OPTIMIZING THE BANKING UNION

Proposals for Member States to benefit from private risk sharing within the Banking Union

Written by Jean-Marie Andrès, Didier Cahen and Marc Truchet

Executive summary

I. More integrated banking markets foster a more effective allocation of capital across the Eurozone and help building a stronger Economic and Monetary Union (EMU)

In response to the sovereign debt crisis, the EU institutions created a Banking Union in the Eurozone in 2012 to safeguard financial stability in the euro area (reduce financial fragmentation, break the link between banks and their national sovereigns), minimise the cost of bank failures for tax payers and create a safer banking sector.

The Single Supervisory Mechanism (SSM) was fully established in 2014 and the Single Resolution Mechanism (SRM) became operational in 2016. The Commission put forward a proposal for a European Deposit Insurance Scheme (EDIS) in November 2015 and a banking package with further risk reduction measures in November 2016. Most of these measures have been implemented, except EDIS, which is still required to achieve the financial stability objectives of the Banking Union.

Beyond the stability dimension, the Banking Union should also contribute to a strong Economic and Monetary Union. By helping to further integrate EU banking markets, the Banking Union would indeed foster a more effective allocation of capital across the Eurozone, help to achieve a better diversification of risks thus contributing to private risk sharing within the Union[1], which is essential in the absence of short term solutions to develop public risk sharing across the EU due to the insufficient economic convergence.

A safer and more integrated banking system would also better support the currency union by improving the efficiency of the transmission of the monetary policy, for which banking activities play an important role in the euro area.

II. The persistence of fragmented banking markets in the Eurozone, despite a common supervision, limits the full benefits of the Banking Union

While supervisory and resolution decisions are now taken at the Eurozone level, following the implementation of the SSM and SRM, further integration of Eurozone banking markets is needed to achieve the private risk sharing and optimised capital allocation objectives of the EMU. Banking markets within the Banking Union are much fragmented along domestic lines: corporate and retail banking markets are still essentially domestic, financial flows within the banking union have not returned to their pre-crisis level, and in many countries the links between sovereigns and domestic banks have not disappeared.

This fragmentation is mainly due to the EU regulatory framework, which does not consider trans-national banking groups structured around subsidiaries at the consolidated level, but as a sum of separate subsidiaries. This was not reviewed when the Banking Union was implemented and limits the possible benefits of developing trans-national banking activities since the management of liquidity and capital is not possible at group level:

- The CRD, CRR and BRRD adopt a solo approach for the definition of capital and liquidity requirements (LCR, NSFR, MREL, leverage…).
- The pillar II SREP (Supervisory Review and Evaluation Process) requirements for banks are also defined and calibrated for each subsidiary.

III. Concerns about the way possible banking group resolutions may be handled in the EU are the main underlying factor of this non recognition of banking groups

Many Member States, which are dependent on Eurozone banks situated in other Member States for the financing of their economies, are not inclined to move towards a more integrated management of capital and liquidity at banking group level, despite the common supervision of Eurozone banking groups.

This is because they are concerned by the impact that the possible failure of one of these financial transnational groups might have on their depositors and on their economies, and by the fact that these impacts would have to be addressed entity by entity domestically.

Three main factors explain these concerns (aggravated by the slow resolution of NPLs and persistent economic imbalances):

- The **availability of group financial support** to a failing subsidiary is not guaranteed but conditional in case of bank failure according to the rules of the BRRD.
- No rule currently prevents liquidity from being **abusively removed** from a foreign subsidiary by the parent company prior to resolution.
- The treatment of bank failures across the EU is not sufficiently **harmonised, consistent and predictable** [2].

IV. A more integrated approach to resolution and liquidation is needed to fully benefit from the Banking Union

Developing private risk sharing through banking activities within the euro zone requires that for each transnational group, all its liabilities (deposits, bonds...) whatever their location in the Banking Union, should contribute to the financing of all its assets (credit, financings...) in the Banking Union. Thus capital and liquidity should circulate freely within these banking groups. For this to be possible, i.e. addressing the three factors mentioned above, which explain the concerns of many Member States, these groups have to be treated in practice as a single entity from an operational, regulatory, supervisory and liquidation perspective.

Of course the current solutions for completing the Banking Union (EDIS, backstop to the Single Resolution Fund) would strengthen the credibility of the bank crisis management therefore contributing to achieving the initial financial stability objectives of the Banking Union. As the current set-up with national deposit guarantee schemes remains vulnerable to large local shocks (in particular when the sovereign and the national banking sector are perceived to be in a fragile situation), common deposit insurance would increase the resilience against future crises as mentioned in the Five President's Report: Completing Europe's Economic and Monetary Union (June 2015).

