SESSION SUMMARY - VIENNA SEPTEMBER 2018

Optimising the Banking Union

1. Not completing the Banking union would be a great mistake

A public decision maker stated that an analytical argument not to complete the Banking Union would be difficult to make. There should be quick agreement among the panel that, following the enormous growth of the financial sector since the Economic and Monetary Union (EMU) came into being in 1999, it was a conclusion of the crisis that a genuine Banking Union was a missing element in the EMU. Steps have been taken to the extent that there is a Single Resolution Mechanism (SRM) and the Single Supervisory Mechanism (SSM), but it is incomplete, which begs the question of how and when the Banking Union can be appropriately finished.

1.1. The euro area economy and the European banking industry are resilient

An official advised that asking why the Banking Union is necessary is important to keep the broader picture in mind. First, the Banking Union is a core part and an essential element of the EMU, which is still unfinished business. Financial stability was the neglected child in the Maastricht talks of 1990-91 and this will be corrected by completing the Banking Union. That is the main reason why the European Commission suggested pushing forward with the Banking Union in 2010-12 and why an agreement was made by the Member States and the European Parliament in the summer of 2012. Significant progress has already been made since it was agreed in 2012. The Single Supervisory Mechanism, established under the auspices of the ECB, has successfully unified and overhauled the supervision of euro area banks. The Single Resolution Mechanism has given the authorities improved powers to intervene in failing banks.

Second, the economic starting point for euro-area reforms is relatively benign and positive. There is a more political genesis, but the economic context is benign. Growth is strong and solid, and the economy has been in recovery mode since 2013. The ECB's policies have contributed to the turnaround. Reforms in euro-area Member States and better economic and financial governance at the EU level have made the euro-area economy more resilient. There is no return to the unsustainable old normal pre-2008 economic and monetary policy; instead, there is a progression to a new normal equilibrium, characterised by stronger regulation, the utilisation of macroprudential policies and a substantial evolution of monetary policy. Such a context should favour further a strengthening of the institutional basis of the Banking Union, particularly in the areas of banking resolution and deposit insurance.

An industry representative noted that the European banking industry is more resilient than it was 10 years ago and the Core Tier 1 ratio is around 11% on average. The SSM and SRM are in place, although elements are still missing. In order to solve the current stalemate, it is necessary to look at the European banking structure and at questions that cannot be solved by the European Insurance Deposit Scheme (EDIS) proposal such as ring-fencing policies across cross border business which include the free flow of capital and liquidity.

1.2. Where the Banking Union stands following the Council's conclusions on a roadmap to complete the Banking Union (June 2016)

A public decision maker noted that there is a question about where the Banking Union stands following the 2016 Council Conclusions on a roadmap to complete the Banking Union. The banking package is in the trialogue. At the same time, that differences remain became clear from the European Council's discussions in June on the desired degree of risk reduction necessary before moving to EDIS. This is nothing special in Europe. The division of responsibilities to decide on which level certain competences, correct powers and forms of risk-sharing should be brought exists in federal societies such as Europe and in the US. It comes back to striking the right balance between liability and control. The jurisdictional level that bears the consequences of decisions will want a say in discussions.

1.3. Safeguarding the credibility of EU institutions is essential

An official turned to the current situation as perceived from an outside rather than an inward-looking perspective. Banks are in global competition and are strategic assets for the continent. Continued discussion of the Banking Union is puzzling. It is important to consider what that means for a normal EU citizen and whether permanently talking about the Banking Union can convince them. Without minimising the institutional achievement, when the idea of the Banking Union was developed in 2012, it was with political impetus on the future of the EMU and a Banking Union to tackle serious sector-limited issues. Forgetting the big picture could end up creating overwhelming differences.

However there is good news. It is positive for business to benefit from a large market with a cross-border vision. It is positive for the banks that are already cross border; it can even be good for German savings banks that are in the markets for good. Savings exist in some countries due to the well-functioning Single Market and because companies benefit from a larger space. The financial sector must have the same non-fragmented analysis.

