SESSION SUMMARY - HELSINKI SEPTEMBER 2019

Making the Banking Union effective

1. The post crisis European banking landscape remains fragmented across national borders notably because member states use the flexibility in the regulatory framework to restrict intragroup cross-border free flow of money (capital, liquidity, MRELs and large exposure regime)

The European banking sector is at a crossroads: Protracted profitability below the cost of equity, the challenge of technological change and digitalisation, issues of overcapacity in a number of markets and a more challenging monetary and macro environment ahead make it all the more important that the regulatory framework should operate smoothly and without distortions. However, the Banking Union is failing to deliver the degree of financial integration expected. Cross-border banking groups are not able to efficiently allocate internal capital and liquidity as they face limitations that block resources from flowing to where demand from businesses and households is greatest. This leaves them unable to compete with their bigger and more efficient global peers and could also explain the absence of major European bank mergers in the last decade. Moreover, the macroeconomic environment is not conducive to banks' consolidation. Completion of the Banking Union is therefore needed.

A central bank official reflected on a similar panel at the previous year's Eurofi. Essentially, it dealt with the same questions that have been collected this year, which is a little sobering. At the same time, there is a new Commission coming in with new priorities, so maybe this is a chance to kick-start the Banking Union. This session would first briefly revisit the impediments to the Banking Union making more progress: legacy issues, lack of trust between authorities and the sources of financial fragmentation. After sketching out the landscape, it would move on to possible remedies.

1.1. The facts

An industry representative commented that integration has recovered from its 2011-12 trough, but most indicators of financial integration, including cross-border loans and the dispersion of rates between countries, have not exceeded pre-2008 levels. For example, 83.6% of loans by Eurozone banks to households and businesses are lent in the home country. Lending across borders increased in the Eurozone between 1997 and 2008 from 2,3% in 1997 to 5,2% in mid-2008, but progress has come to a virtual standstill since then. In deposits, a retrenchment to home markets has been observed since 2008. Today, 54.1% of bank deposits are collected domestically, while the share from elsewhere in the Eurozone has declined to 19.2%.

Another industry representative pointed to some specifics. There is a perception of insufficient integration, which is proven in the European Central Bank's (ECB) aggregate index composing the prices of loans and deposits. This index is still below its peak of 2004 to 2008, after all the progress made towards Banking Union. Government or corporate bond holdings have increased, but this has only worsened the situation. Now, they are more than 60% of domestic bond holdings, when they were less than 40% in 2007. The situation is similar for cross border loans as has already been said. The dispersion of lending rates is less than it was before the crisis, but this has much to do with the abundant liquidity provided to the financial sector.

Despite efforts made towards the Capital Markets Union (CMU), single rulebook, supervision, resolution and deposit guarantee schemes across Europe, progress has not been as expected. Although the system has gone a long way, the Banking Union is still far from weakening the bank/sovereign nexus. The correlation between credit default swaps (CDS) and sovereign bond spreads remains. An official added that for banks in troubled countries, recent capital gains made on sovereign holdings will not incentivise them to reduce this nexus any time soon.

1.2. Cross-border banking groups are not able to allocate efficiently internal capital and liquidity as they face limitations that block resources from flowing to where they are most in demand from businesses and households

A representative of an institution active in multiple European jurisdictions named as a major impediment to a closer Banking Union the lack of trust among Eurozone members and the lack of understanding that doing more together will ultimately work better. Currently most, if not all, European bank retail customers deposit money in their own member state and take products from that same bank. This is not appropriate for competition. Customers do not go to cross border banks, so the banks will have to come to them. To encourage them to, there must be a greater benefit from monies flowing within a bank from one part of Europe to another. The free flow of funds is a major impediment to developing a pan European market and to cross border mergers. Even within an existing banking group, undertaking a merger across one or two member states is very difficult.

Another industry representative saw the same cycle repeating for new banking and finance competitors. Digital is, by definition, cross border and cross industry, but nonetheless it is regulated locally. This could be self destructive if things are not done properly from the start; yet some countries are allowing the massive use of digital onboarding – use of the cloud and artificial intelligence – while others are acting with caution. Anti money laundering (AML) requirements also differ. This is hindering potential progress in banking integration. Regulating digitalisation at the EU level is the right way forward.

