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REGULATION AND PUBLIC POLICIES

Banking Union: Half way there

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The European Commission has published a roadmap to ensure agreement on all the outstanding elements of the Banking Union by 2018, with both risk reduction and risk sharing measures going hand by hand. The EU Commission warns that the Banking Union must be completed if it is to deliver its full potential as a pillar of a strong Economic and Monetary Union and complementary to the Capital Markets Union.

The successful implementation of the measures included in this communication will depend on the outcome of political negotiations between Eurozone Member States, where divergent views on the priorities and timing still coexist. This is especially true when it comes to proposals for a common European Deposit Insurance Scheme (EDIS) that it is essential for the completion of the Banking Union. The communication aims to deliver new impetus to the negotiations on EDIS by offering a possible compromise of ideas for issues where no agreement has been reached so far within the European Parliament and the Council. It also presents a redesigned approach to EDIS by means of a first phase of "re-insurance" whereby EDIS will provide only liquidity coverage to national DGS, followed by a second phase of "co-insurance", subject to "certain conditions". The Commission hopes this approach to EDIS will break the political deadlock on this field guiding the path towards the incorporation of the backstop for the Single Resolution Fund that will culminate the achievement of the Banking Union.

Key features of the Communication

On October 11, the European Commission issued a "Communication to the European Parliament, the Council, the European Central Bank, The European Economic and Social Committee and the Committee of the Regions on completing the Banking Union" which it aims to achieve by end-2018 a completed banking union. This document comes ahead of the December Euro Summit where the completion of the Banking Union will be part of discussions on further deepening the EMU.

The communication of the Commission reviews what has been achieved in creating the Banking Union insofar and what measures are still needed for completion. To build the Banking Union project, EU institutions agreed to establish a Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM) for banks. While these two pillars are already in place and fully operational, with some loopholes to overcome, other tools such as the agreed common backstop to the SRM and a common system for deposit protection have not yet been established. In parallel, there needs to be further progress on risk reduction. To achieve these goals, on November 2015 the Commission proposed the EDIS followed by a banking package with further risk reduction measures on November 2016, all of them still pending entry into force.

Despite significant progress made since the financial crisis, the Commission recognizes that the Banking Union remains incomplete and does not therefore play its full role as a mechanism of shock absorption through private channels. In its opinion, the EU must find a “win-win" equilibrium both for risk reduction and risk sharing strategies. As the end of the legislative term is approaching, clear political decisions are needed in the coming months **to ensure agreement on all the outstanding key elements by the end of 2018.** Hence, the Commission calls upon the European Parliament and all Member States to reach a political agreement in the coming months on a **renewed commitment to complete the Banking Union by 2019**. The key features of the communication are the following:

1. New proposal for EDIS

The European Commission formulates a new suggestion on EDIS as compared to its previous of November 2015. The Commission reiterates the need for an EDIS for achieving a stronger and more uniform deposit insurance coverage for all retail depositors in the Banking Union, regardless of their geographical location. However it recognizes the existence of divergences as revealed in the discussions held in the European Parliament, and in the Council regarding the final design (reinsurance, co-insurance or insurance), the temporary process of establishment of the system and the different starting level in terms of risks of the different national banking systems. In sum, the need to ensure that banks are sufficiently solid before moving on to share the burdens of possible failures of some of them has been a major cause for concern.

For these reasons, and considering co-legislators have not yet adopted the proposal, **the Commission has set out some suggestions to facilitate progress on political negotiations in order to achieve an agreement by 2018.**

The new proposal coming from the Commission maintains the idea of a single Deposit Insurance Fund (DIF), managed by the Single Resolution Board (SRB) and financed by contributions from banks. Nevertheless, **the Commission suggests a more gradual introduction, parallel to progress in reducing risks and managing inherited problems, starting with a re-insurance phase and gradually moving towards co-insurance.**

- In a first **“re-insurance phase”,** the EDIS could provide only liquidity coverage (no loss coverage). In case of a bank default and once the national Deposit Guarantee Schemes (DGS) has exhausted its funds, EDIS would provide liquidity in the form of a loan up to an amount that would cover up to 30% of the needs in the first year (2019), 60% in the second (2020) and 90% the third (2021).

- The move to the second phase would be conditional on measures that must be assessed by an European Commission's decision which among others would include a progress achieved in reducing the level of non-performing loans (NPLs) and other legacy assets assessed through an Asset Quality Review (AQR) (i.e. before 2022 at the least).