'Step-wise' is confusing. Last year, the European Parliament had two years of work on EDIS behind it. It is not fair to put the blame on them, as it is not their fault, but heads of state and government were proclaiming the Banking Union as a positive for outside investors who could know that things are functioning well because of the SSM and the EBA. If promises made at this level are not fulfilled and delivered, given that the Commission made an initial proposal on EDIS in 2015 and a second in 2017, common ground to safeguard the credibility of the political institutions of the EU is essential.

1.4. Trust is built through actions

An official advised that trust is built through actions, not words or beautiful horizons. The examples given illustrate that, for a truly European Banking Union, national governments should understand that the national banking system can no longer be seen as a sort of appendix for national public-policy goals and only that. If that becomes visible, it will create trust among depositors in certain countries that they should also be relaxed about guaranteeing deposits in other countries and banking systems, where there is no longer the national interference that has, unfortunately, characterised European banking for a long time.

1.5. It is in the German interest not to be seen as the ones imposing a vision or system, but as the ones listening to others

Another official noted that if the argument that Germany is two-thirds or one third of the eurozone population is always used as a justification for its system being the right one, something will

be destroyed. A solution must be found which respects the fact that German savers need to be protected and that no one wants to destroy anything. It is also crucial to be aware of other Member States with other structures. It is in the German interest not to be seen as the ones imposing a vision or system, but also as those listening to others.

There are facts and figures that could help to find a common ground on efforts to clean up banks elsewhere, and it is hoped that this could be adopted quickly, as time is running out. Going into the next Parliament will be more complicated. Europe is a good combination of 'big' and 'small' Member States and it is important to build something that is sustainable.

2. Improving the EU resolution framework is a priority

2.1. Balancing liability and control in the Banking Union

A continuous discussion in the EU concerns the division of responsibilities between Member States and the European level. One guiding principle is that competences tend to be allocated to the European level if economies of scale and spill overs between Member States are large, and if differences in local circumstances and preferences are small.

Another principle is the balance between liability and control. The level that bears the consequences of decisions (financially or otherwise), will also want a say in them, for example via policy coordination. These principles are central in the debate on the completion of the Banking Union. Before the financial crisis, banking supervision and crisis management were national. Liability and control were aligned, because EU countries themselves faced the consequences of the failure of a bank under their supervision. Yet the crisis showed that this situation was unsustainable. With the establishment of the Banking Union, the EU was given the responsibility for supervision (via the SSM) and resolution (via the SRM) of large banks. According to a public decision maker, still, the Banking Union currently remains a mixture of European and national elements. In terms of control or policy coordination, the SSM and SRM are responsible for bank supervision and resolution, but bank liquidation will still be executed by Member States under national law. In terms of liability, the European level now bears part of the cost of bank failures via the single resolution fund (SRF) and possibly the ESM-instruments for (in) direct bank recapitalization. It can also impose losses on the private sector via bail-in. Yet an important part of the costs still lies with Member States, because the SRF's public backstop is still in development, because deposit guarantee schemes are national and because national central banks provide emergency liquidity assistance (ELA).

So, the Banking Union is not finished yet. Tensions and discussions may arise as Member States are still partly liable for bank failures while the decisions on supervision and resolution are made under European control.

There are good reasons to complete the Banking Union, along the lines of the roadmap agreed by the European Council. Proposed measures include a public backstop for the SRF and EDIS. Streamlining liquidity provision under resolution is also being considered. The right balance between liability and control is key. These elements all imply more public risk-sharing in EMU as liability for bank failures in other countries is shared at the European level. These measures should therefore be accompanied by sufficient European control over these risks. This is why risk-sharing should be preceded by sufficient risk-reduction.

2.2. Aligning national insolvency regimes with the EU resolution framework in order to avoid a better treatment in liquidation than in resolution

An industry representative agreed that the Banking Union is part of a bigger project. It can be interpreted in two ways: not to focus so much on the Banking Union or taking the Banking Union as a precondition or an element of credibility for the whole approach and purpose. There is a common rulebook with several pitfalls, but it is essentially a common rulebook with common supervision. Other elements remain mostly national. In resolution, there is the mix of common decision-making, the SRM and the SRF, but insolvency remains national. This creates an inconsistency that potentially generates serious problems, which is the work that remains to be done and must be taken seriously.

