What next for banking union?

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The Great Financial Crisis was a critical catalyst for reform in the Economic and Monetary Union (EMU). Much has been achieved since the darkest days of the crisis. With his courageous calls for further fundamental reform in Europe, President Macron is attempting to build on those post-crisis achievements.

Unfortunately, the momentum and the appetite for EMU reform has slowed significantly, reflecting partly political delays and partly the fact that there are intractable differences of views in the different capitals on many, if not most of the critical issues. The latest electoral results in Italy are bound to further entrench opposing positions.

Discussions around strengthening the European Stability Mechanism and appointing a euro area Finance Minister are an inevitable component of a long-term perspective on EMU. However, they don't address what is needed now to make EMU function better. The most urgent component of the reform agenda is to complete not Europe's fiscal, but Europe's Banking Union. Crucially, completing the Banking Union also happens to be feasible.

Conceptually, the banking union might seem an obvious next step for most observers. In practice, however, political barricades go up immediately and most notably in Germany whenever a common deposit insurance scheme is mentioned as one of the central elements of banking union.

I will argue that building a fully integrated cross-border euro area banking market is not only a more important but also an easier next step than attempting to create a functioning common deposit insurance scheme.

The current discussion on the Banking Union is too focused on crisis measures, i.e. resolution and deposit insurance. It is true, of course, that by definition, we cannot entirely rule out another big banking crisis in Europe. But a repeat of the Great Financial Crisis is unlikely. What we therefore need to focus on instead are ways to reduce systemic risks in the first place in order to avoid future crises.

A path to a more stable euro area banking sector critically involves enabling and encouraging cross-border banking consolidation, thereby building more diversified and more profitable banks. This should be far easier to implement than creating a sufficiently large and commonly funded deposit insurance guarantee scheme. Moreover, properly integrated cross-border banking would also immediately help solve a number of inherent problems of the Banking Union.

<u>The establishment of the Banking Union and what is missing for its completion</u>

Let us first look back at the origin of the Banking Union in Europe. The establishment of the euro area's Banking Union in a regulatory sense, i.e. the transfer of banking policy from the national to the EU level, was a direct consequence of the financial crisis. This is not to say, of course, that cross-border lending didn't occur prior to the crisis.

In 2008, 2010 and in 2012, when the euro area was hit by severe and repeated market shocks it became increasingly apparent that a common currency area cannot function without a Banking Union. Since then, significant progress has been made - overall the banking sector in the euro area has stabilized. After the introduction of the single rulebook, all European banks are subject to the same regulation and capital and funding requirements defined in the Capital Requirements Regulation (CRR) but also to common stress testing and Supervisory Review and Evaluation Process (SREP) framework.

With the Single Supervisory Mechanism (SSM)[1],118 large banks are currently supervised by a single entity which takes key supervisory decisions. These banks are therefore subject to the same supervisory framework.

At the same time, a common resolution framework and the Single Resolution Fund was established under the aegis of the Single Resolution Board. A recent milestone is the beginning of the implementation of the minimum requirements for own funds and eligible liabilities (MREL)[2].

All of this has helped bring about the long awaited economic recovery of the euro area. Indeed, the delay in its economic recovery relative to that of the U.S. has undoubtedly been a direct consequence of the several year delay in stabilizing the euro area's banking system.

So far, for the good news. The bad news in Europe is that the Banking Union is far from complete. Banks operate overwhelmingly on a national basis, in particular for retail credit markets. In fact, contrary to what you might expect, the fragmentation in euro area banking has not actually decreased since the formation of the Banking Union in 2014:

- Intra euro-area cross border claims as well as the market share of foreign branches and subsidiaries have significantly decreased since 2008. [3]

- In 2017 domestic institutions accounted for 86% of loans to euro area non-financial institutions. And that number has not changed much over the last years. [4]

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[1] The Single Supervisory Mechanism (SSM) refers to the system of banking supervision in Europe. It comprises the ECB and the national supervisory authorities of the participating countries. As the European banking supervisor, the ECB can take a number of supervisory decisions, which are legally binding on banks under the Single Supervisory Mechanism.

