Making the Banking Union effective: what priorities?

The establishment of the Banking Union was not the result of a collective visionary reflection by EU leaders on how best to address the fundamental issues that are deeply rooted in the EU financial markets: unsustainable fiscal deficits and debts, lack of a true macroeconomic surveillance leading to increasing non- performing loans (NPLs), regulatory fragmentation, an excessive number and dispersion of banks in the EU, the low efficiency of the banking market in Europe...

The idea only got traction in the midst of the European financial and sovereign crisis and was motivated by the need to ensure financial stability and contain the increasingly evident risks to the survival of the single currency. The Banking Union was thus created to break the link between banks and States and solve the banking crisis.

The Banking Union remains unfinished business

The Banking Union has been successful in promoting a more resilient banking sector. Banks are more resilient, liquid and with less leverage. There has been a significant reduction of the level of NPLs (more than half since 2014). Furthermore, a new EU framework needed to deal with this issue has been established.

However, the "sovereign bank loop" has not disappeared and in certain countries like Italy, Portugal, Spain ... has even increased[1]. NPLs continue to pose a risk to the viability of the most affected banks and to economic growth and financial stability in some Member States. The Banking Union is also still failing to deliver an integrated domestic market for banking business. Despite the implementation of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), the banking sector in Europe is too fragmented, not concentrated enough and oversized.

In addition, the EU legislative framework does not recognize trans-national groups at the consolidated level but only as a sum of separate subsidiaries ("national or solo approach") notably due to the insufficient trust of Member States vis a vis the institutional set up of the Banking Union. These ring-fencing practices (increased capital buffers or Pillar 2 requirements for subsidiaries, application at the local level of specific capital, liquidity and MREL requirements) represent an obstacle to the emergence of truly transnational banking groups within the Banking Union because they hinder the effectiveness of the allocation of capital and liquidity within banking groups and reduce economies of scale.

As Andrea Enria has stated several times: "rather than smoothing shocks to individual member States", the banking sector still operates as a shock amplifier".

Consequently, many banks consider that the Banking Union represents a source of costs for significant supervised entities – contribution to the Single Resolution Fund (SRF) and possibly for the backstop of this SRF[2], MRELs, compliance costs – but has not produced beneficial effects.

The present note suggests more radical approaches to solve rapidly the NPL legacy issues and proposes an optional approach to solving the "home-host dilemma" thus making the Banking Union more effective.

Over the last decade, substantial efforts to reduce risks have been made

A wide range of measures introduced since the financial crisis have strengthened bank' solvency, leverage and liquidity positions in significant and practical ways and have substantially improved governance within and supervision of the banking sector;

The average Tier 1 capital ratios of euro area banks directly supervised by the Single Supervisory Mechanism have remained stable, amounting to 15.54% in Q4-2018, compared to 15.63% in Q4-2017. These stronger capital positions are also reflected in higher leverage ratios. The average leverage ratio remains well over the requirement of 3%, standing at 5.28% in Q4-2018. Euro area banks have also maintained their resilience to liquidity shocks, as the liquidity coverage ratio stood high at 145.61% in Q4-2018.

Putting the NPL legacy issue fully behind us requires more radical approaches

Thanks to active measures taken and to a more vibrant market[3], there has been a significant reduction - by almost 50% since 2014 - of the level of NPLs (from 1 trillion to 580 million). Furthermore, a new EU framework to deal with this issue has been established.

However, this major legacy and the age of NPLs[4] of the crisis continues to differ significantly between Member States.

The dispersion in the holdings of non-performing loans (NPLs) is concerning: Indeed, the amounts that are still not sufficiently provisioned are considerable especially in some countries (perhaps close to 100 billion euros out of a total of 580). Greece and Cyprus

[1] As a proportion of Core Equity Tier's, the highest domestic sovereign exposures in the Eurozone are Estonia (787%), Finland (280%), Portugal (184%), Italy (177%), Spain (165%).

[2] The Fund today stands at just under €33 billion. It is on target to reach 1% of covered deposits by 2023, which would be somewhere around €60 billion. If the Single Resolution Fund is depleted, an agreement was achieved in June 2019 in order to allow the ESM to act as a backstop and lend the necessary funds to the SRF to finance a resolution. To this end the ESM will provide a revolving credit line. The common backstop will be in place at the latest by 1 January 2024. The size of the credit line(s) will be aligned with the target level of the SRF, which is 1% of covered deposits in the Banking Union (currently estimated at around €55 billion). If the credit line provided by the ESM to the Single Resolution Fund (SRF) is used, it was decided that the SRF will pay back the ESM loan with money from bank contributions within three years.

[3] Between 2016 and 2018, we saw more and more transactions, sellers and buyers. In 2018, according to an interview of A. Enria dated 14 June 2019, banks from across the euro area sold or securitised around €150 Billion NPLs. Over the same period, they sold around €30 billion foreclosed assets.

[4] For the banks with the highest levels of NPLs, more than half of their NPLs are older than two years and more than a quarter are older than five years (see A. Enria opus cite).

have still (4th Quarter 2018) respectively 42% and 34% of NPLs as a percentage of the assets in their banking systems (against a 3,2% average for the European Union)[5].

