Costs and risks of not achieving the Banking Union

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The cost of not achieving the Banking Union

The COVID-19 crisis and its devastating health, economic and social consequences have overshadowed all discussion about the future evolution of the banking union. Yet it was in recent weeks that we realized once more how important is this project, even though it is still incomplete. SSM and EBA have taken various initiatives to indicate a common path for the whole jurisdiction, thus avoiding that national measures end up fragmenting the European banking and financial system. However, this crisis will most likely show how the lack of determination in completing the Banking Union in accordance with the agreed timelines will seriously jeopardised its key benefits. Today the Banking Union means that supervisory and resolution decisions are mostly European, whilst the ultimate guarantor of financial stability remains national, with limited tools to act. This asymmetry might have serious consequences in future possible banking crisis cases, in which decisions will ultimately be redirected to Member States. Few things can be more destructive to citizens' trust in the European Institutions than threats to financial stability, perceived as risking their savings.

The completion of Banking Union is in many aspects a way to restore European citizens' confidence in the European institutions, build the necessary trust between Member States and address the rise of Euroscepticism. With the benefit of almost eight years of hindsight, it is now clear that several links and stabilising elements are missing in the Banking Union. These need to be urgently tackled.

At the top of the list, there is of course a common deposit protection system. As the ECB has shown in a study on the Commission proposal, with proper risk-based banks' contributions, an almost negligible cross-border subsidisation occurs. The fear that this kind of mechanism could imply significant transfers across countries in case of a new banking crisis is therefore unjustified.

The delay in the set up a common deposit protection system has consequences also in the realization of other steps in the field of banking union. One of these is definitely the harmonisation of EU banks' liquidation regimes. First of all, because without EDIS the asymmetric social and economic impact ensuing from the failure of a bank with systemic relevance at local level would remain. Secondly, because in case of failure of a cross-border systemic relevant bank, the national DGSs would have to reimburse depositors in the subsidiary established in their respective jurisdiction, even though they are neither supervising nor resolving/liquidating the parent company. This problem risks of calling into question the single point of entry/multiple point of entry resolution model, to further strengthening of the supervisory powers of the host national competent authorities, and to make the introduction of capital and liquidity waivers extremely difficult.

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Additionally, the entry into force of the BRRD has meant that, as of today, many institutions would only be deemed resolvable if bail-in would be extended to the level of senior debt or even deposits. This, in turn, has had destabilising effects, by amplifying the incentives for a bank run at the earliest sign of distress. Although this problem has been recently addressed with the BRRD review, it is simply not realistic to expect that compliance with Minimum Requirements for own funds and Eligible Liabilities can be achieved by all credit institutions in a very short time frame – especially given the current and future situation in the financial markets due to the COVID-19

crisis - without seriously aggravating their financing costs and profitability. Therefore, resolution authorities need to be able to rely on alternative sources to support resolution actions, such as resolution funds, especially in the current period of transition during which loss-absorbing capacity is not yet fully available.

I truly hope that the challenges brought about by the COVID-19 crisis will help us get out from the risk reduction versus risk sharing debate, to get back to overall objectives of the Banking Union and to move closer to the finish line that was agreed many years ago.

Markus Ferber

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A Banking Union for a stronger Europe

For a successful European economy that can tackle the challenges of the 21st century, such as digitisation and the transition towards a less carbon-intensive growth model, substantial investments will be needed - by the public sector as well as by the private sector. Those investments require financing via capital markets and bank lending alike. Well-functioning and competitive capital markets and European banks as well as a Single Market for banking and financial services are a prerequisite for that. Arguably, such a Single Market must contain a Banking Union and in turn banking groups that are truly active across the entire Single Market.

Over the past couple of years, we have made quite some progress towards that goal: We have established a single rulebook, effective supervisors such as the European Banking Authority and the Single Supervisory Committee, have set up a resolution regime and agreed on high standards for deposit protection. This already sets an effective framework for the Banking Union, but we also need to acknowledge that European markets are still somewhat fragmented and that the Banking Union is not yet complete.