1.3. The macroeconomic environment is not conducive to the consolidation of the banking system

Central bankers are unanimous in their assessment that an effective Banking Union is needed as an additional stabiliser in case the EU is hit by shocks. They also know what the regulatory and supervisory challenges are. At last year's panel, there was little discussion of the macroeconomic environment or monetary policy not being conducive to the consolidation of the banking system. A high level of liquidity leads to a lack of pressure to consolidate the banking system, because it is easier to keep banks alive than otherwise. Not only that, but the costs of risks are pretty low, which contributes to banks not consolidating. More astonishingly, despite banking prices being at their lowest since the crisis, there are no takers. There are few incentives to purchase or invest in banks in Europe, despite the low prices. This is highly distorting.

Another consolidation worry relates to small tech, bigtech and the other innovators, but this could all be barking up the wrong

tree, in the view of one central banker. An audience member asked whether the ECB truly wants a Banking Union, because lasting negative interest rates can only weaken the sector and increase financial risks. The same central bank official confirmed that the ECB wants a Banking Union because, ultimately, it wants functioning, integrated banks that are prepared for any shocks that may hit. But not everybody wishes to perpetuate negative interest rate policies.

2. The root causes of banking fragmentation

Distrust among member states is the root cause of banking fragmentation. Indeed, host countries still see the need to protect stakeholders, creditors and taxpayers by ring fencing practices, while regulators believe that capital and liquidity will be trapped in individual member states if a pan European banking group fails. The weak profitability of the banking sector and the persistently high level of non-performing loans (NPLs) in certain banks also contribute to explain this lack of confidence among member states.

A central banker described how financial fragmentation is due to national regulators pursuing their own mandates, while another kind of fragmentation relates more to different technical definitions, traditions and national discretions. Participants were asked to give their impressions on whether most fragmentation came from having local financial stability and resolution mandates, or if it was more from the technocratic side, in which supervisors have certain expectations of the rulebook, and to what extent each is soluble.

2.1. Host countries still need to protect stakeholders, creditors and taxpayers by ring fencing practices

An industry representative saw fragmentation arising from various sources. National Competent Authorities (NCAs) apply their own rules pursuing national mandates leading to local add ons. In addition, they exercise their microprudential rights or obligations also leading to national requirements. Moreover, the Single Resolution Board (SRB) has not properly tested resolution plans, and they may not be tested for some time, but they must have a better understanding of how they would work in practice. A European bank might appear as such in life, but then become a bunch of individual country banks in death. This is a further impediment towards closer integration. He therefore concluded that, to achieve a truly integrated Banking Union alongside EDIS, national discretions should be removed to the extent that they impede the efficient allocation of funds within cross-border banking groups.

2.2. Distrust among member states lies at the root of fragmentation

A second industry representative agreed with this view. Incentives still exist for the domestic transposition of European or global rules from local traditions, internal pressures and dynamics. These might only be disassembled at the political level, for which there must be agreement and trust among parties, because discretions are too large and abundant to be justified. Liquidity is trapped in certain jurisdictions, which prevents the diversification of risks and introduces systemic weaknesses. Europe is far from being a single banking jurisdiction, and this notion is inconsistent with banking or monetary union. The protection of national depositors has been a strong argument for ring-fencing measures. Moreover, it is not in the interests of a bank that becomes national in death to allow its capital and liquidity to flow. In this context, everything is interconnected. One needs a grand view and then a political impetus to break down this resistance.

Trust is key, because there is much political difficulty around risk sharing. There is little such difficulty in joint decision making on single rulebooks and supervision but, when it comes to resolution, cracks start to appear. Without more sharing of deposit guarantee schemes, at some point there is likely to be acrimony and recrimination should a bank fail without a buyer. The king's clothes will reveal themselves to be absent.

2.3. Regulators still believe that capital and liquidity will be trapped in individual member states if a pan European banking group fails

A central bank official agreed it is in the interests of the ECB and the euro system to maintain a well functioning single banking market that helps meet the ambitions of monetary policy. Points were made earlier about the sources of fragmentation and how bad it really is but solving it could come down to the question of deposit insurance. This also answers the problem of liquidity trapped in different countries. Regulators still believe that capital and liquidity will be trapped in individual member states if a pan European banking group fails. From a host country perspective, it is understandable that, if a member state is responsible for a bank in its death, it would want some protection. That is where liquidity and capital ring fencing problems originate from.

2.4. The weakness of the banking sector, demonstrated by low returns on capital and the time needed to clean up banks' balance sheets, is also a stumbling block to the completion of the Banking Union

There has been clear progress on the resolution of NPLs. Nonetheless, they keep impeding further progress. There is around €580 billion NPLs in the euro area, where the average ratio of NPLs to total loans is still above its pre crisis levels and much higher than in the United States or Japan. Croatia has seen much progress on this issue already, as has Europe more widely. The market and services for NPLs are there, and people are making nice money out of them. In Croatia, at least, people are now getting enviable yields in this market, and in Italy large chunks of NPLs have been sold. A central bank official also commended the Commission's efforts to facilitate a faster resolution of NPLs by creating the infrastructure to trade them across Europe and for the extrajudicial collection of collateral in insolvencies.

