FUTURE OF THE BANKING UNION

HARALD WAIGLEIN

Director General - Federal Ministry of Finance, Austria

How to close Pandora's box by ensuring progress for the internal market?

While the end of the legislative cycle of the current European Commission and Parliament is already foreseeable, political debates about controversial topics have re-started aiming to strengthen the Internal Market by finalising the Banking Union in the upcoming legislative cycle.

For a start, pandora's box was opened by the proposal of an amended legal framework for the Crisis Management and Depositor Protection within the European Union to align and strengthen the common practise within the EU. The European Commission is striving to give resolution authorities more flexibility in situations where small and medium-sized banks have failed. The proposal expands the possible use of resolution tools and intends to minimize costs in situations where market disruptions are present also on regional or national level.

A common mutualisation of deposit guarantee funds (EDIS) is not foreseen in the proposal. But other elements are highly sensitive: The gap to access the Single Resolution Fund (SRF) shall be closed by the use of national deposit guarantee funds or financial means from the public sector while incentives for resolution authorities to consequently demand the removal of obstacles to resolution from banks are lowered. Furthermore, the proposed broadening of the coverage of deposits will lead to additional requirements for capital and eligible liabilities and have effects on the target level of the funds of Deposit guarantee schemes and the Single Resolution Fund.

Secondly, it is foreseeable that discussions on EU's macroprudential framework and practice will start again. Hopefully, this discussion can be returned to Pandora's box with more legal certainty and EU-spirit. An effective, transparent and common practice throughout the European Union is urgently needed to end the race to the top for capital, liquidity, eligible liabilities, leverage-related indicators and other safeguards requested from Member States and authorities involved.

The application of the final set of the Basel III standards by banks will ensure that banks and banking groups fulfil higher prudential standards. They will have to implement further risk-reducing changes while the introduction of the Output Floor will reduce the discrepancies of capital requirements between banks using internal models and banks using approaches with less deviances. These upcoming regulatory changes will hopefully lead to more confidence of supervisors in the reduction of risks in banks and banking groups under their remit. We thus have been more than glad that after long and intensive discussions between the Council, the European Parliament and the European Commission during the trilogue negotiations on the Basel III-finalisation in the first half of 2023, the involved parties finally have been able to achieve a very well balanced and consistent compromise package.

However, the controversies around the final trilogue of the Basel III-package, which was related to a provision requesting a Commission report also with regard to Home-Host-related matters, showed the fragility of the dead-locked discussion around liquidity and capital waivers. At the moment, I am not sure, whether the European Commission will decide to start another attempt to foster market integration in the banking sector during the next legislative cycle by legislative proposals which shall encourage cross-border-waivers for liquidity, MREL and capital.

I fully understand and support the constant request of the banking sector and the European Central Bank (ECB) for easening cross-border flows of capital, MREL and liquidity and the rationale of the economic considerations behind. However, I do not expect noticeable improvements during the next legislative cycle in regards to the long implementation period of the Basel III-finalisation and the amendments watering-down its content.

Progress can only be achieved with a step-by-step-approach.

The main reasons for the so-called „home-host-conflict" are based on a lack of confidence in the responsible behaviour of the banking sector and politicians from other Member States in times of crisis. Former discussions have shown that progress can only be achieved with a step-by-step-approach and a discussion culture between Member States which is based and committed to mutual respect, tolerance and dialogue.

The statement of the Eurogroup in inclusive format of 16th June 2022 was needed to formulate common ground in the CMDI-discussion and should serve as guiding principle in the negotiations in my view. However, the efforts of politicians will not replace the key precondition for trust, banks and banking groups which act in a responsible way also in times of crisis.

DOMINIQUE LABOUREIX

Chair - Single Resolution Board (SRB)

The SRM is critical for a complete single market for financial services

The Treaty of Rome, signed in 1957, established the single market and outlined a roadmap towards full freedom of movement of capital. Since then, the completion of this roadmap has been a multigenerational effort that continues to this day.

After almost seventy years, with, among others, the introduction of a single rulebook and the Banking Union, we have achieved an integrated framework. In fact, banks can operate throughout the EU and the Single Supervisory and Resolution Mechanisms provide for crisis management and prevention regardless of Member States' borders.

Freedom of establishment in Europe has come a long way. One practical example of this progress is the success of digital banks in the Banking Union. Some of these digital banks have grown in a few years to serve millions of clients within the European Union through their branches. This would not have been possible without the reforms listed above. However, these digital banks, also offer food for thought as to what reforms are still outstanding. Their clients may depend for deposit insurance on a DGS, possibly small, located in one single Member State. Clearly, this is neither a sufficiently Europe-wide nor a clear-cut solution. European authorities should deal with European banks, and European clients should expect European oversight.

