Addressing ring fencing practices in the Banking Union

There are no host supervisors anymore in the Banking Union area but the distinction between home and host authorities and the "national bias" still exists for banks operating across borders in the "Banking Union" under the remit of the Single Supervisory Mechanism. The Chair noted that the session focuses on a very controversial issue in the EU. The home host debate has reached the stage where every legislative file concerning banking runs the risk of getting stuck in it. All Europeans would like to reap the benefits of the single market. The single market in financial services is incomplete; the core issue is distrust between supervisory authorities, as well as distrust between legislators and member states.

1. The Banking Union remains unfinished business

1.1 The Banking Union has achieved progress since its inception

An industry representative agreed that the European banking system has made a significant amount of progress in the last 10 years after the financial crisis. A lot has been achieved in such a short time frame since 2008, such as a convergent set of regulations, supervisory practices, common risk management frameworks and the creation of the different pillars behind the BU.

A supervisor stated that the Banking Union (BU) has been a success story in Europe, especially in the context of the last two years with the pandemic. It has been able to foster and create trust and cooperation in the policies that have been put in place, in the cooperation across banking supervisors outside of the euro area, and with monetary authorities and fiscal support measures.

1.2. Only minor improvements have been made since the creation of the SSM and the mutualisation of resources for resolution from the SRM

An industry representative noted that the Banking Union remains largely unfinished, making the present situation partially a regression. According to Jacques de Larosière, subsidiaries of major banks are governed by national rules known as host country rules. This prevents large banking groups from benefitting from the effects of scale that they had a decade ago. The paradox of the Banking Union is that it does not enable cross-border banking groups to emerge.

1.3 The current regulatory framework still largely relies on a territorial approach

An industry representative observed that the current regulatory framework still largely relies on a territorial approach such as the uneven application of cross-border waivers for capital, liquidity and minimum requirements for own funds and eligible liabilities (MREL), a multiplicity of macro-prudential tools, and the existence of options and national discretions within the Single Rulebook. The question is how scalable European markets are for large European banks to run an operation that becomes even more profitable and have the same opportunities as some of the US banks or large Asian banks if ringfencing is removed. In order to remove some of the ringfencing quicker the territorial approach should be eradicated. The second aspect is the uneven application of border waivers. The third aspect is intergroup support requirements.

The Chair noted that in the past Europe had a better situation regarding capital and liquidity management in European banks. What happened during the financial crisis led to a reversal. Many Austrian banks were exposed in central and eastern Europe, but it was unlikely that any of them had withdrawn support under the direct conditions. They were also supported by the Austrian supervisory authorities and the government. That took place before the Bank Recovery and Resolution Directive (BRRD) and the resolution rules were in place.

1.4 Financing the green and digital transitions cannot be achieved with fragmented banking markets

A supervisor stated that there is a need to make significant investments in the EU with a crucial role for the banking sector. The estimates on green and digital public and private investments that have to take place for transformation for profitability of the banks is about 650 billion, which is 4.6% of the 2019 GDP, per year until 2030.

2. The root causes of ring-fencing practices

Several speakers indicated that ring fencing practices were caused by a lack of trust between home and host jurisdictions.

2.1 Segregation of capital and liquidity is a problem

A supervisor stated that ring-fencing is an important explanation behind the scarcity of cross-border bank mergers in the euro area. Over the last two decades an average of thirty to forty bank mergers occurred each year, including a small number of cross-border ones. The institutional and structural costs of ring-fencing practices are difficult to quantify but can be substantial. For an individual banking group, ring-fencing reduces the economies of scale and impedes the efficient allocation of capital and liquidity that can be realised in cross-border mergers and acquisitions (M&A). Ringfencing measures are a sign of distrust. However, only if both sides are willing to understand the respective

views of home and host authorities, real cooperation can ensue. The Single Supervisory Mechanism (SSM) with the Supervisory Board at the centre is an example of that understanding in action.

The most efficient allocation of capital and liquidity within groups is one that allows for free float. That needs to be in place in the banking sector; not having it puts European banks at a severe disadvantage compared to US peers, who benefit from a much larger and integrated domestic market. The Banking Union and the Capital Markets Union (CMU) are mutually reinforcing policy objectives.