On resolution, the idea was to make an exception when there is a legitimate public interest to be protected; otherwise, the general case would be insolvency. However, insolvency remains national and, in many cases, inconsistent with the spirit of the European resolution approach. How cases in some countries have been dealt with is remembered. The principle of no creditor worse off than in liquidation could be infringed.

A second issue is being serious about the capacity of capital instruments to effectively absorb losses and be truly subordinated when cases come. It could not be the case that senior debtholders are treated better than in resolution, as could happen depending on the national insolvency rules. Differences remain, including in Spain, Portugal and Cyprus. It is possible to pinpoint a number because the Single Resolution Board has done this analysis. It is public and shows the important differences that should be taken into account.

The aim should be at least for a common legal framework of resolution when it comes to insolvency law and to align it fully with the resolution framework, first ensuring that additional Tier 1 and 2 capital truly absorb losses and remain always the most subordinated classes of credit. It should also be clear that this principle of no creditor worse off should be respected in all cases. Finally, it would be a helpful element of discipline to avoid or limit the discretion that authorities have to decide which bank goes into resolution and which into liquidation. This could be avoided if there is an ex-ante communication of which institutions are systemic and connected to the public interest, and which are not.

This proposal is difficult because there is always an element of arbitrariness and it could also be time dependent; in any case, limiting discretion when qualifying an institution as deserving of resolution or liquidation is key. The harmonisation of these regimes is difficult. Those who look at the EU from the outside, like the International Monetary Fund (IMF), for instance, have proposed a common regime for bank liquidation, giving more powers to the SRM and this proposal is worth considering.

An official considered that the European Commission is specialised in working in the electrical power field between Germany and France, and between the German and French economic philosophies, which are at the heart of the European idea. The Commission will have to continue to do that. The Banking Union must be seen as a comprehensive entity, with resolution and diversity instruments intertwined in ensuring financial stability and the enhanced confidence of depositors in the banking system. Both are almost equally important for financial stability. A well functioning, effective resolution regime is an essential condition for credible bail-in rules. Bail-in rules that compensate for bail-out practices need an effective resolution regime to be credible in practice. The fiscal backstop for the SRM is at least as important as EDIS in ensuring that the taxpayer's purse is not used to handle a banking crisis.

3. A pragmatic way forward towards EDIS

3.1. All depositors should enjoy the same level of protection in the euro area

An industry representative advised that a fully mutualised EDIS is essential to genuine monetary union, because money is not only banknotes. One €50 banknote is worth the same in Athens, Berlin and Madrid, but that does not work for deposits. Consequently, genuine monetary union does not exist. The latest commitment

was to have full fungibility of money, where the value of deposits should be the same regardless of location in the Union and the risk profile of the bank. The principle is to disentangle the sovereign and the banks. The only logical conclusion if this principle is accepted is that it is a must. Otherwise, the link is retained.

It is difficult to think in these terms due to emotions, which cannot replace logical arguments. There is a system that people know, so it is desirable to add belts and braces, but starting at the national level and not moving from there. Doing that misses a number of advantages of having a fully mutualised EDIS on top of other elements of the Banking Union functioning well. The possibility of creating a true market for bank deposits across the Union is missed and with it opportunities for investment where investment is more profitable and attractive. It always creates a suspicion that, when difficulties come along, there will be a capital flight to sovereigns that are perceived to be stronger, because of savings, tradition or low debt, for example, or perhaps the TARGET2 balance is inflating, which a country does not like particularly, and so on.