Regulatory fragmentation creates the wrong incentives and undermines trust. In addition, fragmentation has a clear impact on banks' incentives to integrate. One of the issues that pan-European banks could face is ringfencing of capital, loss absorption and liquidity requirements on subsidiaries. Ringfencing is a circular problem as it inconsistent with a complete Banking Union but it is also a reaction to an incomplete Banking Union. Trust is what can break this vicious circle.

To build this trust, the Banking Union must be complete. Unfortunately, though, the Banking Union's third pillar - a European deposit insurance system – is missing and remains out of reach for the time being.

Nevertheless, to further increase the credibility of the Single Resolution Mechanism (SRM), the Single Resolution Board (SRB) has been intensively working on developing its capabilities and policies to deal with cross-border bank crises. Our ultimate goal is to foster trust in the Banking Union, in general, and the SRM in particular.

As an example, the SRB has worked on the operationalization of the Single Point of Entry (SPE) strategy. In particular, since 2022, the SRB has been focusing on rooting out obstacles to the implementation of cross-border bail-in whilst working on the resolution powers in the execution of SPE strategies. In addition, our experts are studying the use of arrangements, including contractual, safeguarding the availability of sufficient resources to support subsidiaries. We believe that this workstream will be critical to ensure that banks (and resolution authorities) are able to execute cross border bail-ins with minimum friction.

Currently, certain safeguards are in place, such as a clearly prepositioned internal MREL. BRRD2 sets a requirement for the level of prepositioned internal MREL counterbalanced by the possibility to grant waivers. We have not hesitated to grant waivers when the conditions were met.

Devising and implementing policies have been at the core of our business since our inception in 2015. In fact, in the last eight years, we have been focusing on requesting the banks to develop their resolution planning and execution capabilities, on preparing the resolution plans and on designing resolution policies. In a word, we have been busy with capacity building.

Since this year, the SRB is entering in a new phase. Now the time has come to operationalize our plans and policies and check the bank's capabilities. We test, regularly, that banks have been correctly implementing our policies and that the SRB (and the SRM at large) have indeed "what it takes" to resolve any kind of bank under our remit, including pan-European institutions. The SRB has already organized resolution weekend simulations (dry runs). Dry runs are thematic. As the last example: how to operationalize a cross-border bail-in. These dry runs will become more frequent over time. In addition, we are also asking the banks to execute dry runs themselves in order to test their ability to undergo a bail-in.

SRB's work is critical to ensure trust in the SRM but legislators should not renounce a complete BU.

Our work, as the one described above, is critical to ensure trust in the SRM but we can only operate with the tools at our disposal. In order to have a true single market for financial services, legislators need to step in and complete the Banking Union. The Crisis Management and Deposit Insurance (CMDI) proposal recently published by the European Commission is a step in the right direction but the third pillar of the Banking Union remains a necessary condition for a complete single market.

JUKKA VESALA
Head of Group Credit Risk Control - Nordea Bank

Why there is little cross-border branching in the EU

Nordea is still the only large EU banking group that has changed its legal structure from cross-border subsidiaries to branches. Our example shows that this transformation can be done and that there are clear benefits from being able to operate a "one bank" model, but also that there are still many obstacles, which can prevent banks from embarking on this transformation.

After operating a few years with a cross-border branching structure under SSM supervision, we can see that the anticipated benefits from the simpler legal structure have actually materialised. These include: clearer governance and accountabilities, simpler and more effective balance sheet and liquidity management, avoidance of many duplicated requirements on subsidiaries, ability to cater for large financing needs (scale benefits from a large balance sheet), one prudential supervisor, improved resolvability, and reduced reporting burden.

However, getting the new legal structure in place was very complex and cumbersome, which can in itself deter banks from changing their structure – even in cases where authorities take a neutral stance and do not, in effect, enforce preference for a subsidiary structure. This includes transition costs e.g. related to deposit insurance contributions, resolving numerous authority concerns and obtaining a large number of approvals, and the operational burden taking focus away from regular banking business.

The main problem probably lies in the fact that "branchification" has no legally defined turnaround time or long-stop date for decision in the EU. We face broad and unprecise requirements as to the content of applications and scope of examination (e.g. "public interest"). There is lack of coordination between authorities (e.g. forwarding of information and notifications between home and host supervisors) and limitations in national law as to when the competent national authority may grant its approval. Finally, there is a need to apply for all approvals and permissions when moving domicile even when valid approvals exist, e.g. regarding internal models. Further challenges are brought by divergent national implementations of options and discretions under CRR. These obstacles are mitigated, but not yet completely removed, even under the single supervisor within the SSM.

