Banking Union challenges

This discussion was divided into three parts: The first part looked at the reasons and concerns of host countries that explain these ring-fencing practices by host countries. The second part focused on the heterogeneity of national macroprudential regimes in Europe and ways to address this issue. The speakers then presented their views on measures to improve the competitiveness of the European banking system.

1. Main concerns of host countries

1.1 Host member states insist on the fulfilment of individual, not just consolidated, prudential requirements for financial stability reasons

An official stated that host countries remain important players in the Banking Union, providing capital adequacy, liquidity, macroprudential supervision and effective resolution. In Slovenia, as in other host countries, foreign banks play a crucial role in financing the local economy and providing employment. However, the interests of subsidiary banks may not be aligned with those of the banking group as a whole. Capital requirements on a consolidated basis may reduce the willingness of groups to provide sufficient recapitalisation to subsidiaries or branches. Host countries are concerned that foreign banks will transfer profits to the parent bank, reducing the resources available to finance local needs and raising concerns about maintaining adequate liquidity and meeting regulatory requirements. Host countries want to ensure that sufficient liquidity is available to support a stable banking system in the European Union.

The Commission's proposed capital and liquidity waivers at the level of individual banks in cross-border groups would allow groups to reallocate resources, creating an unlevel playing field compared to local banks, which have to comply with all capital and other prudential requirements. Such exemptions could also increase the likelihood of the transfer of group problems to subsidiaries and vice versa. On the similar issue of Basel III and the output floor, and the proposal to set capital requirements on a consolidated basis, host countries successfully argued that the output floor should also be applied at the individual level.

1.2 The Banking Union is an unfinished business

1.2.1 Despite EU supervision and resolution mechanisms, there is no internal market in the banking sector

An official commented that there is no internal market in the banking sector, despite partially or fully harmonised supervision and resolution. The benefits of the internal market or economies of scale are not being realised. There are costs associated with inaction. There has been much criticism of host Member States on ring-fencing, but host Member States are only doing what is required by the Treaty, as financial stability is the responsibility of national Member States. Home bias or national bias is rarely mentioned in the context of sovereign risk. This is very important, especially as the so-called bank-sovereign nexus is an initial objective of the Banking Union that has not yet been achieved. The European Deposit Insurance Scheme (EDIS) could address many host country concerns. EDIS would also benefit home Member States in financial difficulty.

The Banking Union is in the interest of host countries but should not be at the expense of their financial stability. The wider economic consequences of bank failures are a concern for host Member States, in particular the supply of credit in the event of difficulties with a systemic bank in the host Member State. Moreover, the so-called piecemeal approach to macroprudential regulation will not work, as has been demonstrated recently with regard to the output floor. Clarification, harmonisation and avoidance of overlaps between the systemic risk buffer and the countercyclical buffer should be addressed through a holistic approach. Capital markets union (CMU) without Banking Union will not work, as noted by Fabio Panetta. The European Stability Mechanism (ESM) treaty has been reformed. The backstop for the Single Resolution Fund (SRF) will soon be established. 26 member states have already ratified the treaty change.

1.2.2 The European banking system remains a collection of national sectors

A Central Bank official noted that much has been achieved in the last 10 years. The Single Supervisory Mechanism (SSM) and the Single Resolution Board (SRB) have been established, and there is extensive cooperation between supervisors and regulators. External shocks in recent years have demonstrated the resilience of the banking system.

However, more was expected from integration and cross-border banking. The Banking Union should allow banks to operate across borders and provide efficient cross-border supervision and deposit insurance. Currently, there is a collection of national banking systems and limited integration. Supervisors have tried to improve the relationship between group support and recovery plans and have also promoted the use of waivers. The legislation provides for the use of a waiver to transfer liquidity between the home bank and subsidiaries, but host authorities are still concerned that there will be insufficient support for subsidiaries in a crisis situation. There are no incentives for real cross-border banking in Europe and the framework is not perfect. Deposit insurance is crucial in this area. The establishment of the third pillar (EDIS) will build trust between home and host authorities and ensure that the banking union works as expected.