So what could the next steps towards the completion of the Banking Union look like? To put it quite clearly, a fully mutualised EDIS is not a prerequisite for the completion of the Banking Union. Having high common standards for deposit protection as well as certain safeguards in place however is important. These objectives can also be achieved by a reinsurance scheme that provides liquidity between national systems in times of crisis. Other than being the logical evolutionary step, a reinsurance scheme seems to be more viable politically in both the Council and the Parliament as well.

In order to allow for an informed, fact-based and sensible discussion about the way forward, the Commission would be well-advised to finally adopt its implementation report of the existing Deposit Guarantee Scheme Directive that was already due in summer of 2019. A thorough assessment of the status quo of the implementation that also identifies possible problem areas could lift the discussion on more solid ground.

At the same time, risk reduction measures in the banking system should continue. A framework that would facilitate selling and buying of non-performing loans on secondary markets is still missing, which prevents banks from cleaning up their balance sheets. Progress on that front is therefore urgently needed. The same goes for the issue of the regulatory treatment of sovereign exposures. As long as sovereign bonds are treated as essentially risk-free assets, the doom loop of failing banks and failing states cannot be effectively broken.

There are other elements that are holding back the Banking Union though: the lack of a harmonised bank insolvency framework poses challenges for the Banking Union in general and the resolution regime in particular. After all, the resolution regime works on the basis of the "no creditor worse off" principle, which uses the respective national insolvency regime as a reference point. As long as there is no progress with regards to the harmonisation of insolvency law, we will not be able to get rid of the inconsistencies in the resolution regime.

An established Banking Union should make cross-border activity easier for all banks. Increased cross-border activity should therefore allow European banks to grow inside the Single Market and benefit from economies of scale thus improving their competitiveness on a global level. Internationally competitive European banks are in turn an important factor for an export-focussed model of economic growth and therefore for the competitiveness of the European economy as a whole. Therefore, there is much to win if we get the Banking Union right.

Robert Holzmann

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What are the costs and risks of a delayed compared to a half-baked completion of the Banking Union?

Against the background of the current coronavirus pandemic and its economic impact the importance of joint initiatives to complete the Banking Union in a sensible manner is once again highlighted.

In response to the economic and financial crisis of 2008 the European Commission initiated the project of creating a three pillared Banking Union back in 2012 in order to reinforce financial stability by reducing financial fragmentation and by breaking the link between banks and their national sovereigns.

While it was possible to achieve progress on the first two pillars in a relatively short period of time with the establishment of the SSM in 2014 and the operationalization of the SRM in 2016, the finalization of the third Pillar – EDIS – is still in the making. Despite progress in the Banking Union, fragmentation is still a defining feature of the EU banking market. Fragmentation certainly has commercial motives - depressed bank valuations, the declining value of banks' retail franchises and many IT legacy issues discourage consolidation within and across borders. Even more so, policy makers have to contribute their part in completing the banking union. At this juncture, it must be understood however, that both inaction with respect to the completion of the Banking Union, as well as "face saving" half-baked compromises in this regard can entail risks and costs for the Euro area.

Let us turn to the costs of a delayed completion of the Banking Union first. In a truly integrated banking market banks would face a single set of rules and the free flow of capital and liquidity would contribute to lower costs of financial intermediation. This would in turn embolden the ability and willingness of banks to expand across borders and reap optimal returns to scale, thereby increasing the capacity of the system to absorb shocks and supporting banks' profitability. Given that European companies, in particular the large SME sector, rely heavily on bank lending to finance investment and working capital this clearly also has macroeconomic implications.

This brings us to the risks of completing the Banking Union in a way that is unfit to address the underlying challenges. These challenges relate to ensuring the right balance between home and host supervisors, achieving swift further risk reduction and breaking the bank sovereign nexus. What could go wrong? Consider cross border banking groups, whose intragroup capital and liquidity cannot flow freely today. Allowing capital and liquidity requirements to be waived could create significant externalities, as the current ring fencing comes for a specific reason - banks are still "global in life" but "national in death". Risk reduction is another case in point. If we fail to implement the right incentives to ensure a lasting effect of risk reduction on banks' balance sheets, risk sharing could prove to be the bedrock for future risk taking. A similar argument could be made with respect to EDIS. The lack of progress on EDIS is grounded on the fact that the level of riskiness differs across countries' banking systems, as does the extent to which banks finance their own sovereign.

