CIRSF Annual International Conference 2019

Financial Supervision and Financial Stability Ten Years After the Crisis: Achievements and Next Steps

Lisbon, 4 July 2019

Banking Union: Crossing an Unstable Bridge

Panel contribution by Elisa Ferreira, Vice-Governor of Banco de Portugal[i]

Good morning ladies and gentlemen. It is a great pleasure to participate in this panel.

Setting the scene

I recognise we have made big strides forward in setting up the first two pillars of Banking Union. However, the political will to complete it has weakened – as highlighted by the last Eurogroup meeting – with a fully-fledged EDIS still far off.[ii]

As economic conditions have improved, a false sense of security has emerged while we are still half-way across the bridge. This is exactly the topic I propose for today's discussion.

As it stands, banks continue to be 'European in life but national in death', as supervisory and resolution decisions are mostly European, whereas the ultimate guarantor of financial stability remains national.

Still in the aftermath of the crisis[iii], as banks' business models are struggling to generate adequate profitability levels in the current macroeconomic environment, also characterized by low interest rates, and to adapt fast enough to the technological progress and to the demands of the digital consumers, Banking Union's ongoing incompleteness compounds the existing challenges.

While waiting for the completion of Banking Union, some of the most disruptive elements of the present framework deserve to be addressed to minimise risks to financial stability.

The fragilities of the resolution framework

One of them is "the approach taken by the EU to the resolution of small and medium-sized banks [which] puts a greater emphasis on the protection of taxpayers from bailouts and a lesser emphasis on systemic stability and avoiding contagious market disruptions than is the case in the US," as highlighted by Bolton (2019) and co-authors[iv].

In fact, some of the main building blocks of the resolution leg (second pillar) may have extremely severe unintended consequences on financial stability:

- Whereas MREL and bail-in requirements may work for larger banks, it is not clear whether such requirements are suited for mid-sized institutions:
    - that operate on a more traditional business model less familiar with capital markets; and
    - that may be of no public interest at EU level but still have systemic importance at local level.[v]
- The internal loss absorption requirements (8% of total liabilities and own funds) and limitations on the amount of the resolution funds that can be used (5% of total liabilities and own funds) subject senior debt and even unsecured deposits in mid-sized banks with traditional business models to risks incompatible with financial stability.
- In view of such risks, recourse to alternatives often perceived as attempts to circumvent the existing rules has been observed in some Member States.
- Some also argue that bank liquidations have become an easy way out for European authorities as the ensuing financial and political costs lie with national authorities.[vi]

The risks of regulatory-driven consolidation

The fragilities of the second pillar – just described – have been linked to calls to speed up consolidation as a means to increase profitability and efficiency in the banking sector, fostering the creation of pan-European banks able to compete with larger institutions outside Europe.

In this regard, the perception that consolidation is regulatory-driven can be disruptive to the much-needed trust in the single rule book. This perception is justified by the increasing complexity of regulation and potentially disproportionate requirements such as MREL which only large banks seem able to comply with, and the speed to de-risk.

Although the supposed increased efficiency associated with size is yet to be demonstrated, it cannot be disregarded that addressing too-big-to-fail (and too complex to supervise or resolve) was one of the main purposes of Banking Union. We should not resolve a problem by creating an even bigger one.

The lauding of consolidation also ignores the fact that the current incomplete architecture of Banking Union creates significant imbalances across home and host countries in cross-border operations, which come to the fore in crisis situations. This is one of the reasons why it has been so difficult to implement capital and additional waivers on liquidity and remove options and national discretions.

In this context, regulators and supervisors should neither help nor hinder M&A. Instead supervisors and regulators should provide the market a stable view of the supervisory and regulatory frameworks that allow market participants to take their informed decisions.

Way forward

While political circumstances prevent decisive progress in Banking Union, a number of intermediary solutions can nevertheless be implemented to address the major sources of instability, paving the way to build trust among Member States.

It seems now sufficiently clear that the first best solution would be to amend the BRRD in relation to the 5% and 8% thresholds. If this is politically unfeasible, the IMF's proposal of a 'financial stability exemption' must be further explored, guaranteeing the applicability of this exception to mid-sized institutions and not only to G-SIBs.

In the absence of a thorough and much-needed fine-tuning of the existing legal and institutional framework, consideration should be given on how to mitigate host countries' concerns.

The European supervisory authorities must monitor closely cross border operations, not only from the point of view of the parent undertaking, but also of all subsidiaries and systemic branches established in the Banking Union, allowing, simultaneously, host country competent authorities to have an adequate oversight on their operations (including from the operational, funding and governance perspectives) and to react to strategic decisions of these subsidiaries/branches' parents, namely those that can affect the financial stability of host countries.[vii]

For significant operations, there should be an adequate level of separability (financial, operational, IT systems, governance), not only in MPE strategies but also when an SPE strategy is envisaged in the resolution plan, in order to allow a subsidiary to be detached from a parent undertaking and thereby foster resolvability even in adverse scenarios, as the enforcement of pre-resolution intra-group parent support mechanisms (e.g. guarantees) may prove to be insufficient in a real crisis situation.