1.3 A dialogue about the technicalities and setup of liquidity waivers must be established and trust built between supervisors

An industry representative noted that several banks have attempted to build liquidity buffers within the current regulatory framework. Sufficient safeguards need to be in place when liquidity waivers are applied. Dialogue on the technicalities of such liquidity waivers has been lacking in recent years. If host countries or other authorities within the SSM have a principled objection, it will be very difficult to make progress. Instead of rejecting the principle, in this case the single liquidity subgroup for cross-border liquidity, there should be a dialogue on the substance.

One official noted that the Banking Union is a confidence-building exercise. Trust needs to be built between and among Member States and supervisors. This may require some institutional changes. The SRB and the SSM could be improved.

The Chair noted that collective work among supervisory Member States is essential, as a Member State may be both home and host.

1.4 Preserving the interests of host countries which may not be aligned with the interests of the countries where banking groups are headquartered

An official commented that changes in the regulatory environment are only possible if appropriate safeguards are in place to protect the economic interests of the Banking Union as a whole. Level 1 safeguards are preferable to contractual obligations, as contractual obligations between group entities may not be strong enough. The latest proposal for the reform of crisis management and deposit insurance (CMDI) has addressed many of the doubts and concerns of small host Member States to prevent excessive use of deposit guarantee scheme (DGS) funds for resolution purposes which could require additional contributions from the bank and cause negative consequences for small local banks and financial stability.

The minimum requirement for own funds and eligible liabilities (MREL) is the first line of defence and additional safeguards, such as a regulated procedure for the use of DGS funds, are needed. Authorities or Member States must have discretion to use DGS funds for alternative or preventive measures. With regard to the Daisy Chain Directive, which is also part of the CMDI reform, a national resolution authority must have the discretion to set internal MREL for intermediate entities on a consolidated basis. Many safeguards focus on a backstop mechanism in case a bank gets into difficulties. Appropriate safeguards or mechanisms for the bank in liquidation will be available when EDIS comes into force, so this is also very important.

1.5 Europe's failure to foster large banks operating across a pan-European market creates risks

An industry representative outlined three risks. First, by restricting capital flows and liquidity across borders, ring-fencing practices limit banks' ability to diversify risks and funding, resulting in reduced resilience to economic shocks. Secondly, by protecting the borders of national banking systems, ring-fencing can create pockets of vulnerability. Insufficient coordination among national authorities in crises can exacerbate systemic risk and impair financial stability. Thirdly, by operating mainly within national borders, European banks struggle to compete with large non-European firms, resulting in diminished financial strategic autonomy. During times of crisis these global firms tend to retrench to their home markets

1.6 Completing the Banking Union would benefit growth, financial stability and financial integration

An industry representative stated that the best use should be made of the existing framework. The Commission focuses on the proper implementation of the legal framework and should play a more active role in financial services in this respect. This would, for example, support the implementation of the cross-border liquidity subgroup.

The European Deposit Guarantee Scheme is needed. The European Commission should be ambitious and follow Mario Draghi's recommendations for the 28th regime. This would create a European DGS only for the largest banks, under the direct supervision of the ECB. Completing the Banking Union is crucial for the EU's competitiveness. Recent reports have concluded that the completion of the Banking Union will lead to a structural increase in euro area GDP of between 0.3 and 0.8 basis points. An effective Banking Union is a powerful engine for growth and would also be a step towards a single market for banking services. In this context, the macroprudential framework should be simplified and optimised. The ECB should be given responsibility. The waiver of capital liquidity should also be considered.

The Chair noted that in Europe more than €130 billion is allocated to national DGS and the Single Resolution Fund (SRF). This is comparable to the US. However, the US is able to mobilise these funds, while in Europe they are frozen. EDIS will help but negotiations on the EU crisis management framework also need to be completed to increase the contribution of national DGS to the the funding gap in resolution for medium sized banks.