An industry representative noted that segregation of capital and liquidity is a costly problem which limits the efficiency and agility of pan European banking groups.

2.2 The insufficient involvement of host jurisdictions in the resolution strategy of transnational banking groups

An official observed that the internal market offers great potential for EU banks, but this potential has been largely unused even though the opportunities for ring-fencing at the national level have been restricted. EU banks can rely on branches rather than subsidiaries to conduct business in other euro-area countries. For MREL there is no role for the host authority to decide whether the resolution strategy will be a single point of entry (SPE) or multiple points of entry (MPE).

2.3 Banks do not always consider host markets as their domestic market, and the sovereign bank nexus remains a concern

An official stated that from the perspective of host countries it is crucial to maintain the financial stability of the banking sector and ensure fair burden sharing in cases when the bank fails. An important requirement for cross-border integration is that the host banking sector is seen as a home market for European banks, which is not always the case. A vital aim is the Europeanisation of European banks. Europe needs to try and overcome home bias. It is very important to address the sovereign bank nexus which currently exists in the EU. Diversification of bond holdings in bank balance sheets is required.

2.4 The governance of Banking Union institutions does not sufficiently take into account host country concerns

An official noted that the absence of trust is a significant issue. The first reaction when the pandemic started was to close borders, which is why people cannot have trust in the system. It is important to improve the governance of the Banking Union, the Single Resolution Mechanism (SRM), the Single Supervisory Mechanism (SSM), or the Single Resolution Board (SRB) to make them more European, taking into account all Member States concerned. Those three elements can be crucial in the effort to overcome the fragmentation which is currently faced.

2.5 Burden sharing remains an issue

An official stated that a shared characteristic for most host states is a persistently high dependence on bank financing, as alternative forms of financing have not yet been adequately developed there and the market is highly concentrated. It is crucial to maintain the financial stability of the sector and ensure fair burden sharing in cases when the bank fails. Host countries have legitimate concerns about the way possible banking group resolutions may be handled in the EU. This is the biggest concern for Slovakia.

EDIS is important for improving cross border banking integration. Fair burden sharing is needed when a bank faces problems, including common safety nets with loss sharing elements, and ideally with a fully fledged EDIS. The ultimate aim should be to have a fully fledged Banking Union with a single jurisdiction within the eurozone.

An industry representative added that there are some reasons to be less optimistic. A lack of trust between public authorities has been a problem for years, especially when they have a common border. EDIS will not solve everything. Public authorities need to do their job; building trust is their job.

3. Possible way forward

3.1 Ring fencing practices are a public authorities' issue, for which banks cannot be held accountable

An industry representative stated that the issues of ring-fencing and lack of trust are to be tackled at a political level, by taking hindsight from the continental view of the SSM. In fact, ring-fencing practices exist among public authorities, when, on the contrary, at a business level, pan-European banks' relations with local public authorities are most of the time excellent. Since the problems that have been highlighted do not prevent banks from doing normal business with total transparency with public authorities, measures should therefore rather be taken on the public authorities' level.

3.2 The SSM is a strong supervisor and the renewed interest in ensuring financial autonomy of Europe are sources of optimism

An industry representative underlined that the existence of the SSM and the new political goal of EU financial autonomy are two reasons to be optimistic. The system of the SSM may be perfectible, but there has been enormous progress after the Great Financial Crisis and a continental view of challenges and benchmarks is in the course of being established. The SSM is a force in favour of more harmonisation of rules and a shared interpretation of common rules, an evolution that should not be underestimated. Furthermore, the state of mind in Brussels has perhaps begun to change regarding the importance of an efficient financing system to reach the political objective of EU strategic autonomy which could help to make a common financing area a priority.

3.3 Branchification is a route for cross border banking but is not a solution for every problem

The Chair asked a supervisor if banks need to go into host countries via subsidiaries, or whether they could

do branchification. If branchification is done, then the burden falls on the home country's deposit guarantee scheme (DGS) and the issue is resolved.

