Note drafted by the Eurofi Secretariat

ADDRESSING RING-FENCING ISSUES IN THE BANKING UNION

The Banking Union has been successful in promoting a more resilient banking sector. However, there are remaining steps towards an effective Banking Union. The quality of banks' assets has significantly improved, but the legacy of non-performing loans is still weighing on a number of banks. The sovereign- loop remains active in peripheral countries. Moreover, the Banking Union is failing to deliver an integrated domestic a market for banking business. Despite the implementation of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), the banking sector in Europe is fragmented, not concentrated enough and oversized. And there are obstacles to the integrated management of bank capital and liquidity within cross-border groups operating in the Banking Union.

1. In an effective Banking Union, there should no longer be any distinction between home and host supervisors for banks operating across borders and the possibility of "national bias" playing a part in regulation or supervision should be eliminated

The distinction between home and host supervisors and the "national bias" still exists for banks operating across borders in the Banking Union. Indeed, regulators still believe that capital and liquidity will be trapped in individual Member States if a pan European banking group fails and are still concerned by the vicious "State-Bank" circle, which still exists in certain EU Countries. This perception is particularly acute in countries that are strongly dependent on foreign banks for the financing of their economies. This lack of trust between national authorities is one of the most damaging legacies of the recent financial and sovereign debt crises.

In addition, the EU legislative prudential framework does not recognize trans-national groups at the consolidated level but only as a sum of separate subsidiaries ("national or solo approach") notably due to the insufficient trust of Member States vis a vis the institutional set up of the Banking Union.

Consequently, ring-fencing policies are applied to capital, liquidity and bailinable liabilities. This clearly distorts the functioning of free banking markets, fragments them, contributes to the low profitability of banks in the EU and impedes the restructuring of the banking sector in Europe, which cannot benefit from the economies of scale of the single market compared to US banks for instance, which can rely on a large unified domestic market.

In addition, defining prudential requirements at group level should contribute to enhancing financial stability. For instance, the main benefit of defining MREL only at the group level rather than also on the level of each subsidiary (internal MREL) is that it increases flexibility. In the case of a loss in a subsidiary that would be greater than the amount of internal MRELs prepositioned in the country of this subsidiary, it would be easier to mobilize the required capital using centrally held resources from the parent company. If all resources have been pre-allocated, it is unlikely that any local supervisor would accept that internal MRELs located in their jurisdiction should be released and transferred to another one.

In such a context, it is essential to consider transnational banking groups of the euro area as unique entities from an operational, regulatory and supervisory perspective, and not as a sum of separate subsidiaries ("the solo approach"). To ensure such an objective, it is necessary to tackle the root cause of domestic ring-fencing practices.

2. The main conditions for the abandonment of the "national and solo approach"

In order to reassure local supervisors, European transnational banking groups that wish to operate in an integrated way need to commit to providing credible guarantees to each subsidiary located in the euro area in case of difficulty and before a possible resolution situation ("the outright group support"). This "outright group support" would consist of mobilizing the own funds of the Group to support any difficulties of a subsidiary located in the euro area. Since the level of own funds and the creation of MRELs have considerably increased the solvency of EU banking groups, they should be able to face up to any difficulty of their subsidiary located in the euro area. This group support should be based on EU law and enforced by EU authorities. This commitment is the key condition for these banking groups to define prudential requirements at the consolidated level. Given the high degree of banking intermediation in Europe, compared to other jurisdictions around the world, striving for a smoother movement of capital and liquidity, across EU countries, is essential.

In order to create a climate of confidence and trust, host countries should be associated and involved upstream in the establishment of living wills.

In addition, if the group was to go into liquidation (and not only local subsidiaries), a European approach to the liquidation of these transnational banking groups is also required. Indeed, even though these transnational banking groups are supervised at the EU level and the impacts of this liquidation would impact the whole euro area, liquidation is still managed at the national level (entity by entity) and this can require the public money of the Member State of the entity. A common liquidation regime for these banking groups should ensure an equal treatment of creditors of the same rank within the group and the addressing of possible costs at the EU level. In an interim stage one solution could 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.

An alternative solution could be to facilitate the validation by supervisory authorities of the transformation of subsidiaries into branches for banking groups who wish to operate in a more integrated way. 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 thus contribute to supervisory decisions taken at the SSM level that may impact their jurisdiction.

These are the main conditions for the abandonment of the “national and solo approach”.

Finally, when the more fiscal and structural convergences (such as a reasonable level of public debt in all Eurozone countries, …) are achieved, the more positive integration trends will creep into the Union and reduce the incentives for national authorities to “ring fence” transnational banks in terms of capital and liquidity, thus strengthening banks in their capacity to become pan-European players. In other words, a monetary union and all the more so a banking (or capital) union are not workable without economic convergence and fiscal discipline. ■