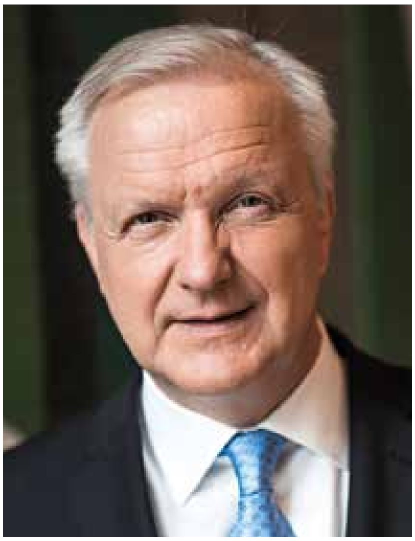
Addressing ring-fencing issues in the Banking Union



Olli Rehn

Governor, Bank of Finland

It is time to complete EMU financial architecture

We still have plenty of work to complete the financial architecture of the Economic and Monetary Union. Following the launch of the euro, financial markets in the euro area steadily integrated and led to the assumption that enhanced private risk-sharing would act as a shock absorber and a source of systemic stability. However, as we now well know, this turned out to be unsustainable. In the wake of the global financial crisis, the euro area financial market quickly started to disintegrate. It was not until the ECB's determined actions to embark on non-standard monetary policy measures that the negative market developments were halted.

Despite the subsequent strong policy response, first and foremost by strengthening the regulatory and supervisory framework and, second, by enhancing the institutional setup to deepen risk-sharing, euro area financial integration has remained weak. There are some positive signs in the post-crisis reintegration trend in prices but not in quantities. In particular, there has been very little what can be called deep banking integration, and the share of cross-border bank loans to and cross-border bank deposits from end-customers has remained stubbornly low. Banks' efforts have focused on safeguarding profitability and solvency and less on cross-border activities, with few exceptions.

There is broad agreement that fragmentation is suboptimal and comes at a cost for banks and the efficiency of the financial system. So why does the progress towards a more integrated euro area financial market remain so difficult? Briefly, as long as the EMU financial architecture is incomplete member states' have legitimate concerns and incentives to protect the interests of domestic stakeholders and engage in ring-fencing activities. The underlying reasons include information asymmetries, desire to protect credit supply, protection against financial stress in foreign jurisdictions, and additional safeguards due to domestic systemic importance.

With the establishment of the Single Supervisory Mechanism SSM and the Single Resolution Mechanism SRM, significant steps to enhance banking integration have already been taken. However, we need to complete the EMU financial architecture to overcome the remaining obstacles. With regard to the Banking Union, we must implement the remaining measures to ensure an effective and credible resolution framework. This, in turn, requires making sure that banks have issued adequate amounts of bail-inable liabilities and, as a second line of defence, ensuring a proper fiscal backstop for the Single Resolution Fund with sufficiently flexible decision-making

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>>> procedures. Furthermore, the common deposit guarantee scheme, built on appropriately designed risk-based insurance premia and medium-term fiscal neutrality, is needed to ensure uniform confidence in secured bank deposits throughout the euro area.

These risk-sharing mechanisms need to be carefully designed to ensure that incentive compatibility and greater risk-sharing will go hand in hand with greater risk-reduction. In this respect, two areas in particular would facilitate further progress. First, efforts to further reduce banks' non-performing loans need to be continued – cleaning banks' balance sheets will increase trust between banks and facilitate cross-border business. Second, banks' exposures to their home country sovereign risks must be reined in – banks are less able to absorb country-specific shocks as long as they are overly exposed to their home country.

It needs to be underlined that while the completion of the Banking Union is crucial, it is not enough. An equally important priority is the Capital Market Union. Recent research has shown that while a banking union is efficient at sharing demand shocks, a capital market union is necessary to help absorb supply shocks. Hence, to ensure efficient private risk-sharing in the euro area, banking and securities market integration need to complement each other.

A more fully integrated financial market will contribute towards a stronger EMU by improving the efficient allocation of capital, smoothing out temporary economic fluctuations, and making the transmission of monetary policy more effective. To take this agenda forward, we need to be able to carefully balance further risk-reduction with further risk-sharing. ●

Pierre Wunsch

Governor, National Bank of Belgium

Ring-fencing is a symptom, it's time to cure the disease

One reason which led to the creation of the Banking Union was the necessity to severe the doom loop between banks and sovereigns. To do so, the European legislators restricted the conditions for bail-out and introduced, in parallel, a single supervisory authority as well as a brand-new single resolution mechanism. There is, however, a potential tension between the action of the single supervisor, which focuses on ensuring the safety and soundness of European banking groups, with a policy choice of promoting cross-border integration through the free flow of capital and liquidity and the objective of resolution authorities tasked to solve the too-big and too-complex-to fail issues. This tension is exacerbated by the inconsistent treatment of groups in life and death.