A supervisor stated that branchification is not a solution for every problem, but it could be better taken advantage of by other business models. Third countries are moving forward with a single headquartered European entity with branch constructs across Europe. It is concerning that only competitive foreign institutions are moving in that direction. UBS has created a Frankfurt head office and has branches across Europe. This allows a far more simplified governance framework and the free flow of capital and liquidity across the entire group. European banks are not taking advantage of what is available with branchification. There would be tremendous savings and risk mitigation if branchification was a more utilised construct.

An industry representative also questioned why EU banks are still making so little use of the basic freedoms of the single market and are not converting more subsidiaries to branches. US banks and some large European banks are setting up European corporations for that purpose. It may seem difficult, costly and time consuming to convert subsidiaries into branches, but it will work and an appropriate way to address the issue. For other regulatory measures one possible solution could be the introduction of a binding intergroup guarantee as part of the recovery plans, which could provide assurance for host supervisors.

The Chair added that there are obstacles to branchification, such as legal issues and a soft pressure not to branchify.

A supervisor agreed that there has been pressure not to branchify. If governments are making it clear that business will not be as available to banks if they set up a branch framework instead of a subsidiary framework then some business objectives will be pursued. That is an awful practice. Governments that are doing that are hurting the whole of Europe in terms of the overall opportunity cost that would be available with the investment and the creation of value for citizens in the form of investment and innovation, investment in climate transition, credit being much more freely available, and for continued economic success.

An official noted that branchification is up to the businesses, companies and banks to decide their models. It is not for policy makers to foster or support ways in which entities want to organise themselves. There should be legislative obstacles, but it should be up to those entities to decide on their model.

An official added that home countries have a concern that those entities are operating inside them through subsidiaries. One concern is that entities see host countries, not as their home country, so they still have the possibility for an easier exit. Home countries want to have a real European market when it comes to the banking sector. Host countries do not have the representatives, but they have the professionals. It is important to make use of this experience when it comes to arrangements on the SSM and the SRB. When a discussion takes place on the Banking Union it is important to think about the purpose of the banking sector.

3.4 A review of the current EU legislative framework and a greater use of regulations across the European Union would be an important step

An industry representative stated that a number of supervisory approaches are not yet fully consistent, as evidenced by the imposition of intragroup dividend restrictions during the COVID-19 pandemic and the link between prudential requirements and restrictions on distributions. There is also a lack of a transparent approach when setting Pillar 2 requirements as they can vary from country to country.

An industry representative noted that the absence of common and fully transparent EU practices for the prudential assessment of M&A transactions further adds to the complexity, despite the initiatives taken by the ECB. The level of systemic buffers of other systemically important institutions (O-SII) varying across the EU creates an uneven playing field dependent on where the entity is based. There is also a lack of transparency as to how an O-SII score equates to the level of O-SII buffer being applied, with firms having a higher O-SII buffer also having a higher MREL requirement.

An industry representative added that inconsistent interpretation and application of the European Banking Authority (EBA) outsourcing guidelines across the EU means that providers and receivers of services work to different regulatory standards. The aspiration is to have a genuine Banking Union, a genuine CMU, and potentially the EDIS. Scalable markets are needed so that operations run efficiently and optimally. Appropriate consideration should be given to the reform of these barriers to further facilitate the formation of transnational banking groups.

3.5 The persistent fragmentation of non-prudential rules needs to be addressed

A Central Bank official stated that the discussion is not only about the Banking Union and EDIS. It is also about non prudential issues such as national insolvency harmonisation at the European level and different taxation regimes. Cross border banking and financing activities will be hindered if those issues are not worked on and only the integration on capital and liquidity waivers are addressed. Host countries are not against instruments like liquidity waiver, but admittance is needed that the situation may change very quickly, especially in terms of illiquidity. A credible and legally enforceable mechanism needs to be created hand in hand with border liquidity waivers, which will ensure that subsidiaries have adequate liquidity in crisis situations.

3.6 EDIS remains a contentious issue, and a fully-fledged EDIS is crucial for host countries

A Central Bank official observed that a fully-fledged EDIS is crucial. But for many leaders of the industry, making the deposit guarantee scheme of the home country responsible for deposit protection function of a transnational group, correcting the uneven distribution of costs of the Single Resolution Fund within the EU and agreeing on target changes to the EU supervisory law should be able to address ring-fencing issues.