It is much easier to tackle the problem of NPLs if the bank is adequately capitalised and so can 'take the heat' better. This helped in the Croatian case, because their average capital adequacy ratio is almost 24%. Even during the crisis, with high leverage it was easier to resolve NPLs. This is thus one of the preconditions to having an integrated banking market in the future, but not the only one.

2.5. Progress to reduce NPLs has been held back by the chronically low profitability of EU banks

A central banker stated that it is unfortunate so little progress has been made on the last leg of the Banking Union. Common deposit insurance is needed. This could notably solve the problems of NPLs, but ultimately, this all comes down to the low profitability of European banks in general, and this is a problem of business models. A low price to book value makes it difficult to raise new capital and to grow out of NPLs.

3. Possible remedies

3.1. Banks need to speed up the process of cleaning up their balance sheets

Although the level of NPLs has reduced, it is too early for one central banker to say whether there are similar levels of risks in the banking sector of all European countries. It would be therefore difficult for ministers of finance to decide tomorrow that there needs to be a functional European deposit insurance scheme (EDIS). Even if Europe went 55 60% down that road, a political decision would be needed at the highest level for risks to be equally shared and mutualised.

3.2. Pan European banks need to be European in death

3.2.1. Improving the EU resolution framework

A central bank official argued that allowing the free flow of capital and liquidity within cross border banking groups would make the Banking Union more effective. However, these same banks would have to remain not only multinational in life, but also in death. The functioning of the current resolution regime for large cross border banking groups begs a number of questions which have not yet been fully addressed, such as single purpose entity (SPE) implementation across borders at a time when the Minimum Requirement for own funds and Eligible Liabilities (MREL) is gradually building up. Liquidity in resolution is another case in point. Here too, a staggered approach including the implementation of the Single Resolution Fund (SRF) backstop could form the basis for future advances in home/host cooperation and thus render the banking union more effective.

3.2.2. Harmonising insolvency regimes is a necessity

An industry representative described the harmonisation of insolvency regimes across member states as a major project in furtherance of completing the Banking Union. It could be testing, but it has to be done. A true single rulebook would help tremendously. Another industry representative agreed a single harmonised insolvency regime managed by the SRB, and with a single creditor hierarchy, would make the EU crisis management framework more effective.

3.2.3. Is harmonising macroprudential regimes necessary?

Additionally, according to a speaker, the harmonisation of macroprudential requirements, not so much the application but the requirement setting itself, would help. There is the ambition in Europe to drive towards completing the Banking Union, but a major impediment is the lack of willingness to reach out across borders, both by banks and regulators. A central banker, however, insists that macroprudential supervision should remain at the national level. It should indeed be accepted that there are different financial cycles in different countries and that there may be different buffer requirements in place at different times. This does not look good from a multinational bank's perspective, but it is the way that macroprudential policy has been designed. It is just unfortunate that the creation of a macroprudential toolbox in host countries has been hampered by home countries' fears about ring-fencing.

3.3. Without EDIS, the fragmentation of financial markets is likely to persist; achieving a consensus on the design and implementation of EDIS is therefore essential

3.3.1. EDIS: an urgent need

Agreement on EDIS would symbolise the Eurozone's willingness to share risk. A well funded deposit insurance system is also key to eliminating zombie banks. The right home/host balance remains a contentious issue closely related to the EDIS discussion. The panel explored what is concretely needed to make EDIS function properly. There have been proposals in particular for liquidity sharing. The question is what is needed to conclude that EDIS is in place.

An industry representative saw EDIS similarly as a symbol. It is a symbol of the union's willingness to take responsibility for the rights of deposit holders within banking groups.

All panellists understood that full blown EDIS could not be achieved from day one. Perhaps it should make its case on the reinsurance side first. Seeing it having more than just a high symbolic value may be optimistic anyway, but a central bank official argued that, to achieve less fragmentation and a smooth flow of liquidity and capital across borders, common deposit insurance is needed. Without solving this problem, no progress will be made in reducing NPL risk.

An industry representative agreed with much of the above. A properly built Banking Union should seldom need to use EDIS, because of the many barriers that go before it that have been constructed since the crisis. The technical design of EDIS could also help foster confidence, but a question has to be asked about the extent to which a legal or reinsurance only EDIS is needed to stop short of providing insurance to all deposits in the Eurozone, so that €1 held in Athens is worth the same as €1 in Berlin.

