SESSION SUMMARY - BERLIN SEPTEMBER 2020

Does the Covid-19 crisis reinforce the case for the Banking Union?

A Central Bank official described how the idea of the Banking Union started with the advent of ECB supervision, which took place in the aftermath of the general financial crisis (2008–2009) and the Eurozone sovereign debt crisis (2011 2012). Now, Europe is dealing with a new and previously unforeseen crisis. COVID 19 is an almost academic example of an exogenous crisis impacting the financial sector, and there are important questions concerning how it will interact with the project of the Banking Union.

1. The COVID crisis shows that Banking Union has been successful in promoting a more resilient banking sector, but Banking Union needs to be completed

1.1 The Banking Union has been a game changer in terms of developing bank resilience

Thanks to the Banking Union, the EU banking sector entered the COVID crisis in much better shape than in previous crises. An official considered it is obvious that the Banking Union has been a game changer despite the fact that it is still incomplete. If the financial industry had faced the current crisis as it had been in 2007, the banks would have been heavily affected.

An industry speaker noted that the COVID crisis began in the real economy and necessitated decisive action in fiscal policy, regulation and state aid to stabilise the economy. The risk of fragmentation in member states' fiscal policy responses will hopefully be mitigated by the historic €750 billion recovery fund. However, when assessing the functioning of the Banking Union in times of COVID-19, this concerns is a project about regulation and supervision, where there has been consolidation instead of fragmentation. The ECB introduced a set of COVID related supervisory measures, and the EBA issued recommendations. In all member states, Finance Ministries and supervisory authorities have taken action. This suggests that regulators and supervisors have ample flexibility to act decisively.

An official underlined the substantial benefits of the SSM and the project of a Banking Union. The Banking Union and all the other regulations, including the NPL rules, have left the banking sector better prepared than in previous crises. This success has been achieved due to the Single Supervisory Mechanism (SSM). The official described how Germany would seek to make progress on a Banking Union and a Capital Markets Union (CMU) during its Presidency of the European Council. During the COVID crisis, corporates and companies were forced to borrow money from the markets, which illustrates why the project of the CMU is also essential.

A regulator considered that to improve real growth an economy needs equity and a vibrant equity market, which highlights the importance of CMU. The Banking Union and the CMU share many problems, however, such as the lack of a harmonised company law and insolvency rules.

1.2 The COVID crisis has created a divergence in member states' economic performance and further fragmented the Banking Union

An industry representative agreed that the key difference between the current crisis and the global financial crisis (2008) is the fact that the banks are not the crux of the problem; rather, they are at the centre of solving the problem. Nonetheless, the situation in the financial markets demonstrates how there is still a risk of economic and fiscal divergence in the Eurozone. This divergence contributes to the risk of a sovereign debt crisis, which suggests that Europe needs a safe asset. Despite the positive summit in July and the new European recovery fund, the Northern European countries are able to increase levels of stimulus and extend fiscal stimulus measures while other countries will have to wait until at least next year to do this.

1.3 The COVID crisis demonstrates the importance of breaking the link between sovereigns and domestic banks and therefore avoiding any amplification of divergent forces in the Eurozone

An industry speaker considered the crisis to have increased the need for and likelihood of founding a Banking Union. The crisis has increased the fragmentation of EU banking markets. The impact of the COVID 19 crisis was extremely uneven. There was a common shock, but there were different features in different countries. The initial reaction necessarily included a relaxation of the state aid framework, but this created a problem for the single market. The subsidies and guarantees offered to bank customers varied significantly from country to country and banks' holdings of home country government bonds have significantly increased.

A public representative agreed that the COVID crisis made achieving a Banking Union even more important. Before the crisis, the project of a Banking Union was 'moribund'. Of the three pillars, only the SSM was operating properly. Even though the Single Resolution Mechanism (SRM) was well established, states have managed to circumvent it (e.g. the rescue of the Veneto Banks). Additionally, there was no deposit insurance scheme and the precautionary recapitalisation rules allow some banks to avoid the European solution and undertake national recapitalisation. This has been exacerbated by the crisis. Each state is undertaking its own action and there is a lack of European instruments to manage the situation. Regulators have sought to ensure there is sufficient capital and liquidity in each market, which means that markets have become more local. In order to avoid this, the SRB should manage EDIS once it is created. The public representative considered that Europe needs a system modelled on the FDIC, noting that the BRRD review is a clear opportunity to introduce EDIS.