In such a context, it is important that the national governments and parliaments should provide an appropriate legal framework. But banks with high levels of NPLs should also engage with borrowers in trouble and identify those who can be restructured. More systemic or radical solutions involving domestic (and EU) public finances need to be designed, identified and implemented in order to handle this problem in the near future and notably before the related economies become less resilient.

To solve the home -host dilemma, the Banking Union needs credible, unconditional and unlimited support provided by parent companies to euro area subsidiaries based on European law and enforced by European authorities

The distinction between home and host supervisors and the "national bias" still exists for banks operating across borders in the Banking Union. Indeed, regulators still believe that capital and liquidity will be trapped in individual Member States if a pan European banking group fails. This perception is particularly acute in countries that are strongly dependent on foreign banks for the financing of their economies. This lack of trust between national authorities is one of the most damaging legacies of the recent financial and sovereign debt crises.

Consequently, ring-fencing policies are applied to capital -including the use of macroprudential buffers in some SSM countries-, liquidity and bailinable liabilities. This clearly distorts the functioning of free banking markets, fragments them, contributes to the low profitability of banks in the EU and impedes the restructuring of the banking sector in Europe, which cannot benefit from the economies of scale of the single market compared to US banks for instance, which can rely on a large unified domestic market.

In addition, defining prudential requirements at the group level should contribute to enhancing financial stability. For instance, the main benefit of defining MREL only at the group level rather than also on the level of each subsidiary (internal MREL) is that it increases flexibility. In the case of a loss in a subsidiary that would be greater than the amount of internal MRELs prepositioned in the country of this subsidiary, it would be easier to mobilize the required capital using centrally held resources from the parent company. If all resources have been pre-allocated, it is unlikely that any local supervisors would accept that internal MRELs located in their jurisdiction should be released and transferred to another one.

In such a context, it is essential to consider transnational banking groups of the euro area as unique entities from an operational, regulatory and supervisory perspective, and not as a sum of separate subsidiaries ("the solo approach"). To ensure such an objective, it is necessary to tackle the root cause of domestic ring-fencing practices.

In order to reassure local supervisors, European transnational banking groups that wish to operate in an integrated way, need to commit to providing credible guarantees to each subsidiary located in the euro area in case of difficulty and before a possible resolution situation ("the outright group support"). This "outright group support" would consist of mobilizing the own funds of the Group to support any difficulties of a subsidiary located in the euro area. Since the level of own funds and the creation of MRELs have considerably increased the solvency of EU banking groups, they should be able to face up to any difficulty of their subsidiary located in the euro area. This group support should be based on EU law and enforced by EU authorities. These guarantees should address the question of group support for subsidiaries during going concerns and not only during resolution. They could be adjusted regularly depending on the risk profile of the banking group.

This commitment is the key condition for these banking groups to define prudential requirements at the consolidated level. Given the high degree of banking intermediation in Europe, compared to other jurisdictions around the world, striving for a smoother movement of capital and liquidity, across EU countries, is essential.

In order to create a climate of confidence and trust, host countries should be associated with and involved upstream in the establishment of living wills.

A European approach to the liquidation of these transnational banking groups is also required

In addition, if the group was to go into liquidation (and not only local subsidiaries), a European approach to the liquidation of these transnational banking groups is also required. Indeed, even though these transnational banking groups are supervised at the EU level and the impacts of this liquidation would impact the whole euro area, liquidation is still managed at the national level (entity by entity) and this can require the public money of the Member State of the entity. A common liquidation regime for these banking groups should ensure an equal treatment of creditors of the same rank within the group and the addressing of possible costs at the EU level. In an interim stage one solution could be to extend to subsidiaries the liquidation approach currently used for branches, whereby resolution is managed under the regime of the parent company. This would allow all the subsidiaries of the Group to be treated under the same liquidation regime.

An alternative solution could be to facilitate the validation by supervisory authorities of the transformation of subsidiaries into branches for banking groups who wish to operate in a more integrated way. This requires that national supervisors and Parliaments should receive the necessary information to understand the risks national depositors are exposed to from these branches and the possible impacts on the financing of their economies. This may require developing specific reporting instruments and processes for the local authorities to continue to be able to appropriately supervise local activities and thus contribute to supervisory decisions taken at the SSM level that may impact their jurisdiction.

These are the main conditions for the abandonment of the "national and solo approach" which would contribute to build a single banking market in Europe, increase the competitiveness of the EU banking sector and favour the emergence of pan European banks.

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Finally, when the more fiscal and structural convergences (such as a reasonable level of public debt in all Eurozone countries, ...) are achieved, the more positive integration trends will creep into the Union and reduce the incentives for national authorities to "ring fence" transnational banks in terms of capital and liquidity, thus strengthening banks in their capacity to become pan-European players.

In other words, a monetary union and all the more so a Banking (or capital) Union are not workable without economic convergence and fiscal discipline. ●

[5] In Italy, at the end of Q3 2018, the NPL ratio was 12,4% and in Portugal 12,6%.