SESSION SUMMARY - BUCHAREST APRIL 2019

Addressing ring-fencing issues in the Banking Union

1. Opportunities and challenges in the development of Banking Union

Fragmentation remains a difficult issue in Europe; in principle, banks must be able to offer cross-border services with as few impediments as possible to foster competition and facilitate optimum capital allocation. This can, however, not be at the expenses of financial stability at EU and at member states levels.

1.1. Fragmentation issues remain and these can trigger negative effects

1.1.1. Fragmentation issues

In an ideal effective Banking Union where cross-border groups would be dealt with as groups in both live and death, there would be no distinction between home and host interests, eliminating the possibility of national bias in regulation or supervision. However, the EU's legislative framework does not recognise transnational groups at the consolidated level but only as a sum of separate subsidiaries, principally due to the institutional makeup of Banking Union including the absence of a formalised unconditional and unlimited intra-group support and a formal group insolvency framework. There is no free flows of capital and liquidity within a group as this could considerably weaken some entities in a crisis. However, as a consequence, some liquidity may be trapped if a pan-European banking group runs into financial trouble or, even worse, fails and there are still concerns around the sovereign-bank loop. Consequently, the beneficial effects from banking integration have not reached their full potential, although cross-border groups already take up a large chunk of banking activities in a large number of smaller EU member states. This, together with differentiation in taxes, insolvency regimes, company laws and other national frameworks is fragmenting the banking markets.

1.1.2. Fragmentation is linked to the unfinished business of the EMU architecture

An official suggested that fragmentation is fundamentally related to the unfinished construction of EMU architecture. As long as the EMU financial architecture is incomplete, member states will have understandable concerns, which will provide an incentive to engage in ring-fencing. The root causes of fragmentation and distrust are information asymmetry and concerns about effective coordination and burden-sharing in the event of a cross-border banking group collapsing. The official noted that Nordea is a case in point of a truly transnational financial group. Compared to other regions in Europe, the Nordic region has very deep financial integration, despite the fact that Finland is a member of the euro, Denmark and Sweden are EU countries but not part of the euro and Norway is outside the EU but in the EEA.

1.1.3. The negative impacts of fragmentation

An official felt that fragmentation in Europe leads to higher capital, liquidity and MREL costs for transnational banking groups without making them safer. Europe lacks an integrated banking market, and society does not receive the benefit of high capital and liquidity. Europe will experience lower growth if it does not have an integrated market. This fragmentation also complicates the implementation of the single monetary policy. Europe must address the notion that institutions are 'global in life but national in death'. An industry representative described how regulators and financial intermediaries have incorrectly resigned themselves to the notion that ring-fencing and fragmentation are facts of life despite the implementation of the SSM and the SRM.

Another official explained how there has been a substantial renationalisation of banking business in the EU following the financial crisis. The level of integration achieved before the crisis was suddenly reversed. Now the European Union is experiencing a period of reintegration despite some diverging signals. This reintegration trend appears to have resumed in convergence and prices while quantity-based integration is declining. In any case, integration does not happen overnight. Many factors must fall into place to achieve more integration in the banking markets; legislation is only one factor.

1.2. To foster competition, facilitate optimal capital allocation and enhance stability, banks should be able to offer cross-border services with as few impediments as possible

1.2.1. The EU economy needs pan-European competitive banks

An industry representative suggested that the work already completed on the banking sector in Europe has produced much safer banks. Legislation and regulation have led to a reduction of risks, much higher capital and liquidity buffers and the existence of the SSM and SRM. Most of the emphasis has been on making the system safer, however. Not enough has yet been done to make the system more competitive and deliver on the promise of having truly pan-European banks which are able to support the economy. European banks are currently suffering in terms of profitability because the emphasis has been on making them safer but not more competitive. Ring-fencing and the trapping of liquidity and capital has resulted in European banks being less competitive. Europe should be mindful of overdependence on foreign banks and ensure that European banks can continue to play the important role of bank-led financing in Europe. The Banking Union is also important because European companies need to develop beyond their national markets. They need to finance significant developments in the digital transformation, the energy transition and the climate transition. Additionally, Europe should promote the geographical diversification of its banks, so they are no longer over-dependent on single economies. Europe needs strong, truly pan-European and integrated banks.