These include:
- setting micro- and macroprudential capital requirements ("buffers")
- deciding on the significance status of supervised banks
- granting or withdrawing banking licenses
- assessing banks' acquisition and disposal of qualifying holdings
- imposing enforcement measures and sanctions on significant banks

Decisions in the SSM are taken by the SSM Supervisory Board which is separated from the ECB's Governing Council. Formally, The Supervisory Board, as an internal body of the ECB, prepares the draft decisions, which are adopted by the Governing Council under the non-objection procedure. If

[2] The Bank Recovery and Resolution Directive (BRRD), which has been transposed in all participating Member States, requires banks to meet a minimum requirement for own funds and eligible liabilities (MREL) so as to be able to absorb losses and restore their capital position, allowing banks to continuously perform their critical economic functions during and after a crisis. MREL is set on a case by case basis. For setting MREL. the resolution authority should consider the need, in case of application of the bail-in tool, to ensure that the institution is capable of absorbing an adequate amount of losses and being recapitalised by an amount sufficient to restore its Common Equity Tier 1 ratio to a level sufficient to maintain the capital requirements for authorisation and at the same time to sustain sufficient market confidence. In particular, the assessment of the necessary capacity to absorb losses should be closely linked to the institution's current capital requirements, and the assessment of the necessary capacity to restore capital should be closely linked to likely capital requirements after the application of the resolution strategy.

[3] Source: ECB Financial Stability Review November 2017

[4] Source: ECB Financial Integration Indicators

- In 2016, the last year for which we have accurate data, the foreign-owned banks' share of domestic banking system was just 17%.[5]

The share of assets of foreign euro area branches and subsidiaries in countries such as France, Germany, Italy, the Netherlands and Spain remains extremely low. It is only significant in a few smaller Member States.[6]

As noted by the ECB in their most recent report on financial integration in Europe there are only limited cross-border bank mergers and acquisitions within the euro area.

The incompleteness of the Banking Union in Europe is not just a technical matter. It is crucially important for the long-term sustainability of the euro area. Because the Banking Union is not complete, the banking sector in the euro area does not act as a risk sharing mechanism across borders via credit markets that could mitigate financial crises.

In the public debate, the discussion of completing the Banking Union has so far tended to revolve almost exclusively around the adoption of a common deposit insurance scheme and a common bank resolution fund. Not surprisingly, given that these effectively involve a common financing instrument, the politics of this discussion have been very challenging, to say the least. Germany and others object to such risk sharing unless significant risk reduction takes place first, in the form of a reduction of large non-performing loan stocks and a reduction of large exposures to highly indebted sovereigns. Such a position is entirely understandable.

In those countries where banks have these characteristics (primarily Italy) object such sequencing, claiming such a policy approach would create enormous headwinds and possibly worse.

The ECB has cautiously taken a position in this debate. Notably, Mario Draghi supported demands to complete the Euro Area's Banking Union by setting up a stronger publicly funded backstop for failing banks in form of a backstop for the Single Resolution Fund.

ECB Vice-President Constancio recently said that, in the ECB's view, sufficient risk reduction has been achieved to move ahead with the European Deposit Insurance Scheme (EDIS). In fact, the ECB and the European Commission came forward with a renewed call for a fully-fledged European Deposit Insurance Scheme (EDIS). It is worth noting that while the statement of Mario Draghi acknowledges in particular, the benefits of cross-border integration, both speakers focus on public risk sharing.

So there are different and contrary views and it seems to me that the debate is stuck. Rather than deepening this divide around what comes first: pooling emergency funding mechanisms or rigorously cleaning up the southern balance sheets, a much more effective and pragmatic solution consists of setting the priority on building a real European banking market, which can only be achieved by cross-border consolidation.

<u>Obstacles to an integrated European market and ways to address them</u>

Once again, of course, a key obstacle to cross-border consolidation is the uncertainty caused by high stocks of non-performing loans, e.g. in Italy, i.e. by deterring other, in particular foreign, banks to acquire banks with high stocks of non-performing loans.

[5] Source: Committee on the Global Financial System, CGFS Papers No 60, Structural changes in banking after the crisis, January 2018.
[6] For example Slovakia, Luxembourg

While it is clear that there is still a long road ahead in select countries like Italy, it is important to recognize that progress has been made in reducing non-performing loans (from over 6% in 2014 to below 5% on European level today). [7]

Clearly, Supervisors should continue to put maximum pressure on banks to further tackle the NPL problem by either allowing more consolidation or by directly fostering the takeover of weaker banks with high non-performing loan ratios by stronger domestic or non-domestic banks. Or in fact they can tackle the issue via other measures, e.g. by ensuring higher levels of provisions and facilitating the sale of NPLs.