To prevent moral hazards, contributions to this fund must be based on the risk profile of the institution, not the country. Many feel protected now because the sovereign is strong. This connection is understandable, but this is not in doubt, although the benefits of doing otherwise are different. Even the private sector is aware of an impact study done by the ECB in April on EDIS's impact in terms of response and cross-subsidisation, which is an important issue that is confused with solidarity. Solidarity has nothing to do with EDIS. It is an insurance mechanism, not one for producing transfers from one banking system to another in a systemic way. This is what the ECB says will not happen with a mutualised EDIS. The April study is good. If reinsurance gets stuck in the middle, paradoxically, there will be more transfers between banking systems.

However, it is important to remember that, if single money is desirable, that is both bank money and physical central bank money, each euro needs to be equally protected, given the risk profile of banks across the Union. This is achieved only by having the four pillars operating fully, on a mutualised basis and as mutualised as they currently are, with: regulation; supervision; an ambition for a common scheme on resolution and liquidation; and deposit protection.

3.2. A solution on EDIS must consider the diversity of banks, which requires a mix of remaining national DGS in combination with a European layer

An industry representative referred to the past and the statement of the four presidents at that time, when the third pillar of the Banking Union consisted in the Deposit Guarantee Scheme Directive (DGSD). Consequently, the statement that there is no common EU-level framework for depositor protection is nonsense and altogether wrong.

The optimisation of the third pillar should be in the focus, taking into account that there are questions which cannot be solved even by EDIS. These include ringfencing and problems around the free flow of capital and liquidity within banking groups. It should be borne in mind that liquidity floors and restrictions on group waivers are applied by the SSM and not only by the National Competent Authorities (NCAs). EDIS would not solve these questions, although they are solutions which would be more efficient than EDIS.

The diversity in the European banking industry was mentioned as being a major merit of the European financial landscape by the Committee on Economic and Monetary Affairs (ECON) of the European Parliament and the Economic and Financial Affairs Council (ECOFIN). The Commission's EDIS-proposal not only negatively affects the diversity of the European banking structure, it ultimately is destroying it. This is because Institutional Protection Schemes (IPS) which are relevant for almost half of all euro area banks and cover 20% of all assets, would no longer be workable. Provisions in the DGSD allowing for alternative measures are also important for countries like Italy as they acknowledge another form of diversity: the existence of highly concentrated banking markets, which is important for France. A solution to the discussion on EDIS must consider this diversity and requires a mix of retaining national systems, maybe in combination with a European layer. The aforesaid statement is meant to be a description of the current situation. Besides, the ECB paper mentioned previously is in many aspects flawed and completely neglects the danger of contagion in a single centralised deposit protection system.

3.3. More trust and stability in Europe requires building on existing trust and national DGS and adding at the EU level a mechanism that works and is acceptable to everybody

A public representative advised that initial discussions about making Europe stronger focused on the Banking Union. For deposit protection, looking back into the history of the story, only about 20% of each national fund is to be voluntarily exchanged between Member States, in case it is needed. This was the endpoint of the Commission's proposals for DGS. The Parliament and Council released this and it was not questioned for some time, until the Five Presidents' paper came out (June 2015), without speaking to anybody with an idea on the topic, without having a political discussion and with no political legitimacy. Five presidents found the definition of deposit insurance to be fully fledged mutualisation. This was never questioned again, and that was a mistake.

The aim is the same. The normal European person was mentioned, and people must be able to trust that deposits are safe. The promise made to the outside world of a Banking Union and what happens if it is not delivered was also mentioned. The promise is to give stability to the eurozone and to the EU concerning the question of topics, so it is crucial to be less dogmatic and more pragmatic, and consider what is needed to earn people's trust. Fully-fledged mutualisation does not give trust to people. The normal person wants to know that there is something above if a bank fails. Everyone, including the Germans, must realise that there are countries where people no longer trust national systems. This is a matter of fact. A Banking Union must accept this and find European answers. Something must be built at the European level.

It is intellectually poor to start at an endpoint because five presidents once thought that this could be a good idea without questioning whether it must be the endpoint or if there are other ways to reach the same level of trust. If something is delivered to European citizens at the European level which imparts the feeling that something in Europe can save their money if their bank or national system fails, they will be interested in nothing else. A system which helps to ensure liquidity helps avoid catastrophe, even in a problematic situation, as demonstrated by the Commission's impact assessment produced after the legislation.