3.6.1 For host countries, a fully-fledged EDIS is crucial.

A Central Bank official explained that the BU is currently confined to the boundaries of the euro area, but Lithuania has a foreign owned, fairly concentrated banking system, with a majority of capital coming not from the SSM or the euro area. When referring to the single market the BU needs to go beyond the limit of the euro area and eventually cover the whole EU. This is important for countries where a substantial share of the banking sector is foreign-owned, primarily by non-euro area entities. The parent companies of many of the largest banks in the Baltic States are not supervised by the SSM.

A Central Bank official stated that there are real problems in an EDIS that is not fully implemented, such as when a consolidated transnational bank fails where its requirements are only applied on a group level. The host country has to compensate its deposits for its domestic subsidiary. A complete EDIS functioning at full scale is a very important tool. Correspondingly stronger safeguards are needed as banks become larger. If a consolidated transnational bank fails where the prudential requirements are only applied on a group level, then the host country has to compensate the depositors of its domestic subsidiary. Local taxpayers' exposure to the risk of losses can be substantially reduced with a fully-fledged EDIS in place.

A Central Bank official added that a fully-fledged EDIS is also necessary to remove present risks of transforming subsidiaries into branches. Home countries as well as hosts face downside financial stability risks, because the home country might be unable to cover depositor claims of the large banks in other Member States. These risks are even more pronounced when a large entity makes its headquarters in a small home jurisdiction. When home countries refer to capital waivers and liquidity waivers, they are talking about efficiency costs. Issues are raised by host countries on the BU about a deposit insurance scheme that is to be used when the company goes bankrupt, how to resolve a failing company, how to supervise in a way that company is regulated, and how to make sure that company keeps afloat. Host countries are not against capital or liquidity waivers. Host countries want to ensure that the system is functioning, working, trustable, and that there is a real single banking and financial market.

The Chair understood a Central Bank official's point regarding EDIS. When the discussion on the Banking Union started it was stated that centralised supervision can have financial effects and can place the financial burden on member states. A centralised burden sharing is needed. The supervision is in place, but EDIS is not. Regarding liquidity and capital waivers, everyone wants banks to provide the real economy with money, but there is also the issue of the competitiveness of European banks.

3.6.2 There is no need for EDIS to address the home host dilemma

An industry representative stated that the Commission's 2015 EDIS proposal has broken into pieces, and EDIS will not make ring fencing disappear. Andrea Enria has stated that cross border integration is progressing very slowly, and that the global financial crisis and the historical past perspective led to repatriation of assets held in subsidiaries. Before the financial crisis a Banking Union was in place without being regulated or legal prescriptions. It is important to get back to this situation and break the vicious circle of ringfencing in Europe.

An industry representative noted that regulators need to work on the large exposure and liquidity waivers within banking groups set by the administration or supervisors. According to the ECB, €250 billion in high quality liquid assets is ringfenced due to European national provisions. The ECB should start by raising the maximum liquidity coverage ratio (LCR) waiver for significant subsidiaries beyond 25%. A commitment is needed from SSM member states to abstain from ring fencing, because it mainly related to the large exposure override.

3.7 Home country DGS being responsible for the deposit protection function of a transnational group

An industry representative observed that the risks linked to the question of deposit insurance could be addressed much easier by making the DGS in the home country responsible for the deposit protection function of the entire group. A separate consideration of the issues will lead to more timely results. EDIS is necessarily linked to the various aspects of risk reduction, including regulatory treatment of sovereign exposures. National deposit insurance schemes would not be an obstacle to cross border consolidation if European legislators provide for a less restrictive transfer of contributions in case of a merger.

A supervisor explained that the ECB has suggested a small legislative change to facilitate branchification. EDIS is the goal, but for the national deposit insurance schemes (DGSs) there should be a change that does not limit the transfer of contributions between DGSs to only the last 12 months. There should be a much more proportional application methodology, such as the one the EBA has suggested.