However EDIS and the SRF backstop would not address the current fragmentation issues in the EU banking markets.

Addressing this situation requires proposing additional solutions, which may improve the consistency and the predictability of transnational bank resolutions and allow the management of liquidation at the group level with no difference of treatment among creditors of the same rank within the group. This entails that all the subsidiaries of these transnational groups should benefit from an unconditional financial support of the Group.

This is already the way groups structured around branches function. This is not currently possible for the other banking groups since the solo approach prevails for banking regulation (prudential, recovery and resolution).

V. Possible solutions to increase the consistency and predictability of potential trans-national bank resolutions at the EU level

A first solution that does not require regulatory changes could be to facilitate the validation by supervisory authorities of the transformation of subsidiaries into branches. This requires that the national supervisors and parliaments should receive the necessary information to understand the risks national depositors are exposed to from these branches and the possible impacts on the financing of their economies. This may require developing specific reporting instruments and processes for the local authorities to continue to be able to appropriately supervise local activities and appropriately contribute to supervisory decisions taken at the SSM level that may impact their jurisdiction. If this would not be possible, a change in the EU regulatory framework would be necessary. Different alternative regulatory solutions could be proposed for increasing the consistency and predictability of the resolution of these banking groups.

Ultimately, a new EU legal framework should be created for managing the liquidation of trans-national banking groups operating in the Banking Union that would impose consistent conditions for all banking groups in the euro area (i.e. an unconditional financial solidarity among the different entities of these groups and an equal treatment in liquidation or resolution, of all the creditors located in the Eurozone). This should go together with a review of the governance requirements for Eurozone-based banking groups (e.g. an integrated organisation and policy for monitoring risks, compliance, legal affairs and internal control).

In an interim stage however, a solution would be to extend to subsidiaries the liquidation approach currently used for branches, whereby resolution is managed under the regime of the parent company. This would allow all the subsidiaries of the Group to be treated under the same liquidation regime.

A first step forward could in addition be to define objective criteria of financial soundness that could enable the SSM to allow the circulation of cash and liquidity at group level. Strengthening the powers of the SRB in case of liquidation (e.g. decision power to trigger a liquidation or resolution, positioning the SRB as the operator of liquidations and resolutions) would also be necessary to facilitate the implementation of those solutions.

A solution is also needed to facilitate the contribution of cooperative and mutual banks to the cross border integration of EU banking markets. One possibility could be to facilitate the cooperation between regional banks on a transnational basis.

To move forward, a discussion between the main transnational banks operating in the euro area and the

EU and national supervisory authorities concerned should be initiated to discuss the conditions of a possible transformation of banking subsidiaries into branches (information of local authorities, possibility for local considerations to be effectively taken into account in SSM supervisory decisions impacting their jurisdiction …) and of the possible pre requisites for adopting the proposed solutions (unconditional group support, common liquidation regime). This discussion will be initiated during the Eurofi Sofia High Level Seminar.

[1] Risk sharing should increase the capacity of the banking sector to absorb potential asymmetric economic shocks (or the asymmetric consequences of a common shock) affecting one or two Member States.

2 Whether competent authorities are resolving (CRD and State Aid regulation) or liquidating (State Aid regulation) a transnational banking group, and whether the effects of a liquidation and notably its implications on public interest and critical financial functions, are assessed at EU or national levels (which apply different sets of criteria), the impacts in terms of levels of state aid and bail-ins are very different. Furthermore, in the event of a liquidation, which is handled at entity level, the creditors of the same rank of different subsidiaries may be treated differently across the Eurozone.

Detailed summary

The sovereign debt crisis was a catalyst for the decision to create a Banking Union in the Eurozone in 2012, to safeguard financial stability in the euro area, minimise the cost of bank failures and contribute to a smooth functioning of the single monetary policy[1].

A well-functioning Banking Union is also an important component of the Economic and Monetary Union (EMU) project. Indeed a stable and prosperous EMU requires an integrated banking and financial system to foster better private risk sharing within the Union[2] (the intra-Union diversification of risks allowed by a reduction of the domestic bias in the shareholding of banks, in the attribution of credit and in the detention by banks of domestic sovereign debt) and thus achieve a more optimal allocation of capital throughout the Union (by the development of trans-national banking and financial activities and capital flows).

Major steps have been taken at unprecedented speed over the past years to establish the key pillars of the Banking Union in order to ensure the stability of the Eurozone banking system. After a comprehensive assessment of all significant credit institutions in the Banking Union, the Single Supervisory Mechanism (SSM) was fully established in 2014. National Competent Authorities (NCAs) are therefore fully involved via their representatives as part of the Joint Supervisory Teams supervising significant institutions. The Single Resolution Mechanism (SRM) became operational in 2016. The banking single rulebook has now been implemented throughout the EU. The integration of the EU banking system has also progressed thanks to the further development of some European banking groups in the context of the financial crisis.

