BANK FRAGMENTATION AND CONSOLIDATION: ARE PROSPECTS IMPROVING IN THE EU?

The Banking Union was a response to the EU sovereign debt crisis, but it is failing to provide the expected degree of financial integration. Indeed, despite the creation of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), the banking sector remains in Europe too fragmented and oversized, and market concentration has only progressed at domestic level. During this session, there was an overall perception that there is a lack of trust between home/host authorities, a lack of trust in the business models of many banks and a lack of trust for investors in returns on the banking sector. Actually, the Banking Union has come to a complete standstill. Different pathways to reignite this project were discussed.

1. The Banking Union has come to a complete standstill

A great deal has been achieved during the past decade on the supervisory side. However, the existence of the SSM and the SRM has not had any marked impact on the banking industry's structure in Europe and the COVID-19 crisis has increased fragmentation across the Banking Union. Member states have ring-fenced their banking sectors and various barriers impede cross-border consolidation.

1.1 The European institutional landscape has improved compared to what it was 10 years ago

An international official commented that, from a broader historical perspective, an enormous amount has been achieved in the euro area on the supervisory side in a short span of time. The SSM and the European Central Bank (ECB) played critical roles in this. The huge economic crisis of the pandemic has not translated into a banking crisis. One consequence of this success is that the policy impetus for Banking Union has diminished.

A Central Bank official agreed that the situation has changed completely since the crises of 2008 and 2011, when every supervisor tried to protect its own banking system by erecting barriers within the European Union, which made the global financial crisis and the European sovereign debt crisis more difficult to treat globally. There has been great progress made in the supervisory architecture in Europe since that time, but there is much further to go.

1.2 The existence of the SSM and the SRM has not had any marked impact on the banking industry's structure in Europe and the COVID-19 crisis has increased fragmentation across the Banking Union

A public representative stated that the factors leading to the doom loop and the factors leading to fragmentation were the two key drivers of starting the Banking Union. These factors have not reduced. In countries like Spain and Italy, the amount of sovereign debt in the hands of the domestic banking sector is still very high. There have been no improvements in cross-border lending and fragmentation.

An industry representative suggested that there would likely be general agreement that no progress has been made on market integration. Instead, there have been symptoms of market fragmentation. More market fragmentation leads to more doom loop risks and therefore a move away from integration towards more national approaches to integration. This must be addressed.

A public representative noted that the Council has developed a roadmap. However, there is a German-Italian conflict, where Italy is not willing to reduce the sovereign exposures and Germany is not willing to introduce deposit insurance. As such, the roadmap is not progressing.

An industry representative emphasised that the issue in Europe cannot be reduced to an Italian versus German conflict. A Central Bank official stated that it is not the case that all progress in the regulatory framework is currently impossible and agreed that the idea of an Italy-Germany conflict is an oversimplification.

1.3 Member states have ring fenced their banking sectors

1.3.1 There are no host supervisors anymore, but there are still host authorities

A Central Bank official stated that mutual trust among regulators and supervisors has increased in recent years. There are no more host and home supervisors within the Banking Union, in the context of the supervisors themselves, because they cooperate and exchange information.

An international official agreed that there are no host supervisors, but there are still host authorities, or host jurisdictions in the broadest sense. It is not just about who pays the bill when a bank fails. It is about the economic disruption that bank failure can create for economies, which is why the supervisory side should be emphasised. Reducing the probability of bank failure should be the first line of defence.

A public representative added that home/host issues are still very important, with the host authorities unwilling to concede any movement or liquidity or capital from one place to the next in a cross border banking group. Host authorities fear that, in time of a crisis, parent companies will protect their own interest, and home authorities will prioritise their fulfilment of their national aims.

1.3.2 The excessive flexibility in the macroprudential framework encourages ring fencing measures

A Central Bank official agreed with previous remarks by Andrea Enria that there is currently an excessive national leeway in the macroprudential framework. The ECB can only intervene in the case of EU harmonised measures and many national macroprudential powers are delinked from EU legislation. Moreover, most of the macroprudential requirements are enshrined in the Capital Requirements Directive (CRD), while most relevant macroprudential provisions in the CRD relate to options for member states. The lack of harmonisation and a sufficiently strong European framework for macroprudential intervention has led to the possibility of those instruments being used as a way of ringfencing.

1.4 Various impediments to cross border consolidation in Europe

1.4.1 Lasting zero interest rates, new entrants and political obstacles

An industry representative stated that coming together across large national champions is difficult currently because of the persistent low rates environment. New entrants are taking market share away from the national champions. Bank CEOs in Europe question how-to take-out cost when bringing two large organisations together. There are obstacles and political sensitivities when reducing overheads. Sector consolidation requires an EU environment fostering the circulation of capital and liquidity within European cross-border banking groups

1.4.2 A strategic hurdle to European mergers

An industry representative commented that banking integration is possible from a pure technology perspective. Technology issues are much more at the front end. European universal banks are still dealing with hard-to-update legacy technology and suffer from costly operating models across too many markets, products and client segments. They also suffer from huge compliance costs.