1.4 Fortunately, EU leaders reacted swiftly and decisively

A policy maker praised the 'European leap' taken by leaders to issue bonds at a European level. However, the situation around a Banking Union is extremely difficult. Europe must address liquidity in resolution and the backstop to the Single Resolution Fund (SRF). An industry representative observed that the Next Generation EU package is a very encouraging reaction. This package makes a Banking Union not only more necessary but also more likely, because it includes the embryo of a common safe asset.

1.5 Completing the Banking Union and realising a Capital Markets Union (CMU) are urgent needs

An industry speaker emphasised that the restoration of growth and investment will require a CMU. It is certainly important to finalise the Banking Union, but Europe's growth requires more venture capital or risk capital. In this respect, the CMU is more helpful than the Banking Union. A Central Bank official noted that Banking Union and CMU are necessary and complementary.

A regulator described how banks, the public sector and supervisors have sought to be accommodative during the first phase of the crisis. However, it is essential to find a 'wise exit' from the support measures. The industry must decide which businesses have viable business models and which businesses already had problems which were aggravated by the crisis. The crisis must be a catalyst for transition and reform.

2. The unprecedented magnitude of the current macroeconomic shock is deteriorating the asset quality of banks, and the expected increase in distressed exposures will require specific measures, such as a European bad bank

The financial and economic outlook is still largely uncertain. Banks are under severe profitability pressure, and asset quality deterioration would imply an additional burden at least for those institutions that are still recovering from the financial crisis. If the situation worsens, the depletion of bank capital would be material. An industry speaker suggested that there will eventually be a cliff edge effect in the eurozone when governments' support measures expire, which creates a risk of increasing NPLs. Banking Union must continue in order to avoid the future divergence triggered by NPLs, defaults and insolvencies.

A public representative stressed the importance of ensuring that loan deterioration does not hamper growth. This current crisis is specific: although many bad loans will be from large banks to corporates, a substantial share of NPLs is likely to be small loans to SMEs with little collateral. This demonstrates why the legislative work on NPLs must continue. A network of national bad banks would not be an appropriate solution, however, because coordination would simply increase banking fragmentation. Experience shows that enforcing a common interpretation of European rules would be impossible. In matters such as asset transfer prices, it is hard to imagine a member state tying the hands of its Asset Management Company (AMC). As the Wirecard example shows, there would be massive regulatory nationalism.

A public representative highlighted the fact that widely different levels of available funding in each country would produce vastly different levels of recapitalisation in different banks and therefore lead to further fragmentation. If the solution is a network or federation of national bad banks, it will not perform as well as it did during the general financial crisis, because SMEs are much harder to manage than real estate. If there is a bad bank solution, it should be European and based on EU common rules. Innovative AMCs could be set up at a European level. The BRRD already enables the creation of EU wide AMCs funded by the SRF. Following the BRRD, aid outside resolution would be allowed through precautionary recapitalisation if it is not granted to offset losses that have already been or are likely to be incurred.

3. Solving the home host issue

Until now, the existence of the SSM and the SRM has not had a marked impact on the banking industry's structure in Europe. Obstacles to the integrated management of bank capital and liquidity within cross border groups operating in the Banking Union remain persistent. Therefore, it is still a key priority to find a pragmatic agreement between the SSM and host national authorities on how to abolish ring fencing.

3.1 Fragmentation and local particularities prevent European banks from fully benefiting from economies of scale and diversification within the Banking Union

An industry speaker described how times of crisis produce 'national reflexes', noting that this crisis is no different. Local decisions often do not match the decisions taken by the SSM. The short answer to many of Europe's problems caused by these 'national reflexes' is further integration of the banking sector and the finalisation of the Banking Union. The industry speaker's firm tries to manage liquidity and capital freely between its subsidiaries, but there are always local constraints. There is a similar situation in relation to dividends, as the SSM has recommended a carve out of intra group dividends but this has not been implemented by most local supervisors in Central and Eastern Europe. The lack of consistency and fragmentation also affects shareholders. Europe wants strong and well capitalised banks, but its banks must compete at a global level when it comes to capital markets and raising capital. This is a component that is factored into the valuation of European banks.

3.2 The possibility of consolidated capital and liquidity ratios for EU banking groups

An industry speaker described how the desire for a Banking Union is often a desire for 'more SSM and less national authorities', noting however that their firm considers that the idea of 'more SSM' should entail the facilitation of a free flow of liquidity and capital within European banking groups. It is very important to consider capital ratios and liquidity requirements at a consolidated level rather than fragmenting these assessments and considering each legal entity in a cross border banking group individually. While local authorities could find this idea somewhat concerning, the European regulators have a mandate to do this. There is an opportunity to develop a reassuring framework for remediation measures to be taken by local entities, subsidiaries and individual countries. In that context, the industry speaker highlighted the potential for a waterfall scheme, for example. The SSM can consider this issue in a consolidated way and encourage the freedom of capital and liquidity across banking groups.