However, the functioning of the Eurozone banking system remains very much fragmented along national lines: corporate and retail banking markets are still essentially domestic, financial flows within the banking union have not recovered to their pre-crisis level and the links between sovereigns and banks have not disappeared. This diminishes the private risk sharing and capital allocation impacts of the Banking Union and also its potential contribution to the transmission of monetary policy and to the EMU.

This fragmentation, which is due to the persistence of a strong domestic bias in the banking single rulebook, mainly stems from an insufficient confidence of EU Member States in the capacity of EU regulations to appropriately manage possible crisis situations which may affect the banking groups operating in their jurisdictions. This lack of confidence persists despite the implementation of the SSM and SRM.

This note identifies the main obstacles to any further integration of EU banking markets. It proposes solutions that may address these obstacles in order to benefit from the private risk sharing and capital allocation of the Banking Union.

1. Effective private risk sharing and capital allocation across the Eurozone, needed for deepening the EMU, requires a further integration of banking markets within the Banking Union

Beyond developing competition and economies of scale and possibly reducing financing costs for the economy, a further integration of EU banking markets would

[1] The Banking Union is a framework applying to countries in the euro area (and that non-euro area countries can also join) which establishes a single supervisory mechanism (SSM) and a single resolution mechanism (SRM) for banks. The SSM and SRM are now fully operational. A further step proposed by the EU Commission is the creation of a European Deposit Insurance Scheme (EDIS) which would provide more uniform and stronger cover for all retail depositors in the Banking Union. The single financial rulebook applying to all financial actors in the EU is the foundation for the Banking Union.

[2] The Banking Union is part of the so-called "private risk sharing" component of the EMU. The Capital Markets Union is also part of private risk sharing.

allow a more effective allocation of capital across the Eurozone, a better transmission of monetary policy and a better diversification of risks.

Contrary to domestic banks that only lend in the countries where they collect deposits, trans-national banks have the capacity to extend credit and contribute to capital market activities across borders, which may improve the allocation of savings and capital to investment opportunities across Europe.

A more integrated banking sector also allows a better diversification of banking risks across the Union, which should increase its capacity to absorb potential asymmetric economic shocks affecting given Member States (or the asymmetric consequences of a common shock). This is the main objective of the private risk sharing component of the EMU. There is firstly a diversification of the risks incurred by the shareholders of banks. Secondly, banks operating in several countries of the Union should diversify their detention of sovereign debt reducing their exposure to any individual sovereign debt. Thirdly, the trans-national development of banks should also help to diversify the risks to which the depositors and savers of these banking groups are exposed and to better maintain lending capacity in case of stress.

Further integration of banking markets in the EU should therefore help all its Member States to better cope with economic and financial shocks, as well as meeting their financing needs.

Some may nonetheless argue that the development of trans-national banking activities may also entail financial stability issues since cross-border exposures may facilitate the spreading of spill-over risks from external shocks. These risks need to be properly mitigated for the further integration of banking markets to be fully beneficial, which is a key objective of the enhanced supervision and resolution mechanism provided by the Banking Union.

2. Further integration of EU banking markets is hindered by the domestic bias of the EU banking regulatory framework

Much progress has been made in a limited amount of time with the achievement of a common banking rulebook and the establishment of the institutions of the Banking Union: the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM).

However, the integration of banking markets within the Banking Union is still limited. The 20 trans-national banking groups that operate within the Union currently appear to function more like a collection of national banks than as integrated banking groups and only playing a more limited role in terms of intra-Union risk sharing and capital allocation.

This is mainly due to the “national and solo approach” of the EU banking regulatory framework (CRD, CRR, BRRD) which does not consider trans-national banking groups in the EU at the consolidated level, but as a sum of separate subsidiaries. This was not reviewed when the Banking Union was implemented.

The Liquidity Coverage Ratio (LCR), which is designed to ensure that banks have the necessary assets to face short term liquidity disruptions, is indeed calculated on a solo basis since liquidity excesses in one subsidiary cannot be used to compensate for possible shortages in other ones[3].

The EU Commission has also proposed that the Net Stable Funding Ratio (the NSFR) agreed in Basel which seeks to calculate the proportion of long term assets which are funded by long term stable funding and is currently being discussed to be transposed in the EU legislative framework) should be calculated both at a consolidated level and on a solo basis. This would oblige banking groups to manage their long term funding also on a local basis, which would add complexity and costs.

