

Banking Union after the June Eurogroup decisions

In December 2021, the European Council reiterated the mandate to the Eurogroup to deliver a work plan charting the ways towards the completion of the Banking Union. The Eurogroup has explored ways to:

- Strengthen the framework for the management of failing banks in the EU;
- Create a more robust common protection scheme for depositors;
- Facilitate a more integrated single banking market for banking services;
- Encourage greater diversification of banks' sovereign bond holdings in the EU.

The President of the Eurogroup proposed 'a phased gradual approach' delivering across all these four objectives to unlock progress, not only to foster private financing of our green and digital future but also to support the EU's ability to prosper in a changing world.

In June 2022, the Eurogroup agreed that, as an 'immediate step, work should focus on strengthening the common framework for bank crisis management and national deposit guarantee schemes (CMDI framework)' and has invited the Commission to bring forward legislative proposals for a reformed CMDI framework before the end of this institutional cycle (early 2014).

In the meantime, no further concrete steps are envisaged for improving the single banking market ('cross-market integration') or for tackling the link between banks and their country's sovereign debt.

Commenting on the results of this June Eurogroup, most speakers noted that the failure of Member States to agree a way forward is disappointing and will have damaging consequences for the EU banking sector (e.g. fragmentation, under-competitiveness at the global level) and the real economy. They also agreed that the costs of inaction should be avoided: some possible solutions to move forward were discussed.

1. The Eurogroup decisions on the future of the Banking Union are disappointing

1.1 The failure of Member States to agree a way forward is disappointing for the integration of the banking sector and the real economy

An industry representative stated that the June decisions of the Eurogroup were not up to the challenge due to political disappointment. The European authorities and Member States produced a collective response to Covid that had positive results, giving the idea that Europe can respond to a common threat. But the Banking Union discussions have revived the debate of returning to risk

mitigation rather than risk sharing. The Eurogroup has not managed to define a path towards achieving all four pillars of the Banking Union, which was their mandate, and this failure is disappointing.

There was no agreement on the European deposit insurance scheme (EDIS) and no progress on the actions to achieve a single market for banking services, which is a problem for further integration of the banking sector. A true Banking Union ensures European banks can efficiently fund the European economy, develop private risk sharing, reinforce financial stability in the Eurozone, and maintain the competitiveness of European Banks. It is critical in particular to support a more efficient flow of liquidity and capital between subsidiaries of the same banking group, allowing cross-border groups to manage in the euro area their liquidity and capital at a consolidated level. This is important for the competitiveness of European banks, not only vis a vis foreign banks that have single, much deeper, and more efficient domestic markets, but also with respect to new players.

The industry representative continued by arguing that he did not think the EU will make any progress on these issues in the short run. It is necessary to ask what will happen to the monetary union and the Banking Union in the current situation and whether we can do without what was expected. In the meantime, the markets will react to a situation in which there is no full Banking Union. The trend will be towards more integration at a national level and less at a European level and a negative interaction with the expected recession. It must be hoped a different approach to strengthening the monetary union can be taken. There is also a risk that the European banking and financial industries will suffer from competition from other regions, including the US and Asia. This will be a challenge and Europe will have lost an opportunity to close this competitiveness gap.

1.2 No agreement to achieve the same progress and level of ambition in all four building blocks (crisis management, deposit protection, single market for banking services and diversification of sovereign holdings) explains the 'limited' results of the Eurogroup in June

An official stated that completing the Banking Union is an issue of equal progress and level of ambition but will not be easy given the amount of decisions to be made. The discussion is about risk sharing versus risk reduction, burden sharing, financial stability, harmonization of legislation, a level playing field for all types of banks...The four pillars of crisis management, deposit protection, single market for banking services and diversification of sovereign holdings are interlinked. The discussions showed that the Eurogroup did not have an equal level of ambition in all four building blocks. There had not been any ambition with regard to the EDIS or sovereign holdings at the first stage. The same level of ambition and progress

needs to be shown on all blocks to reach an agreement otherwise progress on only one or two blocks risks creating imbalance for many Member States.

Although some progress was made on crisis management at the Eurogroup in June, an agreement could not be found, and it will be complicated to reach an EU solution in this area.

1.3 The results of the Eurogroup appear all the more disappointing as completing the Banking Union is an even more urgent task in times of uncertainty

A Central Bank official stated that completing the Banking Union is the most important political and economic objective. It is essential for the proper functioning of the market and economic monetary union and to increase resilience against the coming shocks. The conditions have not yet been met to allow political agreement on EDIS and it would be preferable to see a roadmap towards this, because the answer is not inaction. The gaps in the EU crisis management framework have been identified in terms of managing resources to exit banks out of the market efficiently. It is costly for mid-cap institutions or medium-sized banks to go to the markets and fund the minimum requirement for own funds and eligible liabilities (MREL). A lack of EU progress to improve the resolution of medium sized banks in particular would create a spiral of a fragmented market that is not good for the banks or the investor.