Moreover, the current framework makes it clear that banks that are failing or likely to fail but which are not resolved due to the absence of a public interest are to be wound up in an orderly manner in accordance with the applicable national law.

In this context, a significant number of small and medium-sized banks in the Banking Union are contributing to the Single Resolution Fund (SRF) without having a reasonable expectation of being able to pass the public interest test to eventually benefit from it. This situation must not be ignored.

Obviously, solutions need to be found for the orderly exit of traditional medium-sized deposit-taking banks without disrupting financial stability.

The topic of harmonising EU banks' liquidation regimes has thus been put on the agenda and recognised as a priority by Member States[viii], as recent experiences have been perceived as exploiting existing loopholes. But what does bank liquidation mean? And do we have the tools to ensure its orderliness in the current context?

Liquidation might imply the immediate interruption of lending support, as well as the suspension of payments; it may have disruptive effects for creditors, depositors and other stakeholders, with the ensuing impact on the real economy, ultimately reinforcing the sovereign-bank doom loop.

The European Commission's forthcoming study on the divergences in the insolvency frameworks for banks under different national laws is thus welcome.[ix] However, in the present circumstances we are not in a position to move immediately towards the full harmonisation of EU banks' liquidation regimes.

Instead, efforts must be made to establish an enabling framework for the orderly management of failing banks of locally systemic importance, combining elements of the resolution and liquidation frameworks – akin to the FDIC approach in the USA – while minimising losses and protecting depositors and non-financial borrowers.

In that regard, the existing liquidation regime of small banks in Italy – compatible with the internal market and to which the European Commission did not raise objections – could be a useful first step for our discussions.[x]

Such an enabling framework should include the definition of high-level principles to be agreed by all Member States for application at national level. Possible paths might include:

- The establishment of special insolvency proceedings, with recourse to administrative options, assigning to a liquidating authority some of the instruments currently envisaged in the BRRD, as an alternative to the court-led liquidation regime. The liquidating authority and the funding sources available would need to be identified.
- The use of DGSs for deposit transfers abiding by the least cost principle. For that, the recent judgment of the European Court of Justice on the case of Banca Tercas[xi] could inform the discussion on the role of DGSs in liquidation beyond the pure payout approach[xii], as well as the associated State Aid issues.
- The liquidating authority having the option to offer guarantees or enter into profit- and loss-sharing regimes.

This framework could be applied in situations where resolution: (i) is not considered to be in the public interest, and when it (ii) might not be the best approach given the constraints to its application, namely through the lack of loss-absorption capacity.

The introduction of such a new regime would also raise the following questions, among others:

- How to ensure that business models, size and systemic importance are part of the equation?
- Can the bail-in of senior unsecured debt and uncovered deposits with the accompanying destabilising effects on financial stability be avoided?
- Should institutions subject to liquidation be required to hold an additional bail-in buffer (MREL) on top of own fund requirements to support transfers in FDIC-like insolvency proceedings?
- Can the SRF and DGSs work as complementary instruments according to the envisaged crisis management solution?

- Should recourse to resolution funds and DGSs continue to be considered State Aid on the basis of a pure administrative decision (by DG COMP) with the ensuing consequences?

Until there is the political will to decide and implement the required structural solutions and establish a clear roadmap to revise BRRD and complete Banking Union (including a fully-fledged EDIS), small technical steps must be made in order to mitigate the big stability risks that are hidden by the false sense of security that prevails.

A credible path must be progressively built towards strengthening trust among Member States, namely through reasonable and balanced regulation that reduces to a minimum its potential disruptive spillovers.[xiii]

Let me conclude.

As Jean Monnet once wrote, "I have always believed that Europe would be built through crises, and that it would be the sum of their solutions."[xiv]

However, we have only half-implemented the lessons learned from the biggest crisis affecting the common currency. As President Juncker recently reminded us, "[w]e should not wait for the next crisis to do what we know we have to do."[xv]

As described before, we do know what remains to be done. Only by delivering it can we truly be accountable to European citizens.

Thank you for your attention.

---

[i] As prepared for delivery.

[ii] Evidenced by the Eurogroup President's letter to the President of the Euro Summit of 15 June 2019, on the deepening of the economic and monetary union: "We recognise that further technical work will be needed on defining a transitional path to the steady state Banking Union for relevant elements and their sequencing, adhering to all the elements of the 2016 roadmap. This work should include a roadmap for beginning political negotiations on a European deposit insurance system. We have therefore mandated the HLWG to continue this work and report back by December 2019.", available at https://www.consilium.europa.eu/media/39769/eurogroup-president-letter-to-euro-summit-president.pdf, and the High-Level Working Group Chair report on the strengthening of the banking union, including EDIS available at https://www.consilium.europa.eu/media/39768/190606-hlwg-chair-report.pdf.

