanuel Macron.

Furthermore, it is increasingly more difficult for Germany to defend its principled position on EDIS as compromise ideas appear. An example is an unofficial proposal by the Austrian EU presidency regarding the introduction of a "hybrid" deposit insurance model. It predicts that responsibility would rest primarily on national systems, and then, only after those funds have been used up, would a common fund of previously paid national contributions enter the mix. If this pool is also exhausted, the last form of assistance would be loans granted between national systems.

Opposition to EDIS also runs counter to Germany's growing international ambitions. In the face of increasing conflicts with the U.S. and the growing role of China, there are more and more arguments for strengthening the international position of the euro. This idea appeared, among others, in an article by Minister of Foreign Affairs Heiko Maas at the end of August about a "balanced partnership with the USA." However, it will remain on paper until the banking union is completed: without it, the smooth functioning of the single currency area would remain uncertain.

Conclusions. A compromise on EDIS during the December Euro Summit remains an open question. There is still Germany's reluctance—but also that of other Northern European states, including the Netherlands—against new transfer mechanisms and concerns about the competitiveness of its own banks. The chances of progress are also reduced by internal factors: the weakening position of Chancellor Angela Merkel and the rising support for Alternative for Germany (AfD), a party hostile to the euro and deepening integration. However, the chance for agreement rises if deposit insurance becomes part of a broader compromise within the EU that takes into account not only other areas of change in the euro area (e.g., the competences of the European Stability Mechanism) but also migration policy.

The conclusion of EDIS, the third pillar of the banking union, is very important for the single currency. Confidence in the future of the euro area would surely increase, in particular, the conviction of financial markets that EMU can cope with the next economic crisis. It would also be a political signal—important ahead of the elections to the European Parliament—that should strengthen parties advocating deeper integration.

The final steps in the creation of the banking union, assuming a compromise around EDIS, would have serious consequences for countries not currently interested in joining it, which includes Poland. The positions of these countries would be weakened because they would have to adapt to most of the banking union rules while having little say in them. Financial markets might consider these countries' banking sectors less attractive and more exposed to a crisis. Added to this is the broader problem of the future of integration. The banking union is primarily a strengthening of the EU core, i.e., the euro area. Its creation would underline the dilemma of those Member States that do not want the single currency and are sceptical about deepening integration but at the same time do not want "differentiated" integration in the EU.