Indeed, while supervisors tend to consider a group as a single entity, the group is treated as a collection of legal entities in bankruptcy. To overcome the absence of a group insolvency framework, the resolution framework introduces the concept of Single Point of Entry (SPE). The SPE approach implies coordinated resolution actions at parent company level and establishes a different hierarchy of creditors: the creditors of the parent company always absorb losses first and irrespective of where losses initially materialized.

BRRD2 clarifies that the SPE only works if certain conditions are met:
- a sufficient buffer – the external MREL – should be constituted at parent level, calibrated to absorb losses of the entire group. BRRD2 acknowledges that the SPE strategy is only credible if the group's external MREL buffer amounts to at least 8% TLOF on >>>

>>> a subordinated basis. The current SRB MREL policy is not yet in line with this condition and deviations from the 8% TLOF floor are sometimes material.
- a mechanism to upstream losses and downstream capital should be set up. BRRD2 clarifies that the prepositioning of fully subordinated internal MREL instruments is, at this stage, the only robust way to implement such a transfer mechanism.

The internal MREL mechanism, however, constitutes an imperfect solution to the absence of both a group insolvency framework and a formal legal instrument modelling the parent support for SPE groups in case of failure. The differences in hierarchies of creditors in resolution and liquidation imply that resolution authorities, at the point of failure, might be forced to make an arbitrage between the interests of the creditors of the parent company (expected to be the first to suffer losses in resolution) and those of its subsidiaries (expected to be the first to suffer losses in insolvency when losses materialise locally). Facing this trade-off, authorities might prefer to intervene at the level of a subsidiary rather than resolving the group. This possibility to deviate from the SPE approach is recognized in both BRRD1 and 2. In absence of enough MREL buffer at legal entity level, such a deviation may lead to financial instability and severely disrupt the local real economy. This, in turn, might reintroduce a potential need for national bail-out – in contradiction with the objective of the Banking Union.

This is the reason why a delicate balance between the interests of home and host Member States needs to be preserved. The newly adopted banking package introduces a series of checks and balances necessary to preserve the interests of all Member States. Given the existing gaps in the legislation, the conditions to achieve a more ambitious framework are currently clearly not satisfied. It would not be consistent to implement a more permissive framework allowing free flows of capital and liquidity in going concern without simultaneously addressing the legitimate concerns which result from an incomplete framework to deal with gone concern issues.

However, the new banking package does not constitute a steady state. Reaching the steady-state requires developing a holistic approach of banking groups rather than progressing step by step and stopping in an uncomfortable midstream position. The establishment of the three pillars of the Banking Union is necessary but will not solve the issues raised above. Rather, it requires addressing several fundamental questions which have been left aside up to now, including the question of group insolvency, of the formalisation of parent support, and of the optimal governance of the Banking Union.

Sylvie Goulard

Second Deputy Governor, Banque de France

We must keep up the momentum towards further banking integration in the European Union

Banking integration allows for economies of scale, reduced exposure to asymmetric shocks through enhanced risk-sharing and better allocation of resources. Indeed, having geographically diversified loan book and deposit base makes banks less vulnerable to negative shocks and thus helps reduce the volatility of their lending and income streams.

Decisive steps towards a more integrated banking sector in the European Union were taken soon after the Great Financial Crisis broke out. Financial integration was indeed a key motivation for the launch of the Banking Union. Important measures were also implemented to reduce risks. European banks were made more resilient through gradual increases of their capital and liquidity buffers. According to the 2018 Q3 ECB Supervisory Banking Statistics, the stock of non-performing loans on banks' balance sheets declined from €1trillion in 2014 to €694billion today.

Yet, the European banking sector remains fragmented, this lingering banking fragmentation having multiple causes.

First, national ring-fencing policies applied to capital and liquidity requirements continue to hinder the management of banks at group level. While such policies reflect obvious and understandable concerns of host countries, they are significant >>>

>>> impediments to the creation of genuine pan-European banking groups. A potential avenue to address these concerns is the safeguarding of the financial position of European subsidiaries in both normal times and crisis situations, through credible cross-border guarantees provided by the parent company, based on European Union law and enforced by European Union authorities. Such guarantees, which could also be collateralized subject to a supervisory authorization, would indeed pave the way for lower capital, MREL and liquidity requirements at the subsidiary level, while providing the local supervisors with the proper assurance they can legitimately expect. In addition, the level of capital, MREL and liquidity requirements to be posted at the subsidiary level could be regularly and jointly assessed by the home and host supervisors, taking into account the situation of the whole banking group.