Once having overcome the initial obstacles and operating a "one bank" structure, one can see that there is still considerable room for further harmonised regulation and supervisory practices across jurisdictions especially between the SSM and the rest of the EU. We can still have gold-plating of EU prudential rules by local authorities (e.g. on the definition of default). The main issue is, however, that macro-prudential requirements are not harmonised or coordinated in the EU; not even within the SSM. Macro-prudential buffers are currently applied at totally different levels, and there is no consideration of the total capital requirements faced by individual banks.

Common EU requirements should be trusted to deliver a strong financial system.

The consequence is that banks can have vastly different capital requirements just depending on their country of location. This can be illustrated best with our situation at Nordea – we are subject to the high SSM micro-prudential standards as well as the high Nordic macro-prudential buffers not applied elsewhere in Europe to the same extent. This combination leads to the fact that our overall capital requirements increase out of sync with other major European banks.

In addition, AML and conduct supervision is still national and not sufficiently co-ordinated. We also have varying non-prudential regulation, such as merger directive, banking secrecy, company law, shareholder rules etc.

There is strong confidence in effective prudential supervision and robust rules on capital, liquidity and risk management in the EU. These are strong assets for the EU banking industry. However, at the same time the obstacles to cross-border "branchification" and national discrepancies prevent us from obtaining the benefits of a truly single market.

For investors, it is very difficult to understand differences in requirements that do not correspond to the bank's risks, such as those stemming from the un-coordinated macro-prudential capital requirements. In this way, non-harmonised requirements can hurt banks' ability to compete on a level playing field and attract capital and interfere with the effective allocation of capital across banks and blocks cross-border mergers.

The EU should progressively address the remaining hurdles - both within the SSM and particularly between the SSM and the rest of the EU. The common EU regulatory requirements and well-coordinated micro/macro-prudential supervision and resolution should be then trusted to do the job of delivering a strong financial system without undue country-specific deviations or concerns.

STANISLAS ROGER

Chief Executive Officer - SMBC Bank EU AG

International banks and European banks: partners in the Banking Union

Since it was first announced in 2014, there has been significant progress towards the Banking Union, building on the resilience of the EU banking sector, which has been positively transformed following the Global Financial Crisis. The Banking Union has helped to increase financial stability while also generally reducing friction in cross-border business. For international banks, such as SMBC, continuing to be able to access the European financial markets and do business with our customers, many of whom are large European corporates and financial institutions, is of huge importance.

The ability of international banks to access EU markets benefits all banks, international and domestic. The presence of large global pools of capital provides liquidity to the banking system, which in turn increases cross-border activities between banks, helping to create a well-functioning and efficient European banking sector that provides value to customers, and ultimately, the European consumer. Encouraging cross-border activity within the EU relies on three key principles: 1) partnership between banks, 2) robust rules, and 3) regulatory cooperation.

Partnership between international and domestic banks

As recent events have reminded us, the banking system is highly interlinked and individual markets cannot be entirely separated from other markets. This is particularly true for the EU, which has long benefitted from being an open and attractive destination for international banks. This has in turn benefited the EU, with its large corporates and financial institutions able to access large international pools of capital.

Japanese banks have long been invested in the EU. SMBC has had a presence in mainland Europe for over 50 years and we continue to grow our presence and business in the region. We consider ourselves partners in the Banking Union, and in many ways, we are both a European bank as well as a Japanese bank – many of our customers are large EU-headquartered corporates and financial institutions. A well-funded and profitable Banking Union that promotes cross-border business between Member States cannot be separated from the success of the EU as an attractive destination for international banks.

Robust regulatory frameworks

Confidence in the system is a vital component of a profitable and truly cross-border Banking Union. This confidence can only be achieved through robust regulation and well-functioning and efficient business models. To increase cross-border activities in the EU relies on banks being sufficiently profitable, which can only be achieved through genuine economies of scale.

> **Confidence in the system is a vital component of a profitable and truly cross-border Banking Union.**

The resilience of the EU banking system has been transformed since the Global Financial Crisis and this was evident in the way the sector withstood the shock in the EU of recent events. Banks and regulators have shown effective cooperation to implement reforms and this significant investment from both banks and the public sector has paid dividends. However, in a highly regulated and competitive area of financial services, commercial banks require a stable regulatory landscape to invest and one that recognises the diversity of business models in the sector.