All this shows that any solution that does not tackle the afore mentioned issues will lead to a clearly suboptimal completion of the Banking Union. The current situation caused by the coronavirus underlines the necessity of finding a coordinated answer to this problem. The immediate focus has to be on enabling the banking and financial systems to fulfil their vital role in financing the real economy also in turbulent times. Once the corona crisis has gone by, we however will have to put in place a number of requirements in order to allow an integrated functioning of banking groups while at the same time addressing legitimate concerns of home and host authorities. Banks should continue their pre-coronavirus activities to address pockets of vulnerability, build up loss-absorbing capacity and reduce undue concentration in sovereign exposures. Member States and public sector authorities should establish and enforce credible liquidation regimes for banks with predictable and fair outcomes for creditors at the different levels within a banking group. They should also introduce a last resort fiscally neutral liquidity provision mechanism for bank resolutions, enhance depositor protection in all Member States through the staggered introduction of EDIS and smooth differences in the legal practice of corporate and private insolvencies thus facilitating recoveries. In addition, alternatives to internal MREL within banking groups, e.g., cross-border guarantees based on EU law, could be explored. Progress on all these areas is interdependent.

To conclude, we need to complete the Banking Union and we need to do this in the right way. As the impact of the corona crisis teaches us, taking coordinated action and finding a common European answer is key in this regard. Otherwise financial market fragmentation in the EU will persist leading to higher costs for financial intermediation, limiting the free flow of capital and liquidity across borders, ultimately affecting economic growth and missing out on reaping the benefits of a truly single market. But we also have to take into account, that there are underlying reasons for the currently existing fragmentation in the European banking market, which need to be tackled. ●

Carlos da Silva Costa

Governor, Banco de Portugal

Safeguarding financial stability at local level within the Banking Union

Whilst we must not underestimate the remarkable progress achieved in recent years, we should acknowledge that Europe's financial architecture still needs to be completed and strengthened. Without a pan-European banking system, EDIS, and adequate resolution and liquidation mechanisms, financial crises tend to be local. The responsibility of ensuring financial stability and depositors' confidence lies with individual sovereigns, which have limited instruments and room for intervention. As we stand, effective risk-sharing mechanisms have not been put in place. The sovereign-bank doom loop – the trigger for creating the Banking Union – persists. Indeed, supervisory and resolution decisions are mostly European, whereas the ultimate guarantor of financial stability remains national: banks are European in life but remain national in death, creating a mismatch between control and liability.

As it is clear now, not all countries were ready to implement the Bank Recovery and Resolution Directive (BRRD) as scheduled. This implied that over recent years, some countries have had to resort to alternative instruments to safeguard financial stability – these decisions were met with outcry and criticism as they were perceived as attempts to circumvent the existing rules. It could be argued that the current setup made bank liquidations an easy way out for European authorities as the ensuing financial and political costs lie with national authorities. It should not be forgotten that few things can be more destructive to public trust in European institutions than threats to financial stability. In this regard, the conclusions reached by Denmark and Sweden on the (public) analysis of their possible participation in the Banking Union deserve careful consideration by having clearly identified the risk of conflict arising between the local objectives of financial stability and in the Banking Union as a whole.

Against this background, the harmonisation of EU banks' liquidation regimes has been heralded as one way forward. However, in the absence of an appropriate legal framework, liquidation might imply the immediate interruption of lending support, as well as the suspension of payments; it may have disruptive effects for creditors, depositors and other stakeholders, ultimately reinforcing the sovereign-bank doom loop.

Instead of moving immediately towards such harmonisation, efforts must be made to establish an enabling framework for the orderly management of failing banks of locally systemic importance, combining elements of the resolution and liquidation frameworks, with a view to minimising losses and protecting depositors and non-financial borrowers. Such an enabling framework should include the definition of high-level principles to be agreed by all Member States for application at national level. For those banks assessed as not having (European) public interest, room for manoeuvre should be available in view of national preferences.