2. The EU needs an overhaul of the macroprudential framework

The Chair noted that the macroprudential framework is based on minimal harmonisation and is governed by national designated authorities and member states. The framework should be reformed with a focus on harmonisation and predictability.

2.1 Harmonising the macroprudential stance

A central bank official observed that level playing field issues arise when banks of similar size and footprint across the Banking Union are subject to different buffer requirements by their home macroprudential authorities. In addition, the complexity of the framework increases as some countries have chosen to activate systemic risk buffers while others have not. The

macroprudential framework should take a Union-wide perspective to ensure consistency and minimise potential overlaps. This can be done without changing the existing balance of competences between national authorities and the ECB, for example by updating the commonly agreed methodologies for determining banks' macroprudential buffer requirements.

2.2 The way macroprudential buffers are calibrated and activated creates inconsistencies that weaken the competitiveness of EU banking groups

An industry representative remarked that the buffer landscape is extremely complicated. The unpredictability and inconsistency of buffers may make banks more conservative in their lending. Cross-border business models are discouraged because each member state has its own macroprudential approach, which can change at short notice. Moreover, there is currently no authority responsible for assessing whether the aggregate capital requirements of a banking group are commensurate with its overall risk profile.

The formulation of the systemic risk buffer is problematic, as it can cover basically any risk, and there is also pressure to apply it to new risk issues that fall within the scope of microprudential supervision. The global/other systemically important institutions (O-SII) buffer is another source of concern. The methodologies are more refined, but the way the scores are mapped to capital buffers is not known. The same score in different countries may result in a different buffer. This discourages cross-border activity and consolidation and penalises growth in the domestic market.

One problem with the countercyclical buffer is the issue of positive neutrality, which is not clearly aligned with the Capital Requirements Directive (CRD). This is compounded by the fact that responsibility and power should be aligned. In the context of risk management, the real authority, knowledge and competence lies with the micro-prudential supervisor, the SSM. However, neither the macroprudential supervisors nor the EU authorities have an overview of the micro-prudential supervisor's actions in the first or second pillar. The terms 'systemic risk' and 'macroprudential issue' are not clearly defined, leading to overlaps.

These problems reveal an internal market problem. There is no free movement of services in banking, which creates regulatory risk for cross-border banks. The more jurisdictions a bank operates in, the greater the risk that capital requirements will suddenly increase by 100 or 200 basis points. Incentives need to be increased to allow competitiveness and economies of scale.

2.3 Common methodologies and metrics for determining banks' macroprudential buffer requirements

An industry representative explained that macroprudential requirements are a problem in the context of a competitive Banking Union. A significant part of a bank's capital requirements (1/3) can be macroprudential buffers. This amount has risen sharply in recent years and continues to do so, which is difficult to explain in economic terms.

The underlying measure of the countercyclical capital buffer (CCyB) is the credit-to-GDP gap, which has been negative in most European countries over the past two years. Despite this, the CCyB has been increased in many countries. Pillar one and pillar two are very prescriptive and are rightly closely scrutinised by the SSM and the regulatory framework. This scrutiny is lacking in the macroprudential area. Stronger macroprudential authorities in the ECB would provide a countervailing power to challenge countries that set macroprudential buffers. Data and information on banks are centralised. Macroprudential competence should be more closely linked to national authorities and to the euro area as a whole.

The Chairman explained that the CCyB methodology is the reason why Italy opted for the systemic risk buffer, as the underlying methodology discussed in Basel many years ago is still based on credit to GDP.

2.4 Three priorities to move forward

An industry representative noted that capital is the biggest cost of lending. Covid raised awareness about capital and buffers. Buffers do not necessarily need to be reduced at a systemic level, but there is an issue of a level playing field. Excessive capital in the EU is not a big problem. The problem is that where the buffers are and where the risk is are not always aligned. Solvency is also an issue. High buffers are no help in a crisis if they are not clearly releasable.

