OPTIMISING THE BANKING UNION

eurofi

Written by Jean-Marie Andrès, Didier Cahen and Marc Truchet

Executive summary

A better integrated banking system is a pre-condition for a more effective allocation of resources across the EU economy and for reinforcing a stronger Economic and Monetary Union (EMU)

In response to the sovereign debt crisis, the EU created the Banking Union in 2012 to safeguard financial stability (reduce financial fragmentation, break the link between banks and their national sovereigns), to deliver a safer banking sector and protect the taxpayer from the cost of bank failures.

The Single Supervisory Mechanism (SSM) was fully established in 2014 and the Single Resolution Mechanism (SRM) became operational in 2016, together with a Single Resolution Fund which will gradually accumulate and become mutualized in the period to 2024. The Commission put forward a proposal for a European Deposit Insurance Scheme (EDIS) in November 2015 and Member States have agreed to put in place a common fiscal backstop for the SRF again by 2024 at the latest. The Commission proposed a banking package with further risk reduction measures in November 2016, as well as an NPL action plan early in 2018. While the Banking Union is functioning well, EDIS and the common backstop are required in order to achieve fully the financial stability objectives of the Banking Union.

The Banking Union should also contribute to a strong and better functioning Economic and Monetary Union. Firstly, a safer and more integrated banking system would also better support the currency union by improving the efficiency of the transmission of the monetary policy, for which banking activities play an essential role in the euro area.

Secondly by helping to further integrate EU banking markets, the Banking Union would indeed foster a more effective allocation of resources across the Eurozone (e.g. companies would be able to tap wider and cheaper sources of funding), help to achieve a better diversification of risks thus contributing to private risk sharing within the Union[1]. This is all the more essential as the current euro area institutional architecture does not provide for a supra national fiscal stabilization in the EMU (public risk sharing) to address the inherent imbalances. In the US, 80% of asymmetric shocks are smoothed through banking and capital markets and 20% through fiscal stabilizers. In the EU only 20% are smoothed essentially through capital markets and fiscal stabilizers[2]. While in the United States the credit channel accounts for about 20%, in the euro area its contribution is negative, although small, according to a recent study of the ECB[3]. In such a context, in the EU, crisis can only be absorbed through internal devaluation with associated social and political costs.

Thirdly, an integrated banking system would restore and improve savings allocation mechanisms to address productive investment opportunities more efficiently across Europe and in particular the Eurozone. While they share a single currency, there have never been optimal financial flows between the euro-zone countries. Before the 2009 crisis, cross-border financial flows were mainly intermediated between banks rather than within banking groups and were often used to finance inefficient investment (e.g. in real-estate bubbles, sub-optimal business ventures and infrastructure projects notably in Spain, Italy, Portugal Ireland and Greece). Since then, financial flows between the euro-zone countries have declined. ECB facilities have become a substitute for the unsecured interbank market (depressed by a loss of trust during the crisis and by the Liquidity Coverage Ratio

---

[1] The concept of risk sharing generally refers to the notion that economic agents, such as households and firms, attempt to insure their consumption streams against fluctuations in the business cycle of their country, i.e; they try to smooth out changes in their consumption resulting from economic shocks.

Risk sharing is the ability to smooth adverse income shocks in a particular country, through channels that operate cross-border. In a currency union, it operates either by public or private risk sharing. The private channel works through the operation of banking or capital markets. Risk sharing increases the capacity of the banking sector to absorb potential asymmetric economic shocks (or the asymmetric consequences of a common shock) affecting one or two Member States.

[2] In the US, financial markets smooth more than 50% of a shock to state-specific output growth.

[3] ECB Economic Bulletin, Risk sharing in the euro area, Issue 3 / 2018

regulatory framework) in distributing liquidity among banks with high and low domestic funding respectively.