1.2.2. Europe needs to decide whether it wants to benefit from pan-European banks

An industry representative emphasised that Europe needs to decide whether it wants to have pan-European banks. This does not mean national champions but rather banks that operate throughout the continent and manage capital, liquidity and lending policy on a European scale. If Europe wants that, it should seek to open a dialogue with the few pan-European banks currently operating in Europe. It is important to discover what these banks consider to be the minimum requirements for performing these functions. The existing national approach is the precise contradiction of the Banking Union. While other panellists had mentioned several important technical issues, amongst which

the solo level application of capital and liquidity requirements, the most important action is to understand what are the minimum requirements for a pan-European bank to continue to operate. If there is a suspicion – which has been flagged by some speakers - that a parent bank would not support its subsidiaries in other countries in the event they were in trouble, there is obviously no possible dialogue and no way to tackle distrust amongst home and host countries.

1.3. Building trust in the EU's crisis management framework

An industry representative felt that since the introduction of the SSM and the creation of an integrated mechanism for dealing with banking crises there should not be any arguments for the national approach. The suggestion that host countries can be destabilised by a foreign bank's management of liquidity or capital is grossly overstated. In fact, the evidence suggests that the opposite is true. In Romania, for example, foreign banks consistently supported the real economy during the crisis. In terms of risk reduction and risk-sharing, it is important that there should be guarantees, but these must exist in a cooperative framework and with prior consultation. Another industry representative agreed on the importance of trusting European institutions. Banking Union comes at a substantial cost for banks. For instance, banks are paying a significant cost for the Single Resolution Fund (SRF). This is equivalent to being forced to pay a housing tax on a house one cannot live in.

An official considers it problematic that in case of disagreement national authorities are excluded from the SRB's decision-making process and indicated the SRB's governance framework must be improved. The Chair was struck by the fact that the official was questioning the governance of the SRB. These institutions were conceived in this way. Europe should not blame something and consider it foreign simply because it is a supranational institution. The official replied that it is problematic for authorities to have a seat at the table but not to have a say in the discussion. In addition, irrespective of all the trust you may have in the SRB, it does not currently have the means to force a bank to recapitalise a subsidiary. The Chair felt the need to comment, noting that European countries should not develop a mentality in which everybody is a 'free-rider' on something bigger than themselves. The Chair felt the discussion should not be about small and big countries. Ultimately, the discussion on banks is about whether it is possible to trust someone from another country.

An official suggested that this is not a matter of trust. Rather, if the European Union has agreed something as a whole, it must necessarily use the institutions it has already created. It is problematic for member states to attempt to solve these issues nationally. Once the Union has decided to create institutions, it should make use of them. The European Union relies on trust. The Union has these institutions, and they should carry out their intended functions. Another official considered that trust emerges from the alignment of incentives and interests among different stakeholders. The official described the sudden stop of financing in Central and Eastern Europe, to which the answer was the voluntary Vienna Initiative. The stakeholders discussed the issue together and decided that the industry had to continue to lend; the supervisors allowed this additional lending although the risk was not quantifiable. The Chair emphasised that finance is global and that what Europe seeks is a globally competitive financial sector.

2. Addressing the problem of ring-fencing will require a basket of measures

The panellists suggested a variety of different ways to address the issue of ring-fencing, with some noting the importance of having credible guarantees provided by parent companies to euro-area subsidiaries based on European law and enforced by European authorities. Additionally, member states must develop credible liquidation regimes and there must be a balance between risk reduction and risk-sharing measures. Burden-sharing and capital waivers remain for some of the speakers extremely challenging issues.