- **Once these conditions are met, the second phase of "co-insurance**" could start. EDIS, in addition to providing liquidity, would move to progressively cover losses from the first euro, starting with 30% the first year, but with no clear final stage.

Additionally, the Commission considers that further adjustments to the Directive on Deposit Guarantee Schemes (DGSD) should be made. The harmonisation of national deposit schemes needs to progress in parallel with the establishment of EDIS. This would ensure the correct functioning of EDIS and favors the exchange of information and cooperation among national DGSs, the SRB and the European Banking Authority (EBA). National options and discretions should be further reduced to reduce financial fragmentation.

The Commission's initial proposal seems decaffeinated within its term and scope, since it is not clear if it will reach a "full insurance" and it remains in a "co-insurance", so its capacity to mutualize risk is diluted. No reference is made to 2024 as the deadline for having the fund at full capacity (as the Commission proposed initially). The document only urges now to begin political negotiations to reach an agreement by 2018, and Banking Union in 2019. So this statement implies that progress could be made but slowly (the first phase of the Fund should have begun in 2017 according to the initial Commission proposal).

Regarding the scope, a re-insurance scheme is not enough to break the sovereign-bank vicious circle. It is a good starting point towards a fully-fledged EDIS, but as long as national governments remain liable for depositors' protection, markets will continue to discriminate banks based on their location. Hence, the re-insurance system will not be able to cope with speculation against banks located in countries with weaker governments, even if this is just a market perception. There remains a need for a fully mutualised EDIS after the transition period because depositors must be granted similar protection regardless of their location.

Furthermore, progress on EDIS should not be tied to a specific risk reduction measure, particularly sovereign exposures. Risk reduction is necessary, but following the financial crisis significant reduction has already taken place, making banks more resilient. Furthermore, the recent package launched by the Commission (CRD V) provides for enhanced rules on this front. If despite this, EDIS is finally conditioned to risk reduction, then specific and realistic milestones should be set by the Commission, to avoid further delay. Otherwise, the necessary third pillar of the Banking Union would be postponed indefinitely. The Commission should give more details on the new possible proposal and clarifications on the conditions to move to the second phase[1].

1: On April 2016, the ECB released a document firmly supporting the creation of EDIS, with two main recommendations: EDIS should not be preconditioned by Risk Reduction Measures (RRM), and a common backstop should be created.

2. Other measures: Risk Reduction, NPLs, SBBs, backstop and investment firms

On the risk reduction side, the Commission urges the European Parliament and the Member States to move forward quickly with the comprehensive risk-reduction package of 2016. Further outstanding issues beyond the scope of the package should be considered in later legislative reviews, once the ongoing negotiations on the 2016 Banking Package are concluded in the course of 2018. While recognising the current trend of declining levels of NPLs, the **Commission has also suggested new measures to reduce them, and to help banks diversify their investments in sovereign bonds.**

On one hand, the Commission states that work on NPLs must be based on a comprehensive approach combining a mix of complementing policy actions both at national level and at Union level. Addressing remaining risks in the European banking sector is of the greatest importance, and the Commission seems to be committed to take the necessary measures within its remit to continue driving this process forward. For that reason, by the Spring 2018, the Commission will adopt a comprehensive package of measures to address NPLs and a first report on the implementation of the Action Plan.