Another area where bank groups may not be considered on a consolidated basis from a regulatory point of view is the calibration of Minimum Requirement for own funds and Eligible Liabilities (MREL) currently discussed in the context of the BRRD/SRMR where domestic resolution authorities may have the possibility to add MREL to local subsidiaries of banking groups on top of the MREL decisions made by the SRB. This may lead the subsidiaries of banking groups to have different levels of MRELs from those of domestic banks of an equivalent risk profile and the sum of local MREL to exceed the level of MREL defined at the group.

A further issue is that banking operations between two EU countries, including in the Euro area, continue to be considered as cross-border operations by the EU prudential legislative framework in the calculation of the Global Systemically Important Bank (GSIB) systemic risk buffer[4].

[3] The CRR provides waiver mechanisms which should normally allow the alleviation of these issues with the LCR (Article 8 of the CRR) but they have not been granted by the SSM to GSIBs so far possibly due to the difficulty of providing legal opinions corresponding to a rigorous interpretation of waiver requirements. In such a context, the EU Commission has proposed a mechanism based notably on collateralisation: pooling subsidiaries' own funds would require that they should be guaranteed by the parent and that the guarantee should be collateralised for at 50% of its amount when the waiver occurs on a cross-border basis. However, many GSIBs disagree with the need for additional collateral requirements due to the additional costs and a prepositioning of such collateral may reduce the possibility to allocate funding in an optimal way in case of difficulties.

[4] In other words, all cross-border operations have to be consolidated for the GSIB buffer to be calculated the GSIB buffer but for the calibration of local liquidity and own fund obligations, everything has to be deconsolidated.

This solo approach maintains a domestic focus in the way prudential requirements (capital, liquidity leverage) are imposed on banking subsidiaries across the Eurozone, despite the single supervision principles of the SSM and the involvement of domestic supervisors in the supervisory decisions taken by the SSM. Consequently, the opportunities existing in transnational banking groups to pool cash and match assets and liabilities of similar maturities and therefore to increase intra-Union risk sharing, within the Banking Union are not taking advantage of. Additional regulatory constraints are imposed. This reduces the expected benefits of trans-national development for Eurozone banks in terms of the cost of capital, funding and further intra-union risk sharing, creating major disincentives and hindering a further integration of banking markets in the Banking Union.

In addition, the single rulebook is not truly single, since it contains national options and discretions (OND), which provide government and supervisors with some leeway in applying the rules[5]. Supervision also remains fragmented even if the SSM has harmonised the main tool of banking supervision: the Supervisory Review and Evaluation Process (SREP). However the SREP remains a collection of requirements (capital, liquidity, leverage) regarding both the group as a whole and each of its subsidiaries. Moreover certain supervisory tools are applied in different ways in different countries (e.g. onsite inspections) and tools exist in some countries but not in others (e.g. moratorium).

In the current situation, transnational banking operations are more complex and costly compared to domestic ones, which is a result of additional regulatory requirements (national and solo approaches).

3. Progress towards a European approach to banking regulation, supervision and liquidation is hindered by the solo approach, the heterogeneity of national insolvency laws, and the lack of predictability of the treatment of possible banking groups' failures

The fact that the solo approach to the regulation of banking groups structured around subsidiaries in the EU (CRD / CRR and BRRD) and national discretions were kept despite the implementation of the banking Union for transnational groups, and could be explained by a perceived lack of trust of many Member States that the possible resolution or liquidation of trans-national banking groups operating in their jurisdictions may be conducted in an even-handed and predictable way.

Many Member States are indeed concerned by the impact that non-domestic financial groups might have on their domestic depositors, their deposit guarantee system and the financing of their economies if one or several of the groups present in their jurisdictions were to run into difficulties or decide to discontinue services in the country.

This problem is particularly acute in countries that are strongly dependent on foreign banks for the financing of their economies. This is the case of a large number of Eurozone Member States (Belgium, Luxembourg, Baltic States, Finland, Slovakia, Poland, Hungary, etc.) where most domestic banks are subsidiaries of banks whose headquarters are located in other countries within the Banking Union (Austria, France, Italy, Germany, etc.) or the rest of the EU (Sweden, Denmark). Various factors can explain this lack of confidence:

- **The availability of group financial support[6] to a failing subsidiary is not guaranteed in the case of bank failure according to the rules of the BRRD**

  Article 23 of BRRD limits the application of group support to cases that do not represent a risk for the whole group. Consequently, host countries fear that if a local subsidiary records significant losses, the parent company may let it fail, which leads them to pre-emptively increase the capital requirements of local subsidiaries and to ring-fence liquidity and capital.