3.3 The creation of a common European deposit insurance scheme (EDIS) could help the home host issue

An industry representative suggested that even approaching the coordination problems of cross-border banks in the Eurozone in terms of home and host is paradoxical. This

is incompatible with a genuine single market in financial services and reflects the inconsistencies of an incomplete Banking Union. When Europe has common deposit insurance, however, the paradox will disappear.

3.4 Solving the home host issue is essential for cross border banking consolidation

A policy maker stressed that solving the home host issue is difficult but unavoidable. The profitability of European banks is forecast to decline, with a rising cost of credit and extremely low interest rates. It extremely important to create more incentives for banks to consolidate on a cross border basis. It is essential to break the deadlock between those who want the full prepositioning of MREL liquidity and capital and those who want to manage this centrally.

An official suggested that the SSM has a well-known stance on trying to integrate the market further. To do this, however, it is essential to convince national authorities that the European authorities are as concerned with local financial stability as with European financial stability. The SSM is not a home supervisor; it is both the home and host supervisor. The SSM is also responsible for subsidiaries, and it takes this responsibility 'very much to heart'. This is why the SSM is ready to try, even after seeing the regulation, to embed this responsibility for subsidiaries.

3.5 Additional conditions for fostering cross border banking

3.5.1 Fostering cross border banking does not need EDIS

An industry speaker suggested that solving the so called home host issue does not require EDIS, as restrictions on the free flow of capital and liquidity are set by supervisors. In a recent article published in the Financial Times, Axel Weber 'points his finger' at the regulatory barriers to cross border banking, specifically highlighting the ring fencing of capital and liquidity and the absence of an EU payments scheme. The ring fencing and unequal treatment of parent subsidiary structures and parent branch structures in Europe is the principal disincentive to cross border mergers. One example of a supervisory practice which is a roadblock to pan European banking is the G SIB methodology, where cross border activities are strongly penalised. Such obstacles to cross border banking will not simply disappear with EDIS.

3.5.2 The lack of attractive business models is the main disincentive to cross border mergers

A regulator highlighted the economic reasons for the lack of cross border mergers. There must be a value proposition and a business case for a cross border merger. Mergers are taking place, but they are easier to achieve on a national basis because it is easier to realise synergies through national mergers. In reality, there must be decent value propositions and business proposals for European mergers.

4. A further strengthened and aligned crisis management framework is needed

4.1 Europe needs a harmonised bank liquidation regime for small and medium sized banks

A policy maker emphasised the importance of enhancing the EU crisis management framework which could be improved in a number of ways. The achievements of the BRRD could be complemented by a harmonized bank liquidation regime. Europe should assess how to use certain tools of the BRRD toolbox also in national insolvency proceedings for banks.

A panellist suggested that the current resolution toolbox should be able to be applied more easily, which might involve an adjustment of the public interest test. This requires an assessment of the existing funding architecture and liability structure of banks in order to determine how these tools can be used effectively for less complex deposit taking banks. Additionally, there is a case for improving the conditions for DGS funding in crisis management through the least cost test and/or potentially adapting the conditions to access the resolution fund.

A policy maker described how the EU has diverse insolvency rules. It is important to ensure the triggers for 'failing or likely to fail' and normal insolvency proceedings are consistent to avoid loopholes between the European level and the national level, i.e. the so called limbo situations. Insolvency ranking is another issue, particularly questions about whether there should be a higher level of preference for deposits.

4.2 Paths towards a clear and predictable liquidation regime

A regulator stated that the resolution framework is fit for purpose. There are several issues for the industry to address, and not all of these actions require legislative changes. The Commission must ensure that there is a consistent way of managing resolution, insolvency and the 'creative' forms of market consistent measures. Banking communication must be aligned or there will always be circumvention.

A regulator agreed that there are clear issues with the bank liquidation framework, however. There is a European resolution framework which is matched by 19 different liquidation frameworks. It is essential to establish a European framework to deal with all banks that need to be liquidated, and in particular the deposit funded medium sized banks with no access to wholesale funding markets. These banks might be too small to be resolved while at the same time too big to be liquidated.