2.1. To solve the home-host dilemma, Europe will need credible, unconditional and unlimited support provided by parent companies to euro-area subsidiaries based on European law and enforced by European authorities

An official expressed dissatisfaction with the word 'ring-fencing'. The real issue in this debate is the level of support that groups are prepared to commit to their subsidiaries and the legal instruments to make this solidarity robust and reliable. The first question here relates to the level of support groups want to give to their subsidiaries. It would not be consistent to implement a framework allowing free flows of capital and liquidity in going concerns without simultaneously addressing the legitimate issues which result from an incomplete framework for managing 'gone concerns' issues. If waivers will form part of the policy in this area, the level of support should be full and unconditional. The second issue is about the legal instruments required to ensure that the support is full and unconditional. If there was agreement on this, the question would become a technical one. The main technical issue is how support mechanisms are perceived. The official suggested that "simple" contractual guarantees (as had also been proposed by COM under the banking package) would be insufficient for this purpose.

An industry representative felt that further regulation on such an issue is probably unnecessary. There should be a pause in regulation to allow the industry to assess what has been done since the crisis and evaluate the benefits. The Chair intervened to enquire whether or not it is possible to offer a guarantee without a legal basis. The industry representative noted that their institution had ensured the stability, capitalisation and management of its Romanian subsidiary here even before these mechanisms existed. The Chair replied by noting that Romania is not part of the Banking Union. The industry representative opined that their institution supported its subsidiaries in a highly responsible way. It would do this even if it were not bound by the mechanisms being worked on in terms of the resolution framework and the process of drawing 'living wills'. Going forward, the solution to this issue will be to allow banks to reap the benefits of Banking Union and remove the regulatory requirements at the solo and consolidated level. Capital and liquidity must be allocated in the most effective way possible, because that is how groups manage their subsidiary banks. An official considered that the industry has a range of issues to tackle. Guarantees are not the silver bullet, but they do align incentives. This puts a substantial amount of pressure on a parent. In the case of the 'sudden stop thing', both sides had problems: nobody knew what was happening with the parent groups, and nobody knew what was happening with the subsidiaries. The industry is in a much better situation now. It is possible to know much more, and the European institutions can help.

An official noted that the extensive discussion on the proposal involving simple guarantees has ultimately not resulted in political agreement. Noting the example of Theresa May, who recently had her Brexit deal rejected three times, the official felt it unwise to restart the same discussion the next day on the same basis. Trust is also very important. If there is a discussion at the level of the EU Council and a majority of countries say that they are not comfortable with the proposals, other parties should not immediately blame these countries. This is not conducive to creating the necessary trust to have this discussion. Simple guarantees will not do it; EDIS will not do it; a single supervisor does not do it. The sceptical countries need legal certainty. If a group expresses full and unconditional support for a subsidiary,

there must be a legal instrument to make it valid. As of today, Europe simply does not have this.

2.2. Member States must develop credible liquidation regimes

An official felt there are many things missing in Banking Union. There is no single 'silver bullet': Europe needs a basket of measures. Further risk reduction will need to be carried out by banks. There is still work to do on, for example, loss-absorbing capacity and the concentration of sovereign risk. This cannot be avoided; it must be tackled. On the official side, countries must develop credible liquidation regimes for cross-border financial groups. This is especially needed for banks, and it is the task of justice ministers. Europe needs to align the interests of finance ministers and justice ministers. Additionally, Europe will not develop cross-border banking without deposit insurance. It is too costly for banks to invest in local deposit insurance.