3.8 Correcting the uneven distribution of costs of the Single Resolution Fund within the EU

An industry representative stated that the Single Resolution Fund is certainly useful as a tool. However, its costs are unevenly spread and are strongly viewed as unjust and unsustainable by some of the biggest banks in the EU. As an example, French banks pay about a third of the SRF despite representing only 20% of the Euro Area deposits, which is not a sound basis for ensuring minimal support from the industry in favour of the development of a real Banking Union. If this structural imbalance is not addressed, it will continue to undermine discussions and support on the next steps of the Banking Union.

The Chair observed that Europe has half a European DGS, the SRF, because it fulfils many of the functions of the Federal Deposit Insurance Corporation (FDIC) but not all of them. The problem is that Europe does not yet have the other half. The frustration of banks seems to be because they are paying so much for the first part they want to make sure they do not pay a disproportionate share for the second part. There is also an issue of trust involved in what Europe wants EDIS to do and how it wants to design it.

4. Accelerating CMU and the harmonisation of corporate insolvency

4.1 The CMU and BU are interlinked; progress on CMU would help overcome the current BU deadlock

A Central Bank official stated that trust is built by doing the first things first. The EU, its single market, and free movement of good services, labour and capital is beneficial, but if the EU wants to follow that then it needs to build the Banking Union. If the EU puts its thinking in the direction of how to completely avoid ringfencing then it should do the first things first, which is to build the BU and CMU.

An official observed that it is important to have recognition that the CMU is highly interlinked with the Banking Union. These discussions should go into the roots of the problems which are being faced. Slovakia is ready to discuss corporate insolvency and supervisory arrangements, and when it comes to the CMU it means the role of the European Securities and Markets Authority (ESMA). Those issues should be concentrated on if Europe wants to have real results and promote cross border investment and lending.

An official added that Europe should diversify the lending of its banks and promote cross border lending in the EU. Discussions on the CMU are very important. A deepening of the CMU would increase cross border financing of banks, reduce market concentration and dependence on bank financing. Europe needs to combine its discussions on the BU with its discussion on the CMU. An action plan was proposed two years ago by the Commission and was supported by the Council. The most important action is linked to the harmonisation of corporate insolvency, which would address the problem of the financing of the economy in times where European banking groups are in a market which could be considered a single jurisdiction.

An industry representative emphasized that the CMU and the Banking Union are mutually reinforcing initiatives. There is no aim of a Banking Union if there is no common financing area. Both are important for innovation financing, prosperity, and efficiency.

4.2 A genuine Banking Union does not need an entire harmonisation of insolvency rules

The Chair is hesitant to put too many conditions on the Banking Union now there is the reform of European insolvency laws. A Banking Union only needs a separate insolvency regime for the banking sector. Europe is unsure when the CMU will be complete. It is complementary, but the question is whether Europe needs a complete CMU before it can have a Banking Union.

An official noted that the banking sector should take a lead in this discussion. It is important to concentrate on the possible criteria and its measurements. It will be difficult to identify output criteria which need to be achieved because it is not under the control of the sector, but that can be done with frameworks.

The Chair stated that the entire Banking Union debate is reminiscent of the one on the European single market. The term ‘single market’ only started occurring in the 1980s with the European Single Act. Europe has not arrived at where it is by political design. Europe has the same political economy problems in the BU as it has in the single market.

An expert asked if trust among public decision makers can be created between home and host countries if there are not sufficient economic and fiscal convergence in all parts of the union, in a context where the Covid crisis has accelerated economic fiscal heterogeneities in all parts of the EU.

An industry representative agreed and stated that insolvency laws need to be added to the question. A common aggregate product of corporate debt will not work without a common solvency regime. Insolvency laws are as concrete and important as EDIS, and perhaps even more important in the day-to-day banking operations.

A Central Bank official underlined that it is not the case that the authorities do not trust one another. A more holistic view and approach to an issue is needed.

The Chair clarified that the issue of trust is a ‘prisoner’s dilemma’. Everyone is individually trying to achieve the best outcome, but it is not the optimal outcome for everyone. The hope is that the Banking Union can free Europe from that outcome.