Undoubtedly, further progress needs to be made in cleaning up the balance sheets of European banks. And this is independent of the objective to complete the Banking Union.

However, another critical obstacle to cross-border consolidation is the current regulatory framework and its application. Regulators and supervisors should stop discouraging banks from operating on a cross-border basis.

The whole euro area should be treated as a single jurisdiction for supervisory purposes, with all the benefits that entails in terms of capital and liquidity requirements. Since this would partly entail a change to the current regulatory regime in Europe, this cannot be achieved by the ECB alone but also has a political component, i.e. it would have to be agreed by the European Parliament and the Council.

In particular, regulators and supervisors should allow a free flow of capital and liquidity between euro area entities of the same banking group. e.g. subsidiaries of other euro area banks could be waived from fulfilling capital and liquidity requirements on national level. The European Commission already made a proposal in this respect in 2016.

Other discretions and exemptions for banking groups operating in a single Member State in terms of e.g. capital requirements, deductions and large exposure limits should be extended to groups operating across borders in the euro area.

Supervisors could recognize the benefits from a pan-European diversification in Pillar 2 capital requirements.

Banks should not be penalized with additional capital buffers for cross border exposure as it is currently the case, i.e. the euro area should be considered as a single jurisdiction for calculating the capital surcharges for systemic institutions. The recent agreement by ECOFIN giving Competent Authorities the discretion of taking into account an additional score for G-SIIs that discounts intra Banking Union activities is a right step in this direction.

The application of the European macroprudential framework should be harmonized in such a way as to avoid its use for the ring-fencing of capital and liquidity within countries but to focus it on addressing country-specific systemic or cyclical risks.

Some European countries, e.g. Germany, sustain banking sectors with divergent return objectives which is a third obstacle to cross-border consolidation.

State owned banks, such as German Sparkassen, that do not have the same return targets as privately-owned banks put pressure on the profitability of the national banking sector and reduce its appeal to non-domestic entrants. While this might keep costs for customers low, there is also an economic cost attached.

[7] Source: EBA Risk Assessment of the European Banking Sector 2017.

In addition to the possibility of a misallocation of funds in the economy that any subsidized sector can cause, this can have a number of unwanted consequences. For example, due to low profitability, local banks lack the financial resources to act as acquirer in cross border deals. Also, privately owned banks in turn are more tempted to enter into riskier business segments like investment banking to generate short term profits driven by high leverage only to discover that such strategies turn out to be terrible decisions on a risk-adjusted basis.

It is also important to point out that a number of countries in Europe are still subject to overbanking. This is particularly true for Germany and Italy. The effect on profitability and their consequences are similar to the mentioned banking markets with divergent returns objectives.

Recent examples have shown that politicians and supervisors can drive consolidation, e.g. legislation passed in Italy to enforce consolidation among savings banks ("Banche Popolari") as well as in the cooperative banking sector ("Banche di Credito Cooperativo"). [8]

Benefits of a pan-European banking market

Europe would incur undeniable benefit from a pan-European Banking Union. First of all, and in light of the horrendous experience during the financial crisis, European integration and the development of pan-European banks could reduce bank's vulnerability to asymmetric shocks.

The main source of Europe's current vulnerability is the European banks' overwhelming exposure to their respective national economies and local sovereigns. This is what turns any downturn into a vicious circle of weaker bank balance sheets, weaker lending, weaker economic activity and weaker sovereign. Cross-border banks could offset losses in one region with income from other countries and therefore would not be forced to cut lending in a recession as local banks.

Here I find myself in full agreement with Mario Draghi's recent statements that a Banking Union would deliver meaningful private risk sharing that is currently lacking in the euro area in comparison US. Private risk sharing mechanisms could address concerns of the detractors of fiscal union. To a significant extent, it would deliver by way of the private markets, precisely what Germany is so worried about will be delivered by forced fiscal pooling at the expense of the German tax payer.