- **The treatment of certain subsidiaries in living wills may be insufficiently specific even though they are locally systemic**

  The living wills of banking groups sometimes do not describe the treatment of some local subsidiaries given their limited size compared to the size of the group although they are locally systemic. In addition, the information regarding the living wills provided by the Management Board of the Single Resolution Board (SRB) to national resolution authorities are not always detailed enough notably regarding "small" subsidiaries. This increases uncertainty regarding the handling of a possible resolution and encourages solo approaches.

- **The treatment of bank failures at the EU level is not sufficiently harmonized and predictable, meaning that the same types of creditors of different subsidiaries may be treated differently across the Eurozone**

  Firstly, liquidation is implemented at entity level and follows domestic insolvency laws for part of the creditors[7]. As a result, the treatment of

[5] Despite the elimination of more than 100 National Options and Discretions (OND) by the SSM, there are still national Options and Discretions that lie in the hands of governments. So it is up to them to achieve more harmonisation, but unfortunately very little has been done in this area.

[6] Group support as defined in the BRRD (Chapter 3, Article 19).

[7] Some bail-in rules have been harmonised at the EU level (e.g. CET 1, CET 2, senior non preferred debt), but however some creditors are still treated according to different national regimes (e.g. bank deposits of corporates and retail customers exceeding 100 K€…).

liquidation may differ across the subsidiaries of trans-national banking groups. Indeed resolution is currently organized at the European level, while the calculation of the counterfactual underlying the NCWO safeguard can generate very different results across different Member States.

Secondly, the treatment of bank failures at the EU level is not sufficiently predictable. The decision to resolve (governed by EU rules) or to liquidate (regulated by national insolvency laws) relies on the SRB's assessment (at EU level) of whether public interest is at stake, which depends on whether the functions performed by the failing bank are critical and whether the failure has a significant adverse impact on financial stability[8]. The notion of public interest produces different outcomes depending on the level of the jurisdiction – (i.e. European, national, regional) – for similar banks. For example, in the case of the liquidation of the two Venetian banks the SRB stated that there was no public interest that could trigger resolution but the Italian national authorities considered that there was sufficient public interest to justify their intervention.

Consequently, BRRD bail-in rules were not enforced, the Italian government made available 17 billion euros, and creditors were "in fine" better off than in a resolution which would have entailed a more stringent bail-in of creditors than this liquidation.

- **No rule currently prevents, in all circumstances and Member States, liquidity from being abusively removed from a foreign subsidiary by the parent company prior to resolution or liquidation**

  Host countries fear that in the final stages before resolution, all or part of the liquidity of local subsidiaries situated in their jurisdiction may be transferred to a failing foreign parent or sister company to ease liquidity shortages, leaving the former subsidiaries as "non-preferred creditors" of the entity in resolution. Such a practice would improve the net assets of the parent/sister company, and benefit its creditors while deteriorating the situation of the creditors of the subsidiary. Although the Single Point of Entry (SPE) Resolution approach was specifically designed to ensure a transmission of losses to parent resolution entities, host countries fear that it may not provide, in all foreseeable circumstances, a complete mitigation of the risk of contagion from foreign parent or sister companies.

This lack of confidence in the effectiveness of EU crisis management tools is aggravated by the slow pace of resolution of non-performing loan issues in certain Union countries and the high levels of indebtedness of various home countries of EU trans-national groups (Italy, and Spain for example). This latter situation may indeed affect the soundness of the parent companies of these banking groups – which tend to hold significant amounts of domestic sovereign debt and whose domestic credit portfolio may be impacted by the consequences of an economic downturn affecting their home country. In this absence of sufficient economic convergence, host countries prefer to limit intra-Union risk sharing.

Lastly, Member States need to benefit from all the relevant information from banks, even in the case of a branch of a transnational group, regarding the evolution of their contribution to the financing of the local economy (volume and cost of lending to the different economic players, evolution of deposits...) and the risks to which national depositors are exposed. This also encourages Member States to favour national and solo approaches through which they can more easily get the information they require, despite their presence at the SSM (?) which provide this data.

4. How to address current fragmentation and improve the functioning of the Banking Union?

4.1. The solutions proposed for deepening the Banking Union (EDIS, SRF backstop) should support the completion of the Banking Union, but do not address current fragmentation issues in the EU banking markets

Many stakeholders argue that the current fragmentation of the Banking Union will be solved by its "completion", meaning the introduction of a European Deposit Guarantee Scheme (EDIS) and the addition of a backstop to the Single Resolution Fund (SRF). These tools would help to improve financial stability by providing additional last resort backstop solutions and contribute to achieving the initial financial stability objectives of the Banking Union.

As the current set-up with national deposit guarantee schemes remains vulnerable to large local shocks (in particular when the sovereign and the national banking sector are perceived to be in a fragile situation), common deposit insurance would increase the resilience against future crises as mentioned in the "Five President's Report: Completing Europe's Economic and Monetary Union" (June 2015).