4.3 The completion of the Banking Union is a matter of consistency

An industry representative considered that the missing elements of the Banking Union are well known. There is no rationale for Europe to have two pillars of Banking Union – i.e. supervision and resolution – without the third one (a common deposit insurance). Additionally, Europe must fix the resolution regime, and there are issues about what action to take on NPLs and sovereign risk.

A policy maker stressed that EDIS remains high on the list of priorities. If Europe wants a unified market, there must be unified protection for depositors. Over the last two years, views have converged on a hybrid model. This can evolve over time, and it will be possible to adjust different parameters in this model. The project can start slowly with a focus on the provision of liquidity through the embryo of a European fund, and then it can move gradually towards a European centre that gains in importance and progressively moves to loss coverage.

4.4 Improving the crisis management framework is one of the priorities of the German Presidency

An official described how Germany's Federal Ministry of Finance is working in close cooperation with the Commission on the Banking Union. There is a potential for further refinement in two areas. First, there are frictions between the EU resolution framework and national insolvency regimes. Key point here is a further harmonisation of the ranking of deposits in the creditor hierarchy. Second, there are smaller

banks below the threshold of the public interest for which the requirements of resolvability are not a suitable standard. The official outlined how the German Presidency will seek to advance a harmonised liquidation regime that adds to the toolbox for the liquidation of banks. This will ensure the market exit of non viable banks while minimising the disruption caused by insolvency. The intention is to lay the basis for a legislative proposal by the European Commission that will move forward next year.

An official stated that the issue of fragmentation has become more difficult to address during the COVID crisis. There is ring fencing in some member states, but Germany is committed to continuing the discussion with home and host countries to find a suitable solution. Overcoming this fragmentation will be essential to the project of Banking Union in the long term. Banking groups need to be able to allocate capital and liquidity within their groups, but cross border banking should not come at the expense of local financial stability. It is a task for the SSM to assuage these concerns. The official stressed that a common deposit reinsurance scheme is only one element in the long term picture of the Banking Union. The principal element to address is the finalisation of the common backstop. Responding to a query from a Central Bank official, the official suggested that it difficult to predict whether the backstop to the SRF will be finalised during the German Presidency, expressing cautious optimism about the fact that several member states are in favour of the package on the table.

A Central Bank official stressed that the COVID crisis created the possibility to finalise some of the previously outstanding elements of the Banking Union and to launch some new initiatives. The revision of the BRRD and the question concerning liquidation are two key topics here.

5. The situation remains unstable

An industry speaker opined that the present situation is unstable. If Europe does not move forward, it will move backwards. The industry speaker considered that the industry realises the situation is unstable. Hopefully, mistakes will not be made in tackling the COVID crisis; but if this is the case, the fact that European supervision and resolution are backed by national deposit guarantee schemes and ultimately by national taxpayers is a source of tensions. Even if the resolution framework is excellent and even if the deposit guarantee scheme is protected by any means necessary, the credibility of the deposit guarantee scheme ultimately depends on the implicit guarantee of the treasury. This fact becomes even more relevant without a liquidity in resolution mechanism. Europe is probably the only area in the world without a framework for liquidity in resolution, which exacerbates the inconsistency of the current framework.

An industry speaker stated that there are many right ideas for developing flexibility in the resolution framework. The implementation of the resolution framework has been disappointing, however. Each crisis has been different, and there is no consistency in the way Europe has approached the crises. However, it is important not to forget that the bail in tool is the cornerstone of the resolution framework. Additionally, Europe's insolvency rules should be harmonised. Spain experienced the problem of having a different creditor hierarchy in resolution and liquidation.

A public representative noted that the panel did not discuss the possibility of a full blown banking crisis as a result of COVID. In its analysis on 28 July, the ECB declared the banking sector to be more or less sufficiently resilient, but the ECB did not anticipate a second wave of COVID 19.

A Central Bank official described how the ECB published its vulnerability analysis in July on the basis of the data available at the time. The ECB made assumptions about the real evolution of the COVID crisis and its economic implications incorporating macroeconomic scenarios as least as severe as those published by the ECB. The impact was around 50% more severe than the EBA stress testing exercise that did not take into consideration the health crisis. This suggests that the banks will not emerge unscathed from a second wave of COVID 19. Even in this situation, however, the industry would not face problems on the scale of the financial crisis in 2008. If there is a second wave, the authorities will need to act. The ECB will need instruments of action and will need to work closely with the SRB. The events from July to September have in fact been better than the ECB's forecast. The ECB's message is that something will have to be done in the event of a second wave, but the system is not completely frozen, and it does not have the kinds of structural problems it had in the past. ■