To rethink this absurd mechanism: the endpoint was given first and the Commission had to write a proposal for legislation coming to this endpoint. Then Parliament turned to their obligation to write an impact assessment. What is usually the first step happened after the last point, and an impact assessment was written, with one mistake, which can be found on page 33 or 34: a graphic and explanation which was not deleted from the honest impact assessment, showing that a reinsurance system gives as much stability in 99.3% or 99.5% of cases as a fully-fledged, mutualised system. The Commission made an honest

impact assessment before deleting anything that did not fit with the five presidents' expected result.

Returning to this point, being pragmatic means considering actions that work. Having national DGSs in the future and adding something at a European level which gives protection without endangering trust in existing systems will find broad majorities all over Europe. It would be interesting to conduct research into the IPSs in Germany. In years of conversations with people from the system and different organisations, no system is more trusted than the IPSs. The reason is always the promise that everyone will be rescued, no matter what happens. Germany has more deposits than 15 of the other 19 Eurozone Member States. It has the same amount of deposits as France and Italy combined, and two-thirds of covered deposits are in the IPSs. Any European system which weakens the trust of these German deposits weakens the trust of European citizens in that system. Creating more trust and stability in Europe requires building on existing trust and putting something on top that works and is acceptable to everybody.

3.4. A reinsurance scheme seems the consensual way forward

The Chair noted that several proposals have been made on EDIS, with an official Commission proposal on the table. Since then, the Commission has made a series of suggestions to amend the proposal and distinguish between liquidity assistance in a first phase and loss-coverage in a second, with conditionality. Some banking sectors are promoting the idea of an ex-post funded system. A recent Eurofi/Centre for European Policy Studies (CEPS) paper promoted a European Reinsurance Fund. A reinsurance scheme can be beneficial and protect creditors across the Union, notably in cases of multiple bank failures. There is no guarantee that even strong schemes existing in certain Member States can withstand that, and it may be that, whatever the exact shape, a more unified system can do a better job even for those Member States.

An official noted that elements of compromise exist. A reinsurance scheme should be hoped for at this stage. The full mutualisation of risk seems politically not realistic, at least for the time being, so the solution could be based on reinsurance principles. The models presented in the background notes are good starting points and there should be some flexibility as to how to find a practical, pragmatic and functional solution. Finally, this indeed matters to the real economy, and to consumers and citizens. Numbers and macroeconomic figures are important but popular psychology and animal spirits also play a role. There must be momentum shown in EMU completion, to enhance citizens' confidence in the foundation of the euro.

Another official agreed that time can be spent on conceptual discussions around whether completion of risk-sharing is needed or not. From a pragmatic standpoint, the promise to be delivered on is that every European depositor will have their money back within seven days in a bank-default situation. Interim solutions may well focus on liquidity sharing, such as reinsurance or the Dutch situation of a credit-line-exposed arrangement with banks that can double the size of the fund overnight if needed, to satisfy the requirement of certainty of payout being equal everywhere in Europe and the first requirement. If moving from liquidity-sharing to loss-sharing is largely symbolic, then maybe 10 or 20 years from now it will be a non-event, rather than spending time and energy on what is somewhat a theoretical discussion.

An industry representative advised that the EDIS discussion highlights a remaining problem with the link between banks and sovereigns. A large fund would help in the case of a local or national shock that depletes national funds and the national DGS is unable to pay out. That could have happened in a Portuguese case with regard to the insolvency of Banco Popular's subsidiary, where the fund was lower than the payout amount. Fortunately, it did not, but it highlighted the situation.

In that situation additional funds could be helpful, but the systemic financial crisis at the European level could not be covered by any EDIS in the world. That is not something that EDIS is needed for, nor is it the purpose of EDIS or any DGS. Therefore, the DGS could be permitted to borrow from all other European DGSs in case of liquidity stress, to solve this issue of local depletion of funds. Mandatory lending could be a good starting point for a fruitful discussion. ●