An industry representative stated that, if the banking system in Europe is not profitable enough to invest in innovation, that innovation will instead go to fintech. If the consolidation does not happen, long-term innovation will suffer, and other regions will take over from Europe.

A regulator commented that the endemic challenge for investors is the lack of profitability of the industry and the lack of credibility of sustainable business models. This is part of what the banking union aims to solve.

1.4.3 The lack of EDIS leads to a costly burden that makes it difficult for banks to combine across borders

An industry representative commented that, without EDIS, banks are replicating costly operating models across countries.

2. Avenues to progress in the integration of the euro area banking sector

Different ways of making progress were discussed during this session, including the effective implementation of cross-border liquidity waivers within the Union, a system of contractual guarantees between the parent company and its subsidiaries, backed by the SSM, and the use of branches.

2.1 The ECB is exploring all the possible avenues offered by the existing framework to increase integration in the Banking Union

2.1.1 The aftermath of the crisis offers an opportunity to pursue pragmatic avenues to increase integration in the Banking Union

A Central Bank official agreed with other speakers that there is limited progress at the regulatory level. The crisis offers development opportunities for European banks. More revenue is needed to increase the return on equity from 4%. The only realistic approach to this is to develop cross-border banking. The ECB is in favour of regulatory changes and more European integration. Even if the framework does not change, the ECB will encourage the development of cross-border business. The ECB is prepared to explore all options available to it, including organic growth by restructuring, the use of the freedoms of the treaty, the freedom to provide services, the freedom to branchify subsidiaries and outsourcing projects.

The ECB will use the present framework, recovery plans and the possibility of intra-group guarantees to build confidence. Specific treatments for significant subsidiaries have already been developed in the SSM. In the EU Banking Union there is no longer a host or a home supervisor. The former host now has access to all the information of the SSM. The ECB is ready to commit the whole SSM to increase trust so that parents will support subsidiaries. The point at which it is possible to re-establish trust and help to relaunch the regulatory challenges is when issues are manageable by supervision.

A regulator commented that, since the last crisis, there is a tendency to consider what happens in the worst case, at the end of the stage. This is like asking banks to walk around with their coffin throughout their lives, just to make sure they are ready to die when they die.

2.1.2 The ECB has published appropriate initiatives to address banking fragmentation

An industry representative stated that the ECB has made a step forward in addressing market fragmentation from an M&A perspective. The ECB also presented an interesting proposal to increase incentives to enter into so-called group support agreements, which would link cross-border liquidity waivers to the existence of adequate intra-group financial support. What investors believe they will get out of the value of a consolidation in the banking sector is an important consideration. Investors do not believe that they will get better returns in Europe in the current environment.

2.2 Contractual arrangements within cross border banking groups backed by the common supervisor (SSM) could reassure host authorities and eliminate national ring-fencing practices

A regulator noted that there are not only concerns about the host country in the case of a bank failing. If there is cross-border integration, there could be employment loss, loss of economic activity and loss of control over financial stability.

A Central Bank official commented that arrangements such as guarantees between the parent company and its subsidiaries can make a great deal of difference by demonstrating that the support begins at an early stage, because host authorities are concerned that promises will not be kept in a failure or likely to fail situation.

A regulator noted Andrea Enria's previous proposal on the potential move from subsidiarisation to branches. One of the arguments that has been made for subsidiarisation is the ability to have better earlier information from the host authorities and to generate trust in the day-to-day operations.

2.3 Regulation should foster capital and liquidity movement within European banking groups

An industry representative stated that a calibration of total loss-absorbing capacity (TLAC) requirements at the low end of the Basel range would potentially bring down cost, because there is also more effective cross border regulatory cooperation. Consistency in regulatory judgment, application and outcomes will make comparability of global banks viable. The final implementation of Basel III will increase the credibility of the European banking landscape. The EU should use the opportunity to reduce excessive room for national discretion. The European Union could also play a role in reducing the cost and clean-ups of non-performing loans (NPLs), fostering a faster circulation of capital and liquidity in a crisis.

An international official stated that the home/host issue is a trust issue. The host jurisdictions have legitimate concerns, where new supervisory protocols and mandates could help build trust. The SSM has significant institutions and less significant institutions (LSIs). The introduction of a third category, the significant subsidiary institution – SSI - with new protocols and more of a focus on solo supervision, could assist in information sharing and building trust.

2.4 The upcoming regulatory files (Basel 3, CRD, review of the EU crisis management framework) could allow some progress

A public representative noted that the Basel III regulations and the capital requirements directive (CRD) are expected in the fourth quarter of this year. The package on crisis management is expected in the first quarter of 2022 and will include the Single Resolution Mechanism regulation, the deposits guarantee schemes directive and the Bank Recovery and Resolution Directive (BRRD). Progress on the resolution framework is needed. If other issues are not addressed, the risk is that the Union goes backwards, and the two key problems remain: the home/host issue and the Regulatory Treatment of Sovereign Exposures (RTSE).