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Recourse to alternative measures as foreseen in the Directive on Deposit Guarantee Schemes or to public funds, as an ultimate backstop, should be considered in this regard. It also goes without saying that further stabilisation mechanisms – a fully-fledged EDIS, the provision of liquidity in resolution, a common euro area safe asset – and addressing home-host tensions are also needed and urgent.

This is even more so, as pressure for consolidation to increase profitability and efficiency of the European banking sector is increasing, and raises the question of how to reconcile further integration with safeguarding financial stability at local level in the current incomplete and imperfect set up.

On the one hand, supervisors and regulators should provide a stable view of the supervisory and regulatory frameworks allowing market participants to make informed decisions. On the other hand, without risk sharing and pan-European banks, sovereigns need to find the means to protect competition in their local markets and to safeguard the flow of funding to the economy when branches and subsidiaries of foreign banks exit during a downturn (as observed during the previous crisis).Summing up, decisive political will to move forward with the completion of the Banking Union is required. As the impacts of the coronavirus reverberate, this must now also be a priority for policy-makers and relevant institutions. Failure to do so can call the future of the European project into question. ●

Vitas Vasiliauskas

Chairman of the Board, Bank of Lithuania

Completion of the Banking Union calls for a comprehensive approach

Completing the banking union should remain a key priority on the European agenda. Reaching this goal would help mitigate the sovereign-bank loop, facilitate enhanced competition via expansion of cross-border banking and create additional channels for private risk sharing across the euro area. However, developing the banking union should not come at the expense of the financial stability of individual jurisdictions.

Efforts to finalise the banking union depend on solving a number of complex issues. These include creating a fully-fledged European Deposit Insurance Scheme (EDIS), dealing with some of the inherent inefficiencies in the current regulatory framework and enhancing the crisis management toolkit. In this respect, completion of the banking union should be pursued in a comprehensive manner and feature a package approach.

Some argue that in order to achieve a breakthrough in facilitating the expansion of banking activities across jurisdictions we need to introduce cross-border capital waivers. It is true that ring-fencing practices may to some extent be viewed as hindering the deepening of a single market for financial services. Yet, we also have to recognise that relaxing prudential regulation requirements in the current setting of an incomplete banking union causes financial stability concerns for host jurisdictions. With no EDIS in place, it remains primarily the responsibility of national deposit guarantee schemes to bear the financial burden if a subsidiary fails. Therefore, we need to ensure that facilitating the expansion of cross-border banking does not result in negative consequences for the financial stability of individual jurisdictions.

Against this background, any move towards establishing a mechanism for cross-border capital waivers should be accompanied by implementing adequate safeguards to credibly address the concerns of the host jurisdictions. A possible way forward could be to ensure that subsidiaries eligible for the waiver do not exceed a certain threshold, at the very least the threshold for significance set out in the Single Supervisory Mechanism Regulation. Additionally, the waiver should not be absolute and should have a built-in floor (e.g. 75%), which would in practice limit the reduction of capital held by the subsidiary.

Yet, even implementing the appropriate safeguards will not suffice to fully address the underlying financial stability concerns. This requires a return to the very fundamentals of the banking union's architecture - that is, finally putting in place its third pillar. A fully-fledged common deposit insurance scheme is essential to ensure that measures to enhance cross-border activities do not reduce the overall resilience of the euro area financial system. Ensuring that depositor protection is independent of a bank's establishment location would weaken the link between banks and national sovereigns, while at the same time providing a strong impetus for the expansion of pan-European banking.

> *Developing the Banking Union is key, but it should not come at the expense of the financial stability of individual jurisdictions.*

Furthermore, in order to enhance the financial stability of the single currency area, the current crisis management framework needs to be reinforced. Agreement on creating a common backstop to the Single Resolution Fund represents an important step in the right direction. Nevertheless, it may still not fully address the liquidity needs of a large bank or in the event of a systemic crisis. Therefore, liquidity in resolution remains an important open issue in the current crisis management framework and deserves policymakers' robust attention.

On a broader note, the expansion of cross-border banking in the European Union largely depends on eliminating the existing non-prudential barriers. These include primarily divergent national insolvency and taxation regimes. Without a higher level of harmonisation in these domains, we will still fall short of reaching a truly integrated European banking market. ●