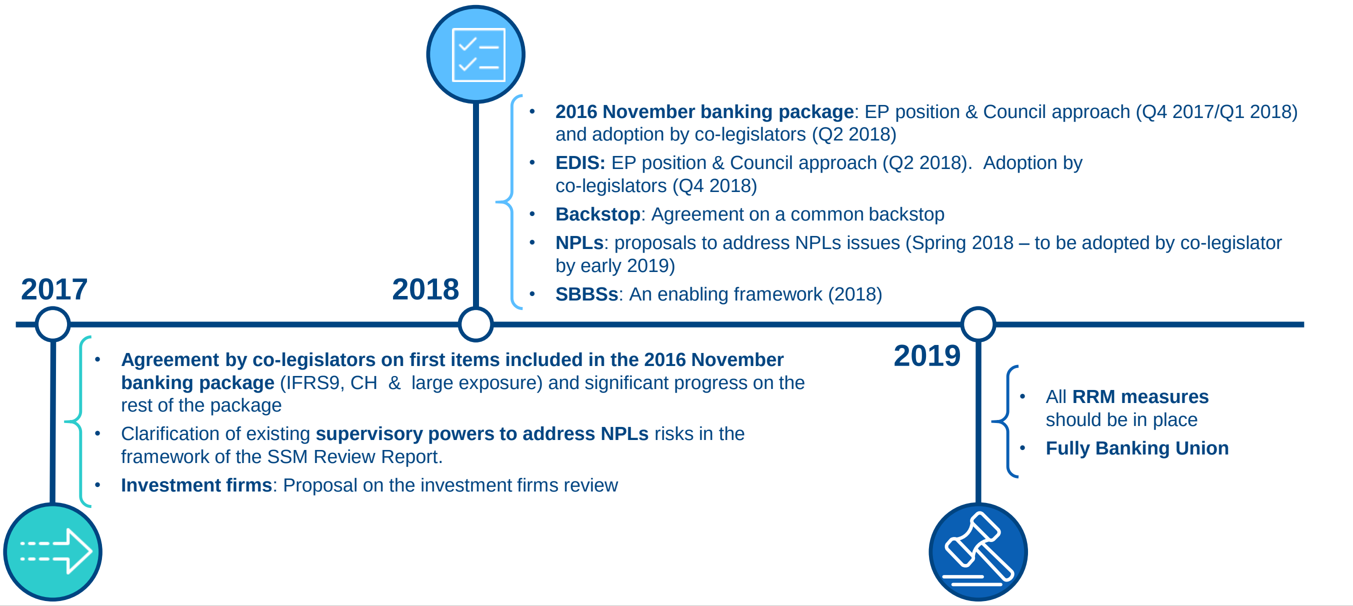
On the other hand, the Commission suggests that reducing risks to financial stability by facilitating the diversification of banks' sovereign portfolios and further weakening the bank-sovereign nexus has a key importance for completing Banking Union. The Commission is following closely and contributing to the ongoing work on Sovereign Bond-Backed Securities (SBBS) within the European Systemic Risk Board (ESRB). Building on the outcome of this work, in December 2017 and consultations with relevant stakeholders, the Commission will consider putting forward a legislative proposal for a framework that could help to develop SBBS in early 2018.

In addition, the Commission remarks **the need to develop a common backstop to the Single Resolution Fund (SRF) to finalize the Banking Union.** Although technical work started in November 2016, further progress is conditioned to a rapid development of risk reduction measures. The Commission insists that a backstop must be operational as soon as possible and supports a credit line from the European Stability Mechanism (ESM) as the most effective option. The Commission urges political negotiations to be finalized by 2018.

Finally, the Commission highlights that as from December 2017 large investment firms carrying out bank-like activities will qualify as credit institutions and be subject to bank supervision. Upon Banking Union these firms will be subject to the SSM. This will ensure that prudential rules are applied consistently and that both large investment firms and credit institutions are subject to the same high level standards of supervision

The Commission **presents the following roadmap regarding both risk reduction and risk sharing measures to complete the Banking Union.**

Figure 1 Overall timeline to complete Banking Union



Source: BBVA Research

Conclusions

Further steps crucially depend on political negotiations, which will be focused on further mutualization of debts versus further control of policies, divergent approaches that reflect the tension between risk control and risk sharing. The key issues to complete Banking Union (EDIS and backstop for the SRF) are first in the line, together with the discussion on SBBS, the regulation of the treatment of sovereign debt and the NPLs. Somewhat further away are issues for directly linked to a fiscal union and the powers of a new institutional framework in the Eurozone.

Now is the time to finalize the Banking Union project, and regulators should not lose the opportunity to look back and analyse how the Banking Union is working in practice. As pointed out in the Commission's communication, of the main elements of Banking Union (Single Rulebook, SSM, SRM and the EDIS), only the first three are operational but with drawbacks to overcome, while EDIS is just missing. There is an urgent need to close the loopholes in the Single Rulebook, in supervision and resolution and this is to be done without holding up progress on EDIS, where much remains to be done. A comprehensive review of the barriers that currently prevent a smooth functioning of the different pillars must be addressed by EU regulators. Its correct implementation will be necessary for EDIS to work properly. At the same time, progress on EDIS should not depend on progress on risk reduction measures. These two important issues should be pursued in parallel. A transitional solution making EDIS dependent on the progress on risk reduction could cause further delays. Nevertheless, if such a conditional phasing-in is supported, any milestones on risk-reduction should be defined precisely ex-ante, should be objectively verifiable, and overall should be realistically achievable in order to guarantee that EDIS is not postponed indefinitely.

In sum, to complete and finalize the Banking Union there are two key pending issues: backstop for the SRF and EDIS. Europe needs not only to finalize what we started, but also to consolidate the framework we have developed so far.

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