2.5 Banks must embrace cross-border consolidation to lead Europe out of the pandemic

An industry representative stated that 50% of the capital across European banking now sits in institutions that earn less than 4% on capital. That is driven by cooperative banks across Europe and COVID. There is a structural challenge around disintermediation of banks. The Next Generation EU package will represent about 16% of non-financial corporate loans in Europe, so a key question is how banks are playing in that segment. Fintechs are increasingly involved in the core banking opportunity. Climate will require €1.5 2 trillion of financing needs in Europe, much of which will need to be cross-border. COVID has demonstrated acceptance of branch closures by customers and that banks are capable of adapting.

2.6 NextGenerationEU could be a game changer

An international public decision maker noted that that BRRD created a carveout for banks from national insolvency procedures. This carveout is, essentially, for large banks, via the public interest assessment. The scope of BRRD should be expanded, perhaps with bespoke clauses, to cover all banks.

An industry representative noted that the pandemic has generated an unprecedented European policy response, which is a reason for optimism. The NextGenerationEU project requires adequate national policy responses. If the project works, the doom loop approach may lose importance. This may increase confidence and provide the trust needed to agree on EDIS.

A regulator stated that NextGenerationEU should be a trigger to help foster questions on how fast progress can go. NextGenerationEU is likely to be a medium to long-term project and integration is a short term issue.

A Central Bank official commented that the way European institutions at all levels responded to the COVID crisis is a demonstration that political conditions may change. Instruments like contractual arrangements or branchification cannot make enormous changes in a short time. Digitalisation can drive faster progress and may increase free cross-border services. Digitalisation also leads to competitive challenge from entities outside the banking system. National borders make less of a difference in the case of digitally provided services.

3. EDIS is important, but will be extremely difficult to achieve in the near term

A fully-fledged EDIS is a missing instrument of the Banking Union but remains a contentious issue. Much more mutual trust is required to achieve progress in this area.

3.1 EDIS is missing but intractable oppositions remain

An international official noted that the IMF was amongst the first to argue that EDIS is a core component of Banking Union. However, Europe does not have the same banking system it had 10 years ago when this project was conceived. There has been €4 trillion of ECB QE in the interim. At the aggregate level, there is now structurally a highly liquid banking system in Europe, notwithstanding some pockets of weakness. Overall, there are no sharp differentials now in retail deposit rates between the north and the south. Thus, a pragmatic way forward could be to pause the push for EDIS. This is not because it is unimportant, but because it is very intractable at this time and the system is very liquid.

An industry representative commented that EDIS is crucial but trust between Member States must be built to achieve it. It might be possible to work around EDIS by attempting to reduce the doom loop obstacle to integration. In the current exceptional circumstances, there is a global European response, where everyone has an interest in addressing the crisis. As to branchification there is a great deal of unexploited potential in it but it is not clear what the industry can do without significant regulatory changes reducing the impact of the geographical barriers for the free circulation of capital and liquidity.

3.2 Is it possible to move forward without EDIS?

A public representative stated that his previous comments on Italy and Germany are common knowledge in the industry. Mario Draghi stopped the roadmap in May. It is hoped that Mario Draghi can finally unlock some progress on this issue. The idea of bypassing EDIS is attractive because the situation is difficult, but it will be very difficult to proceed without

EDIS. If Santander had not intervened just in time in the case of Popular, ATMs would have been closed. There was no money in the Spanish deposit possible insurance and there would have been banking closure.

A regulator commented that the fact that there is no EDIS is being used as an argument to prevent further integration in case a situation like that of Popular arises. Trust must be built, with guarantees around the possibility of a bank collapsing without having sufficient support in these deposits. As previously mentioned, there is currently a great deal of liquidity. Banks are better capitalised and scenarios such as that of Popular are much less likely than previously.

Aa an aside, an international official noted that the ideal solution involves intervening a bank on a Friday and restoring service on Monday morning. With the Banco Popular situation having played out mid-week, he commented that, arguably, intervention in the Popular situation should have been three or four days earlier.

3.3 Much more mutual trust is required to achieve an agreement on EDIS

A public representative stated that, from the perspective of the southern states, clear progress towards EDIS is needed. Even a minimal EDIS, starting with liquidity and moving towards potential future risk sharing, seems hard to achieve. Safe portfolio and safe assets is a focus of the Parliament. Banks should be helped to diversify, so that some states do not suddenly lose demand for their assets. The new government in Germany will be crucial. The French presidency is also important.

A Central Bank official stated that trust must be built at the higher, perhaps political, level. Previous comments by Gert-Jan Koopman highlighted political change in European institutions that would have been unthinkable five years ago. There is no need to be pessimistic about the possibility of changes in regulation and legislation.

A regulator summarised that there is consensus that EDIS is a desirable and potentially necessary outcome. Potential alternatives for going forward have been explored. It is hoped that these alternatives will not be needed, but it is advisable to prepare for the worst and hope for the best.