The state of play on Banking Union

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1. Introduction

The Covid-19 pandemic has drastically changed the agenda of the European Union. Managing the associated economic crisis and the recovery have become the most important items. The banking union, which was at the centre of the policy agenda for most of the previous decade, has receded in urgency. But this does not mean that unresolved issues are any less important. These include adopting a European Deposit Insurance Scheme (EDIS), adapting the regulatory environment to foster cross-border financial integration, introducing a fiscal backstop to the Single Resolution Fund, and providing liquidity to banks in resolution. The latest Eurogroup on September 11, 2020 discussed all of these topics (Eurogroup, 2020).

This note gives an overview of the state of play on the banking union, based largely on the latest progress report from the Council Presidency to the member states towards the end of the Croatian Council Presidency (Council of the European Union, 2020).

2. Risk sharing: common deposit insurance

Proposals for a European Deposit Insurance Scheme take many forms. At one extreme are loans given by European supranational institutions to member states' national deposit guarantee funds. At the other extreme would be a fully federal deposit guarantee scheme replacing the national ones (European Commission, 2016). The version of EDIS under discussion by the Council's ad-hoc working group is a so-called hybrid model (Council of the European Union, 2020). In this model there is a central fund that reinsures national systems, alongside mandatory lending between national deposit insurance schemes which is a later addition. This represents a rejection of the fully mutualised model, but the reinsurance model does imply a degree of federal-level deposit insurance, in so far as the European reinsurer can suffer losses.

There is disagreement on which banks should be covered by EDIS. This is because some countries lack a single national deposit guarantee fund. In the case of Germany, commercial banks, savings banks, and cooperative banks, each have their own separate deposit guarantee. As public-law entities, German savings banks and cooperative banks participate in respective so-called institutional protection schemes (BaFin, 2019). These are mutual arrangements among a group of banks to share capital and liquidity. These are not specifically deposit insurance, even though mutual protection from insolvency is intended to protect depositors of individual member banks (ECB Banking Supervision, 2016).

Institutional protection schemes work partly like banking groups, and European regulations take membership in such schemes into account when calculating capital and liquidity requirements. It is being argued that this membership should also result in lower bank-level contributions to EDIS. Countries where such institutional protection schemes do not exist tend not to agree with this.

Other points of disagreement include the consideration of unregulated financial institutions for the purposes of estimating systemic risk, as well as the use of EDIS for purposes other than pay-outs by national deposit insurance schemes. In some countries, notably Italy, deposit insurance schemes have applied funds to bank restructuring or resolution on the argument that this prevents deposits from being affected by a bank failure. The rationale is that this is less costly to the deposit insurance scheme than compensating depositors for the loss of their insured deposits after the fact. Not all member states do this, though.

The European Commission is considering a survey of member states' positions on a number of quantitative parameters of the hybrid model on which there is disagreement, such as: the allocation of funds between the central reinsurance fund and the loans from national deposit insurance schemes; caps on mandatory lending between national deposit guarantee schemes; caps on lending from the central fund in a transitional period; and features of loans such as interest rates and maturities.

3. Obstacles to risk sharing

Reluctance to make progress on EDIS is often justified by moral hazard and implicit fiscal transfers between member states. These stem from the very different riskiness of the balance sheets of banks in different countries. The argument is summarised by saying risk reduction, meaning a reduction in the risk of bank balance sheets and disparities between countries, should precede risk sharing, meaning mutualised features of the banking union such as EDIS but not limited to it.

Risk reduction focuses mainly on non-performing loans, which are concentrated in the countries most affected by the eurozone government-debt and banking crises of the start of the previous decade. However, other sources of risk that can and do affect banks with low non-performing loan ratios. These include the accumulation of so-called Level-2 and Level-3 assets, which are bank assets that cannot be given a market value without significant modelling assumptions.

Beyond risk reduction, political obstacles to risk sharing are being addressed through risk-based contributions to the common reinsurance fund. Individual banks would contribute to the European reinsurance fund based on the riskiness of their respective balance sheets.

Another source of risk on which there is no agreement is the home bias of the holdings of government bonds by banks. This is a problem because it implies banks lending to the same national government that would rescue them in case of failure. This problem is also concentrated in countries most affected by the previous banking and government-debt crises, which tend to have the higher government debt-to-GDP ratios.

Also being considered is a flat-rate contribution to the reinsurance fund for small banks. Political disagreement on this point can partly be traced to the different size of the typical bank in each member state. Germany has avoided bank concentration and keeps a large number small savings banks and cooperative banks by means of the aforementioned institutional protection schemes. Umbrella organisation such as *Landesbanken* do qualify as large banks, but most German retail banks are small.