2.3. Europe must maintain a balance between risk-reduction and risk-sharing measures

2.3.1. More integration means less risk

An official considered that Banking Union contributed greatly to fostering the EU-wide application of strengthened regulation and supervision. However, the crucial factor of trust is not enshrined in legislation. Markets and market players make objective assessments of risks and opportunities. Risks will not disappear when they are shared. Risk reduction in the European banking sector must continue in a way that is transparent to the market and to all market players. This includes further reducing the levels of the NPLs, addressing exposures to sovereign risks and making more progress on risk diversification. Where risks are further reduced, there is an opportunity to advance with financial integration in Europe. In any case, Europe should note that financial integration does not stop with traditional banking. New technologies and the use of the new technologies by banks will probably also hasten financial integration in Europe.

2.3.2. Providing objective measurements of the processes of risk reduction and risk-sharing

An industry representative considered it necessary to provide objective measurements of the processes of risk reduction and risk-sharing. Before Banking Union, there was a very different situation. Now, the introduction of the SSM is a major measure of risk reduction. This is quite clearly measurable. Additionally, the reduction of non-performing loans and the new liquidity requirements are also measurable. It is essential to move from perceptions and impressions to quantifications of what has been achieved in terms of risk reduction before saying that the problem of trust is a fait accompli.

2.3.3. Increased solidarity must go 'hand in hand' with increased solidity

An official described how in 2012 the industry was able to combat financial fragmentation through the ECB. In this case, however, Europe must find a structural solution. Europe is reducing non-performing loans in banks, but this task is not yet complete. In order to make real progress, risk-sharing must go 'hand in hand' with risk reduction. There is plenty of 'unfinished business' in the Banking Union from the perspective of the private sector. The official noted the importance of considering this issue also from the broader macroeconomic perspective. First, financial fragmentation hampers the transmission mechanism of monetary policy, which means the effectiveness of monetary policy is reduced. Second, there is an imbalanced policy mix in the euro-area. The 'good times' of fiscal policy were not used for building buffers or pursuing economic reforms. Europe is facing a period of uncertainty and an economic slowdown at least for some time. The countries with fiscal space should use it for investment and countries with much less fiscal space should continue to build buffers. The official stressed the importance of meaningful coordination. In the current context, the industry needs a better and more optimal policy mix between fiscal and monetary policy.

2.4. Addressing the challenging issues of burden-sharing and capital waivers

The Chair highlighted the question of whether legally binding guarantees would be sufficient or whether other instruments are needed. An official suggested that the most pressing problem today is the lack of appropriate instruments. In a situation with capital waivers and therefore burden-sharing, the official's concern is about not being at the table or not having a say. Burden-sharing is difficult, and this difficulty should not be underestimated. There are two principal issues here: liquidity and capital. Regarding liquidity, to the extent that groups have a pool of collateral, they can move it. If a group wants to move liquidity and it does not have the collateral, however, there is a problem. For capital, burden-sharing is difficult. A banking group would not want to die with a subsidiary because the host country was taxing the banking system without limit. It would be understandable for some banking groups to say that full solidarity is not that easy because they do not want to die with their subsidiaries. Additionally, it is important to consider the 'single point of entry' resolution. The core idea of single point of entry resolution is the prepositioning of capital and MREL within subsidiaries so that losses can be upstreamed. Most resolution plans foresee an SPE. It is impossible to remove the prepositioning part of this.

An industry representative agreed that burden-sharing is difficult. However, there should be a forum for discussing this, and it must be within the European institutions. If there are countries that belong to the European Union and do not belong to the monetary union, they should have more say in the discussion about banking. The industry representative felt that Europe should 'bring the outs in' as it would have clear benefits and promote further consolidation of the sector. The Chair noted that this is a big task, reminding the participants of the fact that, after the UK leaves the European Union, all countries other than Denmark are committed to joining the eurozone.

The Chair agreed on the difficulty of burden-sharing. However, member states share a single market and a currency. Europe's banks have capital because they benefit from a space without borders, which is the real single market. Europe must do everything in its power to ensure that the benefits from the single market for goods are also reflected in the single market for financial services. Europe always compares its banking system with the US banking system. Europe should seek to build something as strong as the US banking system, but Europe cannot continue to compare itself with the US and regret its lack of organisation. ●