The euro area benefits from a savings surplus of more than €300 billion a year, or 3,5% of GDP, which is no longer being lent to the other euro-area countries but to the rest of the world excluding the euro area[4]. Developing cross-border financial flows within the euro area is essential. The true objective of a currency area is that savings may flow to finance the most productive investments throughout the currency area.

The emergence of effective transnational banking groups is a way for companies and depositors across the euro area to reap these benefits, for improving the financing of EU economies and ensuring the Eurozone's sovereignty in financing. The additional solution is to implement the Capital Markets Union.

The emergence of transnational banking groups would notably help Eurozone excess savings to circulate across borders to those parts of Europe where the most attractive investment opportunities exist (innovation, digital, renewable energy technologies...) and to increase private risk sharing. As local banks are typically heavily exposed to the local economy, a downturn in their home region will lead to large losses and prompt them to cut lending to all sectors. But if there are transnational banks that operate in various parts of the Union, they can offset any losses made in the recession-hit region with gains in another, and can continue to provide credit to sound borrowers. Depositors would also contribute to the financing of a more diversified pool of assets which would insure them against shocks specific to their home country. Such a risk diversification achieved under the surveillance of the EU would also help to reduce the sovereign bank nexus.

Lastly the EU needs transnational EU banking groups to rely on EU sufficient sources of financing and avoid being dependent on international US or Chinese groups.

Such transnational banking groups should go hand in hand with the strengthening of existing diversified banking business models. Such diversity constitutes an asset for the resilience of the EU banking sector and to address a broader range of financing needs. The challenge here is notably to improve the profitability of all existing business models by investing in the digital transformation and addressing the overbanking issue. Similarly while the supervision, resolution and liquidation of transnational banks need to be at the EU level, the supervision, resolution and liquidation of non-systemic local banks should remain at the domestic level but with harmonized and coordinated EU laws to guarantee the level playing field.

Several essential building blocks are missing in order to progress towards a fully integrated EU banking system and make effective that corporates and individuals wherever they are located in the EU can be financed by depositors of a given transnational EU bank.

Despite the implementation of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), the distinction between home and host supervisors and the "national bias" still exists for banks operating across borders in the Banking Union. Ring-fencing policies applied to capital, liquidity and bailinable liabilities clearly distort the functioning of free banking markets, fragment them and impede 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 rely on a large unified domestic market.

In addition, defining prudential requirements at group level should contribute to enhance 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 resource from the parent company. If all resources has been pre-allocated, it is unlikely that any local supervisor would accept that internal MRELs located in their jurisdiction 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 which, in general, lie in the concern that, should a banking group face difficulties, the parent company will repatriate liquidity and capital, to the detriment of subsidiaries in other jurisdictions. This lack of trust between national authorities is one of the most damaging legacies of the recent financial and sovereign debt crises.

The perception of this problem is particularly acute in countries that are strongly dependent on foreign banks for the financing of their economies. 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")[5]. This "outright group support"

[4] German and Dutch savings surplus (external surplus) is no longer counterbalanced by an external deficit for other euro-zone countries, but by an external surplus for the euro zone as a whole.

[5] See E. Fernandez-Bollo, "How to foster trust between home and host authorities in the EU?" Eurofi Magazine, September 2018.

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 any difficulty of their subsidiary located in the euro area. This group support should be based on EU law and enforced by EU authorities. 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 addition if the group was to go into liquidation (and not only local subsidiaries), a European approach to liquidation of these transnational banking groups is also required. Indeed despite the fact that these transnational banking groups are supervised at the EU level and that the impacts of this liquidation would impact the whole euro area, the liquidation is still managed at the national level (entity by entity) and this can require 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 to address the possible costs at the EU level.

These are the two conditions for the abandonment of the "national and solo approach".

It is also important to assess if the governance of the SSM and the SRB needs to be improved in order to ensure an effective confidence by national supervisors on SSM and SRB decisions and to clarify possible trade-offs between local financial stability issues and euro area wide ones ad how to deal with both.

Finally 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 creep in 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 a banking (or capital) union are not workable without economic convergence and fiscal discipline.