Quite a lot is missing without EDIS. The cross border deposit market, for instance, is non existent without it. Some banks are exploiting this loophole and offering deposits with higher rates in certain countries (e.g. Greece), but they do not tell you that the deposit insurance or guarantee scheme in place is also of that country.

A central banker therefore stated that Europe has to clean up its banking system, as there are far too many inefficient banks. But there will be no credible and efficient elimination of ineffective and sometimes disruptive market players without a well funded deposit insurance system. Croatia has closed down two thirds of its banks over the last 20 years, which it accomplished using such a system, without ever resorting to ministry of finance money. The whole clean–up was financed by the banks and it worked. If this is not done elsewhere, supervisors would be able to turn a blind eye to any problems they know will be difficult. Once they have closed down these banks, they can do whatever else is necessary.

3.3.2. When it comes to a fully-fledged EDIS, the harmonisation of national insolvency regimes and the regulatory treatment of sovereign exposures to account for the home bias of euro area banks are important issues

Also on the table during Croatia's presidency is sovereign concentration risk and insolvency. As has been said, different insolvency regimes cannot operate across the great institutions of Europe, if there is to be a truly integrated and efficient banking market and a common deposit insurance system. This is difficult to do piecemeal. A central banker questioned the preconditions for achieving a smooth flow of liquidity and capital. Work must be done on these from the outset.

3.3.3. The critical question is how much risk reduction is needed before the risk sharing needed to make this work

Another central bank official saw cost resulting from both non-implementation as well as an ill designed implementation of EDIS. There is a contrast in the view that EDIS would essentially be a last resort, as well as the first element a consumer needs to be given the confidence necessary to invest money. It is conceded that there are different views of what people in the industry and consumers expect.

Consideration needs to be given to whether EDIS could be done earlier, as a phased approach or wholescale. The argument was made that, by trying to do it, one gets the confidence to know how to do it. However, if a shock were to hit and EDIS were to fail, the hope of bringing it back to the table would be lost for decades. The critical question is how much risk reduction is needed before risks could be shared sufficiently to make this work. There is the matter of whether to include NPLs and, linked to this, how to price risk. Many uncomfortable decisions still need to be made that, unfortunately, will include further risk reductions before risk sharing can go ahead.

A central banker thought EDIS should at least have a pre funded central fund, even if it has different pockets for different countries, then it could start collecting payments centrally. When ready, the risks could be quickly shared. Another issue in this context is that, if EDIS is called on, the deposit insurance scheme becomes a player in the insolvency procedure, and national regimes differ in their effectiveness at recouping

money. Historically, loss given defaults of deposit insurance schemes have varied from zero in some countries to almost 50% in others, and this discrepancy needs to be tackled.

3.3.4. A pragmatic and staggered approach

According to one central banker, agreement on EDIS should be part of a broader EU agreement that includes the harmonisation of insolvency regimes. A deposit guarantee scheme should not be the second step in the insolvency procedure of one country and the sixth in another one. However, another central banker described waiting for a common insolvency law to be in place across all countries as like waiting for Godot. A federal insolvency law needs to be created that would require all countries to follow the same legal procedures. It would take too long to wait until civil law is implemented in an equivalent way. A further central banker therefore believed that ministers of justice, not finance, would need to take these decisions and that they require an understanding of insolvency laws.

An industry representative widened this issue from the harmonisation of insolvency laws to decision making and governance. Fernando Restoy has a proposal to empower the SRB, in the case of small institutions applying resolution, so that it acts like the Federal Deposit Insurance Corporation (FDIC). This concerns not just legislation but its application and is key to banks remaining European in death.

3.4. Is the Eurofi proposal to solve the home/host issue, with outright group support of parent companies to subsidiaries or with branchification of subsidiaries located in the euro area for banking groups that wish to operate in a more integrated way, the right way forward?

Another question for panel members concerned the Eurofi proposal to solve the home/host issue. A central bank official expects the parent to support its subsidiary, though this also depends on the resolution planning. The parent is supposed to have an SPE strategy, but resolution needs to be tested first. Until there has been that experience, there will be a lack of trust, because European regulations are not always implemented in the same way everywhere. How things will work in practice remains to be seen. A second central banker stated that cross-border branches eliminate many of the home/host problems being debated by the EU regulators. The preference for establishing subsidiaries may be a missed opportunity in financial market integration. Some of the energy spent arguing whether regulation should apply at the solo or group level could be better directed at understanding why banks are using subsidiaries instead of branches.