A second obstacle lies in the insufficiently harmonized, consistent and predictable liquidation regimes for credit institutions across the European Union. While the directive on the reorganization and winding up of credit institutions may provide a legal basis conducive to further progress, it does not actually consider the situation of banking groups. Here again, setting rules for more robust group ex ante financial support to upstream losses, especially in the case where subsidiaries face difficulties whereas the group or the parent does not, could help bolster the confidence of host authorities.

Finally, further efforts should also be devoted to the implementation of an effective and harmonized deposit insurance scheme. Such a scheme would help indeed mitigate the potential impact of a bank failure on national public finances. Discussions on this subject are continuing but the devil is of course in the details. A design to meeting liquidity needs seems to be a sensible approach to achieve the main objective pursued, namely covering potential funding gaps.

All in all, to address these key but politically sensitive issues and complete the banking Union, a pragmatic approach accounting for the concerns of host countries seems preferable.

"A pragmatic approach accounting for the concerns of host countries seems preferable."

- SYLVIE GOULARD

There is no doubt that the rewards make the effort worthwhile because at the end of the day, in a completed Banking Union, genuine pan European banking groups would be able to operate more effectively and be better prepared to face and resist foreign competition.

Diony Lebot

Deputy Chief Executive Officer, Société Générale

Addressing fragmentation in the EU banking sector

In order to foster competition, optimum capital allocation and stability of the EU banking markets, banks should be able to offer their services across borders within the Banking Union with as few undue impediments as possible. This calls for banks being able to freely allocate required capital and liquidity within their institutions, which ultimately will provide stability at group level.

Since the 2008 crisis, fundamental improvements in financial stability through the CRR/CRD framework alongside the ramp-up of the Banking Union have made the European financial system safer. However, little has been done to address ring-fencing measures and fragmented prudential requirements, as the recent failure of the overhaul of capital waivers in the CRR II showed it.

To tackle this problem in a way that is consistent with the free movement of capital principle, it remains essential to consider the Banking Union as a single jurisdiction when applying certain prudential requirements (solvency, leverage, liquidity, large exposures).

Countries within the Eurozone not only share the same currency and a single monetary union, but also benefit from having a Single Supervisory Mechanism and a Single Resolution Authority. However, capital and liquidity requirements stemming from the current legislative framework (CRR II/CRD V) are still at odds with these two pillars.

In this context, the priorities should be:

- To change the existing regulatory framework whereby capital and liquidity requirements in the EU need to be met both at consolidated and solo level. Unfortunately, no cross-border waivers have been secured in the last revision of the CRR. Moreover, we are concerned by the possibility granted to the host authority of a subsidiary to impose an additional MREL buffer up to 2% above the group MREL's level (the so-called "safe harbour").
- To capitalise on the progress made in the Banking Union by removing restrictions that isolate capital and liquidity along national lines. Practically, we recommend a zero weighting for intra group loans between two institutions based in two different countries of the Banking Union but belonging to the same group. For Single Point of Entry models, fragmentation or ring-fencing of loss absorbing capacity at sub-consolidated level can increase the risk of bank failure due to "misallocation risk", the risk that banks have enough capital resources overall but cannot mobilise them to the right subsidiary.
- To achieve a European Deposit Insurance Scheme through the establishment of the third pillar of the Banking Union, aiming at underpinning stability in the banking sector. It is aimed to provide strong and uniform insurance coverage for all such depositors, independent of their geographical location in the Banking Union.

Achieving all these reforms will lead to a more effective and safer Banking Union, in which resources flow where they are most in demand by businesses and households. In this regard, we welcome the recent exclusion of intra-EU exposures of cross-border exposures in the review of the calculation of the G-SIB score by the CRR II: this is another crucial step towards the build-up of a fully-fledged Banking Union.

Vitas Vasiliauskas

Chairman of the Board,
Bank of Lithuania

To scale up our banks, let us complete and expand the Banking Union

The presence of intra euro-area ring-fencing practices is one of the root causes of fragmentation in the European banking sector. As much as I would like to see this hindrance removed, consolidation of the banking markets should not come at the expense of host jurisdictions. In my view, the surest way to eliminate the need for domestic ring-fencing is both the completion and expansion of the banking union.