International and European banks have diverse business models, which adds to the strength of the sector and its ability to serve customers of all strengths, size and complexity. Diversification is also an important part of a resilient financial system and can help the sector to better withstand shocks. A regulatory framework that recognises the strength these differences provide will help to promote greater profitability and cross-border activity.

Regulatory cooperation and reform

Just as banks rely on healthy competition and the ability to conduct business cross border, it is important that regulatory frameworks promote this kind of activity. The Banking Union has provided an important example of the benefits of regulatory harmonisation. However, for international banks, many of whom are also European banks, cooperation between EU regulators and third country regulators remains as important as ever. Japan is regarded as equivalent by the EU and is a close partner in promoting high regulatory standards and implementing the internationally agreed Basel framework. We have observed strong regulatory cooperation through the system of joint supervisory colleges and believe that more can be done to share findings across different jurisdictions.

We would urge banks, regulators and policymakers to follow the example of the Banking Union to promote greater harmonisation of rules and the proliferation of cross-border activity.

PIERCARLO PADOAN

Chairman - UniCredit Group SpA

Could Banking Union be revamped by innovation?

Policies to implement and strengthen banking union are both short term and medium to long term. In last year's edition of this column, I argued that in the short-term the introduction of a European deposit insurance scheme and the elimination of ringfencing practices would significantly add to the competitiveness and attractiveness of the eurozone by amplifying the benefits of market expansion and exploiting the early benefits of innovation.

This contribution looks at some aspects of long-term competitiveness and growth capacity that the banking sector needs to fill the gap with respect to competitors, notably the US.

This is partly due to a different market size as well as a more limited contribution of innovation to productivity growth, and a larger role of regulation.

As empirical analysis shows, in the longer run the EU banking industry can reduce the gap and improve its performance thanks to innovation and digitalization, provided the appropriate policies are adopted.

What makes the current innovation episode unique is that, given the nature of the products of the financial industry, public institutions (central banks) react to innovation shocks. Such a mechanism of increased efficiency thanks to innovation could build momentum for making progress in Banking Union.

Innovation such as the use of artificial intelligence (AI) in banking is introducing significant changes affecting the business models of banks, non-financial firms, and the behavior of individuals. However different factors are at work. For example, digitalization is not only directed at changing the way data are treated but, in the case of AI, has also the additional effect of producing new data which should support productivity to a larger extent. With AI still in the early stages of development, it is therefore critical that regulation in the making, such as the Artificial Intelligence Act, does not hamper innovation, by setting excessively strict rules that do not adequately assess the risks associated with AI. We must take into consideration the potential trade off with the diffusion of AI without a proper understanding of these dynamics.

The introduction of digital technologies has also created the grounds for the development of crypto currencies and stable coins. This has been especially the case of Big Tech companies with the aim of introducing their own privately conceived, payment systems. This has prompted the reaction of authorities and central banks many of which have considered introducing their own digital currencies, mostly with the purpose of avoiding the risk of financial instability.

Increased efficiency driven by innovation could build momentum for progress in Banking Union.

However, issuing CBDCs (Central Bank Digital Currencies) is not without risk. CBDC are substitutes for deposits and significantly increase the speed at which deposits may be withdrawn from banks, encouraging disintermediation. It is thus essential that its introduction be accompanied by regulatory and non-regulatory measures to avoid negative effects on financial stability.

Innovation in banking has significant impacts on productivity. However, this is not uniform across sectors. Also, there is no strong evidence that digitalization improves the performance of firms that are already on the technological frontier, neither that it affects the capacity of laggard firms to move to the frontier. It also suggests that investment in digital must be complemented by other variables to produce productivity gains. Most notably intangible and human capital, R&D and supportive regulation aimed at increasing competition and efficiency, notably regulation to support venture capital.

A similar but not identical point can be made with respect to artificial intelligence (AI).

What is more relevant is the impact of the interaction between AI and other digital technologies which promises to be quite relevant and extended over time. For instance, the impact of AI could be quite relevant on labor markets with large numbers of workers being displaced but also possibly compensated by new jobs being created provided that new skills are available. Hence well-functioning human capital and appropriate welfare policies are needed to maximize productivity gains and minimize the costs of transition.

In conclusion, general innovation developments such as the diffusion of digital technologies, in particular AI, provide the basic factors to carry out the structural transformation brought about by the environmental, security, social sustainability challenges that the global system is facing. Such transformation requires a significant contribution in investment, both private and public. Financial markets and banks must provide a front-line contribution to these challenges.

European banks can exploit this unique situation to fill the gap they have been facing with competitors. Even more importantly a more dynamic and productivity driven banking industry could well revamp banking union while short term measures discussed above may provide facilitation effects.