Detailed summary

I. The persistence of fragmented banking markets in the Eurozone, despite a common supervision, mainly results from the solo approach of the EU banking regulatory framework

While supervisory and resolution decisions are now taken at the Eurozone level, following the implementation of the SSM and SRM, a further integration of Eurozone banking markets is needed to achieve the private risk sharing and optimised resources allocation objectives of the EMU. Banking markets within the Banking Union are largely fragmented along domestic lines: corporate and retail banking markets are still essentially domestic, financial flows within the banking union have not returned to their pre-crisis level, and in many countries the links between sovereigns and domestic banks have not disappeared.

This fragmentation is mainly due to the EU regulatory framework, which does not consider trans-national banking groups structured around subsidiaries at the consolidated level, but as a sum of separate subsidiaries. This was not reviewed when the Banking Union was implemented, and the discussions on the current banking package show the persistence of the difficulties. This limits the possible benefits of developing trans-national banking activities since the management of liquidity and capital is not possible at group level:

- The CRD, CRR and BRRD adopt a solo approach for the definition of capital and liquidity requirements (LCR, NSFR, MREL, leverage...). See Annex for further details
- The pillar II SREP (Supervisory Review and Evaluation Process) requirements for banks are also defined and calibrated for each subsidiary.

II. Concern about the way possible banking group resolutions may be handled in the EU is the main underlying factor of this non recognition of banking groups in the regulatory framework

Many Member States, which are dependent on Eurozone banks situated in other Member States for the financing of their economies, are not inclined to move towards a more integrated management of capital and liquidity at banking group level, despite the common supervision of Eurozone banking groups.

This is because they are concerned by the impact that the possible failure of one of these transnational banking groups or their local subsidiary might have on their depositors and on their economies, and by the fact

that these impacts would have to be addressed entity by entity domestically.

Three main factors explain these concerns (aggravated by the slow resolution of NPLs and persistent high level of debt in some countries):

- The **availability of group financial support** to a failing subsidiary is not guaranteed but conditional in case of bank failure according to the rules of the BRRD. In addition in some cases living wills do not specifically define how different subsidiaries would be treated in a resolution context.
- No rule currently prevents liquidity from being **abusively removed** from a foreign subsidiary by the parent company prior to resolution.
- The treatment of bank failures across the EU is not sufficiently **harmonised, consistent and predictable**[6]. Indeed the EU transnational banking groups are supervised and resolvable at the EU level but the liquidation is still managed at the national level. In addition defining and agreeing on what constitutes a 'critical function' is an area of concern. While significant progress has been made in the collection and analysis of data, some important gaps exist between Member States. Such divergence in understanding also contributes to undermine cooperation and trust.

III. A more integrated approach to resolution and liquidation is needed to fully benefit from the Banking Union

Developing private risk sharing through banking activities within the euro zone requires that for each transnational group, all its liabilities (deposits, bonds…) whatever their location in the Banking Union, should contribute to the financing of all its assets (credit, financings…) in the Banking Union. Thus capital and liquidity should circulate freely within these banking groups. For this to be possible, i.e. addressing the three factors mentioned above, which explain the concerns of many Member States, these groups have to be treated in practice as a single entity from an operational, regulatory, supervisory and liquidation perspective.

With the establishment of the Banking Union, the SSM was given the responsibility for supervision and the SRM as given responsibility for the resolution of systemically relevant banks. Nevertheless, the Banking Union 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 of the systemically relevant banks, but responsibility for supervision and liquidation of non-systemically relevant banks is still executed by Member States under national law, which can lead notably to a different treatment among the creditors of the same rank within the Group in case of its liquidation. In this sense, it is necessary to align national insolvency regimes with the EU resolution framework avoiding all inconsistencies between treatment in liquidation and in resolution.

