Q&A

ANDREA ENRIA

Chair of the Supervisory Board -
European Central Bank (ECB)

The integration of the EU banking sector and the challenges of global competition

What remains to be done for further integrating the euro area banking sector and breaking the so-called doom loop between banks and sovereigns? What impacts can be expected in terms of financial stability?

The fragmentation of the euro area banking sector along national lines is still a cause for concern. The situation did not change significantly after the establishment of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM): the banking sector is still, by and large, a collection of national banking sectors. One of the foremost rationales for the establishment of the banking union was to break the so-called doom-loop between banks and sovereigns, but after almost ten years two key elements of the banking union are still missing.

First, there is a need to establish a European Deposit Insurance Scheme (EDIS), which would complete the transfer of the whole safety net to the European level. At the moment, the general perception is that in a crisis the credit standing of banks would still reflect the strength of the respective national deposit guarantee scheme and of the sovereign providing the ultimate backstop.

Second, there has been a lack of progress in the cross-border integration of banking business. This reduces the potential for private risk sharing in the European banking market, and thus increases risks to local financial stability rather than reducing them. In fact, the integration of the banking sector plays a significant role in smoothing local shocks. As the former president of the ECB, Mario Draghi, well summarised in a speech some years ago, retail banking integration de-links the capital of local banks from local credit supply. "Because 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 cross-border banks that operate in all 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"[1] . Also, if a crisis occurs, an integrated market would support smoother resolutions of failing banks, as their assets and liabilities could be more easily transferred to a larger set of potential bidders, including those from other Member States. This would be similar to what we see in the United States, with cross-state mergers and acquisitions.

The two aspects are linked: without EDIS, national authorities are more reluctant to support cross-border integration, fearing that in a crisis, their national safety net would have to support banks failing because of strategic decisions taken elsewhere. On the other hand, without more integration, crises are more likely to occur because of the limits to private risk sharing, and resolving them is more challenging due to the segmented nature of the market. But we need to make progress in parallel on both fronts. I would strongly reject the argument that we cannot move towards greater integration without a fully integrated safety net.

How can progress be made in the completion of the Banking Union? How to address the long-lasting home-host issues?

The difficult negotiations for the completion of the European banking union and the establishment of a European Deposit Insurance Scheme should continue with a renewed sense of urgency. At the same time, we have to pursue all possible avenues to increase the integration of the banking sector under the current regulatory and institutional framework. This requires more commitment and effort also from the side of the industry.

First, "branchification", the process of merging all existing subsidiaries into the parent company and operating through branches of a single, unified legal entity, could enable banks to use the freedom of establishment enshrined in the Treaty to the maximum extent possible. I suggested this option in my speech at Eurofi in September 2021,[2] taking inspiration from the widespread use of this model by third country banking groups relocating business to the euro area as a consequence of Brexit. So far only a few European cross-border banking groups have explored this avenue and only some groups in Nordic and Baltic countries decided to implement it.

I think that this is a missed opportunity because it is a solution readily available and completely consistent with the current legislative and regulatory frameworks. If you are a single legal entity structured in this way across different Member States, you no longer have to abide by the capital and liquidity requirements in the various countries where you operate. You can allocate your financial resources however you like. Therefore, there is no issue of trapped capital and liquidity resources and no obstacle concerning the distribution of capital, liquidity and MREL within cross-border banking groups. The constraints to transferring contributions into deposit guarantee schemes (DGSs) across systems could be the only regulatory hurdle standing in the way of such transformation: this is the reason why the ECB advised the co-legislators to slightly amend the framework. But even in the absence of this legislative change agreements can be found, and have been found, between home and host DGSs to support branchification.

In the absence of major legislative changes, cross-border liquidity waivers are another available integration device. They are more complex and deliver more contained benefits, but they can be enacted in the current context. In a blog post jointly authored with my colleague on the Supervisory Board, Edouard Fernandez-Bollo, we proposed enhancements to the waivers framework aimed at overcoming existing scepticism on the side of national authorities. We suggested a contractual approach to the establishment of intra-group guarantees, which could be made enforceable, and therefore credible, using supervisory tools at the European level. Within the banking union, group support agreements for subsidiaries could be enshrined in groups' recovery plans and approved by the supervisory authority – the ECB – which would be neutral, pursuing neither a home nor a host agenda. This could facilitate the granting of cross-border liquidity waivers at the solo level to the extent possible within the current legislative framework.[3]

Finally, we clearly expressed our neutrality as a prudential authority towards cross-border mergers, which would be assessed against the same yardsticks as domestic mergers. I understand at the moment the cost efficiency rationale makes domestic consolidation more attractive from a business perspective, but hopefully European banks will soon come to explore ways to develop their franchise and diversify their sources of income, rather than just solidify their competitive position in their home market.