However desirable these developments may be, they alone might not address the concerns of Member States described above. In particular they would not guarantee that banking groups are resolved in a more integrated way which is a problem hindering further integration in the EU banking markets at present.

[8] While the use of public funds in a resolution at the EU level would be subject to both BRRD and state aid rules, thus requiring a preliminary bail-in up to at least 8 per cent of total liabilities – the use of public funds in liquidation is only subject to state aid burden-sharing requirements.

4.2. The fully integrated functioning of transnational groups needs to be European in life and European in death

An effective contribution of transnational banking groups to intra-Union risk sharing requires that all the liabilities of such groups, whatever the subsidiary they are located in, should finance the assets wherever they are located notably in the Banking Union. Consequently capital and liquidity should circulate freely within the Group.

In return, all these subsidiaries should benefit from an outright financial support of the Group. At the same time, these liabilities when they have the same rank should be treated equally in the event of a liquidation or resolution.

These groups have to be treated in practice as a single entity from an operational, regulatory, supervisory and liquidation perspective for Member States to benefit from intra-Union risk sharing. This is already the way the groups structured around branches function. This is not currently possible for the other banking groups since the solo approach prevails for banking regulation (prudential, recovery and resolution).

One first solution could be to facilitate the transformation of subsidiaries into branches. This would mainly require providing national Authorities/ Parliaments with the information necessary for them to understand the risks that their national depositors are exposed to and the possible exposure of their economies to these branches. National resolution authorities should also be appropriately involved in the definition of living wills whenever local undertakings are systemic.

An alternative solution is to define a new dedicated regulatory framework for the liquidation of transnational groups integrating the main aspects of the functioning of the groups organised around subsidiaries, to effectively make them European in life and in death.

This should significantly help to increase the confidence of Member States in the sustainability of banking groups operating in their jurisdictions, opening the way to a common regulatory and supervisory approach to banking regulation at the Eurozone level and to a consolidated regulatory approach to banking groups, allowing for example the pooling of own funds and liquidity at group level in the Eurozone.

Different solutions for reviewing the current EU banking framework are possible. The objective is to achieve an effective outright group support, to provide all the creditors of Eurozone banking groups of the same rank with an equal treatment in liquidation or resolution, by considering these groups as a single entity from a regulatory and supervisory perspective. They also address the accountability needs of national Parliaments.

These solutions should work in priority for Eurozone countries to improve the functioning of the monetary union and the stability of the euro area. However, since they involve changes in European regulation, it is important to ensure that they do not impose unwanted consequences on other EU Member States and that specific differentiation between euro and non-euro Member States is possible on certain parts of the framework.

4.2.1 Solution 1: Obtain acceptance of the transformation of Union subsidiaries into branches through a determined policy of information and involvement of the local authorities

The current European legislative framework already allows transnational banking groups to transform their subsidiaries into branches. This approach would solve the main issues mentioned above by creating a 'de facto' unconditional group support for branches and ensuring equality of treatment of creditors of the same ranking, whatever their geographic situation. In addition it would not require requiring any prior harmonisation of multiple national insolvency laws. Experience however shows that the desire of banking groups to operate such transformations often meets significant national resistance, despite the existence of the SSM and SRM. The only significant example of a banking group that has achieved this objective is that of Nordea.

This could be explained by the fact that national authorities fear that the transformation of a subsidiary into a branch would deprive them of the information that they feel is necessary to track the financing of their domestic economy and the risks to which domestic depositors in these branches are exposed.

In order to make this transformation of subsidiaries into branches possible, national supervisors should be guaranteed continue to benefit from an equivalent level of information to what they receive from a solo-regulated entity. If the local branch is of systemic importance for the local economy, we must ensure that the functioning of the SSM allows local supervisory authorities to fully understand the risk profile of the banking group, and its evolution, and to be fully associated to any supervisory decisions that would impact the economy or the population of the Member State concerned.

Whether the branch is significant or not in the whole banking group, domestic supervisors should have a similar capacity to react to strategic decisions (modification of the activity of the branch, reduction of local activity...) as they would had it been a stand-alone entity so that the SSM, SRM, and national authorities fully discharge their responsibility for accountability to the Member States.as regards the supervision of branches located outside the baking union, the improvement of information exchange with national authorities should be the counterpart of removing any capital and liquidity ring-fencing.

As is the case for a universal bank at the national level, the tools required to manage a crisis focusing on the entities that provide critical functions should be defined in the living wills.