Finally, some member states argued that methodological guidelines (European Banking Authority, 2019) by the European Banking Authority on the calculation of risk-based contributions are outdated.

4. Risk reduction: non-performing loans

Because the stock of non-performing loans is one of the main obstacles to progress on banking union, the European Union developed a strategy to reduce it base on the sale of impaired loans (European Commission, 2019). There are two hurdles for this. The first is that capital set aside by banks to cover their non-performing loans tends to be insufficient to absorb the typical losses incurred when selling the loans off. This is related to the second hurdle, which is that distressed-debt investors are willing to pay for non-performing loans only a significantly lower price than implied by banks' loss provisions.

The capital problem has been addressed through the adoption of a stricter calendar for provisioning of dubious credit exposures. The relatively low price of distressed debt is considered an issue of market failure. Policies to address it include speeding up insolvency procedures, including the extra-judicial enforcement of collateral; developing a market for securitisations, that is synthetic bonds channelling the revenue from non-performing loan portfolios. The European Parliament is yet to take positions on necessary regulations: of credit servicing and credit purchasing businesses, which are necessary for the securitisation strategy to work; and on extrajudicial enforcement of collateral.

Progress on risk reduction will be set back by the Covid-19 pandemic, because its is expected to increase non-performing loans. Moreover, the severity of the Covid-19 pandemic so far has partly correlated with debtor status in the previous eurozone banking crisis, notably in the case of Italy. This means that Covid-19 will not only increase the overall NPL ratio, but will also increase existing disparities between member states. This will be an additional source of delay for EDIS. While this is widely expected, there are no published NPL ratios since the start of the pandemic. Widely quoted estimates include that the NPL ratio could double in a baseline scenario without a second epidemic wave, and double again in case of a severe second wave.

5. Bank resolution

The banking union involved the establishment of a single bank recovery and resolution regime. But, nearly five years since the creation of the Single Resolution Board, several issues remain unresolved. The experience of the early years of the banking union has highlighted issues with the regulatory triggers to bank resolution and insolvency, the use of supervisory early intervention measures, and national differences on the application of precautionary recapitalisations. Progress on all these issues has been delayed by Covid-19. Bank resolution ties in with EDIS because sometimes it involves deposit insurance.

The most important open issue in this area is the provision of liquidity in resolution. Because of the way early intervention measures are legislated, there is the risk that a failing bank will completely run out of liquidity by the time it is declared failing or likely to fail by supervisors and resolution measures kick in. Resolution plans are designed to restore a bank to solvency, but not to replenish its liquidity buffers.

6. ESM reform

The solutions to several of the above-mentioned problems have been folded into a reform of the European Stability Mechanism, which was discussed at the latest Eurogroup (Eurogroup, 2020).

One is the home bias in banks' government debt holdings, which is tied to plans to introduce a debt restructuring mechanism for government debt which would involve fiscal support from the ESM.

Another is providing a fiscal backstop to the Single Resolution Fund, on which there is a consensus. This has been expanded to also provide for liquidity in resolution. This is an expansion of the functions of the Single Resolution Fund. Originally it was supposed to only help recapitalise banks that cannot be wound down. Liquidity in resolution, on the other hand, involves lending to banks that have been recapitalised but lack sufficient liquidity to operate on their own after restructuring

7. Covid-19 delays and next steps

In the first half of 2020 the attention of the Croatian presidency was diverted to dealing with the first wave of the Covid-19 pandemic, and there was little progress on the banking union agenda. Based on the May progress report by the Croatian presidency (Council of the European Union, 2020), we can assume that the German presidency will attempt to address at least the following issues.

The Finnish Council presidency had launched a data-collection exercise on legacy risks in the banking union. Its aim was to support the development of the system of risk-based contributions to EDIS discussed above. As a result of the Covid-19 pandemic, three countries were still missing their data in May. It is possible that the data-collection exercise will be completed by the end of the year.

The EU was also getting ready to finalise the implementation of international regulatory and supervisory reforms carried out in response to the global financial crisis that started in 2008. Considering the Covid-19 pandemic, however, the finalisation of post-crisis reforms was considered too difficult. The European Commission decided to postpone its own legislative package originally planned for June 2020. Instead of this, in April, the Commission had introduced a number of *"quick fix"* amendments to European regulations to ease banks' credit support role during the pandemic (European Commission, 2020).

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