Do EU banks face higher capital and prudential requirements than their US counterparts, as indicated by certain studies? If so, what are the underlying reasons?

First of all, I would question the idea, at times embraced by industry representatives, that the stringency of a given bank prudential framework should be judged solely based on the level of capital requirements. As shown by the March 2023 bank turmoil events, including in the cases of Silicon Valley Bank and Credit Suisse, even well capitalised banks can rapidly collapse when underlying governance is particularly weak. Supervisory intrusiveness is equally key to ensuring the stability of the banking sector. The ECB has for instance been particularly intrusive with regard to interest rate risk, well ahead of the monetary policy shift, and we are escalating supervisory action against long-lasting internal governance deficiencies. These are all areas in which intrusive supervision can make a difference.

Having said that, I would also challenge the idea that European banks face higher capital requirements. Comparing capital requirements across jurisdictions is never a trivial exercise, as several factors can blur the picture. The European legislator has chosen to apply the Basel standards to all banks, including small and mid-sized banks, whereas in the United States rule apply differently depending on banks' size. As a result, smaller banks probably face, on average, a more stringent prudential framework in the EU. Based on what happened in March 2023 amidst US regional banks and the current debate on regulatory reforms in that country, I think that no one would suggest a relaxation of the European setting. Global Systemically Important banks (G-SIBs) are, however, those that truly compete on a global scale. In the case of these players, the average supervisory add-on is probably a bit more conservative in the EU, while being more diverse in the US, where significantly higher capital charges are applied to specialised investment banks. The regulatory treatment is, however, more demanding in the US, due to a host of gold-plating choices, especially on the leverage ratio requirements, tighter limitations on the use of internal models to risk weight assets, and a stricter implementation of the buffers for G-SIBs than is specified in the Basel standards. All this makes the overall capital requirements for G-SIBs higher, on average, in the US than in the EU. Of course, to obtain a complete picture of how the frameworks compare to each other, we also need to assess the impact of the choices the two jurisdictions are making to implement the final Basel III reforms.

In moments of turmoil a shift by investors and markets from a balance sheet view to a market-to-market view has been observed. What are the consequences of this situation and how can they be addressed?

We clearly saw this shift from a balance sheet view to a mark-to-market view happening in the Credit Suisse case, for example, but also in the Silicon Valley Bank failure and, in the early days of the sovereign debt crisis, in the Dexia crisis. Market participants, analysts, and customers, in particular sophisticated, uninsured depositors, rapidly shift their focus to how much a bank is valued on a mark-to-market basis and how sustainable its business model is based on the latest market metrics. This shift can be very destructive, so we need to give it a lot of attention.

In particular, in this specific macro-environment, banks need to be very careful about how they manage interest rate risk. This is important not only from the earnings perspective, but also in terms of the economic value of equity, because this is likely to be what the market would focus on during a stress. That is why, since the first signs of inflationary pressure emerged towards the end of 2021, we as supervisors have been putting significant focus on banks' interest rate and credit spread risk management practices. Following the March 2023 turmoil events, unrealised losses on securities held to maturity, in particular, have been very prominent in the minds of analysts and market participants. The Silicon Valley Bank case showed that such losses become an issue in conjunction with other weaknesses, namely those related to funding and liquidity risk, as well as business model sustainability. In my opinion, the best way to address the market concerns that may stem from unrealised losses is enhancing the role of disclosure. Disclosures by banks need to be very granular in order to explain the real situation of the bank. It is particularly important that banks, also with the support of the supervisory authorities if needed, provide market participants with all relevant information to reassure them and dispel any potential unwarranted perceptions.

I have also made the point that securities held at amortised cost should not count as high quality liquid assets, eligible for the fulfilling the liquidity coverage ratio (LCR) requirement. Such a change would certainly reassure market participants about the actual capability of banks to liquidate assets when the need arises. It would also be consistent with the overall purpose of the LCR requirement, which should ensure that a bank can survive a liquidity shock for a relatively long period of time on its own means, enabling a solution to the crisis to be found.

1. *Draghi, M. (2018), Risk-reducing and risk-sharing in our Monetary Union, speech at the European University Institute, 11 May, https://www.ecb.europa.eu/press/key/date/2018/html/ecb.sp180511.en.html*
2. *Enria, A. (2021), How can we make the most of an incomplete banking union?, speech at the Eurofi Financial Forum, Ljubljana, 9 September, https://www.bankingsupervision.europa.eu/press/speeches/date/2021/html/ssm.sp210909~18c3f8d609.en.html*
3. *See Enria, A. and Fernandez-Bollo, E. (2020), Fostering the cross-border integration of banking groups in the banking union, The Supervision Blog, 9 October, https://www.bankingsupervision.europa.eu/press/blog/2020/html/ssm.blog201009~bc7ef4e6f8.en.html*