If it were not possible to achieve an agreement on such a solution, alternative solutions can be envisaged. They require developing specific regulations which achieve unconditional intra group solidarity, an equal treatment of all the creditors of the same rank within the groups and allow integrated regulatory, supervisory and liquidation approaches at the group level.

4.2.2 Solution 2: A new EU legal framework for managing the liquidation of trans-national banking groups (organised around subsidiaries) operating in the Banking Union encompassing an unconditional financial solidarity among the different entities of these groups

A new framework should be developed for EU banking groups, involving an unconditional financial solidarity among the different entities of these groups and providing for an equal treatment in liquidation or resolution of all the creditors of a banking group located in the Eurozone and of all its Eurozone subsidiaries. Consequently, it would also need to ensure that host countries are all treated in the same way in case of difficulties so that the SSM, SRM, and national authorities fully discharge their responsibility for accountability to the Member States.

In this solution, all the regulated subsidiaries of a banking group located in the Eurozone would be subject to the same regulation in case of liquidation or resolution. The depositors and creditors concerned would be informed ex ante of this and of the subsequent resolution and liquidation regime that would apply to them, which would need to be enforceable against third parties.

To preserve the interests of non-Euro countries, their supervisory authorities should be given the possibility to validate or not the inclusion of the subsidiaries located in their jurisdiction in the perimeter of the group mentioned above. This possibility should be exercised ex ante, at the earlier stage. This decision should be communicated to the public for the legal security of creditors and would improve the confidence of investors. This decision would also require the agreement of the SSM and the SRB. The subsidiaries that would remain outside the banking group would be treated following the current domestic liquidation regime and therefore continue to be subject to existing solo regulatory approaches and related own fund and liquidity pooling limitations.

Furthermore, if the parent company were to decide to remove one of its subsidiaries from the perimeter of the group to sell or liquidate it, the group would have to obtain the agreement of the SSM, the SRB and the domestic supervisory authority concerned that this is possible, given the soundness of the subsidiary. In any case a subsidiary liquidated in isolation would need to be in bonis or possible negative net assets be directly allocated to the parent company.

A definition of the related legal conditions and governance requirements for Eurozone-based banking groups to access this banking group status would also be necessary, as well as a definition of the internal organisation needed for managing such groups[9]. In particular, such an approach would require the implementation of a governance framework within banking groups that leads the group-level management (parent company directors) to optimise the value of the entire group within the Banking Union, and not exclusively the parent company's value. This is important notably to avoid any conflict of interest for the managers of the group should the difficulties of a subsidiary threaten the viability of the parent company.

***Solution 2bis:* In an interim stage until a new EU banking legal framework for liquidation is available, a solution would be to extend to subsidiaries the liquidation approach currently used for branches as well as an unconditional financial solidarity among the different entities of these groups.**

The liquidation of bank branches is currently managed under the regime of the parent company (cf. Directive of 4 April 2001 on the reorganization and winding up of credit institutions). The liquidation regime of the different branches of a group is therefore common to all of them and defined ex ante.

The objective of this second solution would be to extend this regime to all the regulated banking subsidiaries of a banking group located in the Eurozone. The liquidation of a trans-national banking group would therefore be managed under the regime of the parent company.

All the banking subsidiaries in the Eurozone would be considered as part of the group and follow the same resolution and liquidation regime. In the same way as for the previous solution, all depositors and creditors of the subsidiaries involved in the perimeter of the banking group would be informed of this and of the consequences in terms of resolution ex ante. Moreover non-Eurozone supervisory authorities would have the same possibility as in solution 1 to validate the inclusion of subsidiaries located in their jurisdiction in the group and to decide in association with the SSM and the SRB on the possible removal of a subsidiary from the group.

[9] These groups should also have an integrated organisation and policy for monitoring risks, compliance, legal affairs and internal control. However, the subsidiary managers would retain their responsibility in relation to the single entity that they are in charge of, including on a criminal level, in order to retain the benefits of having local management with knowledge of the specific features of their domestic markets.

4.2.3 Facilitating the operations of regional cooperative or mutual groups in cross-border economic areas and preserving the diversity of bank business models within the EU

Due to their importance in the Eurozone, a solution should also be proposed for mutual/ cooperative groups and saving banks operating in the Eurozone[10]. Indeed Mutual/cooperative groups as well as savings banks operating in the Eurozone contribute in several ways to stability and protection within a diversified banking landscape. These groups function at present using Institutional Protection Schemes (IPSs). These schemes are contractual or statutory mutual liability arrangements that prevent the possibility of bankruptcy of each member of an IPS by ensuring that it benefits from the other members in case of liquidity and solvency needs.

to preserve the diversity of the EU banking landscape, the added value of IPSs should be a central aspect of the discussion about EDIS, taking into account that some of them are officially recognized as Deposit Guarantee Schemes (DGSs) in accordance with Art. 1 (2c) DGSD.