Of course the current solutions for completing the Banking Union (EDIS, the backstop to the Single Resolution Fund) and clarifying the issue of liquidity in resolution[7] would strengthen the credibility of the bank crisis management therefore contributing to achieving the initial financial stability objectives of the Banking Union. As the current set-up with national deposit guarantee schemes remains vulnerable to large local shocks (in particular when the sovereign and the national banking sector are perceived to be in a fragile situation), common deposit insurance would increase the resilience against future crises as mentioned in the Five Presidents' Report: Completing Europe's Economic and Monetary Union (June 2015).

However completion of EDIS and the SRF backstop should not be preconditions to further advances to fully address the current fragmentation issues in the EU banking markets. Indeed a transnational group should guarantee the unconditional support to all its entities located in the euro area in case of difficulties before a possible resolution situation. In addition Resolution and liquidation should be conducted at group level and no longer entity by entity.

IV. Possible solutions to achieve an effective Banking Union

An effective contribution of transnational banking groups to intra-Union risk sharing requires that all the liabilities of such groups, whatever the subsidiary they are located in, should finance the assets wherever they are located notably in the Banking Union. Consequently capital and liquidity should circulate freely within the Group.

The fully integrated functioning of transnational groups needs to be European in life and European in death.

[6] Whether competent authorities are resolving (CRD and State Aid regulation) or liquidating (State Aid regulation) a transnational banking group, and whether the effects of a liquidation and notably its implications in public interest and critical financial functions, are assessed at EU or national levels (which apply different sets of criteria), the impacts in terms of levels of state aid and bail-ins are very different. Furthermore, in the event of a liquidation, which is handled at the entity level, the creditors of the same rank of different subsidiaries may be treated differently across the Eurozone

[7] A credible tool is indeed needed to address the risks of banks having insufficient liquidity following resolution actions. For instance, as proposed by S. Goulard in the Eurofi Vienna magazine, a single liquidity provision scheme implemented by the Eurosystem and compliant with EU monetary policy rules could provide liquidity to the banks whose financial situation has been restored following the resolution process.

These groups have to be treated in practice as a single entity from an operational, regulatory, supervisory and liquidation perspective for Member States to benefit from intra-Union risk sharing.

In return, all these subsidiaries located in the euro area should benefit from an outright financial support of the Group. At the same time, these liabilities when they have the same rank should be treated equally in the event of a liquidation or resolution.

This entails that all the subsidiaries of these transnational groups that wish to operate in an integrated way should benefit from an unconditional financial support of the Group based on EU law and enforced by EU authorities. This is already the way groups structured around branches function. This is not currently possible for the other banking groups since the solo approach prevails for banking regulation (prudential, recovery and resolution). This is why credible guarantees, provided by EU parent banks to their subsidiaries located in the euro area, based on EU law, and enforced by EU authorities are urgently needed during going-concern and not only during resolution. These guarantees would by nature increase trust between authorities. This commitment is the key condition for these banking groups to define prudential requirements at the consolidated level.

In addition if the group was to go into liquidation (and not only local subsidiaries), a European approach of liquidation of these transnational banking groups is required. Despite they are supervised at the EU level and that the impacts of their liquidation would impact the whole euro area, liquidation is still managed at the national level (entity by entity) and this can require public money of the Member State where the subsidiary is located.

Therefore, a new EU legal framework should ultimately be created for managing the liquidation of trans-national banking groups operating in the Banking Union. It would impose consistent conditions for all banking groups in the euro area (i.e. an unconditional financial solidarity among the different entities of these groups and an equal treatment in liquidation or resolution, of all the creditors located in the Eurozone). This should go together with a review of the governance requirements for Eurozone-based banking groups (e.g. an integrated organisation and policy for monitoring risks, compliance, legal affairs and internal control).

In an interim stage however, one solution would 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 that does not require regulatory changes 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 the 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 appropriately contribute to supervisory decisions taken at the SSM level that may impact their jurisdiction.