Prudential regulations are not the most efficient means to break or reduce the link between the sovereigns and banks. The European response to the pandemic, providing notably flexibility on prudential rules, was a good example of an appropriate response. This type of initiative, along with the NextGenerationEU funds, will reduce the links between sovereigns and banks.

The authorities and supervisors have the power to define capital liquidity in cross-border groups but in some situations, there is pushback because Europe is in a vicious cycle. There should be clear powers for SSM to sensibly set up liquidity and capital across cross-border institutions, but the EU does not have the Banking Union and CMU: there is a fragmented situation where Member States ring-fence their banking sectors. We need to act together and start working together.

Banco de España is interested in reducing the fragmentation of the market for banking services, but this will be almost impossible without first narrowing the gaps between the different legislations and local rules on the national options and discretions (NODs).

2. The costs of inaction should be avoided: some possible solutions to move forward

2.1 The agreement to move forward in Crisis Management Deposit Insurance (CMDI) is a step to be welcome

An official stated that while there will not be a European deposit guarantee scheme until the end of the legislative

term of the current Commission, the resolution for banks is only a partial solution. If a bank does not pass the public interest assessment or does not fall under the national insolvency rules – which are very heterogeneous in Europe – and eventually benefit from external support, justified by financial stability objectives. Therefore, there must be a broader application of the public interest assessment which needs to be defined in a single way in Europe.

The resolution tools are a positive element for future crisis management, as is the flexibility of the deposit guarantee scheme and least cost test.

As much as possible should be copied from the Federal Deposit Insurance Corporation (FDIC), which requires the resolution tools to be used according to the least-cost test. The least-cost test means different things across Europe and need to be harmonised. Introducing indirect macroeconomic costs into the calculation results in the bailout becoming the most cost-efficient way of resolving a banking crisis, which causes a potential conflict.

It is also important to harmonise key aspects of national insolvency laws. There should be one bankruptcy system for non-financial corporations and another for banks, because the liability side of the banks' balance sheet is much more volatile and there is no time to go through the normal insolvency procedures because the assets and liabilities will melt away. Therefore, economically speaking, we need to set up an entirely different system for banks which is not the case for the national insolvency rules of many Member States.

The resolution procedure should also be the same for all banks but there was too much controversy to achieve this. The debate surrounding the Regulatory Treatment of Sovereign Exposures (RTSE) and Home-Host is now off the table. This is more than welcome as it posed a stumbling block for making progress.

2.2 It is up to the European banks themselves to reverse the widening gap with US firms

A market expert highlighted the scale of the challenge. In 2007 the 20 largest European banks had a market capitalisation that was 58% higher than the largest 20 American banks. Currently the 20 largest European banks are 43% smaller than the largest 20 American banks. The profits of some of the largest American banks exceed the market capitalisation of some of the largest European banks. So, the European banking system has become disadvantaged over the last 15 years. Europeans are increasingly marginalised in global business lines and there is an annual erosion of the market share of European banks. This also means that investment budgets are lower in European banks.

The solution to this is to be provocative rather than wait for the Banking Union because Europe does not have a decade to wait for this. The change in the interest rate environment is positive because European banks can use that surplus profit to transform their earnings multiples by offering technology services and creating data solutions for the market. While the balance sheet for a warehousing business might reach 10 times in terms of earnings multiples, that of a data business can be up to 40 times.

European banks need to begin to close the gap that has emerged over the last 15 years.

The chair asked how the banking sector can contribute to help generate the necessary confidence and capabilities to make progress when it is proving to be very difficult politically. An industry representative noted that progressing in the Banking Union has become largely a political issue at this point. Nonetheless, financial institutions could still contribute to achieve further progress in at least three ways: by highlighting the practical issues causing fragmentation in the EU (eg: differences in national bank insolvency laws affecting NPLs rules); by providing examples of best practices that are relevant for the design of regulatory and supervisory policies in the EU (particularly relevant for new regulatory areas under development such as sustainability, governance, and technological risks); and by ensuring sustainable business models for investors. Applying a long-term view to banking activities may also prove useful. The Banking Union is a long-term goal. To align banks and policy-makers planning horizons is also a way to generate trust and credibility on the European model of universal banking.

One practical suggestion in relation to the link between sovereign debt and banks is to stop referring it as the “sovereign bank loop” and become calling it instead the “sovereign-country loop”. The real nexus between sovereign debt and banks is the economy. Macroeconomic factors – such as GDP growth, industrial production, etc – play a major role in explaining the nexus between sovereigns and banks. In fact, country of location is a main determinant of such a nexus. An incomplete Banking Union contributes to reinforce this nexus. The main tool to tackle this problem is the EU fiscal architecture.

2.3 More progress needs to be made on cross-border lending

An official asked how the industry can generate pan-European products to foster cross-border activity. An industry representative commented that a greater focus is required on the consumer and household credit being offered in the EU. Only 0.9% of credit in the Eurozone is issued on a cross-border basis due to a divergence in the scope of creditworthiness assessments and access to credit bureau data, as well as a lack of harmonisation around know your customer (KYC) and anti-money laundering (AML) when onboarding customers.