The CRD should be revised with a focus on three main areas. First, a radical simplification of the tools and decision-making. For example, the three buffers for structural risks - the systemic risk buffer and the G/O-SII buffers - should be reassessed. The level of risk posed by a large bank in a small country should also be reviewed in the light of the Banking Union. Second, standardisation and decision-making at the EU level should be strengthened. Methodologies used in the EU and the European Economic Area (EEA) should be aligned as far as possible. Finally, the micro-prudential supervisor, in this case the SSM, should be able to determine the appropriate level of aggregate capital for a group. At a minimum, the micro-prudential supervisor's assessment should be an integral part of the macroprudential supervisor's decisions. Ideally, micro-prudential tools should take precedence over macroprudential tools.

3. Strengthening the competitiveness of the European banking system

3.1 Banking Union could significantly benefit from greater focus on CMU

An official commented that CMU will likely be the top priority of the new Commission, possibly with more focus on the host member states' perspective. Other features that are important for the host include the attractiveness of the capital market, the visibility of the market and the start-up phase.

The Chair remarked that the reduction of banking market fragmentation was closely linked to the creation of the CMU. Deeper integration of capital markets would facilitate the provision of cross-border financial services, leading to better access for banks to host countries, but it is also true that the Banking Union is a prerequisite for the CMU.

3.2 The focus should shift to strengthening the competitiveness of the European banking system

An industry representative commented that the current system is safe but not necessarily competitive. European banks have suffered since the global financial crisis, especially compared to their US counterparts. Many global banks call their capital markets business 'global markets' because it is a global business. European banks have lost market share in this area every year since the global financial crisis. Resilience is a problem and there is no cross-border diversification. Cross-border lending is still in the low single digits, leading to concentration from a market risk perspective and highly skewed sector exposures within countries. The ability to respond quickly to a crisis in the EU is a concern. Previous crises have shown that containment is possible as long as action is taken quickly, but the need for coordination across different levels of jurisdiction will affect speed. Finally, strategic autonomy is a concern if banks are not strengthened. In times of crisis, banks move their capital back to their home market.

The Chairman noted that the trade-off between resilience and competitiveness is a recurring theme. The outcome in Europe in 2023 could have been very different if the Basel standards had not been applied to all banks.

3.3 Harmonising tax, accounting, insolvency regimes and consumer protection rules

A central bank official noted that banks would welcome greater harmonisation of accounting and tax rules. National consumer protection and anti-money laundering rules also need to allow banks to operate cross-border with subsidiaries. Much can be achieved in terms of harmonisation by improving current macroprudential policies and focusing on cooperation. The subprime crisis showed that very few authorities and countries had introduced and activated macroprudential buffers. During the crisis, ensuring sufficient capital in the banking system was a top priority. There was also a recognition that it should be possible to unwind buffers if necessary. In the aftermath of the Cobid crisis, the authorities in most countries of the Banking Union activated countercyclical buffers.

The Chair commented that there is no need to "reinvent the wheel" if the appropriate tools are already available and that many issues relate to implementation.

3.4 A radical top-down approach is needed to achieve competitive pan-European banks

An industry representative shared that a report for the European Banking Federation showed that the CET1 ratio in the US has stagnated at around 12% in recent years, while it has continued to rise in European banks. The simplicity of the US approach to buffers is noteworthy and should be taken into account. The suggestion around EDIS in the Draghi paper for cross-border active institutions is interesting. An alternative is a reinsurance-type model. This would initially be national, with a European level that could intervene if a crisis became systemic. There is still no common backstop for the SRF, which is particularly important for the resolution of complex organisations. The global systemically important financial institution (G-SIFI) buffer for the larger institutions is counterintuitive. Expanding across Europe spreads risk and capital requirements should therefore be reduced for more diversified European banks. Harmonisation of tax, mortgage, bankruptcy and consumer protection laws will enable banks to operate across borders.

The Chair concluded that the progress made over the past 10 years should not be forgotten. However, the unprecedented pace of change outside Europe has led to higher expectations and a need for faster action. The framework has become too complex, and it is difficult to find the appropriate balance between competitiveness and safety. Political will is needed to implement the proposals raised in recent years.