A solution is also needed to facilitate the contribution of cooperative and mutual banks to the cross border integration of EU banking markets. One possibility could be to facilitate the cooperation between regional banks on a transnational basis.

Annex: the EU prudential framework does not recognize trans-national groups at the consolidated level but as a sum of separate subsidiaries (“solo approach”)

Much progress has been made in a limited amount of time with the achievement of a common banking rulebook and the establishment of the institutions of the Banking Union: the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM).

However, the integration of banking markets within the Banking Union is still limited. The 20 trans-national banking groups that operate within the Union currently appear to function more like a collection of national banks than as integrated banking groups and only playing a more limited role in terms of intra-Union risk sharing and capital allocation.

The Liquidity Coverage Ratio (LCR), which is designed to ensure that banks have the necessary assets to face short term liquidity disruptions, is indeed calculated on a solo basis since liquidity excesses in one subsidiary cannot be used to compensate for possible shortages in other ones.

The EU Commission has also proposed that the Net Stable Funding Ratio (the NSFR) agreed in Basel which seeks to calculate the proportion of long term assets which are funded by long term stable funding and is currently being discussed to be transposed in the EU

legislative framework) should be calculated both at a consolidated level and on a solo basis. This would oblige banking groups to manage their long term funding also on a local basis, which would add complexity and costs.

Another area where bank groups may not be considered on a consolidated basis from a regulatory point of view is the calibration of Minimum Requirement for own funds and Eligible Liabilities (MREL) currently discussed in the context of the BRRD/SRMR where domestic resolution authorities may have the possibility to add MREL to local subsidiaries of banking groups on top of the MREL decisions made by the SRB. This may lead the subsidiaries of banking groups to have different levels of MRELs from those of domestic banks of an equivalent risk profile and the sum of local MREL to exceed the level of MREL defined at the group.

The main benefits of defining MREL only at the group level rather than also on the level of each subsidiary (internal MREL) is that in the case of a loss in a subsidiary that would be superior than the amount of internal MRELs prepositioned in the country of this subsidiary, it would be easier to allocate the required capital from the parent company to this subsidiary since it is likely that no local supervisor would accept that internal MRELs located in their jurisdiction be transferred to another one.

A further issue is that banking operations between two EU countries, including in the Euro area, continue to be considered as cross-border operations by the EU prudential legislative framework in the calculation of the Global Systemically Important Bank (GSIB) systemic risk buffer.

This solo approach maintains a domestic focus in the way prudential requirements (capital, liquidity leverage) are imposed on banking subsidiaries across the Eurozone, despite the single supervision principles of the SSM and the involvement of domestic supervisors in the supervisory decisions taken by the SSM. Consequently, the opportunities existing in transnational banking groups to pool cash and match assets and liabilities of similar maturities and therefore to increase intra-Union risk sharing, within the Banking Union are not taking advantage of. Additional regulatory constraints are imposed. This reduces the expected benefits of trans-national development for Eurozone banks in terms of the cost of capital, funding and further intra-union risk sharing, creating major disincentives and hindering a further integration of banking markets in the Banking Union.

In addition, the single rulebook is not truly single, since it contains national options and discretions (OND), which provide government and supervisors with some leeway in applying the rules. Supervision also remains fragmented even if the SSM has harmonised the main tool of banking supervision: the Supervisory Review and Evaluation Process (SREP). However the SREP remains a collection of requirements (capital, liquidity, leverage) regarding both the group as a whole and each of its subsidiaries. Moreover certain supervisory tools are applied in different ways in different countries (e.g. onsite inspections) and tools exist in some countries but not in others (e.g. moratorium).

In the current situation, transnational banking operations are more complex and costly compared to domestic ones, which is a result of additional regulatory requirements (national and solo approaches). The Banking Union is a source of costs for the significant supervised entities – contribution to the Single Resolution Fund, internal loss absorbing capacity (iMREL), additional compliance costs – but has not yet produced beneficial effects on banking integration.

Notes

eurofi

eurofi