In contrast to the European Deposit Insurance, the diversification benefit can make the banking sector more resilient and as such minimize occurrence of crisis situations in which a pan European deposit insurance scheme would ever be needed. So again, it can be seen as a direct response to long-standing German concerns.[9]

[8] In 2015, the Italian Government decreed that all savings banks with total assets higher than EUR8.0bn had to transform themselves into joint stock companies. By doing so banks lost the one-shareholder-one-vote mechanism which protected them by hostile acquisitions. This triggered a number of events including the merger between Banco Popolare and Banca Popolare Milano into Banco BPM and the demise and subsequent resolution of Banca Popolare di Vicenza and Veneto Banca.
In 2016 a decree was passed pursuant to which the small cooperative banks (approx. 360) must join a holding company with a minimum CET1 of EUR1.0bn. Failure to do so would automatically led to losing the "cooperative status". Pursuant to this two main Holdings have been formed: "Cassa Centrale" and "ICCREA" each controlling circa half of the cooperative banks. Both of them will move under the supervision of SSM in January 2019.

[9] This holds not withstanding valid views that also privately or publicly funded backstops can have an ex-ante effect, e.g. by increasing confidence in the financial system and avoiding market panics during a crisis.

Having fewer but larger and geographically diversified banks can also lead to an overall shrinking euro area banking sector which in 2016 accounted for total assets equal to roughly 280% of GDP vs. 90% in the US. Banks in the euro area also sustain almost twice as many bank branches relative to the population[10] than the US. These are all clear signs that Europe is currently "over banked".

In the euro area, and unlike in the US, banks are the main source of lending to the real corporate sector. The Banking Union can enable the full potential of the banking sector to support the real economy.

A consolidation of banks at a European level and more cross border operations can help solve the problem of low profitability in the euro area banking sector compared to e.g. the US (e.g. 1.2% vs. 3.1% net interest margin; 4.4% vs. 9.3% in 2015-16)[11]. With better profitability, banks could more easily build or rebuild capital buffers.

A European consolidation of the banking sector can also create opportunities and new business models for banks based on scale effects. Looking at the past 25 years it is easy to see how without a sustainable business model in their home market, banks get pushed into much riskier businesses like US style Investment Banking. The complete and tragic misadventure of Deutsche Bank with its investment operations in the past is a prime showcase of the detrimental consequences of sub-scale banking possibilities at home. Rather than an unsuccessful global investment bank, Deutsche Bank could strive to be a scaled and well diversified European corporate, retail and wealth management bank in an integrated European market.

Finally, the existence of true European banks might also in the end solve the dilemma around the European Deposit Insurance. In this case the political fear that funds from one country are used to bail out the banking sector of another country becomes less relevant.

Conclusion

The issue of further developing the Banking Union should also be seen in light of accountabilities and the future role of the ECB.

Under the current and indeed much of the previous presidency, the ECB had no choice but to focus on crisis interventions. When the euro area was hit by the financial crisis or the sovereign debt crisis it sorely lacked any common fiscal stabilization tools. Moreover, it had very little by way of solidarity tools. Effectively, the ECB was the only game in town. Almost single-handedly, it held the euro area together by buying the bonds of countries most under attack; by providing massive amounts of liquidity to euro area banks; by vowing to do "whatever it takes" to preserve the euro; and by implementing a comprehensive quantitative easing program with the aim to bolster aggregate demand.

It seems to me that under the coming presidency, an absolutely crucial priority will have to be to do whatever it takes to complete the Banking Union. A fully integrated euro area banking market would make sure the ECB faces less uncomfortable monetary dilemmas when the next crisis hits.

[10] Source: Committee on the Global Financial System, CGFS Papers No 60, Structural changes in banking after the crisis, January 2018. Branches relative to population measured as banking branches per 100K of population.
[11] Source: Committee on the Global Financial System, CGFS Papers No 60, Structural changes in banking after the crisis, January 2018.

However, this cannot be achieved by the ECB, or in this case the SSM, alone. Supervisors have a role to play and can support a consolidation of the banking sector. But it would be up the European Commission, the Council and the European Parliament appropriately to adapt the regulatory framework.

Last but not least, cross-border consolidation requires an acceptance on a political level to give up influence on the financial sector and also to allow foreign ownership of institutions that may have been seen as “national champions” in the past. So, in the end a full Banking Union can only be achieved in a political process. Political willingness is therefore a prerequisite for a truly pan-European banking market.