[iii] As recently noted by Mario Draghi, "After the crisis, it was inevitable that banking sectors in advanced economies would have to deleverage, both to cover losses and to re-focus their business models. The United States ensured that this process happened quickly and early. Around 500 failing banks were resolved by the Federal Deposit Insurance Corporation, while struggling banks were stress-tested and recapitalised through the Troubled Assets Relief Program. Between 2008 and 2011, US banks improved their leverage ratio by 1.6 percentage points from 7.2 to 8.8%. The response in the euro area was more sluggish. Despite being more levered than their US peers before the crisis, euro area banks improved

their leverage ratio by just 0.9 percentage points, from 3.7 to 4.6%, and this was achieved more through shedding assets and less through raising capital. This in part reflected the fact that, due to the fiscal rules, public support for banks was concentrated in countries with fiscal space. Moreover, without a common resolution framework only around 50 banks were resolved in the euro area in this period. So a weak banking sector continued to drag on the euro area economy, which was especially pernicious given the importance of the banking lending channel for financing.", Draghi, M. (2019), "Twenty Years of the ECB's monetary policy", speech at the ECB Forum on Central Banking, Sintra, 18 June.

[iv] Bolton, P., Cecchetti, S., Danthine, J.-P., Vives, X. (2019), "Sound At Last? Assessing a Decade of Financial Regulation", VoxEU.org, 2 June.

[v] Restoy, F. (2018), "Bail-in in the new bank resolution framework: is there an issue with the middle class?", speech at the IADI-ERC International Conference "Resolution and deposit guarantee schemes in Europe: incomplete processes and uncertain outcomes", Naples, 23 March.

[vi] Valle e Azevedo, J., Bonfim, D. (2019), "Deposit Insurance and Cross-Border Banks", ifo DICE Report I/2019, Spring, Volume 17.

[vii] Some have also argued that "[t]his 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.", Eurofi (2019), Programme of the Eurofi High Level Seminar in Bucharest, 3-5 April.

[viii] As evidenced by the High-Level Working Group Chair report on the strengthening of the banking union, including EDIS (*op. cit.*): "Broad agreement exists on the need for a harmonisation of necessary parts of bank insolvency law, including with regard to cross-border groups and the ranking of creditors, while the toolbox for resolution might need to be expanded."

[ix] This report is expected to feed into the review of the Single Resolution Mechanism, European Commission (2019), "Report from the Commission to the European Parliament and the Council on the application and review of Directive 2014/59/EU (Bank Recovery and Resolution Directive) and Regulation 806/2014 (Single Resolution Mechanism Regulation)", available at http://ec.europa.eu/transparency/regdoc/rep/1/2019/EN/COM-2019-213-F1-EN-MAIN-PART-1.PDF, and European Parliament (2019), Briefing for the purposes of the Public hearing with Elke König, Chair of the Single Resolution Board on 2 April 2019. The European Parliament ECON Committee has also commissioned an external study on "Lessons from the United States for banking resolution in the Banking Union" to be published in spring 2019.

[x] State aid SA.50640 (2018/N) – Italy – liquidation scheme for small banks, available at http://ec.europa.eu/competition/state_aid/cases/274069/274069_1989761_107_2.pdf.

[xi] Judgment in Joined Cases T-98/16, Italy v Commission, T-196/16, Banca Popolare di Bari SCpA v Commission, and T-198/16 Fondo interbancario di tutela dei depositi v Commission.

[xii] The DGS Directive also recognises that DGS funds may be used for purposes other than payout in resolution or insolvency, as a national option under Article 11(6): "Member States may decide that the available financial means may also be used to finance measures to preserve the access of depositors to covered deposits, including transfer of assets and liabilities and deposit book transfer, in the context of national insolvency proceedings, provided that the costs borne by the DGS do not exceed the net amount of compensating covered depositors at the credit institution concerned". Where Member States avail of this option, national DGS may be used to fund P&A transactions along the lines of the US FDIC. For further details see European Parliament – Economic Governance Support Unit (2019), "Liquidation of Banks: Towards an 'FDIC' for the Banking Union?", February.

[xiii] In this regard, the ESM has recently put forward a first interesting attempt that deserves reflection, Mascher, N. (2019), "Structure of the European Deposit Insurance Scheme", speech at the Goethe University, Institute for Law and Finance, Frankfurt am Main, 14 June.

[xiv] Monnet, J. (1976), *Mémoires*, Paris, Librairie Arthème Fayard.

[xv] Juncker, J.-C. (2019), "Building the euro: moments in time, lessons in history", speech at the ECB Forum on Central Banking, Sintra, 19 June.