An industry representative was not surprised by Eurofi's suggestion related to guarantees, but also pointed out that there is another way to achieve these goals economically, which is to allow a bank to make branches of all its subsidiaries within the Eurozone. Local regulations do not really like that though. Banks would be able to move liquidity from one place to another or move dividends upstream, but this can take many months to accomplish as Banking Union has not been finalised. It must be remembered that this solution is a contractual arrangement, so whether it holds in a bankruptcy is doubtful. It is much easier to accomplish the whole thing at once via branchification. A central bank official and this industry representative agreed that, in such circumstances, the local deposit insurance scheme would need to cover all deposits Eurozone wide. EDIS must be in place, working and trusted.

A central banker has also seen the branchification of cross border banking groups taking place in the Nordic/Baltics region, suggesting that there is trust there that is lacking elsewhere in Europe. Estonia has traditionally been a host market for some of the larger Scandinavian banks, which have had both branches and subsidiaries there. The situation has changed in the last couple of years, with a Baltic banking operation now headquartered in Tallinn, which also has a business in Latvia and Lithuania. In a way, Estonia is a home country now and this has worked well. Banks have the choice of having branches instead of subsidiaries, which avoids all the problems of waivers or liquidity and capital requirements. But it is not only down to policymakers to make this work in a single market; it is something for commercial bankers to take on themselves. This central banker therefore felt that Eurofi's proposal is heading in the right direction, but there are questions about how far such an arrangement could be trusted. The regulators would prefer to see real branches other than subsidiaries that are not run as independent banks, but from a different country.

3.5. In a single jurisdiction, the home/host distinction is nonsense

An industry representative commented that the host/home distinction makes little sense to the goal of becoming a single jurisdiction, as there is a disconnect from the responsibilities of functions. Regulators and supervisors love multiple point of entry (MPE) institutions, because the capital and liquidity management, and risk management, are all under control. This is not how a single jurisdiction Banking Union should function, however, so there is a need to wait before such a proposal can be implemented. An official assed that liability and control have to exist at the same jurisdictional level.

3.6. Lowering Basel III implementation standards?

An audience member asked whether the panel agrees with a French proposal to lower Basel III implementation standards to make EU banks more competitive globally. A central banker referred to the impression that, on the other side of the Atlantic, there are movements to deregulate, and asked if it would be a good idea for Europe to act similarly.

An industry representative supported the idea, pointing out that France has been at the forefront of European financial integration and that revenues go down when interest rates do. Banks do not influence this. Additionally, costs have risen with banks taking on more know your customer (KYC) measures, which has further affected their profitability. At the same time, capital requirements are rising, perpetuating this vicious circle and explaining why the price to book of most European banks is below 100. If banks are already well capitalised, and the liquidity measures imposed on them are an effective tool against failure, they should not need more capital.

Another industry representative stated that regulation is here for good reason. A lot of misbehaviour and problems in the crisis occurred because of low or non existent regulation. Hence it is inadvisable to compete by being more lenient towards banking supervision and regulation.

Having said that, the regulatory tsunami that washed over the banks has not yet been analysed in depth. Overlapping regulations represent overkill. Such a review has been promised time and again, but is still missing, and its absence impacts profitability. Banking institutions need profits to survive, and to attract investment in lending to the real economy, which permits monetary policy to work. In that sense, European regulation is not excessive, and Europe can still compete with a deregulating US, but only if it looks first at which elements of its regulations that are excessive and contradict others. Regulations have been imposed in multiple waves without a global analysis of their consistency.

A central banker likewise advised balance and urged caution about becoming much more lightly regulated, given recent experience of thinly capitalised banks. They gave their agreement that a review is needed soon, though clarified that banks can be well capitalised and also profitable. There is not

necessarily a conflict between strong regulations and well capitalised and successful banks. A second central banker supported this call for regulatory review, both for the banking system and more generally, conjecturing that regulations of the last decade have substantially reduced productivity across many industries, not only banks. At the moment, such regulations seek to specify every possible outcome, when they could become more principles based. A third central banker agreed that not all the many different layers of regulation are necessary. From looking at the American banks, their leverage ratios and their price to book, it might appear that capital is not the problem. An overhaul of the regulations would make life easier for the banks, even though they are partly to blame for this tsunami. The Financial Stability Board (FSB) has also concluded that, after rolling out such a major financial reform agenda, it is logical to carry out some targeted evaluations of whether its objectives have been achieved and if there have been any unintended consequences. ●