The contribution of cooperative and mutual banks to the cross border integration of the EU banking markets should also be facilitated. One possibility could be to facilitate the cooperation between regional banks on a transnational basis notably to address the needs in cross-border economic areas. A solution could be to offer the possibility to extend internal guarantee schemes on a transnational basis providing them with legal certainty and solidarity arrangements similar to the domestic level.

4.2.4 Strengthening the powers of the SRB in case of liquidation

Currently, if there is no public interest to put an entity under resolution, the SRB has no power in the liquidation phase. Since the SRB has by definition a more European perspective than national resolution authorities the proposals above could be reinforced by the strengthening of the role and powers of the SRB in the liquidation phase. Indeed, at present the SRB ensures an orderly resolution of failing banks with minimum impact on the real economy, the financial system, and the public finances of the participating Member States. The SRB in particular operationalises resolution plans, calculates MREL for all major banking groups and addresses the quality and location of MREL within a group. The SRB is also in charge of the industry–funded Single Resolution Fund (SRF).

Informing systematically the SRB of any targeted liquidation decision and providing the SRB with the decisive power to trigger a liquidation or resolution and lastly positioning the SRB vis a vis judicial authorities as the systematic operator of liquidations and resolutions would reinforce the perception of consistency and predictability of the EU crisis management framework and facilitate the practical implementation of the previous solutions. In particular this would reinforce the possibility for the SRB to review intra-group transactions and liquidity transfers in the case of likely failure and to check whether they were justified. If this is not the case they could be retro-actively cancelled by the SRB using a "claw back" right.

4.3. Additional solutions could also be proposed to facilitate the circulation of liquidity and cash at group level

Solution 3: Imposing financial soundness conditions for allowing the circulation of liquidity and cash at group level

In the short term a possible area of improvement – which would however not address intra-Union risk sharing issues in the same way as the previous solutions - would be to allow the management of liquidity and the free circulation of available cash at group level within the Banking Union provided that certain criteria of the financial soundness of the banking group are met.

These criteria would be defined and monitored by the SSM. A possible additional safeguard would be to maintain a minimum level of liquidity in each subsidiary (for instance above 60% of the LCR).This would also make it possible to calculate the LCR and NSFR on a consolidated basis.

◇◇◇◇◇◇◇◇◇◇◇◇◇◇◇◇◇◇◇◇◇◇◇◇◇◇

The initial objectives of the Banking Union to improve financial stability in the Eurozone have been partially achieved with the implementation of the SSM and SRM. Indeed differences persist notably in the way supervision is conducted across the Union and many banks in euro area stressed countries maintain a significant exposure to their domestic sovereigns.

Moreover improvements are required in the integration of banking markets for the Banking Union to further contribute towards the objectives of the EMU (improvement of financial stability, reduction of the cost of bank failures for citizens, better allocation of capital, and contribution to a smooth functioning of the single monetary policy...).

[10] At present about 50% of credit institutions in the euro area are members of an IPS, representing around 10% of total banking system assets of the area. In the Eurozone, the vast majority of local savings banks and credit cooperatives belong to cooperative and mutual support networks. European legislation (CRR) recognises some of these networks as Institutional Protection Schemes (IPS).

Indeed an integrated functioning of banking markets is not supported by the current EU regulatory framework which is elaborated on a solo basis and limits intra-Union group-wide waivers. The reasons for this are that the group support to a subsidiary is legally limited and that the EU legislation only recognizes legal entities and not banking groups. Consequently a possible liquidation of these groups or part of them is conducted entity by entity and therefore on a national basis.

Making banks European in life however requires that they should also be treated as European in death. The different solutions exposed in this note propose various legal bases that would help transnational banking groups (including cooperative and mutual ones) to function in a more integrated way notably by proposing a liquidation framework that would apply at the EU level.

Consequently a transnational group should guarantee an unconditional support to all its entities, resolution and liquidation would be conducted at group level and no longer entity by entity and finally a consolidated approach to banking regulation for integrated banking groups based in the Eurozone should be the rule. These solutions should take care of the legitimate national accountability needs by providing national authorities with an adequate level of involvement and information.

Most of these solutions require adaptations of the EU legislative framework. The rulebooks must be clear and equivalently enforced on the basis of transparent and predictable procedures. Legal clarity and enforceability, non-discrimination and consistency are indeed key to building confidence in building the Banking Union.

The implementation of these solutions is challenging, requiring a collective political will, but these actions are essential for fully benefitting from the contribution of the Banking Union towards a genuine EMU (better allocation of capital flows, intra-Union risk sharing).

Notes

eurofi