The question is what needs to be fixed at the EU level in order to create the opportunity in consumer credit, which lacks the complexity of the mortgage product. Indeed, consumer credit lacks the complexity that the mortgage product has with foreclosure, variation of collateral, differences in underwriting approaches, loan to value (LTV) constraints, and so on. That does not exist with consumer credit. That is why our bank is considering moving one product that we have created with a digital retail partner in Germany to an adjacent market where we can offer the same consumer credit product to finance. It is essentially a sales finance product.

On the mortgage side it is much harder although more impactful. The Mortgage Credit Directive has focused

on foreign exchange loans and little else. That is why the focus will be to solve the easy things first and use that success as motivation to do more on other products.

2.4 As Banking Union progress slows, the importance of Capital Markets Union grows

An industry representative stated that there is little that can be done by banks in the traditional sense, but there is the opportunity to focus on products that have more potential for cross-border acceptance. One of the successes of European-regulated products is on the investment side with Undertakings Collective Investment in Transferable Securities (UCITS). There is an opportunity to create a green standard that will avoid greenwashing going forward with the advent of the sustainable finance disclosure regulation (SFDR), which will ensure there is understanding amongst investors around buying a properly sustainable product.

It seems that branchification is a mantra that is going to be the solution to the Banking Union, but it is not a panacea. This presumes there is a common rulebook across the EU, whether or not the point of origin has a set of rules that are applied transnationally. This needs to be addressed to allow branchification to be properly supportive. The more people can be rotated to operate in various countries the more it is possible to create a European culture of banking.

In the current political context and the following the “limited” decisions of the Eurogroup in June, the most fundamental thing that can be done is to focus on the Capital Markets Union and think about banks as an access point for investors looking to access financial products, companies looking to access financial markets and people looking to undertake payments. For banks to operate as an originator-distributor model it requires deep and liquid capital markets. The way to progress the Banking Union is to develop a pan-European deep capital market to ultimately create European banks.

2.5 Building an institutional setup of instruments – based on Support to Mitigate Unemployment Risks in an Emergency (SURE), NextGenerationEU and the ECB Transmission Protection Instrument that will exploit the advantages of the European integration

An industry representative stated that a slowdown in the European region would increase economic divergence across Member States, which is a structural source of financial fragmentation. This translates into a reaction in the financial markets, the appraisal of investment opportunities and the requests for support. Fragmentation has been a major element guiding the financial crisis of the past decade.

The policy toolbox is more equipped this time to react to the risks of fragmentation. There is SURE, the NextGenerationEU framework, and the ECB Transmission Protection Instrument (TPI). The TPI is similar to an implicit instrument, which relates to the ‘whatever it takes’ comments made by Mario Draghi. It is obvious that there should be no limit to the effort that public authorities will eventually make to preserve stability and avoid fragmentation. The EU can build an institutional setup of instruments that will exploit the

advantages of the European integration but which hopefully will not need to be tested. A public decision maker noted that the Banking Union can be seen as a technicality because there has been a lot of progress on integration in more important issues, like SURE.

2.6 Defining the right incentives to move forward

An official explained that the issue is quite complicated on the political side and the only way to increase trust and confidence is to create a stable economic environment to reduce risks and promote solidarity. It is important for Europe to become a stable environment to progress towards economic convergence and for the EU to look to harmonise where possible. It is not possible to achieve a total harmonisation of insolvency laws, but the banking industry can contribute to find a way forward if Europe can get closer together. Ringfencing is an important issue but these ring fencing measures have been introduced to protect all banks and their clients at a national level. It is not possible to simply have another regime for cross-border banks.

An official stated that he refers to a Banking Union in the narrow sense of the three pillars, because the single rulebook has got lost along the way. It is important to have a system that moves Europe forward, but this requires the right incentives and the right system. An incomplete Banking Union and an EDIS that, at its worst, could be an instrument for bringing back bailouts is worse than what there is have now.

The problem is that a Banking Union means many things to many people: cross-border distribution and banking, the three pillars, risk reduction and regulatory treatment of sovereign exposures. It is not clear how RTSE for sovereign bonds is risk reducing, because it has to be specified what the assets are replaced with in the balance sheet and there are no relatively safer assets than sovereign bonds. It is a struggle to see why a safe asset should be necessary to have good regulatory prudential architecture. It is possible that it is a safe liability being spoken of rather than a safe asset, which is another question entirely.

There is a lack of trust in Europe on these matters. EDIS should be a boring, technical subject but it is hugely politicised and blown out of proportion and seen as a danger. To others it is the perfect mechanism to continue business as before with as little pain and payment as possible. Both views are wrong, and Europe should return to the technical basics first. But this is in the realm of politics.

An official concluded that the majority agreed that the June decisions of the Eurogroup were not up to the challenges and that there was clear disappointment with an outcome that should have gone further. While there should be minor technical issues to address, they are somehow highly politicised. It is necessary to reflect on why it remains difficult to continue to build trust in something that was already on the table and to find ways to build back that trust.