To complete the banking union, we must establish a fully mutualised European Deposit Insurance Scheme (EDIS). Should we scrap the solo approach and apply the prudential requirements at a group level, EDIS could solve an unsatisfactory asymmetry in which the engagement of the national host supervisor recedes but the national Deposit Guarantee Scheme must still bear the financial burden when a subsidiary fails. Ultimately, EDIS could help mitigate the sovereign-bank loop, paving the way for consolidation of geographically diversified banking groups.

In finalising the banking union, another key element is clarity concerning liquidity in resolution. The 'Monday Morning Problem', whereby the financial entity may not have adequate access to liquidity after the adoption of the resolution scheme, is one of the main gaps in the current resolution framework, which further reinforces the sovereign-bank nexus. I thus welcome the agreement on the common backstop to the Single Resolution Fund and hope that current policy discussions will continue, including the debates on how to best design a European-level public-sector guarantee for the ECB/Eurosystem liquidity provision in resolution.

Finally, in addition to a complete banking union, I would like to see an EU-wide banking union. Until this is established, we cannot turn a blind eye to the circumstances in countries such as the Baltic States, where the parent companies of the majority of the largest banks reside outside the euro area and are not supervised by the SSM. If such banking groups were to consolidate and start operating in an integrated way, the hosts must be made sure that the domestic subsidiaries receive enough funds in times of market distress. A banking union which spans across the entire EU could help solve this problem. It would allow for the host jurisdictions to sit across the same table as the home jurisdictions, making collective and well-informed decisions.

"A complete and EU-wide banking union will allow us to suspend ring-fencing practices."

- VITAS VASILIAUSKAS

We should therefore put more effort into communicating to non-euro-area countries the benefits of joining the banking union through the 'close cooperation' regime. These include an intensified supervisory scrutiny on the back of the SSM resources and analytical capacities, information sharing, influence on European rule-making, and a strong basis for enhanced competition. Furthermore, if the banking union further develops its depositor protection and resolution tools, membership will substantially decrease the likelihood of a public bailout, which distorts expectations of both consumers and investors.

Overall, a complete and EU-wide banking union will ultimately allow us to suspend ring-fencing practices and unleash the full potential of pan-European banking. This goal could well become one of the top priorities on the European agenda in the new legislative term.

Burkhard Balz

Member of the Executive Board,
Deutsche Bundesbank

Banking Union - More integration needs less risks

The Economic and Monetary Union has so far been the most courageous step towards strong economic integration with all its progress and setbacks over the past more than 20 years. The growth effects of deeper economic integration in Europe are considered to be positive with estimations of contributing approximately to an increase in GDP of 5% to over 25%. With regard to financial integration the Banking Union is about to follow in terms of courage, but, in order to ensure that progress prevails, the positive elements have to be reinforced. While we created the Economic and Monetary Union in times of relative economic stability, the Banking Union has been set up during the most tremendous financial and debt crisis of recent history. It has been a challenging environment for the Banking Union, but the environment also offers the opportunity to make the legislation already more resilient from the start.

Financial integration will be facilitated when the credibility >>>

>>> in the long-term viability of the European banking sector and its credit institutions is restored. This was the working assumption of the Banking Union. The comprehensive set of banking legislation that has been adopted over the past decade has helped to achieve enhanced credibility. The direct supervision of significant European banks has been brought under the roof of the SSM, the resolvability of banks has been tackled, the rules on deposit guarantee schemes have been harmonised and the ESM has been estabilished. In total, much work has already been accomplished. The more recent agreement on the Banking Package and the prudential backstop for non-performing loans adds positively up to the achievements. What is missing in terms of credibility and facilitating financial integration?

Credibility is also about the awareness and transparency of existing risks. Financial integration can be hampered, when risks are not sufficiently disclosed or not adequately priced. Risks won't disappear when they are shared. Where risks are further reduced, there is an opportunity to advance with financial integration in Europe.

"Where risks are further reduced, there is an opportunity to advance with financial integration in Europe."

\- BURKHARD BALZ

Credibility is also about the application and enforcement of existing legislation. The best legislation won't be effective, when its application is not equally ensured and monitored across the European Union. Where legal certainty across borders prevails, integration across borders becomes more and more attractive.

Finally, the goal of facilitating financial integration is not only a matter of integrating banking markets in Europe, but also a matter of integrating capital markets. Advancing the CMU will contribute to mitigating risks in the financial markets and shall therefore be part of any future considerations on financial integration. A Brexit risks to bring more financial fragmentation to Europe, however it can also be an impetus for the Europeans to succeed better in the integration of their markets. ●